Government Executive

You're Going to Have to Make Some Tax Decisions

By Tammy Flanagan

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Most federal employees know that they contribute to their future Federal Employees Retirement System or Civil Service Retirement System benefit via withholding from their biweekly paychecks. But some may not be aware of the tax implications of such withholding.

CSRS employees contribute 7 percent of basic pay (7.5 percent for special groups such as law enforcement officers and firefighters). FERS employees contribute 0.8 percent (1.3 percent for special groups). FERS Revised Annuity Employees (hired in 2013) and FERS Further Revised Annuity Employees (hired from 2014 on) contribute 3.1 percent and 4.4 percent, respectively (the special groups put in an additional 0.5 percent). CSRS Offset employees contribute 0.8 percent until their salary reaches the maximum taxable wage base for Social Security ($118,500 for 2016) and then 7 percent afterwards until the next year begins.

According to the IRS, part of the annuity benefit you receive is tax-free recovery of your contributions to the CSRS or FERS. The rest of your benefits are taxable. If your annuity starting date is after Nov. 18, 1996, you must use the simplified method to figure the taxable and tax-free parts. Over the course of a federal career, these contributions can add up to thousands of dollars of salary on which you've already paid federal and state income tax.

IRS Publication 721 provides a detailed explanation of the calculation of the tax-free portion of your retirement. The formula is different for retirees who have elected spousal survivor benefits than it is if they had elected annuities to be paid within their lifetimes. If you choose not to have tax withheld, or if you don't have enough tax withheld, you may have to make estimated tax payments.

What If You Don't Retire?

IRS Publication 721 also notes that if you leave federal government service or transfer to a job not under CSRS or FERS and you aren't eligible for an immediate annuity, you can choose to receive a refund of the money in your retirement account. The refund will include both regular and voluntary contributions made to the fund, plus any interest you're due. If the refund includes only your contributions, none of the refund is taxable, the publication states. If it includes interest, the interest is taxable unless you roll it over directly into another qualified plan or a traditional individual retirement arrangement.

If you don't have the Office of Personnel Management transfer the interest to an IRA or other plan in a direct rollover, tax will be withheld at a 20 percent rate. You can also transfer the interest portion of the refund into your Thrift Savings Plan account.

If you have set up a voluntary contributions account, you will need to decide between two options: Leaving the money in the retirement fund to be used to purchase additional monthly benefits, or withdrawing the money and transferring the principal (your contributions) to an IRA and shifting any accrued interest to your TSP (or another qualified retirement plan). To learn more about these options, check out this episode of the *For Your Benefit* radio program and a recent column I wrote.

Federal Tax Implications

When you file your retirement application, you can give OPM a Form W-4P-A, indicating whether or not to have tax withheld. The amount of withholding depends on your marital status, the number of withholding allowances, and any additional amount you designate to be withheld. If you don't make any of these choices, OPM will withhold as if you were married with three withholding allowances. OPM also will accept the W-4 that is already on file with your employing agency if you attach a copy with your retirement application.

OPM will withhold federal income tax from your interim retirement payments while your retirement application is being processed. You may receive several interim checks during the processing of your retirement. If you choose not to have tax withheld, then you can make estimated tax payments directly to the IRS.

State Tax Implications

OPM will not withhold state income tax from your interim retirement checks. This comes as a surprise to many new retirees. It also comes with an unfortunate consequence of a tax penalty if you neglect to make estimated tax payments while you are in interim retired status.

Some states do not tax federal retirement benefits – and some don't even have an income tax at all. The National Active and Retired Federal Employees Association publishes an annual state tax roundup to summarize the state tax treatment of your federal retirement benefits.

If your retirement will be subject to state income tax, be sure to consider the amount of tax you will owe on your retirement income at the state level as well as federal income tax.

Photo: Pictures of Money, via Flickr

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http://www.govexec.com/pay-benefits/retirement-planning/2016/07/youre-going-have-make-some-tax-decisions/129724/