How is Your Retirement Income Taxed?

Once you're retired, you will likely need to draw on several types of income for your living expenses. You'll need to know where these funds are coming from and how much you can count on, but you should also be aware of how this money is taxed — because this knowledge can help you plan and budget for your retirement years.

Here's the basic tax information on some key sources of retirement income:

• *Social Security* – Many people don't realize they may have to pay taxes on their Social Security benefits. Whether your benefits will be taxed depends on how much other taxable income you receive from various sources, such as self-employment, stock dividends and interest payments. You'll want to check with your tax advisor to determine whether your income reaches the threshold where your Social Security benefits will be taxed. The lower your total taxable income, the lower the taxes will be on your benefits. The Social Security Administration will not automatically take out taxes from your monthly checks — to have taxes withheld, you will need to fill out Form W-4V (Voluntary Withholding Request). Again, your tax advisor can help you determine the percentage of your benefits you should withhold.

• *Retirement accounts* – During your working years, you may have contributed to two basic retirement accounts: an IRA and a 401(k) or similar plan (such as a 457(b) plan for state and local government employees or a 403(b) plan for educators and employees of some nonprofits). If you invested in a "traditional" IRA or 401(k) or similar plan, your contributions may have been partially or completely deductible and your earnings grew on a tax-deferred basis. But when you start taking withdrawals from your traditional IRA or 401(k), the money is considered taxable at your normal income tax rate. However, if you chose the "Roth" option (when available), your contributions were not deductible, but your earnings and withdrawals are tax-free, provided you meet certain conditions.

• *Annuities* – Many investors use annuities to supplement their retirement income. An annuity is essentially a contract between you and an insurance company in which the insurer pays you an income stream for a given number of years, or for life, in exchange for the premiums you paid. You typically purchase a "qualified" annuity with pre-tax dollars, possibly within a traditional IRA or 401(k), so your premiums may be deductible, and your earnings can grow tax deferred. Once you start taking payouts, the entire amount — your contributions and earnings — are taxable at your individual tax rate. On the other hand, you purchase "non-qualified" annuities with after-tax dollars, so your premiums aren't deductible, but just like qualified annuities, your earnings grow on a tax-deferred basis. When you take payments, you won't pay taxes on the principal amounts you invested but the earnings will be taxed as ordinary income.

We've looked at some general rules governing different sources of income, but you should consult your tax professional about your specific situation. Ultimately, factors such as your goals, lifestyle and time horizon should drive the decisions you make for your retirement income. Nonetheless, you may want to look for ways to control the taxes that result from your various income pools. And the more you know about how your income is taxed, the fewer unpleasant surprises you may experience.

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