10 Questions Retirees Often Get Wrong About Taxes in Retirement

You worked hard to build your retirement nest egg. But do you know how to minimize taxes on your savings?

You worked hard for your retirement nest egg, so the idea of paying taxes on those savings isn't exactly appealing. If you know what you're doing, you can avoid overpaying Uncle Sam as you start collecting Social Security and making withdrawals (including RMDs) from IRAs, 401(k)s or 403(b)s. Unfortunately, though, retirees don't always know all the tax code ins and outs and, as a result, end up paying more in taxes than is necessary.

Click here to learn more about the NYSUT Member Benefits Corporation-endorsed Financial Counseling Program which offers financial services to help with planning for retirement.

Here are **10 questions retirees often get wrong about taxes in retirement.** Take a look and see how much you really understand about your own tax situation.

1) Tax Rates in Retirement

Question: When you retire, is your tax rate going to be higher or lower than it was when you were working?

Answer: It depends. Many people make their retirement plans with the assumption that they'll fall into a lower tax bracket once they retire. But that's often not the case, for the following three reasons.

- **Retirees typically no longer have all of the tax deductions they once did.** Their homes are paid off or close to it, so there's no mortgage interest deduction. There are also no kids to claim as dependents, or annual tax-deferred 401(k) or 403(b)contributions to reduce income. So, almost all of your income will be taxable during retirement.

- **Retirees want to have fun—which costs money.** If you're like many newly retired folks, you might want to travel and engage in the hobbies you didn't have time for before, and that doesn't come cheap. So, the income you set aside for yourself in retirement may not be much lower than what you were making in your job.

- **Future tax rates may be higher than they are today.** Let's face it…tax rates now are low when viewed in a historical context. The top tax rate of 37% in 2020 is a bargain compared with the 94% of the 1940s and even the 70% range as recently as the 1970s. And considering today's growing national debt, future tax rates could end up much higher than they are today.

2) Taxation of Social Security Benefits

Question: Are Social Security benefits taxable?

Answer: Yes. Depending on your "provisional income," up to 85% of your Social Security benefits are subject to federal income taxes. To determine your provisional income, take your modified adjusted gross income, add half of your Social Security benefits and add all of your tax-exempt interest.

The IRS has a handy calculator that can help you determine whether your benefits are taxable.

And don't forget state taxes. In most states (but not all!), Social Security benefits are tax-free.

3) Withdrawals from Roth IRAs

Question: Are withdrawals from Roth IRAs tax-free once you retire?

Answer: Yes. Roth IRAs come with a big long-term tax advantage: Unlike their 401(k), 403(b) and traditional IRA cousins—which are funded with pretax dollars—you pay the taxes on your contributions to Roths up front, so your withdrawals are tax-free once you retire. One important caveat is that you must have held your account for at least five years before you can take tax-free withdrawals. And while you can withdraw the amount you contributed at any time tax-free, you must be at least age 59½ to be able to withdraw the gains without facing a 10% early-withdrawal penalty.

4) Taxation of Annuity Income

Question: Is the income you receive from an annuity you own taxable?

Answer: Probably (at least for some of it). If you purchased an annuity that provides income in retirement, the portion of the payment that represents your principal is tax-free; the rest is taxable. The insurance company that sold you the annuity is required to tell you what is taxable. Different rules apply if you bought the annuity with pretax funds (such as from a traditional IRA). In that case, 100% of your payment will be taxed as ordinary income. In addition, be aware that you'll have to pay any taxes that you owe on the annuity at your ordinary income-tax rate, not the preferable capital gains rate.

5) Age for Starting RMDs

Question: At what age must holders of traditional IRAs, 401(k)s and 403(b)s start taking required minimum distributions (RMDs)?

Answer: Age 72. The SECURE Act raised the age for RMDs to 72, starting on January 1, 2020. It used to be 70½ ... and for those born before July 1, 1949, it still is.

As for the amount that you are forced to withdraw: You'll start out at about 3.65%, and that percentage goes up every year. At age 80, it's 5.35%. At 90, it's 8.77%. Your plan sponsor/administrator, however, should calculate the RMD for you.

6) RMDs From Multiple IRAs, 401(k)s and 403(b)s

Question: Are RMDs calculated the same way for distributions from multiple IRAs and multiple 401(k) or 403(b) plans?

Answer: No. There are important differences if you have multiple retirement accounts. If you have several traditional IRAs, the RMDs are calculated separately for each IRA but can be withdrawn from any of your accounts. On the other hand, if you have multiple 401(k) accounts, the amount must be calculated for each 401(k) and withdrawn separately from each account. For this reason, some 401(k) administrators calculate your required distribution and send it to you automatically if you haven't withdrawn the money by a certain date, but IRA administrators may not automatically distribute the money from your IRAs.

Note that the rules for 403(b) plans are similar to traditional IRAs. If you have more than one of these accounts, you can total the RMDs and then take them from any one (or more) of them.

7) Due Date for Your First RMD

Question: Do you have to take your first RMD by December 31 of the year you turn 72?

Answer: No. Normally, you have to take RMDs for each year after you turn age 72 by the end of the year. However, you don't have to take your first RMD until April 1 of the year after you turn 72. But be careful—if you delay the first withdrawal, you'll also have to take your second RMD by December 31 of the same year. Because you'll have to pay taxes on both RMDs (minus any portion from nondeductible contributions), taking two RMDs in one year could bump you into a higher tax bracket.

It could also have other ripple effects, such as making you subject to the Medicare high-income surcharge if your adjusted gross income (plus tax-exempt interest income) rises above certain income thresholds.

8) Taxation of Life Insurance Proceeds

Question: If your spouse dies and you get a big life insurance payout, will you have to pay tax on the money?

Answer: No. You have enough to deal with during such a difficult time, so it's good to know that life insurance proceeds paid because of the insured person's death are not taxable.

9) Estate Tax Threshold

Question: How valuable must an individual's estate be at death to be hit by federal estate taxes?

Answer: For 2021, an individual can shelter as much as $11.7 million in assets (up from $11.58 million in 2020) from federal estate taxes. Married couples can exempt twice that amount. If the value of an estate is less than the threshold amount, then no federal estate tax is due. As a result, estate taxes aren't a factor for very many people. However, 12 states and the District of Columbia charge a state estate tax, and their exclusion limits can be much lower than the federal limit. In addition, six states impose inheritance taxes. See IRS.gov for the latest information.

10) Standard Deduction Amounts

Question: If you're over 65, can you take a higher standard deduction than other folks are allowed?

Answer: Yes. For 2020 returns, the limits are $12,400 for individuals and $24,800 for married couples filing jointly. However, those 65 and older get an extra $1,650 in 2020 if they're filing as single or head of household. Married filing jointly? If one spouse is 65 or older and the other isn't, the standard deduction increases by $1,300. If both spouses are 65 or older, the increase is $2,600.

For 2021 returns, the limits will grow to $12,550 for individuals and $25,100 for married filing jointly. Those 65 and older who file as single or head of household will get an extra $1,700 ($1,350 for married couples filing jointly if only one spouse is 65 or older; $2,700 if both spouses are).

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