Part Three: Things to Know Before Retirement - Retirement Accounts

Planning for retirement may feel like trying to solve a complex puzzle, and sometimes you may need help to put all the pieces in the right place. In previous parts of the series, we discussed **Social Security** and **Medicare**, critical puzzle pieces as you enter retirement.

In this final installment of our retirement series, we focus on your retirement accounts, one last piece of that puzzle.

While Social Security provides a steady income stream during retirement, most of your financial independence lies within your retirement accounts. These accounts represent the fruit of your labor, diligently saved and invested throughout your career.
As we explore this final segment of our retirement series, we will dissect the complexities of retirement accounts, pinpoint critical timelines, and outline strategies designed to boost your savings and secure a comfortable retirement.

A Guide to Tax-Qualified Retirement Savings Accounts:

Different retirement accounts offer varying benefits. Your choice typically depends on your income today compared to your expected income tax bracket at retirement and benefits provided by your employer, like matching 401(k) contributions.

- **401(k):** Most common among full-time employees, a 401(k) often comes with a sweetener; your employer may match part of your contributions, helping you grow your retirement funds faster. Also, a 401(k) has higher contribution limits which can be important if you start saving late for retirement.

- **Defined Benefit Plans:** A Defined Benefit Plan, also known as a pension plan, is a type of retirement plan that an employer sponsors, where the benefits that you receive in retirement, typically in the form of monthly income, are calculated using a specific formula. This formula typically considers factors such as your salary, age, and the number of years you worked for the company.

  One way of viewing a Defined Benefit Plan is like a "retirement paycheck" that your employer would give you for the rest of your life once you retire, based on your earnings and years of service. It's like a reward for the years you spent working for the company.

  Having said that. Defined Benefit Plans have become less common in recent years, as many employers have shifted to Defined Contribution Plans like 401(k)s.

- **Traditional IRA:** A Traditional IRA can be a good choice for those anticipating a lower tax bracket at retirement. The reason is that a traditional IRA offers a tax deduction now while working and likely in a higher tax bracket and defers your taxes until you retire at a possibly lower tax bracket.

- **Roth IRA:** What if you expect to be in a high tax bracket when you retire? A Roth IRA might be your best bet. Your contributions to a Roth IRA are after tax, meaning you already paid taxes on that money. However, with a Roth IRA, your withdrawals are tax-free. A Roth IRA could be a viable option for those who want to avoid tax surprises in retirement.

- **SEP IRA, SIMPLE IRA, and Solo 401(k):** These plans cater to the self-employed and small business owners. They offer varying benefits like higher contribution limits (SEP IRA and Solo 401(k)) and mandatory employer contributions (SIMPLE IRA).

When Can I Dip Into My Retirement Funds?

An essential aspect of retirement planning is pinpointing critical timelines –knowing when to tap into your retirement accounts. Withdrawing too early may face penalties; too late, you may miss the optimum tax benefits.

Let us explore two important aspects of this:

- Withdrawals before age 59 ½
- Required Minimum Distributions

Withdrawals Before Age 59 ½

For most qualified plans, such as a 401(k) or a Traditional IRA, if you withdraw funds before you reach the age of 59 1/2, you will generally have to pay an early withdrawal penalty of 10% on the distribution amount. Please remember that this would be in addition to the regular income tax you will owe on the withdrawal.

The rules are different for Roth IRAs. You can always take the contributions to your Roth IRA both tax and penalty-free. It is tax and penalty-free because the money you placed in the Roth IRA you already paid taxes on, and you cannot be taxed twice.

Your earnings in a Roth IRA are tax and penalty-free as long as the account has been open for at least five years and the Roth IRA owner is at least 59 1/2 years old. If you do not meet either of these two conditions, you will owe taxes on the earnings removed from your Roth IRA, and you will be subject to the 10% penalty.

Generally, the magic age is 59 ½ - when you can begin penalty-free withdrawals from most accounts.

Required Minimum Distributions (RMD)

In simple terms, an RMD is the minimum amount you must withdraw from certain types of retirement accounts each year once you reach a certain age. The U.S. government requires this to ensure that people don't just accumulate money in these tax-advantaged accounts forever and never pay taxes on it.

When considering RMDs, your age and the type of retirement plan are important factors.

- ***Roth qualified plans*****:** For Roth IRA and Roth 401(k) plans, there is never an RMD required because the government already received the taxes on the contributions in these plans. The “no RMD” feature of a Roth-qualified plan makes this type of retirement saving plan a good choice when you have other income in retirement and do not need to use your IRA.

- **Traditional IRA and qualified plans:** Regarding RMDs, there are two dates and ages to keep in mind. In 2023 the age to start taking RMDs moves from age 72 to age 73. However, beginning in 2033, the RMD age will leap to age 75.

Qualified Charitable Distributions (QCDs)

A Qualified Charitable Distribution allows those aged 70 ½ and older to donate directly from their IRA to a charity, which could effectively reduce the taxable income at retirement.

A QCD may be appropriate for those who are charitably inclined and do not need their RMDs for living expenses.

Here are some of the key points about QCDs:

- **If you meet certain rules, QCDs count toward satisfying your required minimum distributions (RMDs) for the year.**
- **The maximum annual amount to qualify for a QCD is $100,000, indexed for inflation. This amount applies to the sum of QCDs made to one or more charities in a calendar year.**
- **You do not include QCDs in your taxable income. This feature of a QCD is unlike regular withdrawals from an IRA, which typically count as taxable income.**
- **The contribution made to the charity must go directly from the custodian of your IRA to the charity.**
- **Because you do not include the QCD distribution in your income, you don't get to claim a charitable contribution deduction, but the trade-off is that it can help keep your taxable income lower.**

Guidance for your Golden Year

Consider Roll Over: You might have multiple 401(k) accounts when you move from job to job. Consider rolling these 401(k) plans into an IRA to consolidate your assets for simpler management and broader investment options.

Match Game: If your employer offers a 401(k) match, take full advantage of it. It's a good opportunity to maximize your retirement savings.

Delay, If You Can: If you do not need to tap into your retirement savings immediately, consider delaying your withdrawals. The longer your money stays invested, the more potential it must grow in a tax-advantaged manner.

Mind the Tax: Consider your retirement accounts as part of your tax planning. Balancing withdrawals from taxable and tax-free accounts could potentially optimize your tax liability.

Consider Professional Help: Navigating the retirement landscape can be complicated. Working with a financial advisor may provide valuable insights tailored to your situation.

Summary

Remember, planning for your retirement is never too early or too late. You can chart a comfortable and secure retirement course with the proper knowledge, tools, and advice.

Retirement is not an end - it's a beautiful new beginning. A beginning where you have the time and freedom to pursue what you love, spend time with loved ones, and truly savor the fruits of your labor.

It is a journey worth preparing for.

Sources

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