Government Executive

What You Need to Know About Taxes

By Tammy Flanagan

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If you are planning to retire in the near future, there may be things that you don't know you don't know. You know?

One of those things may be tax planning. Over the years, I've learned a lot about taxes from friends and associates like Micah Shilanski and Bob Leins. I've also been fortunate to learn from many financial and tax experts who have a comprehensive understanding of federal retirement.

Let's review some of the basics regarding the taxes you pay now compared to what you'll pay after you retire.

Most federal retirees pay taxes on their retirement benefits. Some retirees aren't required to pay income taxes -- or pay very low taxes -- but only if they have very low income or live off of investments that produce tax-free income.

Here are a few things you should know about how taxes are different when you're working and when you're a federal retiree.

Social Security and Medicare

While employed, most workers pay Social Security taxes (known as FICA taxes). As of 2015, FICA taxes are 6.2 percent on wages up to $118,500. Federal employees covered under the Civil Service Retirement System are exempt from FICA, but they contribute 7 percent of their basic pay towards their retirement benefit instead. Those under the Federal Employees Retirement System pay into Social Security, and contribute 0.8 percent of salary towards their retirement. (FERS employees hired in 2013 or later contribute a higher amount towards their retirement.)

Employees also pay a Medicare tax of 1.45 percent on all wages, and higher wage earners pay an additional 0.9 percent tax assessed as a result of the Affordable Care Act.

After retirement, there are no FICA or Medicare taxes withheld from investment income or CSRS or FERS retirement benefits. Only wages and salaries are subject to these taxes. One thing to note, however: Although it isn't a tax, there is a premium for Medicare Part B, the outpatient part of Medicare that isn't financed by payroll taxes.

Federal Income Tax

There are seven federal income tax brackets, and four filing statuses:

- Single
- Married filing jointly
- Married filing separately
- Head of household (this applies to people who are considered single for filing purposes who provide more than half the support for a child and are able to claim that child as an exemption)

The income tax system is progressive: The more money you make, the higher tax rate you pay. Federal employees can reduce their taxable income by:

- Making contributions to the Thrift Savings Plan (up to $18,000 in 2015 and an additional $6,000 if age 50 or older) on a pre-tax basis. The contributions and earnings grow tax-deferred until they are withdrawn. Roth TSP contributions are contributed on an after-tax basis, but they grow tax-free.

- Participating in premium conversion: that is, paying tax-free premiums for health insurance. Premium conversion is automatic for all federal employees unless they opt out. Contributions to a flexible spending account for health care and dependent care expenses also are covered by premium conversion. For example, let's say that your federal salary is $80,000. Suppose you contribute $8,000 per year to the TSP, pay $4,000 a year for federal health insurance and contribute $2,000 to a flexible spending account. Your taxable income for federal and most state tax withholding will be reduced by $14,000 per year, to $66,000.

After you retire, your income may not be as high as your salary, so you may drop down to a lower marginal tax bracket. However, don't be too sure it will make that much of a difference. Remember, things like TSP contributions and health insurance premiums that reduced your taxable income while you were working will no longer apply once you've retired.

Another thing to remember is that your retirement income will increase over time due to cost of living adjustments and increased withdrawals of investment income to keep pace with rising prices and inflation. This increased income may push you into a higher marginal tax bracket in your later years of retirement.

There is some good news, however. As you get older, you may gain some tax breaks for seniors. And portions of your retirement benefits are tax-free, including:

- CSRS or FERS retirement contributions. This money is returned to you as a tax-free portion of your retirement benefit. (But since these contributions are returned over your life expectancy, don't get too excited.)
- Part of your Social Security benefit. Some people don't pay any tax on their Social Security benefit because it's their only income. If you have enough other income, you will pay tax on 50 percent or 85 percent of your Social Security benefit. If you receive the FERS Supplement, keep in mind that this benefit is fully taxable. It is not treated the same way as the actual Social Security retirement benefit.

Although you have control over how much and when you withdraw from the TSP, remember that this is money that has never been taxed (with the exception of contributions and earnings in the Roth TSP). In many cases, the TSP will withhold taxes from the payments you receive from your funds, but there may be more taxes you have to pay, depending on your marginal tax bracket, state income tax situation and possible tax penalties. The TSP offers a publication on how withdrawals are taxed.

Taxable Income

Keep in mind that some of the things that lowered your taxable income while you were working may not be available after you retire. For instance if you're not making mortgage payments anymore, you wouldn't have mortgage interest to deduct. And your children may no longer by your dependents. (Although if that's because they're truly financially independent of you, that may be a good thing.)

On the other hand, there may be some reductions applied to your CSRS or FERS benefit that will reduce your taxable income. These could include:

- Providing a survivor annuity for your spouse. This reduction of up to 10 percent of your retirement benefit reduces your taxable retirement income. Because of this, providing a survivor annuity is less expensive than it seems.
- A reduction to your CSRS retirement benefit for having left unpaid deposits and redeposits owed for civilian service that was either not covered by retirement deductions -- or for retirement deductions that were withheld but later refunded. (Under FERS, if you elect not to pay a service credit deposit, this will generally mean that service is no longer creditable in the computation of your retirement.)
- Age reductions that affect your CSRS or FERS retirement. Under CSRS, there may be an age reduction for retiring before age 55. For FERS, a reduction could apply to those who retire under MRA + 10 provisions (covering retirees who have

reached the FERS minimum retirement age of 55 to 57, depending on year of birth, and have more than 10 years of creditable service, but less than 30).

You can choose to have taxes withheld from each of your federal retirement payments. Here are some links to more information:

- Office of Personnel Management (CSRS and FERS benefits)
- Social Security Administration
- Thrift Savings Plan

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http://www.govexec.com/pay-benefits/retirement-planning/2015/06/what-you-need-know-about-taxes/114520/