Taxes in Retirement

In retirement, your income may come from several sources, including Social Security, employer-sponsored and individual retirement accounts, and other savings vehicles (e.g., an annuity). Depending on your individual situation, your various streams of income may be taxed differently from source to source.

What you pay in taxes depends on your income level – specifically, the amount of taxable income that you earn (or withdraw) in a given year – and your tax filing status. Couples that are married, filing jointly may have higher combined income than single filers or those who are married, filing separately. However, the tax rate for those that are married, filing jointly is typically lower than the tax rate for a single filer. Tax rates range from 10% to 37%.

In addition to your income and filing status, two things can affect your taxes:

- **Tax credits**: Tax credits reduce the amount of tax you owe.
- **Tax deductions**: Tax deductions reduce the amount of your taxable income that is subject to income taxes; if you are eligible for enough deductions, you could reduce your net taxable income enough to lower your overall tax rate.

You can minimize your income – and therefore the amount you owe in taxes – by limiting your distributions from pre-tax plans to only the amounts you need (or are required to withdraw through required minimum distributions), and by taking advantage of the **tax credits and deductions** for which you are eligible.

Note that, while you are always required to file federal taxes if your income is above a certain level, some states do not have an income tax, meaning that you won't have to report your income to the state government if you live in one of those states. Even among the states that do have income tax, there may be special tax treatment for distributions from retirement accounts, income from pension plans, and Social Security benefits.

The following information is offered solely for educational purposes and is effective only as of the date of this post. Please consult your own accountant, tax preparer, or financial advisor for individual tax advice.

Social Security

Most people are required to pay federal taxes on at least a portion of their **Social Security income**.

- If your filing status is *individual* and you make between $25,000 and $34,000, up to 50% of your Social Security income may be taxable. If you make over $34,000, up to 85% of your Social Security income may be taxable.
- If your filing status is *married, filing jointly*, and you make between $32,000 and $44,000, up to 50% of your Social Security income may be taxable. If you make over $44,000, up to 85% of your Social Security income may be taxable.
- If your filing status is *married, filing separately*, your Social Security income is likely to be fully taxable.

You may also have to pay state taxes on your Social Security income – unless you live in either a state without income taxes or a state that specifically does not tax Social Security income.

The following states *do not* tax Social Security income: Alabama, Alaska, Arizona, Arkansas, California, Delaware, Washington D.C., Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Virginia, Washington, Wisconsin, and Wyoming.

Employer-Sponsored Retirement Accounts

Employer-sponsored retirement accounts, including 401(k), 403(b), 457(b), and **TSP accounts**, provide employees with a tax-advantaged method of setting aside a portion of their current income for retirement. In some cases, a portion of the funds that employees deposit into their accounts is matched by their employer.

You are eligible to withdraw money from your employer-sponsored retirement accounts when you turn 59 ½ years old. You are required to withdraw money from these accounts during and after the year in which you turn 72 years old – these withdrawals are called required minimum distributions (RMDs). Unless the distribution is from a Roth account, all withdrawals, including RMDs, are subject to income tax.

> **Note:** If you fail to withdraw some or all of an RMD, the amount that was not withdrawn but should have been will be taxed at 50%.

Withdrawals from the traditional component of your retirement account are subject to income tax on the full amount of the withdrawal (both contributions and earnings). This is because contributions were made on a pre-tax basis, meaning you deposited the funds into the account without first paying income taxes on them.

Withdrawals from the Roth component of your employer-sponsored retirement account are not subject to income tax.

With the exception of withdrawals from 457(b) accounts, any withdrawals made prior to age 59 ½ are also subject to a 10% penalty. Early withdrawals are also subject to income tax.

While the federal government taxes distributions from retirement accounts, the following states *do not* tax funds withdrawn from qualified retirement accounts: Alaska, Florida, Illinois, Mississippi, Nevada, New Hampshire, Pennsylvania, South Dakota, Tennessee, Texas, Washington, and Wyoming.

Pensions

You will be required to pay federal income tax on pension payments that you receive in retirement during the year that you receive the funds. You may be required to pay state income taxes as well, depending on where you live.

The following states *do not* tax pension distributions: Alabama, Alaska, Florida, Hawaii, Illinois, Mississippi, Nevada, New Hampshire, Pennsylvania, South Dakota, Tennessee, Texas, Washington, and Wyoming.

Further, the following states *do not* tax military retirement income: Alabama, Alaska, Arkansas, Connecticut, Florida, Hawaii, Illinois, Iowa, Kansas, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Nevada, New Hampshire, New Jersey, New York, North Dakota, Ohio, Pennsylvania, South Dakota, Tennessee, Texas, Washington, West Virginia, Wisconsin, and Wyoming.

Individual Retirement Accounts

If you open a **traditional IRA**, your earnings grow tax-deferred, meaning that you will not be required to pay taxes on your earnings until you receive distributions in retirement. Traditional IRAs are subject to required minimum distributions once you reach age 72. If you make a withdrawal before age 59 ½, you will be subject to a 10% penalty.

> **Note:** If you have a traditional IRA, direct charitable contributions (in which money is transferred directly from the IRA to a charity) satisfy RMD requirements. Donations up to $100,000 per year made in this manner are *not* subject to income taxes.

Contributions to a traditional IRA may be **tax-deductible** during the year of the contribution, thereby lowering your taxable income. However, this depends on whether you have a retirement plan through your employer (or your spouse through theirs) and on your income level. Deductible contributions and their earnings are taxed as income when withdrawn in retirement.

If you did not or could not claim a tax deduction when you originally contributed funds to your traditional IRA, you will not have to pay taxes on that portion of your withdrawals (provided you filed a non-deductible IRA deposit form – Form 8606 – with your IRS return). You will, however, be required to pay taxes on earnings at ordinary income rates.

A **Roth IRA** is only available to individuals who meet **IRS income guidelines**. This account allows you to contribute after-tax dollars and therefore does not reduce your total taxable income at the time of contribution. However, because you already paid taxes on the contributions, your future retirement distributions are completely tax-free, provided the account is at least five years old. Roth IRAs are not subject to RMDs.

The following states *do not* tax IRA withdrawals: Alaska, Florida, Illinois, Mississippi, Nevada, New Hampshire, Pennsylvania, South Dakota, Tennessee, Texas, Washington, and Wyoming.

Annuities

How an annuity is taxed depends on how the annuity was purchased.

If an annuity was **funded with pre-tax dollars** (for example, using money from a 401(k) or a traditional IRA), payments from the annuity, including any earnings, are taxable as income. This type of annuity is also called a qualified annuity.

If an annuity was **funded with after-tax dollars**, only the portion of payments that comes from the annuity's earnings is taxable as income, because the original contribution amount was already taxed. This type of annuity is also called a non-qualified annuity.

> Navy Mutual annuities are funded with after-tax dollars, so you'll only have to pay taxes on your earnings if you purchase them. Annuities can provide a level of safety not found elsewhere in your retirement portfolio, as they can create a stream of income that cannot be outlived. If you have any questions, you can **schedule an appointment with an annuity expert** or give us a call at 800-628-6011.

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