FS Know-How: Retirement Planning 101

By John K. Naland

Who in their late 20s to early 50s, preoccupied with the demands of work, family and daily life, has time to plan for a retirement that is years or even decades away? The answer is that we all had better give retirement some advance thought if we wish to be well-positioned to enjoy life after the Foreign Service. I know you're busy, so here is a quick guide for early- and mid-career employees who realize that retirement planning is important, but have not yet gotten started.

Show Me the Money

Many Foreign Service members have only a vague idea of what makes up their retirement package. That, obviously, makes it impossible to do even basic planning. So here is an overview. This article focuses on those of us who joined after 1983 and are thus in the "new" Foreign Service Pension System (FSPS). Employees who fall under the "old" Foreign Service Retirement and Disability System should consult the Department of State retirement office's Web site (https://rnet.state.gov) for information on that retirement plan.

Once FSPS participants qualify for retirement, here is what we receive:

- **Pension:** Our pension is based on our "high three" average salary and years of service. The "high three" salary is calculated by adding our average basic pay (determined by multiplying each salary by the number of days that it was in effect) for our three highest-paid consecutive years and then dividing by three. Basic pay includes regular pay, domestic locality pay and overseas virtual locality pay, but excludes allowances, differential bonuses and overtime. This "high three" salary is then multiplied by 1.7 percent for each of the first 20 years of service plus 1 percent for each additional year. For example, an employee with 25 years of service and a "high three" salary of $100,000 would qualify for an annual annuity of $39,000. That amount, however, provides no benefits to a surviving spouse after the annuitant's death. Providing the maximum survivor benefits reduces the annuity by 10 percent to $35,100.

- **Thrift Savings Plan:** As you can see, no matter how many years you serve, your FSPS annuity will not come close to replacing your pre-retirement income. Instead, the Thrift Savings Plan must be a key part of retirement planning. Contribute at least 5 percent of your salary and Uncle Sam will match that contribution – "free" money that no one should pass up. Unless you are independently wealthy, to position yourself well for retirement you should contribute at least 10 percent of your salary to TSP. Those who can should contribute as close to the annual maximum ($18,000 in 2015) as possible and take advantage of "make up" contributions (up to $6,000 in 2015) after age 50. Where you invest that money matters. Since stock funds have historically out-performed bond funds over long periods, you may want to take more risk now in your TSP account to increase the likelihood of generating gains in the coming decades that out-pace inflation.

- **Social Security:** FSPS members pay into Social Security throughout our careers and thus qualify for benefits beginning as early as age 62 for those willing to take reduced payments in return for a longer benefit period. However, because most Foreign Service members qualify to retire before age 62, federal law affords FSPS members an annuity supplement until age 62. This annuity supplement is calculated by dividing your years of federal service by 40 and then multiplying that by your age 62 Social Security benefit. The annuity supplement and Social Security payments are subject to reduction if the annuitant goes back to work and receives significant wage earnings (in excess of $15,720 per year in 2015).

To estimate how much you will receive each year in pension, TSP withdrawals and annuity supplement, Department of State employees can follow these three steps:

  - Use the Employee Benefits Information System (EBIS) software tool on HR Portal to generate an individualized estimate of your annuity as of any potential retirement date.
  - Use EBIS to estimate the annuity supplement if retiring before age 62. Use the Social Security Administration website at www.ssa.gov to generate an individualized estimate of post-62 Social Security benefits.
  - Use calculators on the TSP website at www.tsp.gov to generate estimates of TSP account growth and post-retirement withdrawals under different scenarios.

Reality Check

How much money will you need to retire comfortably? Experts say that many people can continue their current lifestyles into retirement on 85 percent of their pre-retirement gross income. One reason for that reduced need is that deductions for Social Security, TSP, Medicare, and FSPS contributions can consume 15 percent or more of pre-retirement gross income. Those deductions end at retirement, thereby reducing the drop-in “take home” income. Of course, your retirement income needs may be higher or lower than 85-percent guideline, depending on such things as your desired retirement lifestyle, possible income from a still-working spouse, and future financial commitments such as children’s college expenses.

Pulling all this data together, you can judge how realistic your target retirement date is by estimating how much retirement income you will need and then running your own annuity, TSP and annuity supplement numbers. If you have no idea when you might want to retire, then run your numbers based on first eligibility – which, for most FSPS employees, is at age 50 with at least 20 years of service.

If the calculations fall short of how much money you desire, then you need to adjust plans. For example, staying in the Foreign Service a few additional years will substantially increase your annuity by raising the multiplication factor and the “high three” average salary. Post-retirement employment is an option exercised by many Foreign Service retirees, but be sure to study the rules on how earnings can affect your annuity and Social Security payments.

Another option is to invest more of your take-home pay in TSP, the stock market, rental property and/or an Individual Retirement Account.

Feathering Your Nest

As you plan your future finances, there are several things to keep in mind in order to best position yourself for retirement:

- How you manage your TSP savings while you are still working will have a major effect on your retirement finances. Because most current employees will need to draw on their TSP savings 30, 40 or even 50 years from now, most experts recommend investing in funds with relatively high average rates of return (the C, S, I and the long-range L funds) to increase the chances that your TSP savings will be around as long as you are. Conversely, keeping most money in funds with lower average yields (the G and F funds) may allow inflation to eventually outpace earnings.

- While saving for retirement is vital, doing so can be difficult depending on your cash flow situation. To increase savings, some experts urge cutting back on frequent small splurges that add up over time – for example, that daily gourmet coffee. Other experts say to cut back on big purchases, such as buying a luxury car. Most experts endorse the tactic of "pay yourself first" by, for example, signing up for a large TSP payroll deduction so those funds never enter your take-home pay for discretionary spending. If you receive a high hardship differential or an inheritance consider investing a chunk of it in retirement savings.

- Where you retire can have an impact on your net income. The IRS taxes annuity payments, TSP withdrawals and annuity supplements, but some states do not. Thus, retiring to certain states can increase your after-tax income. For a state-by-state analysis, see AFSA's annual tax guide published each February in the *Foreign Service Journal* and posted at www.afsa.org

- If you have prior military or civilian service that is creditable for FSPS retirement purposes, be sure to "buy it back" by making the required contribution to FSPS. For example, I paid around $5,000 to buy back three years of U.S. Army service in order to increase my FSPS annuity multiplier by 3 percent. That will more than repay itself if I survive even a few years into retirement. Consult https://rnet.state.gov for information on buy-back procedures, which can take six or more months.

- If possible, do not make TSP withdrawals early in retirement. Due to the power of compound interest, the longer money is left in the TSP, the more it can grow. Also, in most cases, anyone who retires before age 55 and begins to withdraw TSP money must pay a 10-percent IRS penalty on amounts received before reaching the age of 59 ½.

- As long as you are enrolled in a federal health insurance plan for the five years prior to retirement, you may keep that coverage after retirement. The government will continue to pay its portion of the premium just as it does while you are employed.

Live Long and Prosper

This article has focused on the financial aspects of retirement because that is what most pre-retirees consider to be the key to a happy retirement. However, surveys of current retirees show that they consider health to be the most important factor in that regard. After all, having all the money in the world can only do so much for someone who is in chronically poor health. Therefore, a vital component of pre-retirement planning should be to take care of your health. Obviously, little can be done about genetics or bad luck with accidents and diseases, but steps such as maintaining a healthy weight, eating well, keeping fit and not smoking are keys to a longer, healthier retirement.

Let's wrap up with a short list of actions that you can take now to start planning for a happy, healthy retirement:

- Run you annuity, TSP and annuity supplement numbers to do a reality check on the viability of your target retirement date.

- Consider moving your TSP savings into funds with relatively high average rates of return to increase the chances that your funds will be around as long as you are.

- Maximize your ongoing savings for retirement.

- Stay (or get) healthy and fit, especially as you move through your 40s and 50s.

- Take the Foreign Service Institute's excellent retirement planning courses: the two-day Mid-Career Retirement Planning Seminar if you are more than 10 years from retirement eligibility and the four-day Retirement Planning Seminar within 10 years of retirement.

- Check out the Department of State retirement office's Web site, https://rnet.state.gov, for official information, including in the extensive "AskRNet" question-and-answer section.

- Maintain your AFSA membership after retirement to support the association's efforts to protect Foreign Service retirement benefits from potential future cuts.

-- John K. Naland served in the Foreign Service for 29 years, including as director of the Office of Retirement. His overseas assignments included Colombia, Mexico, and Iraq. He twice served as AFSA president. The views in this article are his alone and do not necessarily represent the views of the U.S. Department of State or the U.S. government. The general advice contained in this article may not be appropriate for all employees, so please consult other competent sources before making major financial decisions.