Early Retirees Should Max Out Retirement Accounts

I've noticed a hesitancy among people aiming to reach financial independence and retire early (FIRE) at a young age (like 30s-50s) to use retirement accounts. There seems to be this idea floating around that you need a big old taxable account to live off of up until the time you hit 59 1/2. So some people aiming at FIRE actually purposely try to build a big taxable account at the expense of maxing out available retirement accounts. I think that is probably an error for most of them. Today I will explain why.

But first, let's look at why it probably doesn't matter anyway. If you want to retire really early, you generally have to save a large percentage of your income. Like 50%+ of your net income. And if you're doing that, chances are that you can both max out your retirement accounts and have to save a significant amount of money in a taxable account anyway. And of course, you'll want to live off that taxable account first. Far better to let the compounding happen in an account that is protected from taxes. James Lange has done some great work demonstrating the value of spending taxable dollars first, and that's ignoring the estate planning and asset protection issues, which make retirement accounts look even better.

But if for some reason you won't build a taxable account large enough to last from retirement until you hit age 59 1/2, don't forego maxing out retirement accounts in order to do so. Here are 6 reasons why.

6 Reasons Why Early Retirees Should Max Out Retirement Accounts

1 You Can Avoid the Penalty

First, despite me debunking this myth years ago, there are still lots of otherwise smart people, including financial bloggers, who aren't aware that you can access retirement account money prior to age 59 1/2 penalty-free for lots of different reasons, including early retirement. That's right,

EARLY RETIREMENT IS AN EXCEPTION TO THE AGE 59 1/2 PENALTY.

I can't explain that any better. Is there a catch? Sure. You have to follow the SEPP rule– Substantially Equal Periodic Payments. But what does that mean? Well, that means you have to take money out every year until you turn 59 1/2 and for a minimum of 5 years. How much money? Oh, about what you should be taking out anyway if you actually plan to spend your nest egg in retirement. If you're 30, it's 3.3%. If you're 40, it's 3.7%. If you're 50, it's 4.3%. If you're 55, it's 4.7%. Those numbers look an awful lot like the 4% rule, don't they?

Not comfortable spending 4%+ in your 50s? Okay, that's fine. You don't actually have to spend that money. You can take it out of the IRA, and…wait for it….reinvest it in a taxable account. Where it would have been anyway if you had never put it in the retirement account in the first place. Except that money enjoyed some tax-protected compounding in the mean-time and probably an arbitrage between your marginal tax rate at contribution and your marginal tax rate at withdrawal. And asset protection. And easier estate planning.

Need more money than 3-5% a year? There are some other great exceptions to the rule as well that may allow you to take out even more penalty-free. These include medical expenses, disability, college for your kids, and even a house.

Here's another cool trick- as long as you separate from your employer (i.e. retire) you can get to your 401(k) money at 55 without paying a penalty or SEPPing it. That's a good reason not to do an IRA conversion of those dollars, at least until age 59 1/2.

But even if you don't have one of those exceptions and need more than you can get via SEPP (also called 72(t)), you can always just pay the penalty. It's only 10%. And chances are you've gotten more than a 10% benefit given the years of tax-protected compounding and the arbitrage.

2 Arbitrage

What do I mean by the arbitrage? I mean the difference between your marginal tax rate at the time you contributed the money into the retirement account (probably 28-39% federal for most readers of this site) and your marginal tax rate at the time you pulled the money out in early retirement (likely 0-15%.) That is a huge benefit. And one that you completely give up if you invest in taxable instead. Just do the math. Say you've got $20K you can either invest in a retirement account or you can pay the taxes on it and invest what remains in taxable. Let's say your marginal tax rate is 46% like mine was last year.

What's dumber than not maxing out your retirement accounts?

Option A: Invest $20K at 8% for 15 years in a retirement account

After 15 years, let's say you pay 15% at withdrawal. So you're left with

=FV(8%,15,0,-20000)*0.85 = $54K

Option B: Invest $10,800 in taxable at 7.5% (don’t forget taxes on the distributions)

After 15 years, let’s say you pay 0% on the withdrawal. So you’re left with

=FV(7.5%,15,0,-10800) = $32K

You get 69% more money by using that tax-deferred account. And make no mistake, if you’re given the choice between tax-deferred and tax-free and you’re the FIRE type, take that tax-deferred account. Your peak earnings years are far fewer than those of your peers, so take advantage while you can.

3 Asset Protection

Just a quick note here. In almost every state in the country, retirement accounts get protection from your creditors in bankruptcy. Meaning if you are successfully sued for $10M, far more than the policy limits on either a malpractice policy or an umbrella policy, you still get to keep your retirement accounts. Generally, 401(k)s get a little better protection than IRAs, but the point is that protection has some value, especially for a doc in a risky specialty like OB/GYN or neurosurgery, even though getting sued above policy limits is an exceedingly rare event for all docs.

4 Estate Planning

What am I talking about here? I'm talking about the ability for your heirs to stretch a retirement account. Or simply withdraw money at a lower rate than you could. Or even just the ease of using beneficiary designations to avoid probate. Far easier to estate plan with retirement accounts than a taxable account.

5 Roth Conversions

Here's another great benefit of maxing out tax-deferred accounts for FIRE types. After you quit working you can do little Roth conversions every year between retirement and when you start getting Social Security. That might be 15-30 years worth of Roth conversions for a very early retiree who waits until 70 for Social Security. Sure, you generally want to pay for those conversions using taxable money, but as I mentioned above, you're probably going to have a taxable account anyway because you're a super-saver.

6 Lower Taxes = More Spending Money

Finally, let's not forget the main point of retirement accounts. The main reason we use them is that your after-tax return is higher inside a retirement account than in a taxable account. It might only be a 0.5% tax drag a year (if you are smart about how you invest in a taxable account), but that 0.5% adds up over decades. Over 3 decades the difference between an investment compounding at 8% versus at 7.5% is about 15% more money. Over 6 decades with an investment with a 1.5% tax drag, it is 130% more money!

The bottom line? Max out your retirement accounts, ESPECIALLY if you want to retire early. There are precious few good reasons not to max out your retirement accounts. I can really only think of three:

1 You have an investment available to you that has such a high return that it is worth passing up those tax benefits in order to use it (and you can't invest in it in a retirement account.)

2 You have a particularly terrible 401(k) or a risky 457. We're talking exceptions like 2%+ ERs on the mutual funds and a bunch of account fees. We're talking about a 457 offered by an employer that is teetering on bankruptcy.

3 You will have a dramatically higher marginal tax rate in retirement compared to right now. There are a lot of people that think this applies to them, but it really applies to very few people. There just aren't a lot of people in the lower tax brackets during their earnings years who will be taking all their retirement money out at the top marginal tax rates. Even if tax rates climb, most people will still see far lower tax rates on those dollars in retirement. And even if you are one of those super savers worried about this, there is still a workaround – do as much Roth as you can including Roth conversions throughout your career.

What do you think? Do you know anybody not maxing out retirement accounts because they have early retirement plans? Did I convince you that's foolish? Why or why not? Comment below!