Are You Leaving Tax Savings on the Table? How to Maximize Your Employer Benefits

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How does the prospect of paying higher taxes sit with you? From 2013 on, many households with earned income experienced tax increases and were impacted by deduction limitations as well as taxes to support The Affordable Care Act (Obamacare). However, you have the ability to significantly reduce your income taxes through prudent utilization of your employer-provided benefits. Here are 5 tips for you to consider:

Maximize your retirement deferrals – When you defer money from your paycheck into a 403(b) or 401(k) plan it reduces the amount of your current income that is subject to income tax. So, the more you defer the greater the amount of income tax savings you receive. By doing so you are essentially paying yourself by adding to your retirement savings, which will grow in a tax deferred manner. Your nest egg has the opportunity to grow even faster if your employer is matching a portion of your contribution. Therefore, you will want to defer up to at least your match percentage. This is free money!

For 2018 the maximum amount that you are able to defer from your pay is $18,500 ($24,500 for individuals who are 50 and over during the year). For a household with a 25% effective tax rate, a $18,500 deferral would save approximately $4,625 in federal income taxes (a $6,125 savings for a $24,500 contribution). ***Applied over a 20- to 30-year period, an individual may save hundreds of thousands of dollars in federal income taxes.*** And let's face it, today there are not that many strategies left which allow us to reduce our income tax liability.

One last point to be made regarding deferrals – you may be tempted to only defer a percentage of your income up to the match. While you would be taking advantage of the "free money," you would be missing out on the additional retirement savings available to you as well as the corresponding tax savings.

Don't forget catch-up contributions – It is easy to forget to increase your deferral when you become eligible to make catch-up contributions into your retirement plan. If you turned 50 in 2018, you are entitled to defer an additional $6,000. Forgetting to increase your deferral can be a costly mistake over the long term however. For example, a 50-year old in the 33% tax bracket who saves an additional $6,000 each year would be able to defer an additional $96,000 through age 65. If the individual earned an annual return of 6% during this time, these catch-up contributions would grow to $163,000. If the individual was paying a 25% effective tax rate another $24,000 in federal income taxes may have been saved along the way.

Enroll in the 457(b) plan - This plan allows you to save an additional $18,500 pre-tax annually which could significantly boast your retirement savings.

Let's look at some examples and examine the potential impact of these additional contributions. A 30-year old contributing $18,500 annually through age 65 while earning a 6% annual return would approximately save an additional $2.3 million for retirement. But it's never too late to start. A 40-year old would approximately save an additional $1.2 million; a 50-year old $503,000.

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When deciding whether to take advantage of this savings vehicle, there is an important factor to consider: a participant's 457(b) balance is subject to your employer's creditors. Thus, in the case of bankruptcy, your employer's creditors could have their obligations satisfied by accessing 457(b) account balances. You should consider your comfort level with this tradeoff.

Discover the Roth 403(b)/401(k) - One of the most overlooked yet powerful retirement benefits available through most employers is the ability to make Roth contributions. The Roth 403(b)/401(k) offers an interesting tradeoff. Contributions are made after-tax, meaning they do not reduce your current taxable income.

If you stopped reading here, however, you would miss the other side of the story; namely that when you eventually begin taking withdrawals from your Roth 403(b)/401(k) you will not be required to pay income tax on either the contributions or the growth of the contributions. The IRS essentially relinquishes its share of ownership over the Roth account at the time the contributions are made, whereas it maintains ownership over a portion of your traditional 403(b) and 401(k) accounts equal to your effective tax rate at the time you withdraw your money.

Please note: individuals contributing to Roth 403(b)/401(k) plans are subject to the same max contribution limits as traditional (pre-tax) plans.

Roth contributions are ideal for those who believe their income tax bracket will be greater in retirement. They also work very well for younger employees who haven't yet grown accustomed to receiving the reduction in taxable income afforded by traditional contributions.

Make the most of your Flexible Spending Account - A FSA allows employees to set aside before-tax earnings to pay for two kinds of expenses: health care expenses not covered by insurance plans and dependent care (childcare and elder care). Health expenses such as insurance co-payments and deductibles are covered, as well as certain dental and eye-care related expenses. Dependent care FSA contributions are limited to $5,000 per year per household; health care expenses $2,650.

It has been estimated that the use of pre-tax money to pay for these expenses has reduced the cost of covered items by as much as 20%. Yet a 2010 Mercer study reported that only 37% of employees with access to an FSA use it. Perhaps a reason for this is the "use-it-or-lose-it" requirement.

Your 2018 FSA balance needs to be used by March 15th, 2019 or you will lose it. 2017 Therefore, if you still have a balance you should consider how you may use it to purchase items such as contact lenses, vaporizers, inhalers and orthopedic supports to name a few items.

If one puts a bit of planning into managing the contributions, the FSA can be a helpful tax-planning tool. The pre-tax contributions, when combined with those made to non-Roth 403(b)/401(k) and 457(b) plans, may result in a substantial total income tax savings.

Putting it all together – Back to our example, a person with a 25% effective tax rate who is maxing out 403(b)/401(k) and 457(b) deferrals may contribute $37,500 ($43,000 if 50 and older) and in the process can save as much as $9,250 ($10,750 with catch-up) in federal income taxes. Taking advantage of dependent care and health care FSA contributions may save approximately another $1,912 in income taxes. **Thus, by maximizing benefits, a household with a 25% effective tax rate could potentially save between $11,000 - $12,600 in federal income taxes. Consider Ohio income tax savings and the tax reduction will only be greater.**

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Contact us for a review of your employer benefits.

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Eric is a managing partner of the independent wealth management practice, Wealth Impact Advisors, LLC. He has provided financial guidance to medical professionals, business owners and families for over two decades. He is proud to serve clients in a fiduciary capacity as a CERTIFIED FINANCIAL PLANNER™ practitioner and an Accredited Investment Fiduciary®.

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