Which Accounts Should I Draw From in Retirement?

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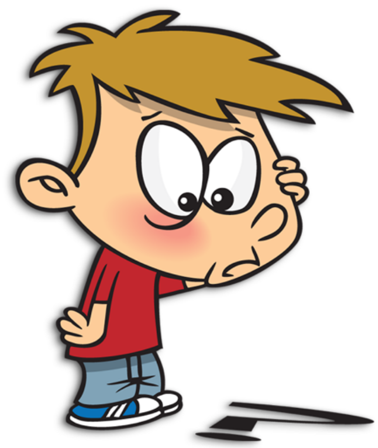

How do I get money in retirement? While the idea of not working should be relaxing, the lack of a steady paycheck can often bring anxiety and stress. Before you retire, you'll have to strategize which retirement and investment accounts will replace your paycheck. Many questions will arise as you sort through each account and its various tax implications.

You'll often find a generalized recommendation advising you to pull from taxable accounts first. However, we believe only withdrawing from one account can limit your flexibility in retirement and force you into higher tax rates further down the line.

What Are the Three Types of Accounts I Could Pull From?

Using a mixture of taxable, tax-deferred, and tax-exempt accounts strengthens your retirement strategy. By diversifying withdrawals, you can control your taxable income to stay in lower tax brackets. However, it can be easy to confuse which account is which:

> **Taxable Investment Accounts:** Refers to checking, savings, and brokerage accounts. Since these accounts are funded with after-tax dollars, withdrawals are tax-free. You must pay taxes annually on income and net realized gains (i.e., dividends, interest, and gains from investments sold) in these accounts.
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> **Tax-deferred Retirement Accounts:** These accounts, such as your 401(k) or traditional Individual Retirement Account (IRA), are funded with pre-tax money. While investment income and gains are not taxable, you will pay income tax on money withdrawn from

these accounts in retirement. If you need to withdraw money from these accounts before age $59^{1/2}$, you'll likely be subject to a 10% penalty as well as taxes.

Tax-exempt Retirement Accounts: Tax-exempt, otherwise known as Roth accounts, are funded with after-tax dollars. Investment income and gains in the account are not taxable, and withdrawals will be tax-free. These rules make Roth money some of the most coveted savings for one's retirement.

How Much Will I Need in Retirement?

Your primary goal in retirement is to have enough income to support your lifestyle. To do this, many look at their previous paychecks to estimate how much they might need. However, you probably need less than you think.

During your career, you were building up emergency savings, preparing for retirement, and paying taxes. When you retire, you no longer need to save in your 401(k) and you won't need to pay Federal Insurance Contributions Act (FICA) taxes (FICA combines your Social Security and Medicare taxes and is automatically deducted from your paycheck).

Since these expenses disappear, you don't need to budget for them in retirement. For instance, if you made $150,000 a year and on average budgeted $50,000 for saving and tax purposes, you may only need $100,000 a year to maintain a similar lifestyle.

Where Do I Get My Withdrawals?

There is a lot to consider when strategizing withdrawals, which is why you shouldn't follow blanket advice. While front-loading taxable withdrawals may minimize your tax liability at the beginning of your retirement, it could force your future self into higher tax rates. Only exclusively pull from taxable accounts if you're trying to qualify for certain benefits that have income limitations (i.e., low capital gains tax rates and Medicare premiums). Aside from one-off situations, most investors should draw from a combination of taxable and tax-deferred accounts. By having control over your taxable income, you can stay in lower tax brackets over longer periods of time.

To successfully do this, you need to be familiar with the current year's tax schedule. Knowing how much taxable income you (or if you're married and filing jointly, you and your spouse) plan to receive annually can help you closely estimate how much you'll be taxed.

Think of tax brackets like buckets, each one bigger than the last. You have seven federal tax brackets (seven different buckets) and every time you fill up one bucket, the rest spills into the next to be taxed at a higher rate. For instance, those filing jointly with their spouse need to keep their taxable income less than $89,450 to stay in the 12% tax bracket. Any more taxable income will spill over into the 22% tax bracket. Following this example, you can pull $89,450 from tax-deferred accounts and supplement the rest with taxable accounts. Although you'll have to account for realized gains in your taxable income, withdrawals from these accounts will be tax-free.

Keep in mind, taxable income includes Required Minimum Distributions (RMDs) from tax-deferred accounts. as well as Social Security benefits. Therefore, plan accordingly around your monthly benefits and retirement account withdrawals. If you still need more income, you can draw from tax-exempt accounts, like a Roth IRA. We often recommend pushing off withdrawals from Roth accounts for as long as possible. The tax benefits are hard to beat, so it's best to let them grow tax-free until you need the money.

The Bottom Line

The conventional advice to minimize tax implications at the beginning of your retirement can only limit your flexibility in future years, forcing you into higher tax rates. Aside from specific circumstances, there is often little benefit in only pulling from taxable accounts. Instead, diversify your withdrawals between taxable, tax-deferred, and tax-exempt accounts to stay in more favorable tax brackets.