



# **Plan Ahead, Pay Less: Tax Strategies for Feds**

**A NARFE Federal Benefits Institute Webinar**

*Presented by Mark Keen, CFP*



## U.S. Tax System

- **Progressive tax system**
  - As taxable income increases, so does the tax rate
- **Marginal tax rate based on taxable income**
  - Gross income
    - Above the line deductions
    - = Adjusted Gross Income
    - Below the line deductions
    - = Taxable income



## U.S. Tax System

2019 Income Tax Brackets						
Marginal Tax Rate	Single		Married Filing Jointly			
10%	\$0	to	\$9,700	\$0	to	\$19,400
12%	\$9,701	to	\$39,475	\$19,401	to	\$78,950
22%	\$39,476	to	\$84,200	\$78,951	to	\$168,400
24%	\$84,201	to	\$160,725	\$168,401	to	\$321,450
32%	\$160,726	to	\$204,100	\$321,451	to	\$408,200
35%	\$204,101	to	\$510,300	\$408,201	to	\$612,350
37%	Over		\$510,300	Over		\$612,350



## Federal Benefits and Taxes

- **CSRS and FERS annuities**
  - Taxed as ordinary income
  - Your contributions are received tax-free
- **Thrift Savings Plan**
  - Traditional balance is fully taxable as ordinary income
  - Qualified Roth TSP distributions are tax-free
- **Social Security Benefits**
  - Up to 85 percent of benefits are taxable as ordinary income



## Tax Cuts and Jobs Act

### Major Changes

- Tax brackets
- Mortgage interest deduction
- State and local taxes
- Miscellaneous itemized deductions
- Standard deduction
- Medical expenses
- Chained CPI
- Alimony
- AMT
- IRA recharacterization
- 529 plans
- Kiddie tax
- Estate tax
- Pass-through deduction



## Below the line deductions

### Standard deduction & exemptions

	2017		2019	
	Single	Joint	Single	Joint
Standard Deduction	\$6,350	\$12,700	\$12,200	\$24,400
Addl for >65 or Blind	\$1,600	\$1,300	\$1,650	\$1,300
Exemptions	\$4,050	\$4,050	\$0	\$0

### Itemized deductions

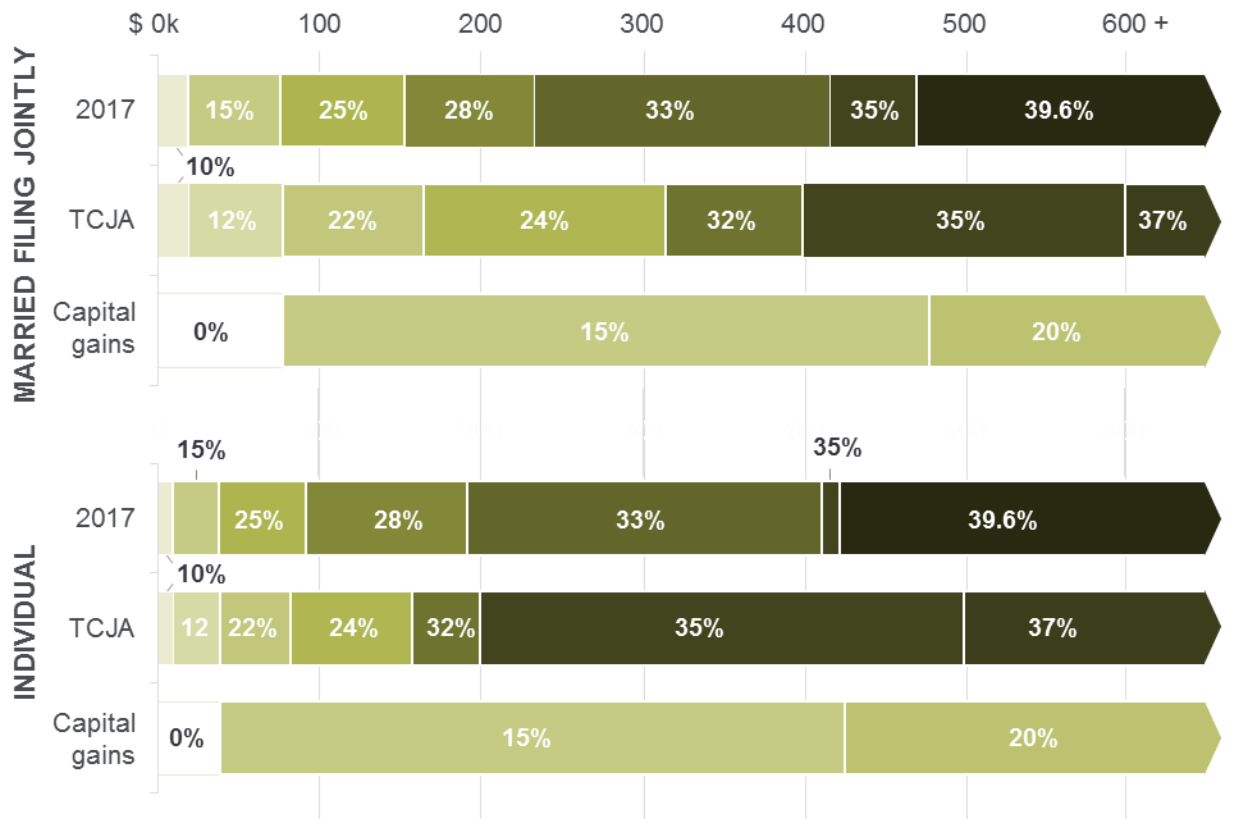
	Pre-TCJA	Post-TCJA
Mortgage Interest		
Acquisition Indebtedness	\$1.0 Million	\$750,000
Home Equity Indebtedness	\$100,000	0
Charitable Contributions (Cash)	50% AGI	60% AGI
Property Tax	Unlimited	\$10,000 Cap; Prop & State Combined
State & local Taxes	Unlimited	
Medical Expenses	In excess of 7.5%/10% AGI	In excess of 7.5% of AGI for '17 & '18
Misc. (Tax Prep, Investment)	In excess of 2% AGI	\$0



## The Tax Cuts and Jobs Act: Marginal Tax Brackets

### Federal income tax rates

Comparison of marginal tax brackets by filing status



### OUT WITH THE OLD, IN WITH THE NEW

While the number of tax brackets remains the same with the Tax Cuts and Jobs Act (TCJA), income ranges and marginal rates are significantly modified.

Income thresholds for capital gains and qualified dividends remain unchanged.

Spending

Top tax rate not reflective of additional 3.8% Medicare Surtax on unearned/investment income for individuals/married couples with MAGI at or exceeding \$200,000/\$250,000. Marginal tax brackets under TCJA will sunset after 2025. Note that capital gains and qualified dividends are aligned to income thresholds and not marginal brackets under the new law. In the future, tax brackets will be adjusted for inflation using chained-CPI (also known as C-CPI-U); this is a permanent feature under TCJA.



## Know Your Rates

- Marginal tax rate
- Versus
- Effective marginal rate





## Know Your Rates

### Effective Marginal Rate

Married couple, age 66, filing joint

	No IRA Distribution	With IRA Distribution	Difference
IRA Distributions	\$ -	\$ 10,000	\$ 10,000
Pensions and annuities	\$ 30,000	\$ 30,000	\$ -
Social Security benefits (\$25,000)	\$ 5,250	\$ 13,225	\$ 7,975
= Adjusted Gross Income	\$ 35,250	\$ 53,225	\$ 17,975
- Standard Deduction	\$ 27,000	\$ 27,000	\$ -
= Taxable Income	\$ 8,250	\$ 26,225	\$ 17,975
Federal Tax Liability	\$ 825	\$ 2,759	\$ 1,943
Marginal Rate	10%	12%	
Average Rate	2%	5%	
Effective Marginal Rate		19%	



## Smart Tax Moves

- **Contribute to TSP wisely**
- **Isolate basis for tax-free Roth conversion**
- **Back-door Roth**
- **Roth conversions**
- **Qualified charitable distributions (QCDs)**
- **Plan ahead for large distributions**



## Wise TSP Contributions

	\$25k Traditional Contribution	\$25k Roth Contribution	\$17k Trad/\$8k Roth Contribution	Difference
Wages	\$ 120,000	\$ 120,000	\$ 120,000	\$ -
- Traditional TSP Contribution	\$ 25,000	\$ -	\$ 17,050	\$ (7,950)
Adjusted Gross Income	\$ 95,000	\$ 120,000	\$ 102,950	\$ 7,950
- Standard Deduction	\$ 24,000	\$ 24,000	\$ 24,000	\$ -
= Taxable Income	\$ 71,000	\$ 96,000	\$ 78,950	\$ 7,950
			\$	\$ -
Federal Tax Liability	\$ 8,132	\$ 12,837	\$ 9,086	\$ 954
Marginal Rate	12%	22%	12%	
Income Taxed at 22%	\$ -	\$ 17,050	\$ -	\$ -
Income Taxed at 12%	\$ 51,600	\$ 59,550	\$ 59,550	\$ 7,950



## Don't Forget About IRAs

- **Roth IRA (est. 1997)**
  - Taxed contributions grow tax-free
  - Qualified distributions are tax-free
  - No RMDs for the original owner
  - AGI limit no longer applies for conversions
  - \$6,000 contribution limit (under age 50); \$7,000 (above 50)
  - Contributions subject to AGI limits
- **Traditional IRA (est. 1974)**
  - Pretax contributions grow tax-deferred
  - Distributions are taxed (treated as ordinary income)
  - Required minimum distributions (RMDs) typically required beginning at age 70½
  - \$6,000 contribution limit (under age 50); \$7,000 (above 50)
  - No adjusted gross income (AGI) limit
    - (AGI may impact deductibility of contributions)



## Back-Door Roth IRA

- **Eligibility to make Roth contributions is subject to income limits**
  - Single                      \$122,000 - \$137,000
  - Joint                         \$193,000 - \$203,000
- **If income exceeds income limits, consider a back-door Roth IRA**
  - Involves a Roth conversion



## Back-Door Roth IRA

### Step 1. Contribute to Traditional IRA

- Non-deductible if income above certain limits
  - Covered by a retirement plan
    - Single                   \$64,000 - \$74,000
    - Joint                     \$103,000 - \$123,000
  - One spouse covered by retirement plan
    - \$193,000 - \$203,000

### Step 2. Convert after-tax contribution to Roth IRA

- Be aware of pro-rata rule
- Isolate basis if IRA contains pretax funds



## Isolate IRA Basis For Tax-Free Conversion

- **Basis = after-tax contributions made to IRAs**
  - After-tax contributions  $\neq$  Roth contributions
  - TSP does not permit after-tax contributions
- **Earnings on basis grows tax-deferred and is taxed when distributed**
- **Basis may be distributed and/or converted to Roth IRA tax-free, however...**



## Isolate IRA Basis For Tax-Free Conversion

- **IRS pro-rata rule prevents retirement plan owners from distributing or converting only their basis**
- **Must determine how much basis represents as percentage of IRAs**
  - Must aggregate value of all IRAs (Traditional IRAs, SEP IRAs, SIMPLE IRAs)
  - Employer plans are not included in the pro-rata calculation
- **Distributions and/or conversions will consist proportionately of basis and pretax money**





## Isolate IRA Basis For Tax-Free Conversion

### IRS Pro-rata rule example

	Total Value	After-tax Contributions	Pre-tax Contributions and Earnings
Traditional IRA 1	\$ 25,000	\$ 25,000	\$ -
Traditional IRA 2	\$ 100,000	\$ -	\$ 100,000
Totals	\$ 125,000	\$ 25,000	\$ 100,000
<b>Pro-rata calculation</b>		<b>20%</b>	<b>80%</b>
Distribution	\$ 25,000	\$ 5,000	\$ 20,000
		Tax-free	Taxable



## **Isolate IRA Basis For Tax-Free Conversion**

- **IRS pro-rata rule applies to all distributions and conversions, except...**
- **Rollovers to employer-based retirement plans**
- **It is possible to isolate your IRA basis by transferring all pretax money from IRA to TSP**
- **Once you have isolated basis, you may convert it tax-free to Roth IRA**



## Isolate IRA Basis For Tax-Free Conversion

Step 1. Transfer \$100,000 from IRA to TSP

Step 2. Take distribution...or better yet, convert to Roth!

	Total Value	After-tax Contributions	Pre-tax Contributions and Earnings
Traditional IRA 1	\$ 25,000	\$ 25,000	\$ -
Traditional IRA 2	<b>Transferred to TSP</b>	\$ -	\$ -
Totals	\$ 25,000	\$ 25,000	\$ 25,000
<b>Pro-rata calculation</b>		<b>100%</b>	<b>0%</b>
Distribution	\$ 25,000	\$25,000	\$ 0

Tax-free                      Taxable



## Roth Conversions

- **Conversions are a taxable event**
  - Pre-tax money = taxable
  - Basis = tax-free
- **Five-year rule applies to each conversion**
- **Dollars eligible for conversion**
  - Traditional IRAs
  - Qualified plan distribution—eligible to rollover
  - 403(b) distributions—eligible to rollover
  - Simple IRA—after two years from initial deposit
  - SEP IRA

RMDs are not eligible for conversion



## Roth Conversions

### Dollars eligible for conversion

- Traditional IRAs
- Qualified plan distribution—eligible to rollover
- 403(b) distributions—eligible to rollover
- Simple IRA—after two years from initial deposit
- SEP IRA

RMDs are not eligible for conversion

IRA — Individual Retirement Account  
SEP — Simplified Employee Pension  
SIMPLE — Savings Incentive Match Plan for Employees  
[www.irs.gov](http://www.irs.gov)



## Roth Conversions

### Traditional Versus Roth IRA: Constant Tax Rates

	Traditional IRA		Roth IRA
Account Balance	\$100,000		
Tax Liability (22%)	\$22,000		\$22,000
After-Tax Balance	\$78,000	=	\$78,000
<b>Return = 7.2%</b>			
Balance After 10 Years	\$200,000		\$156,000
Tax Liability (22%)	\$44,000		\$0
After-Tax Balance	\$156,000	=	\$156,000

**All things equal, no economic difference!**



## Roth Conversions

### Traditional Versus Roth IRA: Increasing Tax Rates

	Traditional IRA		Roth IRA
Account Balance	\$100,000		
Tax Liability (22%)			\$22,000
After-Tax Balance		=	\$78,000
<b>Return = 7.2%</b>			
Balance After 10 Years	\$200,000		\$156,000
Tax Liability (25%)	\$50,000		\$0
After-Tax Balance	\$150,000	<	\$156,000



## Roth Conversions

### Traditional Versus Roth IRA: Decreasing Tax Rates

	Traditional IRA		Roth IRA
Account Balance	\$100,000		
Tax Liability (22%)			\$22,000
After-Tax Balance		=	\$78,000
<b>Return = 7.2%</b>			
Balance After 10 Years	\$200,000		\$156,000
Tax Liability (15%)	\$30,000		\$0
After-Tax Balance	\$170,000	>	\$156,000





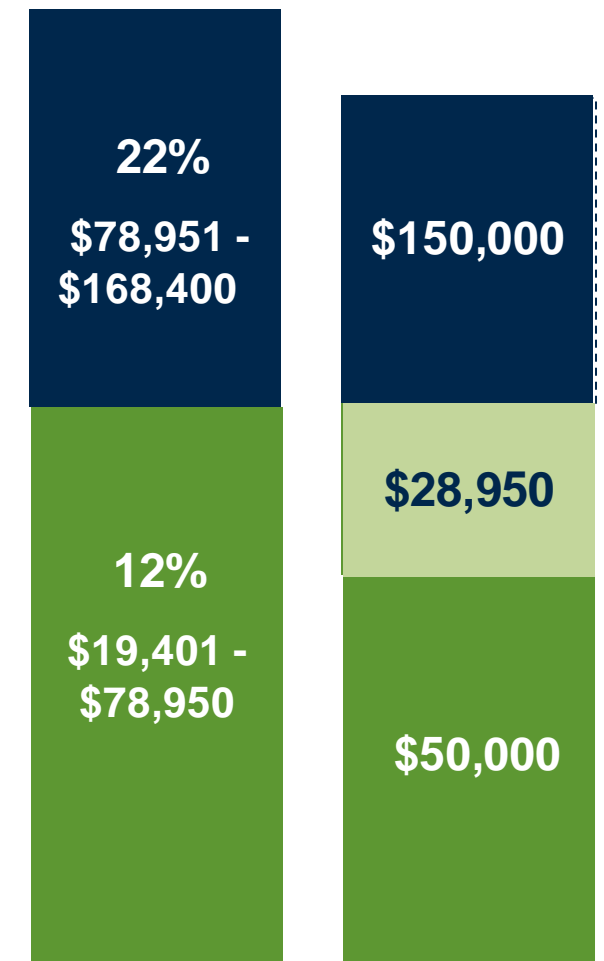
## It's never all or nothing

### Assumptions: Ed & Judy

- 65 years old
- Married Filing Jointly
- Judy has \$100,000 in a traditional IRA

### Income Effect

- Current taxable income: \$50,000
- T.I. post conversion: \$150,000
- Limit conversion: \$28,950



Tax Brackets Ed & Judy's Income



## Why Convert if no Economic Difference?

**Things are rarely equal (Not a one-time decision)**

- Non-qualified dollars available to pay taxes
- TCJA rates are temporary
- Increasing tax rates
- Reduce Required Minimum Distributions
- Reduce future taxable income
- Estate planning objectives
  - Heirs' tax rates
- Changes to the rules



## Qualified Charitable Distributions

### Cash Charitable Contributions

	2019	2020	2021	2022	Total
Other Itemized Deductions	\$ 20,000	\$ 20,000	\$ 20,000	\$ 20,000	\$ 80,000
Charitable Contributions	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000	\$ 40,000
<b>Total Itemized Deductions</b>	<b>\$ 30,000</b>	<b>\$ 30,000</b>	<b>\$ 30,000</b>	<b>\$ 30,000</b>	<b>\$ 120,000</b>
Standard Deduction	\$ 27,000	\$ 27,000	\$ 27,000	\$ 27,000	\$ 108,000
<b>Deductions Taken</b>	<b>\$ 30,000</b>	<b>\$ 30,000</b>	<b>\$ 30,000</b>	<b>\$ 30,000</b>	<b>\$ 120,000</b>
Marginal Tax Rate	22%	22%	22%	22%	22%
<b>Tax savings</b>	<b>\$ 6,600</b>	<b>\$ 6,600</b>	<b>\$ 6,600</b>	<b>\$ 6,600</b>	<b>\$ 26,400</b>



# Qualified Charitable Distributions

- **Must be 70 ½**
- **Direct transfer from IRA to charity**
  - Traditional, rollover, inherited, SEP (inactive plans only), and SIMPLE (inactive plans only)\*
  - You may not use the TSP for a QCD
- **Excluded from taxable income**
- **May satisfy all or part of RMD**
- **Up to \$100,000 per year**
- **Reducing Adjusted Gross Income may provide other benefits**



## Qualified Charitable Distributions

	2019	2020	2021	2022	Total
Other Itemized Deductions	\$ 20,000	\$ 20,000	\$ 20,000	\$ 20,000	\$ 80,000
Charitable Contributions	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Total Itemized Deductions</b>	<b>\$ 20,000</b>	<b>\$ 20,000</b>	<b>\$ 20,000</b>	<b>\$ 20,000</b>	<b>\$ 80,000</b>
Standard Deduction	\$ 27,000	\$ 27,000	\$ 27,000	\$ 27,000	\$ 108,000
Deductions Taken	\$ 27,000	\$ 27,000	\$ 27,000	\$ 27,000	\$ 108,000
Reduction of AGI from QCD	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000	\$ 40,000
<b>Total Reduction in Income</b>	<b>\$ 37,000</b>	<b>\$ 37,000</b>	<b>\$ 37,000</b>	<b>\$ 37,000</b>	<b>\$ 148,000</b>
Marginal Tax Rate	22%	22%	22%	22%	22%
Tax Savings	\$ 8,140	\$ 8,140	\$ 8,140	\$ 8,140	\$ 32,560
<b>Deductions and Reductions Gained</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$ 6,160</b>



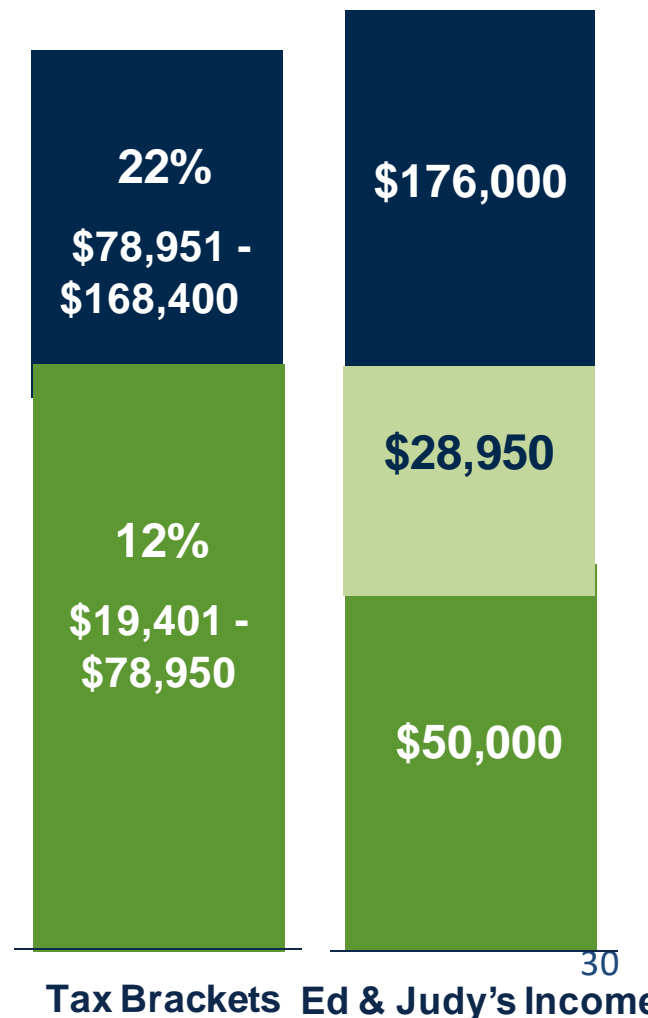
## Plan Ahead for Large Distributions

### Assumptions: Ed & Judy

- 65 years old
- Married filing jointly
- Judy has \$500,000 in a TSP
- Ed & Judy Plan to buy vacation home & need \$100,000 for down payment

### Income Effect

- Current taxable income: \$50,000
- Lump sum distribution: \$126,000
- Limit distribution: \$28,950





## Plan Ahead for Large Distributions

### Taking a Lump Sum Distribution

	No Distribution	Lump Sum Distribution	Difference
IRA Distributions	\$ -	\$ 126,000	\$ 126,000
Pensions and annuities	\$ 77,000	\$ 77,000	\$ -
= Adjusted Gross Income	\$ 77,000	\$ 203,000	\$ 126,000
– Standard Deduction	\$ 27,000	\$ 27,000	\$ -
= Taxable Income	\$ 50,000	\$ 176,000	\$ 126,000
Federal Tax Liability	\$ 5,612	\$ 30,588	\$ 24,977
Marginal Rate	12%	24%	
Average Rate on Distribution			20%



## Plan Ahead for Large Distributions

### Taking Equal Distributions

	No Distribution	4 Equal Distributions	Difference
IRA Distributions	\$ -	\$ 28,950	\$ 28,950
Pensions and annuities	\$ 77,000	\$ 77,000	\$ -
= Adjusted Gross Income	\$ 77,000	\$ 105,950	\$ 28,950
– Standard Deduction	\$ 27,000	\$ 27,000	\$ -
= Taxable Income	\$ 50,000	\$ 78,950	\$ 28,950
Federal Tax Liability	\$ 5,612	\$ 9,086	\$ 3,474
Marginal Rate	12%	12%	
Average Rate on Distribution			12%
Tax on Lump Sum Distribution	\$	24,977	
Tax on 4 Equal Distributions	\$	13,896	
Savings From Equal Distributions	\$	11,081	





# Thank You!

## A NARFE Federal Benefits Institute Webinar

*Presented by Mark Keen, CFP*

*mkeen@keenpocock.com*

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