



### O'Keefe Investment Management, LLC

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# OIM

O'KEEFE INVESTMENT MANAGEMENT

## Converting Savings to Retirement Income

During your working years, you've probably set aside funds in retirement accounts such as IRAs, 401(k)s, or other workplace savings plans, as well as in taxable accounts. Your challenge during retirement is to convert those savings into an ongoing income stream that will provide adequate income throughout your retirement years.

### Setting a withdrawal rate

The retirement lifestyle you can afford will depend not only on your assets and investment choices, but also on how quickly you draw down your retirement portfolio. The annual percentage that you take out of your portfolio, whether from returns or both returns and principal, is known as your withdrawal rate. Figuring out an appropriate initial withdrawal rate is a key issue in retirement planning and presents many challenges. Why? Take out too much too soon, and you might run out of money in your later years. Take out too little, and you might not enjoy your retirement years as much as you could. Your withdrawal rate is especially important in the early years of your retirement, as it will have a lasting impact on how long your savings last.



One widely used rule of thumb on withdrawal rates for tax-deferred retirement accounts states that withdrawing slightly more than 4% annually from a balanced portfolio of large-cap equities and bonds would provide inflation-adjusted income for at least 30 years. However, some experts contend that a higher withdrawal rate (closer to 5%) may be possible in the early, active retirement years if later withdrawals grow more slowly than inflation. Others contend that portfolios can last longer by adding asset classes and freezing the withdrawal amount during years of poor performance. By doing so, they argue, "safe" initial withdrawal rates above 5% might be possible. (Sources: William P. Bengen, "Determining Withdrawal Rates Using Historical Data," *Journal of Financial Planning*, October 1994; Jonathan Guyton, "Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?," *Journal of Financial Planning*, October 2004.)

Don't forget that these hypotheses were based on historical data about various types of investments, and past results don't guarantee future performance. There is no standard rule of thumb that works for everyone—your particular withdrawal rate

needs to take into account many factors, including, but not limited to, your asset allocation and projected rate of return, annual income targets (accounting for inflation as desired), and investment horizon.

### Which assets should you draw from first?

You may have assets in accounts that are taxable (e.g., CDs, mutual funds), tax deferred (e.g., traditional IRAs), and tax free (e.g., Roth IRAs). Given a choice, which type of account should you withdraw from first? The answer is—it depends.

For retirees who don't care about leaving an estate to beneficiaries, the answer is simple in theory: withdraw money from taxable accounts first, then tax-deferred accounts, and lastly, tax-free accounts. By using your tax-favored accounts last, and avoiding taxes as long as possible, you'll keep more of your retirement dollars working for you.

For retirees who intend to leave assets to beneficiaries, the analysis is more complicated. You need to coordinate your retirement planning with your estate plan. For example, if you have appreciated or rapidly appreciating assets, it may be more advantageous for you to withdraw from tax-deferred and tax-free accounts first. This is because these accounts will not receive a step-up in basis at your death, as many of your other assets will.

However, this may not always be the best strategy. For example, if you intend to leave your entire estate to your spouse, it may make sense to withdraw from taxable accounts first. This is because spouses are given preferential tax treatment with regard to retirement plans. A surviving spouse can roll over retirement plan funds to his or her own IRA or retirement plan, or, in some cases, may continue the deceased spouse's plan as his or her own. The funds in the plan continue to grow tax deferred, and distributions need not begin until the spouse's own required beginning date.



The bottom line is that this decision is also a complicated one. A financial professional can help you determine the best course based on your individual circumstances.

## Certain distributions are required

In practice, your choice of which assets to draw first may, to some extent, be directed by tax rules. You can't keep your money in tax-deferred retirement accounts forever. The law requires you to start taking distributions--called "required minimum distributions" or RMDs--from traditional IRAs by April 1 of the year following the year you turn age 70½, whether you need the money or not. For employer plans, RMDs must begin by April 1 of the year following the year you turn 70½ or, if later, the year you retire. Roth IRAs aren't subject to the lifetime RMD rules.

If you have more than one IRA, a required distribution is calculated separately for each IRA. These amounts are then added together to determine your RMD for the year. You can withdraw your RMD from any one or more of your IRAs. (Your traditional IRA trustee or custodian must tell you how much you're required to take out each year, or offer to calculate it for you.) For employer retirement plans, your plan will calculate the RMD, and distribute it to you. (If you participate in more than one employer plan, your RMD will be determined separately for each plan.)

It's important to take RMDs into account when contemplating how you'll withdraw money from your savings. Why? If you withdraw less than your RMD, you will pay a penalty tax equal to 50% of the amount you failed to withdraw. The good news: you can always withdraw more than your RMD amount.

## Annuity distributions

If you've used an annuity for part of your retirement savings, at some point you'll need to consider your options for converting the annuity into income. You can choose to simply withdraw earnings (or earnings and principal) from the annuity. There are several ways of doing this. You can withdraw all of the money in the annuity (both the principal and earnings) in one lump sum. You can also withdraw the money over a period of time through regular or irregular withdrawals. By choosing to make withdrawals from your annuity, you continue to have control over money you have invested in the annuity. However, if you systematically withdraw the principal and the earnings from the annuity, there is no guarantee that the funds in the annuity will last for your entire lifetime, unless you have

separately purchased a rider that provides guaranteed minimum income payments for life (without annuitization).

In general, your withdrawals will be subject to income tax--on an "income-first" basis--to the extent your cash surrender value exceeds your investment in the contract. The taxable portion of your withdrawal may also be subject to a 10% early distribution penalty if you haven't reached age 59½, unless an exception applies.

A second distribution option is called the guaranteed\* income (or annuitization) option. If you select this option, your annuity will be "annuitized," which means that the current value of your annuity is converted into a stream of payments. This allows you to receive a guaranteed\* income stream from the annuity. The annuity issuer promises to pay you an amount of money on a periodic basis (e.g., monthly, quarterly, yearly).

If you elect to annuitize, the periodic payments you receive are called annuity payouts. You can elect to receive either a fixed amount for each payment period or a variable amount for each period. You can receive the income stream for your entire lifetime (no matter how long you live), or you can receive the income stream for a specific time period (ten years, for example). You can also elect to receive annuity payouts over your lifetime and the lifetime of another person (called a "joint and survivor annuity"). The amount you receive for each payment period will depend on the cash value of the annuity, how earnings are credited to your account (whether fixed or variable), and the age at which you begin receiving annuity payments. The length of the distribution period will also affect how much you receive. For example, if you are 65 years old and elect to receive annuity payments over your entire lifetime, the amount of each payment you'll receive will be less than if you had elected to receive annuity payouts over five years. Each annuity payment is part nontaxable return of your investment in the contract and part payment of taxable accumulated earnings (until the investment in the contract is exhausted).

\*Guarantees are subject to the claims-paying ability of the issuing insurance company.



## Disclosure Information -- Important -- Please Review

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