The 3 biggest tax mistakes retirees make

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Are you falling victim to one of these traps?

It's not unusual for seniors to find themselves cash-strapped in retirement. Once you stop working and move over to a fixed income, you'll probably have less financial flexibility than you did during your working years. That's why it's important to be mindful of the impact taxes will have on your finances. To avoid surprises, be sure to steer clear of these major tax mistakes.

1. Forgetting about taxes in the first place

Though there are a number of tax breaks available to seniors, many are shocked to learn that some, or most, of their income is taxable in retirement. Take Social Security, for example. Seniors without much additional income typically don't pay federal taxes on their benefits, but if you have a healthy amount of extra income coming your way, you might be taxed on your Social Security payments. To see whether you'll pay taxes on Social Security, you'll need to calculate what's known as your provisional income as follows:

- Take your total income outside of Social Security
- Add in any tax-free interest you receive (such as municipal bond interest)
- Add in 50% of your Social Security benefit amount

If your total falls between $25,000 and $34,000 as a single filer or between $32,000 and $44,000 as a joint filer, you could be taxed on up to 50% of your Social Security benefits. Furthermore, if your provisional income exceeds $34,000 as a single filer or $44,000 as a joint filer, you could be taxed on up to 85% of your benefits.

In addition to federal taxes on Social Security, these 13 states tax benefits to some degree:

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- Montana
- Nebraska
- New Mexico
- North Dakota
- Rhode Island
- Utah
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- West Virginia

But it's not just Social Security income that's taxable in retirement. Unless you have a Roth retirement account, withdrawals from your IRA or 401(k) are also subject to taxes – ordinary income taxes, in fact. If you fail to factor taxes into the equation when taking withdrawals, you could wind up with a hefty IRS bill. And if you don't have the money on hand to pay that bill, you may need to resort to withdrawing extra money from your retirement account to cover it and then paying additional taxes on that added withdrawal. Ouch.
To avoid this situation, plan to be taxed on your retirement income from the get-go and set aside money to pay whatever taxes you might end up owing. If you're not yet retired, another option is to open a Roth account or convert your non-Roth account into one. Roth withdrawals are always tax-free in retirement, and they're not subject to required minimum distributions, which, as you'll see next, can be another major tax trap for seniors.

2. Neglecting required minimum distributions

While required minimum distributions (RMDs) don't apply to Roth accounts, if you have a traditional IRA or 401(k), you'll need to start taking minimum withdrawals once you turn 70-1/2. The exact amount you'll need to take will be based on your account balance and life expectancy at the time, but if you fail to make that withdrawal, you'll lose out big time. Specifically, you'll be hit with a 50% tax penalty on whatever amount you neglect to remove from your account. So if your RMD for the year is $5,000 and you don't take it, you'll be kissing $2,500 goodbye.

It's important to pay attention to RMD deadlines so you don't get slapped with that penalty. Your initial RMD will need to be taken by April 1 of the year following the calendar year in which you turn 70-1/2. So if you turn 70 in May 2017 and 70-1/2 in November 2017, you'll need to take your first RMD by April 1, 2018. Following that initial withdrawal, you'll have until Dec. 31 of each calendar year to take your RMD.

3. Keeping sloppy health care spending records

Health care is a huge burden for retirees, and countless seniors spend a large chunk of their income on medical costs alone. But if you don't hang onto your records and receipts, you'll be doing yourself a major disservice. The reason is that if your out-of-pocket health care spending for the year exceeds 10% of your adjusted gross income (AGI), you're allowed to claim a medical expense deduction on your taxes. This means that if your AGI is $40,000, you can deduct any amount you spend above $4,000. So if your out-of-pocket costs total $6,000, you'll get a $2,000 deduction. Without proper documentation, however, you won't know how much to claim or whether you're eligible to take a deduction in the first place.

Sometimes, all it takes is a single tax error to leave you reeling financially. Avoiding these mistakes can help you better manage your money at a time when it's the most crucial.

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