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Retirement - Six Steps to Consider Before Tapping Your Retirement Savings Plan

You've worked long and hard for years, saving diligently through your employer-sponsored retirement savings plan. Now, with retirement on the horizon, it's time to begin thinking about how to tap your plan assets for income. But hold on, not so fast. You may need to take a few steps first.

Step 1: Evaluate your needs

The first step in any retirement income plan is to estimate how much income you'll need to meet your desired lifestyle. The conventional guidance is to plan on needing anywhere from 70% to 100% of your pre-retirement income each year during retirement; however, your amount will depend on your unique circumstances. While some expenses may fall in retirement, others may rise. So before even thinking about how to tap your plan assets, you should have a concrete idea of how much you'll need to (1) cover your basic needs and (2) live comfortably, according to your wishes.

First, estimate your non-negotiable fixed needs — such as housing, food, and medical care. This will help you project how much you'll need just to make ends meet. Then focus on your variable wants — including travel, leisure, and entertainment. This is the area that you'll have the easiest time adjusting, if necessary, as you refine your income plan.

Step 2: Assess your sources of predictable income

Next, you'll want to determine how much to expect from sources of predictable income, such as Social Security and traditional pension plans. These could be considered the foundation of your retirement income.

Social Security

A key decision regarding Social Security is when to claim benefits. Although you can begin receiving benefits as early as age 62, the longer you wait to begin (up to age 70), the more you'll receive each month.

The Social Security Administration (SSA) calculates your retirement benefit using a formula that takes into account your 35 highest earning years, so if you had some years of no or low earnings, your benefit amount may be lower than if you had worked steadily.

You can estimate your retirement benefit by using the calculators on the SSA website, ssa.gov. You can also sign up for a *my* Social Security account so that you can view your Social Security Statement online. Your statement contains a detailed record of your earnings, as well as estimates of retirement, survivor, and disability benefits, along with other information about Social Security.

Pensions

Traditional pensions have been disappearing from employer benefit programs over the past couple of decades. If you're one of the lucky workers who stand to receive a pension benefit, congratulations! But be aware of your pension's features. For example, will your benefit remain steady throughout retirement or increase with inflation?

Your pension will most likely be offered as either a single or joint and survivor annuity. A single annuity provides benefits until the worker's death, while a joint and survivor annuity generally provides reduced benefits until the survivor's death.[1]

Step 3: Reflect

If it looks as though your Social Security and pension income will be enough to cover your fixed needs, you may be well positioned to use your retirement savings plan assets to fund the extra wants. On the other hand, if those sources are not sufficient to cover your fixed needs, you'll need to think carefully about how to tap your retirement savings plan assets, as they will be a necessary component of your income.

Step 4: Understand your plan options

Upon leaving your employer, you typically have four options:

Keep in mind that taxable distributions from employer-sponsored plans and IRAs prior to age 59½ may be subject to a 10% penalty tax, unless an exception applies.

Qualified withdrawals from Roth 401(k) accounts are those made after a five-year holding period and in one of the following circumstances: the participant has reached age 59½, becomes disabled, or dies.

1. Plans may allow you to leave the money alone or may require that you begin taking distributions once you reach the plan's normal retirement age.
2. You may choose to withdraw the money, either as a lump sum or a series of substantially equal periodic payments for the rest of your life, or you might use other withdrawal options offered by your plan. In its 63rd Annual Survey of Profit-Sharing and 401(k) Plans, the Plan Sponsor Council of America (PSCA) found that other options included installment payments (offered in 55% of plans) and periodic/partial withdrawals (54.5%).
3. You may roll the money into an IRA. You'll want to carefully compare the investment options, fees, and expenses of both your current plan and the IRA before making any rollover decision.
4. If you continue to work during your retirement years, you may be able to roll the money into your new employer's plan, if that plan allows. Again, be sure to compare plans before making any decisions.

If, after assessing your anticipated Social Security and pension benefits, you discover they will not be enough to meet your basic needs, one option may be to use a portion of your retirement plan assets to create another source of predictable income using an annuity.

An annuity is an insurance contract designed to provide steady income over a set period of time or over either your lifetime or that of you and your spouse. According to the PSCA, just 17.2% of retirement plans in their survey offered an annuity. If your plan is not one of them, you may want to consider rolling at least some of your tax-deferred money into an IRA and purchasing an immediate fixed annuity. As noted above, however, you'll want to carefully compare fees and expenses associated with all options before making any final decisions. (Legislation passed in late 2019 has made it easier for employers to offer annuities as an option. This may result in an increase in the percentage of employers offering them.)[2]

Step 5: Compare tax deferred and tax-free

If you have both tax-deferred and Roth accounts, consider that the taxable portion of distributions from tax-deferred accounts will be taxed at your current income tax rate, while qualified withdrawals from Roth accounts are tax-free. For this reason, general guidelines often suggest tapping tax-deferred accounts before Roth accounts to allow those accounts to continue potentially growing free of taxes.

Note that all assets in employer-sponsored retirement savings plans — even money held in Roth accounts — will be subject to required minimum distributions (RMDs). These rules state that minimum distributions generally must begin once you turn age 72; however, you may delay your first distribution up to April 1 of the following year.[3]

Roth IRAs, however, are not subject to RMD rules until after your death. This is just one reason you might consider converting your employer-sponsored retirement assets to a Roth IRA. Keep in mind that a conversion will trigger an immediate tax consequence on the taxable portion of the converted assets, which can result in a hefty bill from Uncle Sam.

Step 6: Seek professional assistance

Determining the appropriate way to tap your assets can be challenging and should take into account a number of factors. These include not only your tax situation, but also whether you have other assets you'll use for income, your overall health, and your estate plan. A financial professional can help make sense of your options in light of your unique situation.

[1] Current federal law requires employer-sponsored plan participants to select a joint and survivor annuity unless the spouse waives those rights. This requirement is not mandated in an IRA, however.

[2] Generally, annuity contracts have fees and expenses, limitations, exclusions, holding periods, termination provisions, and terms for keeping the annuity in force. Most annuities have surrender charges that are assessed if the contract owner surrenders the annuity in the early years of the contract. Qualified annuities are typically purchased with pre-tax money, so withdrawals are fully taxed as ordinary income. Withdrawals prior to age 59½ may be subject to a 10% federal income tax penalty. Any guarantees are contingent on the financial strength and claims-paying ability of the issuing insurance company. It is important to understand that purchasing an annuity in an IRA or an employer-sponsored retirement plan provides no additional tax benefits other than those available through the tax-deferred retirement plan.

[3] The Setting Every Community Up for Retirement Enhancement (SECURE) Act passed in late 2019 raised the RMD age from 70½ to 72, effective January 1, 2020. Anyone who turns 72 before July 1, 2021, (and therefore reached age 70½ before 2020), will need to take an RMD by December 31, 2021.