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5 Mistakes When Withdrawing Money for Retirement

Your traditional 401(k) and IRA distributions could result in a huge tax bill.

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The complicated tax code creates a wealth of opportunities for you to keep more of your hard-earned money, especially if you are willing to put some of it in retirement accounts. But after years of accumulating assets without giving Uncle Sam a share, the tax bill eventually comes due in retirement. However, there are still ways to minimize your tax bill, even after you are required to take withdrawals from your IRA and 401(k) accounts. Here's what to watch out for when withdrawing money from retirement accounts:

Keeping money tax-deferred as long as possible may not be the best move. You are not required to withdraw money from traditional IRAs and 401(k)s and pay the resulting income tax bill until after age 70½. Many people aim to defer taxes for as long as possible to give their money more time to accumulate without the drag of income taxes on yearly dividends, interest and capital gains. But tax deferral is no longer a slam dunk. In some cases you could pay a lower tax rate on your distributions if you withdraw smaller amounts each year over a longer period of time. Take care to factor the income tax you will pay on 401(k) and IRA distributions into your retirement income projections, and test out different withdrawal strategies to see which results in the lowest tax bill for you.

Owning only pre-tax accounts could result in a huge tax bill. Getting a big tax break while also saving for retirement may be too tempting to pass up during your high earning years. But it will give you flexibility in retirement if you prepay taxes on at least some of your retirement savings using a Roth account. Sometimes it makes sense to realize the taxes early by converting pre-tax assets to a Roth in a year when you have a particularly low income.

Don't withdraw so much you start losing tax breaks. Many tax breaks phase out for people who earn more than a certain amount. Your 401(k) and IRA withdrawals are generally considered income, and could reduce your eligibility for tax deductions and credits if you withdraw too much in a single year. If your various sources of retirement income put you close to the income limits for tax breaks, consider adjusting your retirement account withdrawal strategy to make yourself eligible for credits and deductions.

Consider using windfalls to pay the tax bill on your retirement savings. When your investments perform well, think about putting some of those gains aside to help cover your tax bill in retirement. For example, after a few good years of stock returns you might want to take more than is necessary from a pre-tax account and pay off the taxes because you have the extra income available to take the tax hit. Just remember to keep your spending constant and deposit the extra back into the market via a taxable account.

Social Security bumps up your income every year. Extra income from Social Security's annual adjustments for inflation or from an inflation-adjusted pension or annuity is great for keeping up with rising costs, but it also acts as an income floor that could cause your other income to be taxed at a higher rate if you are close to the cutoff for a higher tax bracket. Remember to include the portion of Social Security income that is taxable in your retirement income calculations, and don't forget to factor in that Social Security and other inflation-adjusted payments will increase over time

The ability to defer taxes offers many advantages over paying taxes up front, but there are also scenarios when tax deferral doesn't make sense, especially if holding investments in tax-deferred accounts comes with increased investment costs. The calculations are complicated, but the hours you spend figuring out the most tax efficient way to draw down your retirement savings could significantly increase your spending power in retirement.