InvestmentNews

9 Ways Retirement Income Is Taxed

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Clients don't always understand the interactions of different types of retirement income and how they are taxed. During a recent webinar, Joe Elsasser, president and founder of **Covisum,** a software company focusing on Social Security claiming strategies and tax efficiency, discussed ways to improve retirement income strategies.

Generally, withdrawing from traditional IRAs and 401(k) plans first and delaying Social Security benefits until full retirement age or later can reduce future required minimum distributions, extend portfolio longevity and optimize inflation-adjusted Social Security benefits for life.

Tapping the wrong accounts first can trigger higher taxes on capital gains and Social Security benefits and lead to Medicare premium surcharges.

IRAs, 401(k)s and 403(b)s

Working Americans love to save for retirement in tax-deferred individual retirement accounts and workplace-based plans such as 401(k)s and 403(b)s because it boosts retirement security and reduces taxable income. But in retirement, distributions from those plans are fully taxable as ordinary income at the federal level, with tax rates ranging from 10% to 37%.

Account holders must start taking annual required minimum distributions after age 70½. Those who continue to work beyond that age can delay their 401(k) and 403(b) distributions until they retire, but not their IRA distributions.

Pensions

Some retirees lucky enough to have a traditional pension are surprised to learn that those guaranteed monthly income benefits are fully taxable as ordinary income at the federal level. State tax rules vary, with some excluding a portion of various types of retirement income from taxes and others exempting pensions altogether.

Roth IRAs

Including tax-free distributions from Roth IRAs and Roth 401(k) plans in a retiree's income mix can minimize both income taxes and high-income surcharges on Medicare Part B and Part D premiums.

Many advisers are encouraging clients to consider partial Roth IRA conversions over the next few years, at least up to the top of their tax bracket, to take advantage of current low rates before they expire at the end of 2025. Roth IRAs must be held at least five years and at least until age 59½ to take tax-free and penalty-free withdrawals from earnings, but contributions can be withdrawn at any time.

Social Security

A portion of Social Security benefits are tax-free at the federal level, but once "combined income," defined as adjusted gross income plus one-half of Social Security benefits plus tax-exempt interest, exceeds certain thresholds, some benefits are taxable at ordinary income tax rates.

For single taxpayers, up to 50% of Social Security benefits are taxable if combined income is between $25,000 and $34,000 and up to 85% of benefits are taxable when combined income exceeds $34,000. For married couples, up to 50% of Social Security benefits are taxable when combined income is between $32,000 and $44,000 and up to 85% of benefits are taxable once combined income exceeds $44,000. Most states do not tax Social Security benefits.

Investment gains and dividends

The sale of stocks, bonds and mutual funds held for more than a year, as well as qualified dividends, are taxed at the preferential long-term capital gains rates, ranging from 0% to 20%.

For 2019, if you're single with taxable income of $39,375 or less or married filing jointly with taxable income of $78,750 or less, your long-term capital gains are taxed at 0%.

For people with higher taxable incomes, the rates go up. The next rate is 15% (singles with incomes between $39,376 and $434,550, and married couples with incomes between $78,751 and $488,850). The top capital gains rate is 20% for people with incomes above those amounts.

Municipal bond interest

One of the appeals of investing in municipal bonds is that the interest is tax-free at the federal level and generally at the state level, too, for bonds issued in the taxpayer's home state.

But nontaxable muni bond interest is included in the modified adjusted gross income calculation used to determine whether a high-income Medicare beneficiary must pay a monthly premium surcharge, and profits from the sale of a bond are subject to capital gains taxes.

Medicare taxes and surcharges

High-income taxpayers are subject to special taxes that help fund Medicare. If net investment income exceeds $200,000 for single individuals or $250,000 for married taxpayers, they will pay an additional 3.8% tax, boosting the maximum capital gains rate as high as 23.8% (20% + 3.8%).

Working taxpayers must pay an additional 0.9% in payroll taxes to help fund Medicare if their earned income exceeds the $200,000/$250,000 thresholds. High-income Medicare beneficiaries also pay larger monthly premiums for Part B and D when their modified adjusted gross income tops $85,000 for singles and $170,000 for married couples.

Annuities

Some or all of the income you receive from an annuity is taxable at ordinary income tax rates.

If you hold the annuity outside of a qualified retirement account, the portion of the payment that represents a return of your investment, known as the exclusion amount, is tax-free. The remainder is taxable. But if you hold the annuity inside a traditional retirement account, 100% of the payouts are taxed at ordinary income tax rates.

Life insurance

Life insurance proceeds paid to a beneficiary upon the death of the insured are tax-free. So are withdrawals of the cash value portion of a permanent life insurance policy or loans against that value.

Putting it all together

In 2019, a married couple who are both 65 or older and claim the standard deduction can have up to $104,450 of capital gains and pay no federal income taxes. But once Social Security and IRA distributions are included in the mix, the tax picture changes dramatically, Mr. Elsasser said.

In their 12% federal tax bracket, every additional $1,000 withdrawn from an IRA would subject not only $120 of the IRA distribution to income taxes but cause $850 of Social Security benefits to be taxed and push $1,850 of investment gains into the 15% capital gains bracket, for an additional combined tax of $499.50. That works out to an effective tax rate of nearly 50% on a $1,000 IRA withdrawal, Mr. Elsasser said.