For Retirement, Income Matters as Much as Savings

A recent poll of pre-retirees suggests that truth risks being ignored.

Provided by Ivana Lotoshynski, CFP®

Steady income or a lump sum? Last year, financial services firm TIAA asked working Americans: if you could choose between a lump sum of $500,000 or a monthly income of $2,700 at retirement, which choice would you make?[1]

Sixty-two percent said that they would take the $2,700 per month. Figuring on a 20-year retirement for today's 65-year-olds, $2,700 per month comes to $648,000 by age 85. So, why did nearly 40% of the survey respondents pick the lump sum over the stable monthly income?[1]

Maybe the instant gratification psychology common to lottery winners played a part. Maybe they ran some numbers and figured that the $500,000 lump sum would grow to exceed $648,000 in twenty years if invested – but there is certainly no guarantee of that. Perhaps they felt their retirements would last less than 20 years, as was the case with many of their parents, making the lump sum a "better deal."

The reality is that once you retire, income is the primary concern. The state of your accumulated retirement savings matters, yes – but retirement is when you start to convert those savings to fund your everyday life.

Could you retire with income equivalent to 80% of your final salary? If you have saved and invested consistently through the years, that objective may be achievable.

Social Security replaces about 40% of income for the average wage earner. (For those at higher income levels, the percentage may be less.) So where will you get the rest of your retirement income? It could come from as many as six sources.[2]

Systematic withdrawals from retirement savings and investment accounts. You may start taking distributions from these accounts at an initial withdrawal rate of 4% (or less). If these accounts are quite large, the income taken could even match or exceed your Social Security benefits.[3]

Private income contracts. Some retirees opt for these, though the income they receive may not be immediate.

Pensions. The health of some pension funds notwithstanding, here is another prime source of income.

Your home. Selling an expensive residence and buying a cheaper one can free up equity and reduce future expenses, thereby leaving more money for you to live off in the future.

Passive income streams. Examples include business income produced without material participation in the business, rental income, dividends, and royalties.

Work. Part-time work also lessens the pressure to draw down balances in your retirement and investment accounts.

Work longer, and you may indirectly give your retirement income a boost. One recent analysis from the National Bureau of Economic Research concluded that by delaying your retirement even three to six months, you could give yourself the potential to raise your standard of living in retirement as much as you would if you save 1% more of your pay over 30 years.[3,4]

Remember that earning too much in retirement can impact your Social Security benefits. Part of them can be taxed if your "provisional income" surpasses a certain threshold.

Social Security calculates your provisional income with the following formula: provisional income = your modified adjusted gross income + 50% of your yearly Social Security benefits + 100% of tax-exempt interest that your investments generate. (Since pension payments and retirement account withdrawals are considered ordinary income by the federal government, they both count in this formula.)[3,5]

If you are a married taxpayer who files a joint income tax return, as much as 50% of your Social Security benefits can be taxed if your provisional income tops $32,000, and as much as 85% if it exceeds $44,000. For single filers, the 50%/85% taxation thresholds are set at $25,000 and $34,000.[5]

Although your retirement benefits may be taxed, more retirement income is decidedly better than less – and a key part of retirement planning is estimating both your retirement income need and your retirement income potential. Talk to a financial professional about that matter before you retire.

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Citations.

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