Finding the perfect U.S. retirement tax haven

By Kay Bell • Bankrate.com

It seems like it would be easy to find a tax-friendly place to while away your golden years. Nine states don't have an income tax. Five don't levy any sales tax. By this measure, a perfect state to retire to is Alaska , since it falls into both groups. There's just that minor issue of the weather.

Think a little snow -- OK, maybe a lot -- is a fair trade to avoid state taxation? Don't pack your parka just yet. Alaska isn't totally tax-free.

Some Alaskan municipalities do charge local sales taxes. Some cities and boroughs (roughly equivalent to counties) also collect property taxes, although the first $150,000 of assessed value is exempt if it's owned by residents 65 or older. And for the time being, the state still has an estate tax, something to think about if you're worried about what you'll leave the grandkids.

The Land of the Midnight Sun is a prime example of the complexities you could face when looking for a domestic retirement spot on the basis of tax considerations. You've got to sort through 50 states and the District of Columbia , each with its own set of tax rules, not to mention the assortment of local taxing jurisdictions they contain.

Even then, if you simply use tax rates as the overriding factor in deciding where in the United States to retire, you could make a big mistake.

Taking taxes personally

The two big taxes that everyone worries about are income and real estate taxes. These could be of special importance for retirees, since they could have an inverse relationship, says Bob D. Scharin, editor of Warren , Gorham & Lamont/RIA's Practical Tax Strategies, a monthly journal written for tax professionals.

"Look at your particular situation," says Scharin. "Perhaps you have a moderate income, but want to buy as big a house as possible since you'll have family, grandkids, visiting a lot. In this case, you'll be more sensitive to the real estate tax than the state's tax on your moderate income.

"When you buy a house, you always ask: How much is the real estate tax on the property," says Scharin. "But also try to find out if you make renovations, would that be re-evaluated and taxes go up?"

The answers could be critically important to a fixed-income retiree facing increasing property taxes.

"The flip side is the retiree with a higher income who says, 'I've had enough of cooking and cleaning and am happy to be in small apartment, eating out in restaurants,'" says Scharin. That well-off retiree won't have the property taxes to worry about, but because of his resources, he could be hit harder by a state's income-tax rates.

Where the money comes from

Just how hard the income tax hit will be depends not only on where you decide to retire, but also the source of your retirement money.

Say, for example, you decide to move to a state that doesn't collect income tax -- Alaska , Florida , Nevada , South Dakota , Texas , Washington , Wyoming , Tennessee or New Hampshire . In general, that's a sound way to tax-proof your retirement income. But if you move to a couple of these locales, you might find you've outsmarted yourself.

" New Hampshire and Tennessee have no general wage income tax, but do tax stock and bond income, a prime source of income for many retirees," says John Logan, senior tax analyst with CCH Tax and Accounting. "So one of the main considerations is what type of income will you be relying on in retirement."

It works the other way, too. A state that might look unappealing at first tax glance could, in fact, be a tax-smart retirement move.

" New York is considered a big tax state for good reason," says Scharin. "But it also has exclusions for certain types of retirement income. The pension income of government employees -- teachers, postal workers, fire department employees -- is not taxed by New York state, so although they're living in a high-tax state, these people are exempt from state tax."

That's why, says Scharin, "it's kind of misleading to look at a table that says you're in a high-tax state, because it depends."

Don't forget other state taxes Illinois, too, exempts most federally qualified retirement-plan income and offers very broad exceptions from taxation for other retirement income, say Logan, who's based in CCH's Riverwoods, Ill., office.

Coupled with the state's low income tax rate, 3 percent of federal adjusted-gross income, Illinois might be a tempting place to retire. But when you start spending your income-tax-exempt retirement money, look out. The state and many of its local taxing jurisdictions will get their piece of it through the sales tax.

"The amount of the tax varies considerably," says Logan . "You can't just look at the state sales tax rate. When you factor in local taxes, in Illinois , some combined sales taxes are at 9 percent."

It can go that high because, in part, there are so many local taxing jurisdictions. The 2005 Illinois Sales Tax Rate Reference Manual says that, along with the state's general 6.25 percent sales tax, the department of revenue also might collect combinations of one or more of the following locally imposed taxes: mass transit tax, water commission tax, municipal home rule tax, municipal non-home rule tax, county home rule tax, county public safety or transportation tax, metro-east park and recreation district tax and business district tax.

Then there's the issue of exactly what goods and services are taxed when purchased. Most states exempt prescription drugs from tax, a relief for many retirees, but other items, even food and over-the-counter medications, are taxed in some states. If you plan to spend your retirement cooking gourmet meals for friends, make sure the local grocery won't be collecting tax on more of your pension check than you had planned.

Perhaps a better retirement-tax move would be to Alaska , Delaware , Oregon , New Hampshire or Montana , the five states that don't have a state sales tax. Perhaps not. Remember Alaska 's local sales taxes? City, county, school district or other special taxing jurisdictions (a la Illinois) are common nationwide, even in states without an overall sales tax.

And even if you do find a suitable retirement spot in a state without an income or statewide sales tax, you'll likely come back to that property-tax consideration mentioned earlier. Every government has to get operational money from somewhere. States without income or sales taxes, says Logan , tend to have higher property taxes.

Eventual estate taxes

Sometimes the state collects your money after the fact through estate and inheritance taxes. Many retirees look for places to settle where they can be assured they'll be able to leave their family and friends well taken care of.

The federal estate tax is being gradually phased out and is scheduled to expire in 2010, but unless lawmakers act it will be right back in 2011. Meanwhile, the states who tie their estate tax laws to the federal statute have been working to reconcile the changes. "Some codes are automatically updated to correspond with federal law," says Logan . "But in others, the legislature must act. Some did and some didn't before the effective date of the [federal estate tax] law."

The upshot, says Logan, is that there are now several jurisdictions that still have estate tax provisions that could be costly: Illinois, Kansas, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Oklahoma, Oregon, Rhode Island, Virginia, Vermont, Wisconsin, Washington state and Washington, D.C.

A separate, but related, issue is inheritance tax. Estate taxes are collected from the estate based on its total value of assets at death. Inheritance taxes are imposed when the estate is distributed and are based on the amount that each heir receives. States with inheritance taxes include Indiana , Iowa , Kentucky , Maryland , Nebraska , New Jersey , Pennsylvania , Ohio , Oklahoma and Tennessee .

Ready to just stay where you are? That might not be such a bad idea. As Logan puts it, "I don't know that I'd designate any state a particular tax haven."

His words probably are welcomed by the various state promotion boards. They also underscore the truth of taxes: You can deal with just about any of them as long as you know going in what they are, how they will affect your retirement plans and how you can manage those effects.

Bankrate's state tax directory can help you get an idea of your state's tax laws or those in a state you might like to call retirement home. You also should check out retirement-income tax breaks that many states offer.