Retirement Traps

#2: The Access Trap

Just to re-cap, the first Retirement Trap was the Tax Trap – Deduct Now, Pay Later. You will pay more to Uncle Sam in the long run by taking a deduction now into your qualified account (IRA, 401k, etc) than you will actually save in taxes. Would you rather pay taxes on the seed or the crop?

Now onto the Access Trap…Almost all qualified accounts have an age limit of 59 ½ before you can access it without penalties. The penalty to access your money prior to age 59 ½ is 10% plus ordinary income tax. So, if you are in a 25% tax bracket you will be paying 35% to access your money – YOUR money. It kind of takes the idea of retiring early out of the picture doesn't it? There are circumstances where you can access your funds prior to that age, but they do not revolve around retirement, more for emergency funds for medical or first-time home buying.

What would you do if you could access your retirement accounts prior to 59 ½? Would you leave your current job and take on something that you had hoped you could do? Would you take a couple of years off? Spend more time with the grandkids?

We spend so much time accumulating our retirement funds that we rarely sit back and think about how we are going to access our money. Further, most advisors that people sit down with are unfamiliar with any other than qualified accounts…I mean, my parents told me to sock away as much into my 401k as possible since that's what everyone needs to do, right? Maybe.

There is no bad retirement account. What's important is to realize what types of accounts you have and how they fit into your overall retirement plan. Take the bucket approach to retirement. What I mean by this is having your market-based investments such as your 401k and IRA, your emergency cash funds, and your guaranteed accounts. As you get older you reallocate your funds more towards the guaranteed accounts and away from the market (I don't think anyone wants a repeat of 2008 and the dramatic effect that had).

One more thing, most people are aware of the first age limit, 59 ½, but most are unaware of the second, age 70 ½. The IRS stipulates that if you do not take out what is called your Required Minimum Distribution, you will be assessed a 50% penalty, yes 50%, AND ordinary income tax. That's 75% for someone in a 25% tax bracket. More about that in the next paper, the Distribution Trap.