How the IRS Taxes Retirement Income

It's important to know how common sources of retirement income are taxed at the federal and state levels.

Navigating taxes in retirement can be challenging. Your tax situation may differ from your working years due to income and tax bracket changes. Required withdrawals from retirement accounts and income from other sources can also affect your tax liabilities.

That’s why it's crucial to know how common sources of retirement income are taxed. Having this information can help you develop a tax-efficient strategy for your retirement years.

Is retirement income taxable?

Comprehensive retirement planning involves considering various sources of income and understanding how they are taxed at the federal and state levels. But thankfully, not all income is considered taxable income. For example, life insurance proceeds, long-term care insurance payments, disability benefits, muni bond interest, and alimony and child support are generally not taxable. Additionally, earned income in states with no income tax isn't subject to tax at the state level.

Still, your tax planning should consider the tax treatment of income from annuities, pensions, Social Security benefits, and retirement savings accounts. You will also want to assess tax liability from various investments, earnings, and proceeds.

Here's a breakdown of some common retirement income sources and a brief description of their federal tax implications.

How some income in retirement is taxed

Social Security Benefits: Depending on provisional income, up to 85% of Social Security benefits can be taxed by the IRS at ordinary income tax rates.

Pensions: Pension payments are generally fully taxable as ordinary income unless you made after-tax contributions.

Interest-Bearing Accounts: Interest payments are taxed at ordinary income rates, but municipal bond interest is exempt from federal tax and may be exempt from state tax.

Sales of Stocks, Bonds, and Mutual Funds: Long-term gains (held over a year) are taxed at 0%, 15%, or 20% capital gains tax rates, based on income thresholds. Net investment income tax (NIIT) factors in for some taxpayers. at a rate of 3.8%.

Dividends: Qualified dividends are taxed at long-term capital gains rates; non-qualified dividends are taxed as ordinary income based on your federal tax bracket.

Traditional IRAs and 401(k)s: Contributions to traditional IRAs and 401(k)s reduce your taxable income. However, withdrawals are taxed at ordinary income rates. Required minimum distributions (RMDs) start at age 73. Withdrawals before age 59 ½ are subject to a tax penalty.

Roth IRAs and Roth 401(k)s: Contributions to Roth accounts are not tax-deductible. However, withdrawals after five years following the first contribution are tax-free for Roth IRAs, including gains. Withdrawals before age 59 ½ are subject to a tax penalty.

Life Insurance Proceeds: Life insurance proceeds are generally not subject to tax when received as a beneficiary. However, surrendering a policy for cash may have tax implications.

Savings Bonds: Bond interest is generally taxable at ordinary income rates upon maturity or redemption but may be tax-free for education expenses if certain conditions are met.

Annuities: For annuities, the portion representing the principal is tax-free; earnings are taxed at ordinary income rates unless purchased with pre-tax funds.

Home Sales: Primary home sale gains up to $250,000 ($500,000 for married couples) are excluded from income tax if specific ownership and use criteria are met.

Which states do not tax retirement income?

Crafting a tax-efficient retirement strategy requires careful consideration of various income sources and their tax implications.

- Seek professional guidance if you need help making decisions that maximize your retirement funds and minimize tax burdens.

Also, note that while this article focuses on federal taxes on different types of retirement income, it is essential to consider the impact of state and local taxes on your finances. (There are more than a dozen states that don't tax retirement income.)

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