Fix My Portfolio

I retired at 55 with $2 million in my 401(k), should I buy an annuity with the $200,000 in my taxable brokerage or use it to fund a Roth conversion?

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By Beth Pinsker Follow

A reader wants to know how to best arrange his assets so he's got guaranteed income when he's older.

When you're retired, you don't want to be all-in on any one kind of account. GETTY IMAGES/ISTOCKPHOTO

Got a question about the mechanics of investing, how it fits into your overall financial plan and what strategies can help you make the most out of your money? You can write to me at beth.pinsker@marketwatch.com.

Dear Fix My Portfolio,

I am fortunate to have retired at 55. I'm using the Rule of 55 to withdraw money from my 401(k), which is worth $2 million. I also have about $50,000 in a Roth IRA and $200,000 in a taxable brokerage. My annual expenses (which includes everything) are about $66,000, and I live in California. I am planning on taking Social Security at 65, which would be about $2,571 monthly, and am single.

Does it make sense to use all my taxable brokerage to buy a fixed-income annuity or should I use it to convert a portion of my 401(k) into a Roth? I heard it is best to use "outside" money to pay the conversion tax rather than take the tax out of the conversion.

The Roth conversion would minimize required minimum distributions later in life, but having a guaranteed income with the annuity sounds good as well. A fixed annuity at $200,000 would give about $1,051 a month.

Would either be a good strategy to use at this point of my retirement?

Thanks,

Rick

Dear Rick,

When people talk about retiring early with financial independence – the FIRE movement – they're probably thinking of a scenario like yours. You've got a lot saved up and your expenses are relatively low, so you're set to enjoy yourself.

Your question is about what to do with your taxable brokerage account money, but really it's your 401(k) that needs the most attention. If you buy an annuity or do a Roth conversion, you would most likely want to do that from 401(k) funds and leave your brokerage alone. Here's why.

Consequences of retiring early

The Rule of 55 means that you're able to take distributions from your 401(k) before age 59 ½ without paying a 10% early withdrawal penalty. You still have to pay income tax on the money you take out, however.

If you remain cautious about spending, you could withdraw your $66,000 annual spending and end up with considerably more than you started with after 40 years, assuming a very modest growth rate average of 5%.

You can use an online savings distribution calculator to play around with the numbers to see how long $2 million will last you depending on how much you withdraw each year and how the balance grows over time. Just make sure to plan for a very long life. You don't want to retire at 55 and then run out of money in your 80s, when it's too late to go back to work.

Your looming RMDs

That spend-down plan is only going to work for a little while. You need to plan ahead for required minimum distributions (RMDs), which for you will likely start when you're 75, based on Secure 2.0 rules implemented this year – and it could be even later if there are more changes down the road.

The government will require you to take out roughly 4% of your account balance to start, and then it'll shift over time. If you were turning 73 this year (which is the current RMD age), you'd have to take around $75,000 out, even if you didn't need that much for your expenses.

That's why financial planner Scott Bishop, of Avidian Wealth Solutions in Houston, suggests looking first at your 401(k) for any transactions you're going to do with an annuity, and using those funds for the purchase. What an annuity is going to do for you is take a portion of your $2 million and turn it into a guaranteed monthly payment.

And maybe not even just one annuity. Bishop says there are several different types of annuities to consider, some that will give you immediate income and others that will wait until you are older.

You might even soon be able to buy an annuity within your 401(k), but it'll depend on how fast your company plan adopts the new options, which could either be stand-alone or folded into target-date funds that shift their allocations over time.

"There's a lot of innovation in this space," says Jessica Baehr, head of group retirement for Equitable, which is developing in-plan annuity solutions. "We've seen the greatest success when an annuity is part of a target-date fund solution."

Your overall plan matters

What you're looking for is income diversification in retirement. You don't want to be all-in on any one kind of account. You want your 401(k) for tax-deferred growth, a Roth IRA for tax-free growth, a brokerage account for flexibility and an annuity and Social Security for guaranteed income.

If you look at your big picture and still want to shift more away from that big 401(k) balance, you may want to do a Roth conversion along the way. Bishop says 55 is the perfect age to consider this – up until the age you enroll in Medicare at 65. After that point, the increased income may cause you headaches with higher IRMAA premiums and higher taxes on your Social Security benefits. You can do small amounts over the next 10 years to reduce the tax burden, and figure out with an accountant the most efficient way to pay the tax because the answer on that is complicated.

And with that said, why take Social Security at 65? Given your assets, you would receive more if you wait at least until your full retirement age at 67, and you'd maximize your monthly checks if you wait until 70.

Bishop says the two key questions to ask yourself are these:

- How much income do you need and will it ever change?
- How can you "mute" the future taxes? If you annuitize the brokerage, for instance, and let the 401(k) grow, you may have large RMD issues later.

What to do with the brokerage account, then? Leave it as is, perhaps. "Brokerage accounts can also be used for unexpected 'lump-sum' expenses so that it will not all be ordinary income," says Bishop. "What if you need to pay a health bill or fix your roof? Any money lump sum out of brokerage would be more tax-efficient in many cases."

Keeping that account invested for capital gains and qualified dividends treatment will help you have an overall balanced portfolio.

April is National Financial Literacy Month. To mark the occasion, MarketWatch will publish a series of "Financial Fitness" articles to help readers improve their fiscal health, and offer advice on how to save, invest and spend their money wisely. Read more here .

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Beth Pinsker is a financial-planning columnist at MarketWatch. She has been a certified financial planner (CFP®) since 2018. Previously, she was a personal finance columnist and editor at Reuters, an editorial director at Fidelity and editor-in-chief of Walletpop.com. Prior to covering personal finance, she was a film critic and entertainment business reporter, writing for Entertainment Weekly, The Dallas Morning News and many more publications. You can follow her on Twitter @bethpinsker.