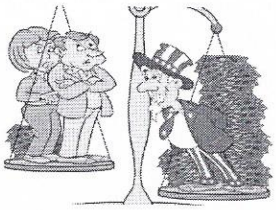
Tax obligations can be a surprise to retirees

Nancy Tengler, Special for The Republic | azcentral.com *7:21 p.m. MST December 10, 2014*



(Photo: Getty Images/iStockphoto)

If you are like most people, you probably expect your greatest retirement expense to be health care. But that may not necessarily be so. A recent study completed by the Employee Benefit Research Institute identifies the single largest expense for retirees as housing. Health care ranks second. And the third-largest retirement expense? Taxes.

Most of us expect to pay taxes over the course of our career. We also understand that contributions to Social Security are a tax against our future draw on the system. But we probably don't consider that we will most likely have to pay taxes on our Social Security income once retired. According to a February 2012 article on kiplinger.com, "Up to 85 percent of Social Security benefits are taxable," and the income threshold that triggers income taxation is $32,000 for a married couple. Not a very high hurdle to say the least.

In other words, the vast majority of us will have to pay taxes on Social Security income we receive after years, even decades, of paying into the mandatory government retirement program and doing so with what are considered "after-tax dollars" (according to ssa.gov, the official Social Security website).

That isn't the end of the tax burden hoisted by retirees. Pre-tax contributions to traditional IRAs or 401(k) plans are also taxed upon distribution. Although most of us understand that our retirement funds are accumulated with pre-tax dollars and grow tax-free, we still may be unprepared for the tax bill when we finally do take distributions.

Importantly, the money we withdraw is taxed at our ordinary-income tax rate. So, let's say that you are in the 25 percent tax bracket and you find yourself with a $10,000 health-care bill. You will need to withdraw $13,333.33 to cover the expense and the $3,333.33 tax bill.

There are various tax-planning strategies that can be employed by retirees. One obvious strategy is to deplete taxable assets first. Another we discussed a few weeks back: the possibility of converting a traditional IRA to a Roth.

Even better, if you are young enough and meet the income restrictions, you may want to start contributing to a Roth now. Roth IRAs do not mandate the annual required minimum distribution at 70$^1/_2$ like a traditional IRA, and distributions are tax-free. Consult your financial adviser or begin your research now. The plethora of comprehensive research and advice available online is an extraordinary boon to the average individual.

The important thing to consider when you retire, is that you are effectively embarking on 20-plus years of unemployment. On a fixed income. And you still will have the same obligation to render unto Uncle Sam what is his. Budget for your tax liability because the Old Man is not shy about collecting his share.

Next week: Best retirement investment.

Nancy Tengler spent two decades as a professional investor. She is a financial-news commentator and university professor and the author of "The Women's Guide to Successful Investing." Reach her at nancy.tengler@cox.net.

Read or Share this story: http://azc.cc/1yfpZBo