Retirement Withdrawal Strategies

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The strategy in which a person withdrawals from their retirement portfolio can have a meaningful impact on their financial wellbeing during retirement. In order to be strategic in retirement withdrawals, one must first understand the withdrawal rules and consequences from certain accounts. Each type of savings vehicle has its own set of withdrawal rules. A few types of retirement accounts that will be discussed are: Traditional IRAs, Roth IRAs, and 401ks.

When can withdrawals be made from an IRA?
Withdrawals may begin at age 59.5 years old penalty-free. However, any funds withdrawn from a Traditional IRA is classified as taxable income. Early withdrawals can also be made, although the owner of the IRA will incur an additional 10% penalty on any funds withdrawn. There are exceptions that may apply to void the 10% withdrawal penalty, including death, disability, qualified higher education expenses, qualified first time home-buyers, and qualified medical expenses. Additionally, one may make withdrawals from an IRA while still working after age 59.5 with no penalty.

When can withdrawals be made from a 401k?
401k plans are company specific and may have different rules that need further detailed analysis. Generally speaking, 401k plans have similar traits to Traditional IRAs. Funds withdrawn from a 401k are also classified as taxable income. Withdrawals may begin penalty-free at age 59.5 years old, as long as the plan allows for it. Depending on the plan specific rules, early withdrawals may be allowed, although the owner of the 401k will incur the additional 10% penalty on any funds withdrawn. There may be exceptions that apply to void the 10% withdrawal penalty. In addition to withdrawals, some 401k plans allow for loans to be taken from the plan, with a specific payback schedule.
Please note: Typically, the 401k owner must be separated from the company that sponsors the 401k before being able to make withdrawals from the 401k. However, there are plans that specify otherwise and allow in-service distributions.

When must distributions be made from retirement accounts?
Eventually, funds must be distributed from *most* retirement accounts, whether the account owner has a need for the funds or not. For tax-deferred accounts, like Traditional IRAs and 401ks, distributions generally must be made from these accounts once the account owner reaches age 73, due to the SECURE 2.0 Act. The amount that is required to be withdrawn is called a **required minimum distribution or RMD**. The RMD is recalculated each year based on factors, such as age and account balance based on the 12/31 value of the previous year. Prior to 2023, there was a heavy 50% penalty on any remaining balance of the RMD that the account owner failed to distribute by the end of the year. The SECURE 2.0 Act has reduced this penalty to 25%.

Please note: The rules for tax-exempt accounts, such as Roth IRAs differ. As the account owner will not be required to make distributions. However, after the account owner's death, the party that inherits the Roth IRA must make distributions from the Inherited Roth IRA.

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Establishing a withdrawal strategy is essential to provide the income needed to fund retirement, whether those investments are held in an IRA, a 401(k) or another type of plan.
Consider these two common strategies:

1) Fixed-percentage withdrawals
2) Fixed-dollar withdrawals

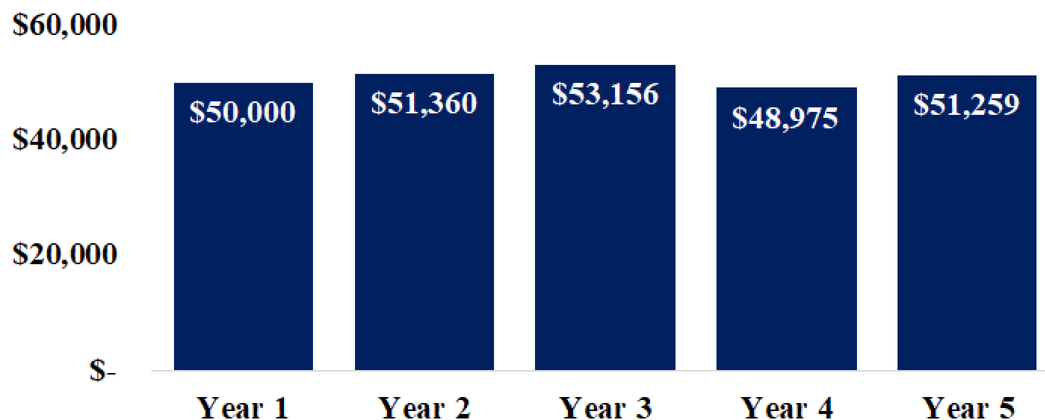
What are fixed-percentage withdrawals?

The fixed-percentage withdrawal is when the retiree withdrawals a certain percentage, say 4%, of their retirement savings each year during retirement. The retiree continues to withdrawal this same percentage of their retirement assets in the following years, regardless of market growth or a regression in the markets.

For example, if the retiree has $1,250,000 saved under this strategy, they would withdraw 4% or $50,000 during the first year in retirement. The portfolio would then have a value of $1,200,000. However, if the market returned 7% throughout the year, the portfolio would have grown to be $1,284,000 by the end of the year. The second year, the retiree would once again withdraw 4% from the portfolio. Although now 4% would result in $51,360 being withdrawn from the portfolio. The retiree will repeat this process each year.

Potential advantages: This has been a longstanding retirement withdrawal strategy to minimize longevity risk. Many retirees value this strategy because it's easy to follow and provides the opportunity for the portfolio to maintain the principal.

Potential disadvantages: The amount withdrawn may change year-to-year depending on market returns. During dips in the market, the retiree will withdrawal the same percentage, but less dollars. Therefore, the retiree must be able to adjust their spending to the different withdrawals.



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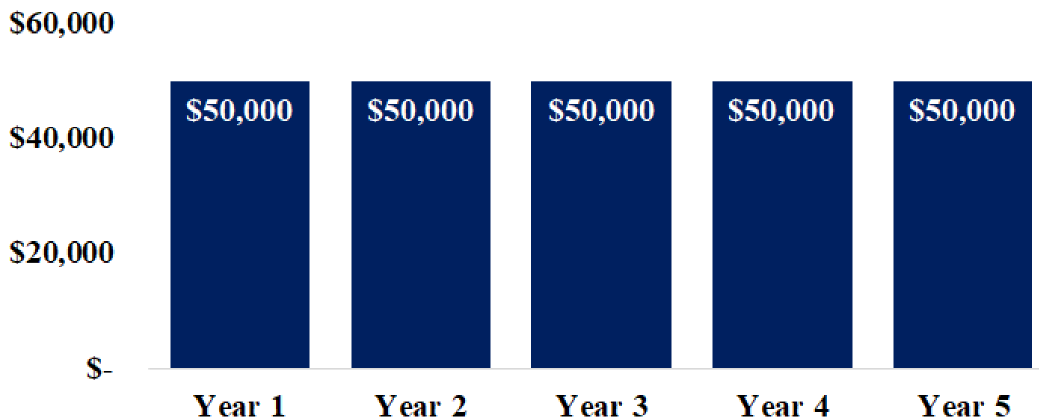
What are fixed-dollar withdrawals?

Another strategy for retirees is the fixed-dollar withdrawal strategy. This is when the retiree withdrawals a fixed amount, say $50,000, of their retirement savings each year during retirement. The retiree continues to withdrawal the same dollar amount in subsequent years, regardless of market growth or a regression in the markets.

For example, a retiree may withdraw $50,000 annually and then reassess the dollar amount needed at the end of a five-year period. While this provides predictable annual income (which can help the retiree budget accordingly), it doesn’t do much to protect against inflation. In addition, the principal could erode depending on the dollar amount withdrawn. Furthermore, if investments are currently down in value due to market volatility, it could lead the retiree to sell more assets in the portfolio to meet the withdrawals needed.

Potential advantages: This approach can simplify personal money management, as the retiree is on a fixed budget.

Potential disadvantages: This approach doesn’t protect against inflation. For example, $50,000 today may not have the same purchasing power one year from now. Additionally, in a down market, you may have to liquidate more assets to meet your fixed-dollar withdrawal.



Additional Considerations

This article is simply an introductory overview. There are many additional complexities not explained, as each individual's financial situation differs. In order to optimize strategy, one must incorporate their full financial picture when planning. This includes tax strategy, pensions, retirement savings, Social Security Benefits, additional savings, etc. We strongly recommend working with an advisor to achieve optimization. If you would like to discuss strategies further, please reach out to Landmark Wealth Management. Our advisors would be happy to assist.

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