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How Retirement Income Gets Taxed

Required minimum distributions (RMDs) currently kick in at age 72 for holders of traditional IRAs and 401(K)s.

Aug. 17, 2023

By Joy Taylor.
Kiplinger Consumer News Service (via TNS).

Savers love tax-deferred retirement accounts like 401(K)s and traditional IRAs. Contributions to the plans generally reduce their taxable income, saving them

money on their tax bills in the current year. Their savings, dividends and investment gains within the accounts continue to grow on a tax-deferred basis.

What they tend to forget is that they will pay taxes down the line when they retire and start taking withdrawals, and that those taxes apply to their gains and their pretax or deductible contributions. You can delay withdrawals, but the money can't stay in these accounts forever. At some point, you must withdraw money from the accounts. Required minimum distributions (RMDs) currently kick in at age 72 for holders of traditional IRAs and 401(K)s. People who work past age 72 can delay taking RMDs from their current employer's 401(k) until they retire, provided they don't own more than 5% of the company that employs them.

Withdrawals from traditional IRAs and 401(k)s are taxable at ordinary income tax rates, though any after-tax or nondeductible contributions are excluded. Payouts before age 59½ are generally slapped with a 10% penalty on top of the regular tax hit.

Roth IRAs come with a big long-term tax advantage: Contributions to Roths aren't deductible, but withdrawals are tax-free.

Two important caveats: You must have held a Roth IRA account for at least five years before you can take tax-free withdrawals. The five-year clock starts ticking the first time money is deposited into any Roth IRA, through either a contribution or a conversion from a traditional IRA. Second, although you can withdraw the amount you contributed at any time tax-free, you generally must be at least age 59½ to be able to withdraw the gains without facing a 10% early-withdrawal penalty.

Similar rules apply to Roth 401(k)s – contributions aren't deductible, and withdrawals are tax-free, provided at least five years have passed since your first contributed to that Roth 401(k). The five-year period begins on January 1 of the year you first contributed to the Roth 401(k) and ends after five years.

Pension payments that you receive from private and government pensions are fully taxable at ordinary income tax rates when you receive them, assuming you made no after-tax contributions to the pension plan.

Some **Social Security** recipients aren't subject to federal income tax on their benefits. But others, depending on their "provisional income," aren't so lucky and may have to pay federal income tax on up to 85% of the benefits. To determine your provisional income, start with your income on Line 9 of Form 1040 or 1040-SR (without an amount for Line 6b), and add tax-exempt interest plus 50% of your Social Security

benefits. If your provisional income is less than $25,000 ($32,000 for married couples filing a joint return), your Social Security benefits are tax-free. If your provisional income is between $25,000 and $34,000 ($32,000 and $44,000 for joint filers), then up to 50% of your benefits are taxable. If your provisional income is more than $34,000 ($44,000 for joint filers), then up to 85% of your benefits are taxable.

Any proceeds you receive as a beneficiary of a **life insurance** policy when the insured person dies are generally nontaxable. The tax rules are more complicated if you're the holder of the policy and surrendered it for cash. The IRS has an online tool that can help you determine whether the proceeds you receive are taxable.

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 taxed at ordinary income tax rates. For example, if you purchased an annuity for $100,000 and it's worth $160,000 in 10 years, you would only pay tax on the $60,000 of earnings. 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.

If you sell **stocks**, bonds or mutual funds that you've held for more than a year, the proceeds are taxed at long-term capital gains rates of 0%, 15% or 20%. Compare these figures to the top 37% tax rate on ordinary income.

The 0%, 15% and 20% rates on long-term capital gains are based on set income thresholds that are adjusted annually for inflation. For 2022, the 0% rate applies to individuals with taxable income up to $41,675 on single returns, $55,800 for head-of-household filers, and $83,350 for joint returns. The 20% rate starts at $459,751 for single filers, $488,501 for heads of household, and $517,201 for joint filers. The 15% rate is for individuals with taxable incomes between the 0% and 20% break points. The income thresholds are higher for 2023. For 2023, the 0% rate applies to individuals with taxable income up to $44,625 on single returns, $59,750 for heads of household filers, and $89,250 for joint returns. The 20% rate starts at $492,301 for single filers, $523,051 for heads of household and $553,851 for joint filers. The 15% rate is for individuals with taxable incomes between the 0% and 20% break point. The favorable rates also apply to qualified dividends (*see below*).

There's also a 3.8% surtax on net **investment income** (NII) on top of the 15% or 20% capital gains rate for single taxpayers with modified adjusted gross incomes over

$200,000 and joint filers over $250,000. This 3.8% extra tax is due on the smaller of NII or the excess of modified AGI over the $200,000 or $250,000 amounts.

If you sell investments that you've held for a year or less, the gains are short-term and are taxed at your ordinary income tax rate.

If you sell at a loss, the loss can offset capital gains for the year, plus up to $3,000 of other income. Excess losses can be carried forward indefinitely each year, subject to the same tax treatment, until those losses are exhausted.

Many retirees own stock, either directly or through mutual funds. Dividends paid by companies to their stockholders are treated for tax purposes as qualified (most common) or non-qualified. Qualified dividends are taxed at long-term capital gains rates (*see above*). Non-qualified dividends are taxed at ordinary income tax rates.

Ordinary income tax rates apply to interest payments on certificates of deposit, savings accounts, money market accounts, and corporate bonds. Municipal bond interest is exempt from federal tax. Likewise, interest from bonds issued in an investor's home state is typically exempt from state income taxes (but check your own state's laws). Capital gains rates apply when you sell corporate or municipal bonds.

For federal income tax purposes, interest on EE and I U.S. savings bonds is generally taxable at ordinary income rates in the year the instruments mature or when they are redeemed, whichever is earlier. Holders of HH bonds report and pay U.S. tax on interest annually as it is paid to them. Interest on U.S. savings bonds is exempt from state and local income taxes.

If you're heading back to school in your golden years, know that interest on EE and I bonds that are used to pay for higher education may be tax-free, provided certain rules are followed. The bonds must have been purchased after 1989 by buyers who were age 24 or older. They must also be redeemed to pay for college, graduate school or vocational school tuition or fees for the bondholder or the bondholder's spouse or dependent. Room and board costs aren't eligible. Also, the bonds are required to be in the taxpayer's name. Grandparents can't use this tax break to help pay for their grandchild's college tuition unless the grandparent can, on his or her federal tax return, claim the grandkid as a dependent.

The income exclusion is subject to income limits. For 2022, it begins to phase out for joint return filers with modified adjusted gross income over $128,650 and $85,800

for everyone else. The tax break disappears when modified AGI hits $158,650 and $100,800, respectively. For 2023, it begins to phase out for joint return filers with modified AGI over $137,800 and $91,850 for all other filers, and it disappears when modified AGI hits $167,800 and $106,850, respectively.

A home is often the biggest and most valuable asset that retirees own. Luckily, the tax laws give a generous federal income tax break when you sell your primary home at a gain. If you have owned and used the property as your personal residence for at least two out of the five years before the sale, you can exclude up to $250,000 of the gain from income ($500,000 for married couples filing a joint return). Any gains in excess of the $250,000 or $500,000 exclusion are taxed at long-term capital gains rates. Losses aren't deductible.

Payments that you get from a reverse mortgage on your home are treated as nontaxable loan proceeds and not income. Also, you can't deduct the interest you eventually pay when you satisfy the mortgage, unless you used the original proceeds to buy, build, or substantially improve the home securing the loan.

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