How Is Pension Income Taxed?

By: Exchange Capital Management
July 13th, 2023

Pensions are a rare but valuable retirement benefit provided by some companies. If you're among the fortunate individuals with this benefit, you need to consider the tax implications that follow. Most pensions are funded with pre-tax dollars, and you will pay income tax when you withdraw the money. When it's time to collect your benefits, pension providers often offer a choice between monthly payments or a lump sum. This option grants you more leeway when considering tax strategies.

Monthly Payments

Tax rules for monthly payments are straightforward. You receive the monthly payment and will be taxed at federal ordinary income rates for the money received in that calendar year. The exact rate you will be taxed depends on your income level and filing status. To avoid a hassle come tax time, most companies will withhold federal taxes on your pension income.

State income taxes will be assessed based on where you live. While some states may have no income tax, others may charge up to 12.3%. Even if your state does charge income tax, there are a handful of states that exempt retirement income from taxation. Always research your state's income tax brackets and rules on retirement income to have a thorough understanding of how you will be taxed.

Lump Sum

Pension income is considered ordinary income. If you decide to take the cash lump sum all at once, you will have to pay ordinary income tax on the entire amount received. This could result in a significant tax bill and will probably push you into a higher tax bracket.

To avoid immediate taxation on the lump sum, you have the option to do a direct rollover from your pension to a Traditional IRA (Individual Retirement Account). While a rollover to an IRA will help avoid immediate taxes on the entire lump sum, you can't avoid taxes indefinitely. IRAs are tax-deferred, meaning the funds in the account will be taxed when you withdraw the money.

Traditional IRAs have a rule to keep in mind – Required Minimum Distributions (RMDs). These accounts mandate that you withdraw a minimum amount starting at age 73*. Your RMD will be taxed as ordinary income.

For this tax strategy to be successful, it needs to be a direct rollover. You CANNOT receive the lump sum and then deposit the money into your IRA. This will trigger income taxes.

The Bottom Line

Pension income will be taxed as ordinary income, whether received as monthly payments or a lump sum. The only difference is that taking a lump sum gives you the option to do a rollover to an IRA, allowing you to defer taxes until withdrawal.

If you're deciding whether to take your pension as monthly payments or a lump sum, comparing how each option will be taxed is just the tip of the iceberg. The choice between the two should depend on your personal circumstances and long-term financial plan.