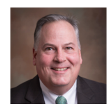
How to Determine the Amount of Income You Will Need at Retirement

Determine your income replacement rate to help you better plan for retirement.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KEY INSIGHTS

- Your preretirement income replacement rate is based on your estimated spending in retirement.
- Through analysis, we found that a 75% replacement rate may be a good starting point to consider.
- Understanding the income you'll need from sources other than Social Security can help you estimate a savings level to aim for before you retire.

Many people find that it's easier to think about money in terms of income rather than spending. For example, how much money do you make? That's a fairly easy question. How much money do you spend? That one might be harder to answer. What exactly counts as spending? Are you including taxes? If you're paying down a mortgage, is the principal portion considered spending? What about your child's tuition payment from a 529 account?

These questions highlight how, for many people, calculating total spending can be more difficult than simply looking at income. That's why your income replacement rate—the percentage of your preretirement income before taxes that you'll need to support your lifestyle in retirement—can be a useful planning tool.

This simple metric may help you put your retirement finances into clearer context. The key to making this percentage useful is to estimate it with your specific financial situation in mind.

Your income replacement rate

Start with a general rule of thumb. After analyzing many scenarios, we found that 75% is a good starting point to consider for your income replacement rate. This means that if you make $100,000 shortly before retirement, you can start to plan using the ballpark expectation that you'll need about $75,000 a year to live on in retirement.

You'll likely need less income in retirement than during your working years because:

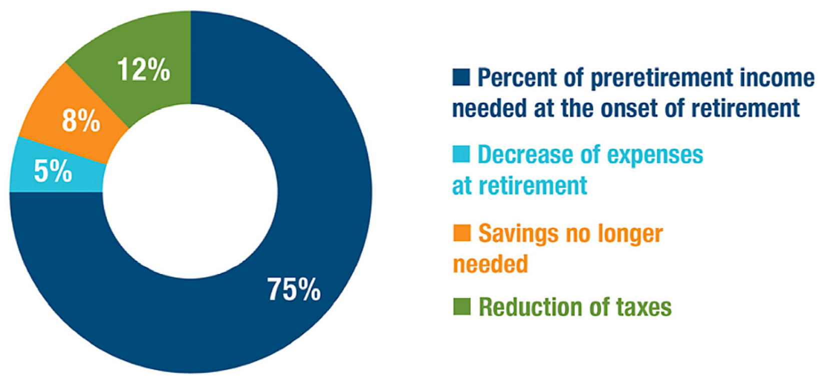
- Most people spend less in retirement.
- Some of your income during your working years went toward saving for retirement, which isn't necessary anymore.

- Your taxes will likely be lower—especially payroll taxes, but probably income taxes as well.

The 75% income replacement rate ballpark figure is based on reducing your spending at retirement by 5% and saving 8% of your gross household income during your working years. We chose 8% because it's about the average that people are saving in their retirement accounts. (See "Income Needed in Retirement.")

Income Needed in Retirement

You're likely to require less than during your working years.



Example is for illustrative purposes only. (See Assumptions section in "Income Replacement Rate by Source.")

How to tailor the rule of thumb

These savings and spending assumptions may not fit your situation, so the 75% starting point may not be right for you. For example, you may be saving closer to the 15% we suggest for retirement. Fortunately, T. Rowe Price analysis found this to be an easy adjustment to make: Every extra percentage point of savings beyond 8%, or spending reduction beyond 5%, reduces your income replacement rate by about one percentage point.

Think of these adjustments as a nearly one-to-one ratio. If you're saving 12% of your income instead of the assumed 8%, take your replacement rate of 75% and subtract four percentage points, resulting in a personally adjusted estimate of around 71%.

The way you've saved for retirement also affects the replacement rate. The 75% starting point assumes all savings are pretax—like a Traditional 401(k) or individual retirement account (IRA). That's a conservative assumption, since, generally, you're fully taxed on those assets when you withdraw them. Saving with a Roth account, on the other hand, is after tax and can generate tax-free income when distributions are qualified.* This means that if you have a large proportion of your retirement savings in Roth accounts, your income replacement rate should be lower.

Finally, your marital status and household income are two factors that affect Social Security benefits and your tax situation. Those two factors, in turn, affect your income replacement rate. The 75% starting point reflects a household earning around $100,000 to $200,000 before retirement.

See "Income Replacement Rate by Source" as a starting point, then make any necessary adjustments for your personal

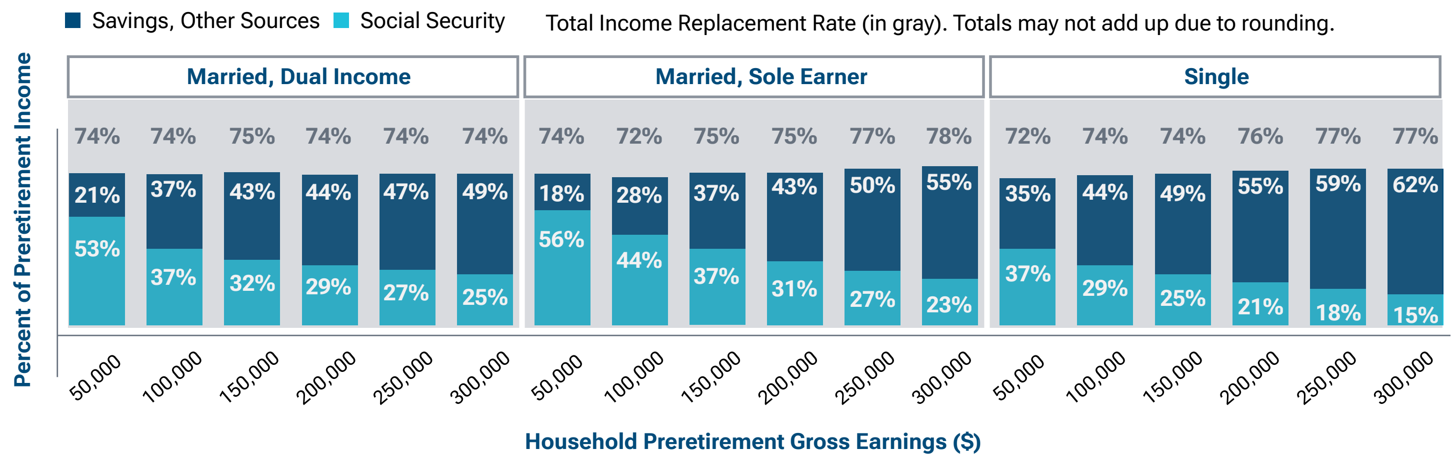
*Generally, qualified distributions are tax-free once you reach age 59½ and have held the Roth account for at least 5 years.

circumstances based on the parameters outlined in this section.

Understanding the income you'll need from sources other than Social Security can help you estimate a savings level to aim for before you retire. At higher income levels, Social Security benefits make up a much smaller percentage of the total income replacement rate—meaning you'll need more savings or other income sources to fund retirement.

Income Replacement Rate by Source

Higher earners will need to draw more from savings.



Assumptions: The household's income and spending keep pace with inflation until retirement, and then spending is reduced by 5%. Spouses are the same age, and "dual income" means that one spouse generates 75% of the income that the other spouse earns. Federal taxes are based on rates as of January 1, 2024. While rates are scheduled to revert to pre-2018 levels after 2025, those rates are not reflected in these calculations. The household uses the standard deduction, files jointly (if married), and is not affected by alternative minimum tax or any tax credits. The household saves 8% of its gross income, all pretax. Federal income tax in retirement assumes all income is taxed at ordinary rates and reflects the phase-in of Social Security benefit taxation. State taxes are a flat 4% of income after pretax savings and are not assessed on Social Security income. Social Security benefits are based on the SSA.gov Quick Calculator (claiming at full retirement age), which includes an assumed earnings history pattern.

The income replacement rate in action

Suppose you're a married, two-income couple and your preretirement income is $100,000 a year before taxes. Based on the graph "Income Replacement Rate by Source," as a starting point, you should plan to replace around 74%, or $74,000, of that income. Let's assume you expect $37,000 of it to come from annual Social Security benefits, which means you'll need about $37,000 of gross income from other sources.

To find out how much you might need to have saved for retirement, you can work backward from the $37,000 figure. If you're comfortable with a 4% initial withdrawal rate on your assets, then you should aim for a $925,000 nest egg. (To arrive at that figure, we took $37,000 and divided by 0.04.) You'll want to bump that up for inflation, especially if you're a long way from retirement.

Another way to look at it is to focus on accumulating an amount equal to a multiple of your preretirement income. In this case, the $925,000 target is based on a $100,000 salary times 9.25. We recommend that most people consider a target between 7½ and 13½ times their ending salary. This target will vary based on your income and marital status.

There's no "right" number that works for everyone, and your situation can change over time. As you approach retirement, it will be important to assess your spending needs more carefully. But for someone several years from retirement, the income replacement rate—which is based on estimated spending—can be a helpful guide.

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