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FEDERAL INSIGHTS

What feds need to know about financial disclosures and investing for retirement

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FEATURED GUEST

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The Office of Government Ethics requires federal employees to annually submit a Confidential Financial Disclosure Report (Form 450) each year before February 15. Federal News Network sat down with Shawn Steel, a certified financial planner with ClearLogic Financial, to learn how this can affect federal employees' retirement plans and what they need to consider when investing.

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Do federal professionals and executives planning to retire in a few years need an investment plan that considers their financial disclosure requirements?

Shawn Steel

Yes, they have some unique considerations because of their role. A lot of their work can affect a specific company or an entire sector. They are also subject to financial disclosure and conflicts of interest rules to minimize conflicts of interest between their official duties and their personal financial interest. And so yes, their investment plan needs to account for that.

Federal News Network

And what kind of conflict of interest are we talking about here?

Shawn Steel

Federal employees by the nature of their jobs can sometimes be in a position where their actions are going to affect a specific company. So the financial disclosure and conflicts of interest rules are aimed at making sure the federal employee does not have a personal financial interest in a particular company that they might be regulating or taking action against or something like that. It's designed to prevent the federal employee from having an incentive that's contrary to their official duties.

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So what are the disclosure requirements that federal professionals need to keep in mind?

Shawn Steel

There are two basic financial disclosure forms: There's the form 450, and the 278. Since we're coming up on the due date for the form 450, we'll focus on that one. The form 450 has five basic parts, but we'll focus on the part that talks about investments. Basically, the rule is you have to report any asset you held that had a value more than $1,000 at the end of the year, or generated more than $1,000 of income. However, there are some exceptions. For example, you do not have to report your TSP. Also, if the fund you are investing in meets the definition of a diversified mutual fund, you do not have to disclose that. For the form 450, a mutual fund that you would not have to report is one that doesn't have a stated goal of investing in a specific sector, industry, single country, or the bonds of a single state. So if it meets that definition, you don't have to disclose it.

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And since they don't have to report their TSP, should they have investment accounts other than the TSP?

Shawn Steel

Yes, and this is very important. A lot of what we hear is "save for retirement." And so almost everybody saves for retirement in tax-deferred retirement accounts, such as the TSP. While that makes it easier to save in your working years, there's a problem that can be a little bit off of the radar that comes up in your retirement years. Every dollar that you take out of a tax deferred retirement account in retirement is going to be taxed at ordinary income rates. If you do not have different types of accounts, you do not have the ability to manage your taxes in retirement. And so you should have a brokerage account and a Roth IRA, if you're eligible to contribute to a Roth IRA. Now, there are some income limits on the Roth IRA that might prohibit a federal professional or executive from making Roth IRA contributions, so we'll focus on the brokerage account. The advantage of having a brokerage account, along with your TSP is that you're going to be able to fund the same level of expenses with less dollars from savings in retirement. And the reason for that is money from a brokerage account is taxed at lower rates than money from the TSP. And only the growth on your brokerage account is taxed, not your contribution. So every dollar you take out of your brokerage account in retirement will not be taxed, only the growth.

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Can you give us a concrete example of how tax deferred retirement works when the taxes come out?

Shawn Steel

Yes, basically, the way it works is, let's say that you need to fund $100,000 to cover your expenses in retirement. If every dollar is in a tax deferred retirement account, you have to take out 100,000 plus enough to cover the tax on that 100,000. And if everything is in a tax deferred retirement account, the portion that you have to take out to cover the tax is going to be higher than it would be if you had a combination of tax deferred retirement accounts and brokerage accounts.

To illustrate the benefits of a brokerage account, let's compare the tax outcomes of someone who retires at age 63 at the GS-14 or GS-15 level with a $40,000 FERS pension and supplements their pension using either the TSP or their brokerage account. For this example, I am using a married couple who lives in Virginia, files jointly using the standard deduction, and 50% of the money used from the brokerage account is taxed as long-term capital gains. I am also assuming neither person has started Social Security. In both scenarios, the goal is to fund $100,000 of annual living expenses.

The details are below, but the key takeaway is the ability to use money from a brokerage account to supplement the pension income resulted in a combined federal and state tax savings of $12,600, and this means the same level of expenses can be funded with less money from savings. You will notice there is a significant tax savings on the federal side. The reason is at the federal level capital gains are taxed at 0% until your taxable income reaches $83,350 for married filing jointly or $41,675 for a single person. Note, this is intended to illustrate the benefits of having a brokerage account, and the taxes are rounded to the nearest $50. This should not be considered tax advice.

	Supplements pension using only TSP	Supplements pension using only brokerage account
Resources used		
Pension	$40,000	$40,000
IRA	$77,600	$0
Brokerage Account	$0	$65,000
Total Resources used	**$117,600**	**$105,000**
Expenses		
Federal Income Tax	$11,400	$1,400
State Income Tax	$6,150	$3,550
Living Expenses	$100,050	$100,050
Total Expenses	**$117,600**	**$105,000**

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We've touched on this a little bit, but what's better for federal professionals: a Roth IRA or a brokerage account? Assuming that they qualify for a Roth IRA.

Shawn Steel

All three need to be a part of your retirement savings if you're eligible, because when you get into retirement, you're going to draw down money in a different order. Your Roth money is tax free money, and that is very valuable money. To maximize the benefit of the Roth, you want to maximize that growth, which means you want to give it the longest time possible for that money to grow. So you want to save that money for your later years. Now, in the early years, that's when you want to use a combination of your brokerage account and your tax deferred retirement account. This helps keep your taxes as low as you can in the early years and helps stretch out your retirement savings. Since you're not pulling as much money out at the beginning of retirement, this leaves more money in savings to continue growing for the later years.

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So how does this impact the financial disclosure requirements on form 450?

Shawn Steel

As long as you're investing in funds that meet the diversified mutual fund exception, you don't have to include them. On the other hand, if you invest in individual stocks in your brokerage account, they will have to be reported on your 450 every year. But if you use diversified mutual funds that meet the exception, you don't have to report them. So it'll keep it nice and simplified, and diversified.

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And what's the best way to save in a brokerage account?

Shawn Steel

The best way is to automate it. If you set up a monthly deposit from your checking account to your brokerage account every month, you're more likely to save. So the best way to do this is to set up an automated transfer once a month, just like a TSP contribution, where it automatically comes out of your checking account. If you set it up and it's automated, it's not sitting in your bank account where you're tempted to spend it or do something else with it. And this is the perfect way to save for folks whose children have left the house and are independent. This is a good time to start focusing on that brokerage account. Because it's probably not something that was focused on when you were raising children, trying to save for school, and had all the expenses of caring for children. It was probably pretty difficult to accumulate brokerage account money. So this is a good thing to focus on in the window between when the children are out of the house and independent and when you're preparing to retire. This is a good time to focus on that.

Shawn Steel is a CFP® practitioner and joined ClearLogic Financial in 2013 after several years of practicing law. Shawn advises clients on retirement planning, tax planning, investments, and federal employee financial disclosure requirements. He also supervises preparation of financial disclosure forms for federal employees and advises clients retiring from federal service on the retirement process. All investing involves risks, including the potential for loss of principal. There is no guarantee that any investment plan or strategy will be successful.