Employees: How to Maximize Your Tax Breaks in 2018 and Beyond

The Tax Cuts and Jobs Act preserved or even beefed up many tax breaks available through workplace benefits programs. Here’s how to make the most of those benefits.

A key component of building wealth is minimizing taxes, so it’s worthwhile to review the different valuable tax breaks often available through workplace benefit programs.

Here are three different employee benefits that look even more attractive now, considering the recent tax law changes.

1. Discover how tax changes can enhance Roth 401(k) contributions

Most readers of this column likely know to take advantage of the tax breaks available through investing pre-tax contributions in a traditional 401(k). But there’s a different savings vehicle worth
considering, as well: A Roth 401(k), if you have access to one, or a Roth IRA if you don’t, can benefit your situation and lower your overall tax burden in the future.

First, tax rates were lowered by the Tax Cuts and Jobs Act, starting in 2018. With a Roth 401(k) or Roth IRA contribution, you pay the tax upfront (unlike with a traditional IRA), which means many savers will benefit from a reduced tax rate under the new tax law.

One thing to be mindful of is that the new tax law also sunsets these lower tax rates starting in 2026. At that point, tax rates are set to rise automatically to earlier levels. Of course, there is also the possibility that the federal deficit could grow larger, and therefore lawmakers may decide to further increase taxes at some point.

If you pay your taxes now and contribute to a Roth, you essentially “lock in” the lower rates. Even if you are confident that you’ll be in a lower tax bracket when you retire, due to having a lower income, it still could make sense to contribute to a Roth. That’s because you could potentially have even lower taxes if you have a mix of Roth and traditional 401(k) accounts from which to draw income. For example, if you are retired and age 67 and need additional income in December, you can choose to draw income from a tax-deferred retirement account (like a traditional IRA) until you fill a lower tax bracket up and then draw the additional income needed from a Roth account. Social Security income can also remain tax-free if you keep your income under certain levels in retirement. Drawing Roth income in retirement is a great way to accomplish this.

Those under age 50 can contribute up to $18,500 in a 401(k) plan in 2018 whether the contributions are Roth, regular pre-tax contributions, or a combination of the two. Those 50 and older can contribute $24,500. For Roth IRAs, subject to income limits, those younger than 50 can contribute up to $5,500, while those 50 and older can contribute up to $6,500, subject to income limits. Single individuals with adjusted gross incomes (AGI) under $120,000 can contribute the maximum amount to a Roth IRA, as can married individuals filing jointly with AGI under $189,000. You can contribute a reduced amount if you are single and have AGI between $120,000 and $135,000 or are married filing jointly with AGI between $189,000 and $199,000. There are no income limits for Roth 401(k) contributions.

2. Use Health Savings Accounts and Flexible Spending Accounts

Health savings accounts (HSAs) are likely the best tax-preferred vehicle you can have these days. HSAs offer a unique triple tax benefit: a tax-deductible contribution, tax-free earnings and tax-free withdrawals if paying for qualified health care expenses.

There is no “use it or lose it” restriction with HSAs, so you can let your HSA account roll over from year to year. In fact, the withdrawal of funds from an HSA can be years later, as long as the qualified health care expenditures were incurred during a year the HSA was in place.

The Employee Benefit Research Institute (EBRI) calculates that a 65-year-old married couple who want a 90% chance of having enough money saved for health care expenses in retirement should have $273,000 at retirement. That is a daunting number. Now, let’s assume you need to pull that money out of a 401(k) account and pay taxes at a combined federal/state tax rate of 30%. That number
now needs to be $390,000. Is it any wonder why saving in an HSA is important? To save in an HSA, you need to be enrolled in a high-deductible health insurance plan. The annual contribution limit for 2018 for those under 55 is $3,450 for singles and $6,900 for those with qualifying family plans. If you are 55 or older, you can contribute an additional $1,000 annually.

There are two types of Flexible Spending Accounts (FSAs)—health care FSAs and dependent care FSAs. If your employer allows, up to $2,650 can be contributed to a health care FSA, but you cannot also contribute to an HSA (unless the FSA or HSA is limited and can only be used for specific costs, such as vision or dental). In other words, there is no “double-dipping.” And, unlike an HSA, there is an annual “use it or lose it” restriction on FSAs. Dependent care FSAs can be used for tax-qualified day-care expenses for dependent children or senior citizens who live with you. In essence, you can make these expenses tax-deductible by setting up a dependent care FSA.

One often-overlooked tax benefit of HSAs and FSAs is that they typically reduce the gross income of the employee. As such, they are not considered wages and therefore not subject to federal or, in some cases, state income taxation and avoid Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes as well. The reduced taxable income could also put you into a lower tax bracket. It is important to note that maximizing the tax benefits requires not spending the HSA. It’s worth asking the question: Do I need to spend the HSA during the year, or do I have other funds available to use for medical expenses?

3. Advantages of payroll deduction 529 accounts extended to elementary and secondary education

It’s no secret that college costs continue to skyrocket. Many elite private colleges are charging approximately $70,000 in total costs for the 2018–2019 academic year. This means, assuming a 3% inflation rate, parents will have to fork over almost half a million dollars in 18 years for a newborn’s four-year education at an elite private college. That’s why it is so important to minimize taxes and contribute regularly to a college savings account. Many employers offer payroll deduction 529 plans, which allow investments to be made with after-tax dollars, grow tax-deferred, and be withdrawn for qualified educational expenses.

For families with younger children, the new Tax Cuts and Jobs Act Bill extends these 529 advantages to private elementary and secondary tuition. Starting in 2018, you can use up to $10,000 in 529 proceeds for elementary and high school costs per child. Families can save with 529 plans since the investment earnings in these accounts are not subject to federal tax and generally not subject to state tax when used for qualified education expenses.

Day-to-day expenses are ever increasing for workers and their families, but taking advantage of tax-saving opportunities at the workplace is one way to make it a little easier.

Vishal Jain is the Financial Wellness Officer for Prudential’s Workplace Solutions Group. He leads the development and delivery of financial wellness solutions for the Workplace Solutions Group’s institutional clients and their participants. For more information, please contact Vishal at vishal.jain@prudential.com.