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Forbes Magazine

Tax-Free In the Rust Belt

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By Ashlea Ebeling

Looking for a retirement tax haven? You might find it close to home.

When John Jazdcyk retired in 2004 from his management job at a Green Bay, Wis. **Procter & Gamble** (NYSE:PG - News) plant, he and his wife, Susan, debated whether to move full-time to their vacation home on Lake Mullet in Cheboygan, Mich. Then they learned that Michigan exempts $81,840 a year in private retirement income per couple, in addition to Social Security, from its 3.9% state income tax. Wisconsin, by contrast, taxes private retirement payments, as it does salary and other income, at 5.6%. "Whenever taxes can be avoided, I feel better," says new Michigan resident Jazdcyk, 59.

Accepted wisdom: Tax-averse retirees should move to Florida or Nevada, which have no state income or estate taxes. But what if you don't worship the sun or relish a long-distance move? In recent years other states, too, have been lavishing tax goodies on retirees, including affluent ones. With a little research you might discover your own retirement tax haven is close to home.

In Pictures: 7 Best (Unknown) Retirement Tax Havens

Most states don't tax Social Security benefits. Three states with broad income taxes (Illinois, Mississippi and Pennsylvania) exempt all private and public pension payouts, including withdrawals from individual retirement accounts, from their taxes. More than a dozen other states exempt some annual dollar amount of seniors' income--from private pensions, IRAs and sometimes other nonwage sources (see table).

With all these special breaks the best tax locale for a retiree isn't necessarily the same as for a working stiff, particularly when high real estate levies in some income-tax-free states are considered, says Thomas Wetzel, president of Retirementliving.com, which tracks taxes by state. In addition to Florida and Nevada, seven states--Alaska, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming--have no broad income tax.

New Hampshire has no sales tax either, which would seem to make it an ideal New England retirement retreat. Except New Hampshire taxes investment income, as does Tennessee, which can be significant if your financial assets are mostly in nonretirement accounts. Worse, according to a recent National Association of Home Builders study, New Hampshire's real estate taxes are among the highest in the nation, at a median 1.6% of home value, double Massachusetts' median rate.

Even if you are years away from hanging it up, it makes sense to consider taxes in your retirement planning now. "If your taxes are a lot lower, your retirement funds are going to go further," reasons Don R. Weigandt, 60, a managing director at JPMorgan Private Bank in Los Angeles, who is considering following the well-worn trail to Nevada himself when he retires.

Your tax outlook could affect not just how much you save, but how. Example: A growing number of workers have a choice between contributing pretax dollars to a traditional 401(k) or funding a newfangled Roth 401(k). You put aftertax dollars in the Roth, meaning you get no deduction now. But when you retire, withdrawals don't count as taxable income.

A Roth is a good deal for young workers whose tax rates are likely to rise. But what if you're fiftyish, paying

California's hefty top 10.3% state income tax rate and likely to retire to a state that doesn't tax pensions? In that case grabbing the deduction now, when your combined federal-state tax rate is higher, probably makes more sense than forgoing a current deduction to open a Roth.

Is a Roth 401(k) Right For You?

There are other reasons that tax planning should start well before you collect your gold watch. Stock options and deferred compensation require special handling since, if you move, your old state might pursue you for taxes on these--particularly if that old state is New York or California.

Do you hold your employer's stock in a workplace retirement account? It may be better to cash out the stock portion than to roll it into an IRA, since gains in employer stock are taxed at the lower federal capital gains rate, which now tops out at 15%. By contrast, withdrawals from a regular IRA are taxed as ordinary income, at a federal rate as high as 35%.

The Jazdcyks sold big blocks of P&G stock to take advantage of this provision and made sure to do so before leaving Green Bay. Why? Wisconsin exempts 60% of capital gains from tax, reducing the effective Wisconsin tax on gains to 2.6%, versus the 3.9% they now pay on long-term gains in Michigan, explains the couple's CPA, Stephen Bigge of Virchow Krause & Co. in Green Bay.

Here are some tax issues to consider:

Social Security

Better-off seniors generally pay federal taxes on 85% of their Social Security benefits. But only 15 states still tax any of these benefits, and some of those are dropping or cutting their taxes. Wisconsin will end its tax next year. Missouri is phasing out its tax by 2012 and Iowa by 2014. The greediest states? Seven that follow the feds in taxing up to 85% of Social Security benefits. Among the offenders are Minnesota, with a top state rate of 7.85%, and Rhode Island, at 9.9%.

Private pensions and IRAs

Good news: You can now accumulate large amounts in a pretax retirement account while working in a high-tax state and then move to a state that doesn't tax pension withdrawals without worrying about tax collectors from your old state coming after you. In 1996 Congress ordered states to stop pursuing most former residents for taxes on pensions. This stops California from going after a former resident who is living in Reno, Nev. when he taps an IRA or draws a pension from Procter & Gamble. The 1996 law protected employees; last year Congress extended it to cover former partners (e.g., lawyers and accountants), too. Warning: This still doesn't keep your old state from taxing deferred compensation paid out to you in a lump sum. It does, however, protect deferred compensation received in equal installments over ten years or more.

If you retire to a state that provides a limited annual exemption for private pensions, try smoothing out your income to take maximum advantage of it. New York exempts $20,000 a year in pension income per person, beginning when a resident turns 591/2.. An older New Yorker who isn't receiving any other pension should consider taking out $20,000 a year from his pretax IRA and rolling the money into a Roth IRA, suggests New York estate lawyer Bruce Steiner.

Public pensions

Retired government employees get even better state tax treatment than private pensioners. In addition to the nine states without income taxes and three that don't tax any pension income, another seven (Alabama, Hawaii, Kansas, Louisiana, Massachusetts, Michigan and New York) exempt all federal, state and local pensions from tax. In fact, only five states (California, Indiana, Nebraska, Rhode Island and Vermont) don't provide public pensioners with any special breaks.

This favored tax status dates back to a time when (unlike today) state and local workers weren't well paid and received relatively small pensions. Rather than cut their own retirees bigger checks, the states gave them tax breaks. But in 1989 the U.S. Supreme Court ruled a state couldn't exempt its own pensions and not federal government ones. It's still legal for states to favor their own retirees over those who worked for other states, and a handful do. Kansas, for example, gives a full exclusion for Kansas pensions but none for pensions earned working for other

states.

Other income breaks

Many states give old folks higher standard deductions or personal exemptions--for example, an extra $4,200 per couple exemption in Arizona and Michigan. Plus, a handful give seniors large breaks for income from virtually any investment. A two-year-old break allows Georgians 62 and older to exclude from taxable income $60,000 per couple (rising to $70,000 per couple in 2008) of interest, dividends, capital gains, rents, pensions and annuities.

Substantial deductions are also available to folks who contribute to 529 college savings plans, as many grandparents do. Deposits in these plans aren't deductible on federal returns. But South Carolina, West Virginia, New Mexico and Colorado allow an unlimited deduction--up to total taxable income--for contributions to the 529s they sponsor. (While 529s are mostly marketed by financial service companies, all but one are legally sponsored by an individual state.) New York allows couples a $10,000 per year deduction for contributions to its plans. Pennsylvania allows each individual taxpayer to deduct $12,000 per child a year in contributions to any state's 529. You can check on your own state at savingforcollege.com.

Real estate taxes

Forty states exempt a certain amount of the value of a resident's primary home from real estate tax, and many of them provide an even larger exemption to old folks. So, too, do some local governments. (Warning: Some of these "homestead" breaks aren't automatic--you have to apply for them.) While exemptions have been growing, they haven't generally kept pace with fast-rising assessments, causing heartburn for real-estate-rich seniors.

Florida is the current center of retiree real estate tax angst. A law in place since 1995 keeps the assessment on a primary residence (not a vacation home) from rising more than 3% a year. But that isn't much help to retirees moving to the state now or current Florida residents who move, since houses are reassessed to market value when sold. In January Floridians will vote on a new scheme that would exempt 75% of the first $200,000 and 15% of the next $300,000 of a primary home's value from tax, for a maximum $195,000 exemption. Current homeowners could choose between the new exemption plan, which includes no limit on annual assessment increases, and the existing one--a $25,000 exemption and the 3% cap.

The new exemption tilts protection to those with less-valuable properties. "They're saving the rich people who already live here and throwing the rich people who don't already live here off the bus," observes Clearwater, Fla. tax lawyer Alan Gassman, who intends to opt for the 3% cap. Thanks to that cap, his home, worth $1 million, is taxed as if it were worth $598,000.

Sidebar: Island Savings

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Estate taxes

Twenty-three states and the District of Columbia impose their own estate or inheritance taxes on money left to anyone other than a spouse (see map). While the federal estate tax doesn't, generally, hit estates of $2 million or less, most of the state levies kick in at lower levels. Ohio, for example, exempts just $338,000 from its estate tax. New Jersey, Rhode Island and Wisconsin exempt $675,000. Nine other jurisdictions, (the District of Columbia, Maine, Maryland, Massachusetts, Minnesota, New York, Oklahoma, Oregon and Tennessee) exempt $1 million. Pennsylvania imposes its quirky inheritance tax on every dollar not left to a spouse, with the rate dependent on who gets the money.

One problem in deciding where to move based on estate tax--particularly for youngish retirees--is that this politically charged tax is in flux in many states, just as it is in the federal tax law. Virginia's estate tax expired in July. Wisconsin's expires at the end of this year. Kansas' tax is slated to disappear at the end of 2009. Michigan eliminated its estate tax in 1993 in part to stem the outflow of retirees. Now, to patch a budget deficit, Michigan's Democratic governor has suggested reincarnating its death tax. If she does, threatens new resident John Jazdcyk, he just might move again.

Sidebar: Island Savings

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