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Taxes to Watch Out for in Retirement

Moving to a low-tax state could significantly reduce your tax bill in retirement.

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Taxes are likely to be one of your biggest bills in retirement, especially if you have done most of your saving in tax-deferred retirement accounts. But where you live plays a big role in the tax rate you pay on your retirement income. “Taxes are not the only thing that matters for retirement, but they can definitely have a sizable impact as people start to narrow down which states they are considering for retirement,” says Scott Drenkard, an economist for The Tax Foundation. “I think one of the driving reasons to move to Florida is because the weather is a lot nicer, and there’s no tax on income.” Here are the taxes to consider as you select a place to retire:

Income tax. If your retirement income is high enough that you will owe taxes on it in retirement, you can reduce your tax burden if you move from a state with high income taxes to one without an income tax. Seven states do not have an individual income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Two other states – New Hampshire and Tennessee – tax dividend and interest income only. However, reducing your income tax bill isn’t a guarantee that your overall tax bill will decline. “Before impulsively moving to a state without an income tax, though, the retiree should make sure he or she isn’t trading one tax for another,” says Twila Slesnick, co-author of “Nolo's Essential Retirement Tax Guide.” “For example, although Texas does not have an income tax, the average property tax rate in the state is quite high. You might find that you are paying more in property taxes in the new state than you were paying in income tax and property tax combined in the old state.”

Sales tax. Sales tax will typically apply to many of the purchases you make in retirement. There are five states without a sales tax: Alaska, Delaware, Montana, New Hampshire and Oregon. California has the highest sales tax rate at 7.5 percent, and the state sales tax is 7 percent in Indiana, Mississippi, New Jersey, Rhode Island and Tennessee. “You should have a sense of where your dollars go so that you can determine how the sales tax structure of your target state will affect you,” Slesnick says. Also, local jurisdictions might add on an additional sales tax.

Property tax. You property tax bill is affected by many factors, including the state and neighborhood you select as well as the value of your home. Obviously, a small home in a less-expensive neighborhood can reduce your tax bill. Many states and some local jurisdictions also offer property tax exemptions, credits or rebates to senior-citizen homeowners who are above a certain age, have lived in their home a specific number of years or who are below a certain income level.

Taxes on retirement benefits. Some states give preferential tax treatment to Social Security and pension income. “There are a lot of states that will exempt or partially exempt Social Security income, and other states will exempt or partially exempt other types of retirement or pension income,” says Rocky Mengle, senior state tax analyst for Wolters Kluwer. Most states don’t tax Social Security income, but 14 states do, including Colorado, Connecticut, Iowa, Kansas, Minnesota, Missouri, Montana, Nebraska, New Mexico, New Jersey, North Dakota, Rhode Island, Vermont and West Virginia. Some states also exempt some pension or retirement account income for people above a certain age or whose adjusted gross income is below a certain amount. “For a state that only taxes retirement income for people with a certain AGI, try to see if you are going to fit within that exception window,” Mengle says.

When selecting a place to retire, it is important to factor in all the types of taxes you might need to pay and the tax exemptions you might be newly eligible for. “You have to balance all the tax aspects from a particular state and roll them all up to see what the tax burden will be and compare that from state to state,” Mengle says. “There are a lot of factors that go into deciding where to retire, and it’s difficult to say if the tax savings you have will outweigh distance from family members and other factors like that.”