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HOW RETIREMENT INCOME IS TAXED

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Many people in or nearing retirement know something about how retirement income is taxed. But according to veteran financial advisors, most don't know a great deal about the subject. Their lack of understanding can be costly.

Social Security and pension payments, as well as required minimum distributions (RMDs) from IRAs and 401ks, are primary sources of retiree income. Additional income may come from part-time work, rental income and savings, among other sources.

According to Nick De Jong, financial advisor with Savant Capital Management in Naperville, Illinois, typical sources of retirement income are taxed this way.

Social Security. Social Security benefits are taxed as ordinary income. The retiree's income level will determine how much of Social Security benefits will be taxable at the federal level. Illinois is among many states that do not tax these benefits.

Pensions. Income from pensions is taxed as ordinary income.

IRAs, 401(k)s, 403(b)s. Withdrawals from these retirement accounts are typically taxed as ordinary income. Roth IRAs, Roth 401(k)s and Roth 403(b)s are exceptions.

If all IRS requirements of a qualified distribution are met, distributions from Roth accounts are typically tax-free. Unless an IRS-defined exception applies, distributions before age 59-1/2 may be subject to a 10 percent penalty.

Annuities. "Distributions from annuities are taxed differently depending on the type of annuity," De Jong reports. "Some annuities are IRAs, in which case the distributions are taxed like regular IRAs. Other annuities are non-qualified, meaning that tax is only due on the earnings on a pro-rated basis."

Interest. The IRS regards interest income as ordinary income. Some bonds and bond funds pay tax-exempt interest; interest is only taxable at the state level.

Dividends. For federal tax purposes, the two types of dividends are ordinary and qualified. Ordinary dividends are taxed as ordinary income. Qualified dividends receive preferential tax treatment. Depending on income level, they can be taxed at from 0 to 20 percent, De Jong reports.

Capital gains. Two types of capital gains and losses exist: short-term and long-term.

"Short-term capital gains are gains from the sale of investments that were held one year or less," De Jong notes. "Long-term capital gains are gains from the sale of investments that were held for more than one year.

Short-term capital gains are taxed as ordinary income and long-term capital gains receive preferential tax treatment and can be taxed at anywhere from 0 to 20 percent, depending on income level.

Taxing Social Security

For many, Social Security is a significant retirement income source. "With Social Security, you want to really understand what provisional income means," says Hagen M. Pruemm, founder of SIS Financial Group in Hoffman Estates, Illinois. "Provisional income determines how much of Social Security will be taxable."

RMDs after age 70-1/2 from 401ks and IRAs, along with any pension and employment income, plus tax-free interest from instruments like municipal bonds, all qualify as provisional income. "Even though Munis are federally tax free, they will still be added back in to calculate your provisional income for that year." Pruemm says. "And then you will add 50 percent of your Social Security Income."

If provisional income falls between $32,000 and $44,000, up to 50 percent of Social Security income is taxed. If it's more than $44,000, up to 85 percent of Social Security income is taxed, Pruemm says.

Older adults often fail to weigh tax ramifications of taking Social Security earlier than they might, asserts Michael Tove, founder of AIN Services, a retirement planning and wealth management firm in Cary, North Carolina.

Consider a hypothetical couple opting to take Social Security at age 67 to meet income needs. They fail to consider that in three years, they'll have to take RMDs, and that the monthly income stream they gain from Social Security will grow eight percent annually each year up to age 70 if they wait and begin Social Security at that age.

Rather than waiting until 70 to withdraw from 401(k)s and IRAs and taking Social Security now, they might reverse the plans. They can withdraw from tax-advantaged accounts at 67 to reap income, reducing the amount on which they will pay RMD taxes starting at 70, and lock in permanently larger Social Security payments as well.

Tax-savvy retirees legally reduce taxes through several measures. They donate to charities from IRAs, which excludes from their income the donation amount. They also offset capital gains with capital losses. Pre-tax money in an IRA, 401(k) or 403(b) can be converted to a Roth in low-income, low-tax years. Consult investment and tax advisors before doing so.

Generally speaking, if withdrawals from taxable accounts are taken first, assets in tax-deferred retirement accounts are allowed to continue to build in a tax-advantaged way, notes Craig Bartlett, division consulting manager for US Bancorp Investments in Minneapolis, Minnesota.

"Using income that has already been taxed, or selling assets such as stocks or mutual funds that may generate long-term capital gains and may be taxed at a more favorable rate" tend to be smart approaches, he adds.