Beware of hidden taxes in retirement

YOUR FINANCE

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Your taxes in retirement may be a lot more complicated than taxes while you're working.

Social Security checks may or may not be taxed, depending on your income. You'll pay federal income taxes on most retirement plan withdrawals. Tax rates on investments can vary as well.

Here's what to expect when you hit retirement age:

'Combined income'

Whether and how much of your Social Security benefit is taxed will be determined by "combined income." That's your adjusted gross income, plus any nontaxable interest, plus half your Social Security benefit. If your combined income is below $25,000 and you're single, your benefit won't be taxed. If your combined income is between $25,000 and $34,000, you may pay tax on up to half of your benefits. Over $34,000, up to 85 percent of your benefits may be taxable. For joint filers, the 50 percent range is $32,000 to $44,000, and the 85 percent range is more than $44,000. The tax calculations are fairly complex so you'll want to use software, or a tax pro, to figure yours.

Note that you won't lose half or more of your benefit to taxes. Instead, up to 85 percent could be subject to income taxes at your ordinary income tax rates. (There are currently seven tax brackets, ranging from 10 percent to 37 percent.)

Required minimum distributions

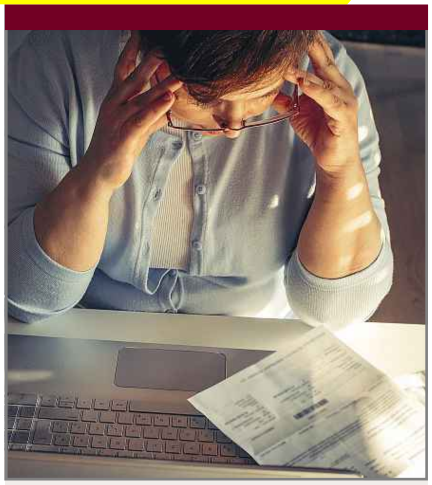
At age 70½, you must begin withdrawing money from most retirement accounts. Required minimum distributions typically are taxed at your regular income tax rates. If you've been a diligent saver, these mandatory distributions could be big enough to push you into a higher tax bracket.

In some cases, it can make sense to convert some retirement funds to Roth IRAs in your 60s to avoid a sharp increase in taxes in your 70s, certified financial planner Michael Kitces says. A tax pro or financial planner could help you run some projections to see if this approach makes sense.

Home sales

Selling your home — to downsize, free up equity or move to a new community — may generate a tax bill. If you've lived in your primary residence for at least two of the five years prior to selling it, you can exempt up to $250,000 of home sale profit from capital gains taxes (or up to $500,000 for a couple). Profits above that are subject to federal capital gains tax rates that range from 0 percent to 20 percent.

You also may owe a "depreciation recapture tax" if you took a home office deduction, rented out rooms or rented out the whole house. The depreciation you took or should have taken over the years is added back to your income in the year you sell and you'll pay a maximum rate of 25 percent on it, says Mark Luscombe, principal analyst for Wolters Kluwer Tax & Accounting.



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Federal estate taxes aren't an issue for most people now that $11,180,000 per person is exempt. But 12 states and the District of Columbia also levy estate taxes. Hawaii, Maine and the District of Columbia use the federal exemption amount, but Oregon and Massachusetts may tax estates worth $1 million or more. The other states — Connecticut, Illinois, Maryland, Minnesota, New York, Rhode Island, Vermont and Washington — exempt varying amounts, says Bruno Graziano , senior writer and analyst at Wolters Kluwer. Consult an estate planning attorney if you might be affected, since you may be able to minimize taxes with the right plan.

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