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The dos and don'ts of taxes in retirement

With different rules for different kinds of accounts, taxes in retirement can be complex. Follow these tips to help make the most of your savings.

QUICK: DO YOU KNOW HOW YOUR TAXES MAY CHANGE in retirement? Will IRA withdrawals be tax-free? How about Social Security benefits? Which gains are taxed at the federal ordinary income tax rate, and what qualifies for the federal long-term capital gains rate? The answers to questions like these could have a big impact on how much tax you owe — and consequently, how long your retirement assets could last.

"Just as it's sensible to pay attention to tax-efficient ways to save for retirement when you're younger, you should start thinking about the tax implications of tapping your retirement accounts as far in advance as possible," says David Koh, managing director and senior investment strategist, Chief Investment Office, Merrill and Bank of America Private Bank.

Tip: Holding some of your retirement savings in Roth accounts can help you limit how much income tax you'll owe in a given year in retirement.

As you work with your financial advisor and tax professional to develop a tax-efficient retirement income plan, consider these dos and don'ts for keeping federal income taxes to a minimum. (State and local taxes are not addressed below, so be sure to consult your tax advisor about those rules.)

Do: Know how different types of income are taxed

In retirement, your income may come from annuities, pensions, IRAs, taxable savings, Social Security and qualified retirement plans such as 401(k)s. Tax treatment of all those assets varies widely: Roth 401(k) or Roth IRA qualified distributions are generally tax-free.[1] Traditional IRA, traditional 401(k), pension or annuity distributions, short-term capital gains, bond income and non-qualified dividends are generally taxed at your ordinary income rate.[2] Social Security income is generally taxed at your ordinary income rate for up to 85% of your benefits; the rest is generally tax-free. Long-term investment gains, including qualified dividends, are generally taxed at the long-term capital gains rate (plus a potential 3.8% net investment income tax).[3]

Don't: Limit yourself to one kind of retirement account

Contributing to different types of accounts gives you a greater degree of control over taxes in retirement. Roth 401(k)s and Roth IRAs, for example, provide federally tax-free income when certain conditions are met and generally don't impose required minimum distributions (RMDs) during the owner's lifetime — which can help you manage how much income tax you'll owe in a given year in retirement.

Do: Try to let tax-advantaged accounts keep growing

Tip: Watch out for any bump to your income that might temporarily put you in a higher tax bracket.

"For some people, it will make sense to consider tapping taxable accounts first, then tax-deferred and finally tax-free," says Koh. "But, depending on your circumstances, this order may not be right for every person." When you sell long-held investments in your taxable accounts, you'll likely pay long-term capital gains taxes, which are usually lower than the ordinary income taxes you'll owe on distributions from your traditional 401(k) accounts, traditional IRAs and certain other tax-deferred accounts. "If you're not accessing your retirement funds, they're still growing tax-deferred," Koh adds.

Don't: Make moves that could put you in a higher tax bracket

Any bumps to your income can cause you to unexpectedly move into a higher tax bracket. This could happen if you sell a business or tap your investments to renovate your home. A higher income can also affect taxes on your Social Security benefits and push up your Medicare premiums.

If you can't avoid moving into a higher tax bracket for a short time, you might want to switch the order in which you tap retirement accounts and draw federal (and potentially state and local) tax-free income from a Roth IRA. You can also pay for qualified medical expenses with your health savings account — those withdrawals are also tax-free. Talk to your advisor and tax professional anytime you expect a temporary income bump.

Do: Look ahead to when you'll turn 73

Even if you're not yet retired, you'll need to consider what happens once you reach age 73 (or age 75 for individuals who reach age 74 after December 31, 2032). That's generally when RMDs[4] kick in for all employer-sponsored retirement plans, including profit-sharing plans, 401(k) plans, 403(b) plans and 457(b) plans. The RMD rules also apply to traditional IRAs and IRA-based plans such as SEPs, SARSEPs and SIMPLE IRAs. The RMD rules do not apply to Roth IRAs and Roth 401(k) accounts while the original account owner is alive. If your RMDs are large enough to push you into a higher tax bracket, you may want to consider starting withdrawals earlier to spread out the taxable income.

Don't: Overlook how long you've owned an investment

You may end up owing more in taxes than you expect when you sell investments held for one year or less in taxable accounts since those gains don't qualify for the lower, long-term capital gains rate, says Koh. "You'll need to decide whether to hold the asset longer for further potential appreciation, and your tax rate becomes more favorable, or sell it and take your gains now. It's a delicate balance."

Tip: Selling investments held in taxable accounts for one year or less could end up costing you more in taxes.

Do: Review your tax situation whenever your life changes

A number of life events, says Koh, could trigger a change in your tax circumstances: taking Social Security, staying employed past retirement age, returning to work part time, relocating to a more (or less) tax-friendly state or dealing with increased healthcare costs. Whenever you see a change like this on the horizon, it's time to check in with your advisor and your tax professional.

Another reason for periodic conversations, according to Koh, is tax laws can change. Your best bet is to check in regularly with your advisor and tax pro, says Koh. "There's no one-size-fits-all rule for managing taxes in retirement," he says. "The most important thing to remember is that you don't have to make these decisions alone."