GAZETTE SENIORS

# RETIREMENT ACCOUNTS

## ◆ What you need to know about when and how to tap into them ◆

BY KAREN FINUCAN CLARKSON

What goes in must come out. So says the Internal Revenue Service. In the case of individual retirement accounts or employer-sponsored retirement plans—401(k), 403(b) or 457(b)—it literally pays to understand when and to what extent you must tap those accounts. Otherwise, penalties may accrue.

When it comes to utilizing retirement funds, many factors come into play—tax and employment status, pension and Social Security income, family, health and lifestyle. "As you near retirement, it's important to calculate how much you'll need to withdraw and with what frequency so that your money will last throughout your lifetime," said Ted Davis, a private wealth advisor and certified financial planner with Davis and Devine, a financial advisory practice of Ameriprise Financial Services Inc. in Fairfax, Va.

Retirement plans, either individual or employer-sponsored, are taxed in one of two ways "and it's helpful to understand the difference," said Davis. Traditional IRAs and most 401(k), 403(b) and 457(b) accounts are tax deferred. The idea is that you make contributions when you are in a higher tax bracket and need the deduction and you take withdrawals when you are in a lower tax bracket and need funds for retirement. "The money grows tax-deferred but distributions are taxed at whatever your tax rate is when you withdraw."

There are tax-free retirement accounts. Roth IRAs and some employer-sponsored plans are comprised of after-tax dollars. As a result, when distributions are taken, neither the principal nor earnings are taxed, noted Clark Kendall, president and founder of and a certified financial planner with Kendall Capital Management in Rockville.

IRS rules governing withdrawals from the two types of retirement plans differ. Generally, to tap a Roth IRA without penalty, you must be at least 59½ years of age and the account must have been in existence for at least five years. You are not required to take a distribution from a Roth, no matter what your age, and if you do withdraw, there is no minimum or maximum.

If you have a traditional IRA, you may begin taking distributions as early as age 59½ but you must start drawing down funds from the account by April 1 of the year following the year in which you turn 70½. Failure to do so could result in a 50 percent tax on the amount that should have been withdrawn. That is more than you would pay if you had taken the required distribution. For example, if your mandated withdrawal was $1,000 and you failed to make it, you could incur a penalty of $500. That is $104 higher than the tax you would pay if you were in the top—39.6 percent—tax bracket and followed the rules.

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IRS Publication 590 includes three tables that stipulate how much you must withdraw based on age and life expectancy. Most retirees, according to Davis, use the Uniform Lifetime Table, which covers unmarried owners, married owners whose spouses are not more than 10 years younger, and married owners whose spouses are not the sole beneficiaries of the IRA.

For example, a 71-year-old with $100,000 in an IRA is required to withdraw a minimum of $3,774 this year, as his life expectancy is 26.5 years. A 72-year-old with the same amount in an IRA must withdraw at least $3,906, as he is expected to live 25.6 years. "The required minimum distribution is recalculated at the end of every year," said Kendall. "At 98, when you have a life expectancy of seven years, you're required to take out one-seventh, or about 14 percent, of what remains in your IRA."

Just because you have to withdraw the funds doesn't mean you have to spend them. Depending on your situation, you may choose to invest them, said Kendall.

Ascertaining whether the minimum is sufficient to support your retirement needs requires planning. "I call it calculating your magic number," said Kendall, "and there are many variables that go into that."

"Longevity is a huge concern," said Kendall. Unless you are in poor health, "plan for a long retirement. A 65-year-old couple has a joint life expectancy of more than 26 years and there's a 50 percent chance that one of the two will see a 91st birthday." Funds may need to cover not several years but several decades of retirement.

Determining how much cash you'll need and when to withdraw it begins with an analysis of anticipated expenses. Start with essential expenses, suggested Davis, such as mortgage, taxes, utilities, home maintenance, insurance, medical, clothing and groceries. "There may be some expenses—a golf club membership or maintaining a horse—that one person views as essential and another considers discretionary," he said. "Then think about what you want to do in retirement—go on a cruise or live abroad .... These are things that, if life gets tough, can be delayed."

Lifestyle expenses are likely to be greater in the first decade of retirement, noted Kendall. "It's not unusual when



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people first retire to want to travel—to Italy or China—so they spend more money during that time. Between 75 and 85, they often become less focused on seeing the world and more on seeing their grandchildren," he said. By their late 80s or early 90s, the focus shifts to more sedentary activities.

But, as lifestyle expenses decrease, medical expenses often increase. There is, according to Kendall, a 30 percent chance that you will end up in a nursing home at a cost of roughly $100,000 a year. Some of that expense may be offset by government programs and savings in essential expenses, such as housing, taxes and food. Because the life expectancy of those in a nursing home drops precipitously, "I can, when doing financial plans, say with 97 percent confidence that a stay in a nursing home won't go beyond five years," he said.

Consider how much of your retirement savings you can afford to set aside for long-term care and for what length of time. Then, review "all sources of known income that you can count on," said Davis. That includes nonqualified accounts, such as those with banks and brokerages, pensions and Social Security. "Once you add up the guaranteed sources of income and subtract expenses, you'll have a shortfall. That gap is what we want to address with retirement assets."

Ideally, said Kendall, to stretch retirement funds over a lifetime, couples between the ages of 65 and 75 should be looking at no more than a 4 percent distribution rate. As your life expectancy and amount of retirement savings decrease, the distribution rate rises. For those between 70 and 80, "a distribution rate of 5 percent is probably okay," said Kendall, "and from 75 to 85 they can do 7 to 8 percent."

Positioning retirement assets to provide an income stream that addresses your monthly shortfall is important. "Typically, we look at retirement assets as being in one of three buckets," said Davis. "The first is one year's worth of shortfall—say $50,000. It should be liquid, sitting in a safe reliable cash account."

The second bucket "is short-term—investments you plan to hold two to five years. The objective is to earn a better rate of return and use the interest to help replenish funds you're drawing down from the first bucket," said Davis. "Risk attitudes will come into play."

"The third is positioned for growth. That money can be positioned in the market consistent with a client's risk tolerance: conservative, moderate or aggressive. Profits are moved to the second bucket, which then replenishes funds in the first," said Davis. "It's a sort of cascading effect."

For those with traditional IRAs or employer-sponsored plans, "we want to minimize the tax hit," said Davis. "So what's the right order to withdraw money? First from nonqualified accounts and then from IRAs."

Funds remaining in a retirement account may be bequeathed to a person or institution. To avoid complications, be certain you have completed a beneficiary designation form and filed it with the institution holding the account rather than naming the beneficiary in your will, said Kendall.

While it is possible for individuals to navigate the financial aspects of retirement on their own, assistance from a tax advisor and financial planner can go a long way toward insuring that retirement funds are maximized. "At the end of the day, retirement should be hassle- and stress-free," said Davis. "You should enter it saying, 'Yes! It truly is everything it's cracked up to be.'"