Episode 105: Managing Taxes in Retirement using the Effective Marginal Tax Rate

Bob French 00:00
The purpose of Retire with Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style and sign up to take the industry's first financial personality tool for retirement planning. John Maynard Keynes once said that the avoidance of taxes is the only intellectual pursuit that carries any reward. Let's check in with Wade and Alex to see if they've made any progress on this front.

Alex Murguia 00:55
Hello, everyone, welcome to retire with style. I am Alex and I'm here with my trusted and sage companion. Dr. Wade Pfau. Hello, Wade.

Wade Pfau 01:09
Hey, Alex, and hi everyone. Hope y'all had a great Thanksgiving.

Alex Murguia 01:16
So, any postprandial stories, Wade from Thanksgiving that you want to share with us?

Wade Pfau 01:24
Just as a reminder, with all the food that I need to do my push ups, but beyond that, it was a pretty standard Thanksgiving. Really yourself?

Alex Murguia 01:35
Do you focus on the push down or the push up?

Wade Pfau 01:39
It's all about upward and onward.

Alex Murguia 01:44
There you go. No, myself. It was fine. We went to Dean's daughter, her daughter's house Lynn. Dean is a principal of McLean as well. It does daughter's house and Wade and I were discussing this before Wade's married to someone from Japan. And my wife is a jet. You know, she's second generation Japanese. And so Dean, Dean is my wife's uncle and Dean is, you know, they're all Asian. They're all Japanese. And so we were talking about what kind of food you have. Wade said he does the red, white and blue Thanksgiving. For us, right? all the fixins right, when it's right. For you. Do you cook? Or does your wife you know, cook? Who leads here the church?

Wade Pfau 02:34
I did not? I'm not able to cook Thanksgiving style stuff.

Alex Murguia 02:37
You're not able to or you don't want to? Let's be honest. Well,

Wade Pfau 02:42
I haven't tried formally tests my skill, but I'm guessing it would not turn out. Well, if I did try to get

Alex Murguia 02:49
that I gotcha. Gotcha. As for us, the only Japanese court of influence that we have is we you know, we're effectively Northern Virginia. So let's just say it's close enough to Maryland. And so in the Chesapeake of Maryland, blue crabs is the thing to do. Right. And so we have a crab sort of dip with Japanese rice and then, you know, on the side you have a sheet of seaweed, Nori, and use that to pinch the dip. And that's that's, that's as good as it gets. You know, in terms of Thanksgiving, before dinner, there's always like sharks circling around that good night beats, it beats a tuna casserole. That's for damn sure.

Wade Pfau 03:32
The conveyor belt sushi restaurants, they usually have something along those lines like a roll. That's sort of a crab salad inside.

Alex Murguia 03:40
Really,

Wade Pfau 03:41
I vaguely know what you're talking about there.

Alex Murguia 03:44
Vaguely

Wade Pfau 03:45
I think had something similar. I don't know that how similar. One that's good. Same theme. All

Alex Murguia 03:55
right. And so speaking about crab dishes, today, we're going to talk about something completely different right now. Completely different. Exactly. That's a better transition. Well, we published an article with Joe L. Sasser, a good friend of the RESA, he runs a software company called COVID, som, a tax planning software. So it's very specific to advisors, if you will, but it's a very popular one. And, you know, if you're an advisor listening in, I invite you to check it out. If you're a consumer listening in, I invite you to talk to an advisor who uses it, I guess, it's not consumer driven. These softwares are very specific to the profession. And there probably wouldn't be a market honestly, for consumers just

because of the complexity and because of the servicing needs that you would have but that's another topic in and of itself. And

Wade Pfau 04:51
we will be able to explain quite a bit without access to software. It's not just a complete black box. We're going to try to break into that black box. and lay its component parts out. But certainly, Joe has been very helpful because he developed this idea of tax maps that we'll be talking about today. And that it's now going to be the third year in a row where when I do the update for the retirement planning guidebook, I completely change how I explain tax planning for retirement. So now it's going to be about this effective tax rate management and tax maps. And I learned that from Joe and and so his software, it's a tax planning software that does that. And he also has a Social Security claiming software as part of that package as well. COVID some? So yeah, he's been a big help to just helping me it's not that all these different methods lead to that much difference in the outcomes, but it's more about being able to wrap your head around. How does this work? And how can it be explained? And how can you actually start to use this even if you don't have access to software?

Alex Murguia 05:53
No, I think they do a good job of quote, unquote, going back to elementary school that showing your work, they do a great job showing your work. So they help you conceptualize things, but the article that you wrote is managing taxes in retirement using the effective marginal tax rates. There it is. So wait, I want to ask you, how do you how did you come up with this title? Well, it was it inspiration.

Wade Pfau 06:24
These titles are very utilitarian terms, trying to explain what the article is about so that there's no surprises. I think that's always important because sometimes people give some sort of poetic title that isn't at all what the articles about and then if you're trying to find this article, you're you're never going to think to look at it because the title is something completely different. So

Alex Murguia 06:46
when we didn't, we didn't need an answer who just

Wade Pfau 06:50
that's a rhetorical question. But there's a method to the madness.

Alex Murguia 06:57
No, no, no, that's awesome. And we're coming off of Rob corridos masterclass on year end planning, which largely was about taxes. So absent of us doing a formal tax arc, which we'll get to at some point, I guess this is this is in running with the theme from the last podcast here. After reading this article, I found, obviously, from a high level, and then you'll you'll rip it to shreds hear, you know, drilling down, but effectively, there's two foundational things to think about. There's, to me, there's the order of operations from taking tack from taking distributions from an investment portfolio. And there's a standard, you take first, from taxable accounts, then you take from tax deferred accounts, then you take from tax exempt accounts, and that being a regular brokerage account, individual brokerage account, then like a 401 K IRA, then like a Roth, effectively, that's what

Wade Pfau 07:56
you want. And to be clear, that's the conventional wisdom, which a lot better than other things, but it's not the be all end all. That's where we're going to dive deep, better method, but yeah, I

Alex Murguia 08:05
don't know. But even though it's conventional wisdom, it's, well, I was gonna say common sense, not so common, you know, but you can't say, convention is still not fully understood, right? Because Wade, and I were speaking to somebody who's a fairly learned person in this industry, knows a lot about planning and things like that. And he was talking to us offhand about how he just inherited a Roth from his parents. And he was going to use that money to help fund that person's son or daughter, their their college education. Right, and that person had access to other available funds as well. It wasn't like, that's all the money that. And so Wade, and I looked at each other. And, you know, we're thinking politely how to tell this person. Not so fast. You know, there's an order of operations with regards to distributing income for knees like this that may not follow the order that this person was thinking of.

Wade Pfau 09:01
Although, yeah, honestly, in this case, and this, I don't completely remember that it was an inherited Roth IRA. But if it was, it doesn't really fit into conventional tax planning, because now you do just have that 10 year window to spend it anyway. You don't get a bid, push it back to the the end of retirement.

Alex Murguia 09:17
I don't remember exactly. But I remember you and I were looking at ourselves, like, I'm not so sure. You know, like, there's more to it, there's more to the story than just flipping it. Right. But the point is, there's there's convention to this, but then Gremlins that you have with regards to this convention is what you term in the underclass, nonlinear, non linearity. So I think if you could spend some time just talking about the convention, and then what are things that kind of throw a wrench into that would be helpful in terms of setting up the case study that you did this article on?

Wade Pfau 09:48
Sure. And so this, this article was in advisor perspectives, and we'll have a link to it in the show notes for anyone who'd like to read the article itself, but as we talked about last week, with Rob this idea of tax diversification Sherman, that is a foundational point that you're in advance of retirement, getting yourself into a position where you have these three different types of accounts, you've got your taxable brokerage accounts, you've got your, we'll try to use the term IRA to just summarize the broader world of tax deferred accounts where you get a tax deduction when money goes in, and then everything comes out as ordinary income. And then you'll have will try to simplify as a Roth IRA, but could also be Roth, 401, k's and so forth, where you put after tax money into the account, but then everything, including any gains comes out tax free in the future. And so you've got these and where do you put your savings? Well, part of that as you want to diversify between the different accounts, but the other part of it is, we know we have to pay taxes, but we want to look for opportunities to pay taxes at the lowest rates. And so the idea is, if you believe you're in a higher tax year, get your tax deduction today, put it into the traditional IRA, if you believe you're currently in a lower tax here, go ahead and pay the taxes now and put it into the Roth IRA so that you don't ever have to pay taxes again. And that's really

driving also, we're going to be talking a lot about Roth conversions, we're gonna where you're intentionally drawing money out of the IRA to move it to the Roth IRA, and that becomes taxable income, you want to do that and lower tax years. Now, often people have this idea that they'll be in lower tax brackets in retirement. And that may be true. But there's some big caveats on that, and that sees nonlinearities in the tax code that we need to really clarify. And then we're going to look for strategies to help manage these nonlinearities as well. So we'll keep things simple, in that we're gonna assume we're in a state with no state income tax, if there was a state income tax that just overlays on top of everything we're talking.

Alex Murguia 11:52
So you're talking about the great state of Florida, Florida,

Wade Pfau 11:55
Texas. Yes. There's a lot of people in this country do you live in states with no state income tax, but if if there's a progressive state income tax, that's just a whole additional overlay and add on to all of this. That's an add on. That's not a nice to have. It's more more taxpaying. But otherwise, even with federal income, there's a progressive tax system. So we have the federal income tax brackets that are progressive, which just means as your income increases, it's going to start to push into that next chunk of income is taxed at a higher rate. Now you've got 10%, and 12%, and 22%, and 24%, then think 32 comes after that, and or keeps going then 35, and then 37. In current laws, two years from the start of 2024, and 2026, we're going to kick back to a different set of tax rates unless Congress decides to extend But currently, there's going to be a sunset Where then 10% 15% 25%, and so on 28% 32%, that sort of thing. So that that is just the idea that I think I may be in a lower tax bracket in retirement, because right now with my salary, maybe I'm in the say, 22% bracket. But I think by the time I'm retired, I'll be in the 10 or 12%, bracket, or ultimately 10 or 15%, a few years from now, we've learned a tax bracket in the future. However, there's four things we want to talk about with this to help set up the conversation around what we're looking at in the article, which is, how can we find a more tax efficient distribution strategy? In these are the Social Security taxation. That's the first one, the way social security benefits are taxed is extremely complicated. I don't think it'd be possible to hardly think of something more complicated unless you start pulling in random things to add into it. Give it

Alex Murguia 13:59
Give it to me with let me have at it well,

Wade Pfau 14:02
no, it's there's going to be thresholds of income where it expands your taxable income. So I take money out of my IRA, I'm taking ordinary income, but then that can also trigger more of my social security benefits to be taxed. And so I take $1 out of my IRA, and there's going to be a phase that shows up a lot in this case study where that dollar I take out of my IRA triggers 85 cents of a Social Security dollar to also be taxed. And so I may think I'm in say that 22% bracket, but that dollar I took out is taxed at 22%. It's also causing 85 cents of $1. My Social Security to be taxed at 22%. That's a 40.7% effective marginal tax rate on that dollar, and it's because that dollar uniquely also cost Social Security to be taxed. Now once you get to the threshold, where 85% of your Social Security is counted as taxable income, then you leave the tax torpedo and this is no longer an issue. And last week's episode, Rob

mentioned like 85% of Social Security is taxable. For higher net worth individuals, it may be hard to avoid the tax torpedo and so you will be in that situation. But in the case study we're going to talk about today where this is a couple at age 62. They have one and a half million dollars, they have an opportunity to set things up so that that statement is not going to be true, they can get less than 85% of their Social Security taxed. And that's gonna be a big part of the conversation.

Bob French 15:41
Have you signed up for retirement researchers retirement income challenge yet it starts next week, Monday, December 4, at noon, Eastern and it's filling up fast. Don't miss your chance to join Wade, Alex and I in this free four day challenge where we walk with you and discover how you approach retirement income, where you stand relative to your retirement goals, and what you can be doing to bridge that gap and make sure that your retirement is on track. Think of it like a pop quiz for your retirement plan. We can only accept a limited number of participants for this challenge, and we're filling up fast. So head over to resource profile.com/podcast. To learn more, and find out how you can join Wade, Alex and I, again, that's Risa profile.com/podcast. See in the challenge. The

Wade Pfau 16:33
second item is Medicare surcharges. We talked about that last week as well Irma, once your income exceeds certain thresholds, you have a discrete jump in Medicare premiums in the first threshold and 2020 for 103,000 for singles 206,000 for a couple where then that would be based on income from two years prior, your modified adjusted gross income when it exceeds these thresholds, you're going to be looking at another $1,800 for the couple of additional Medicare premiums if you have $1. Too much income. Now, Joe, and I will have a second article coming with a case study where the couple has five and a half million dollars. And managing those Irma surcharges will be a big part of that second case study. But in this particular case study we're talking about and then the article we're talking about today. They're not wealthy enough, and their spending goals not high enough that they ever run into the Irma surcharges. So this is something very important. But it's not directly relevant to today's conversation. The next item will be quite relevant to today's conversation. And this is a complicated one, and it affects pre retirees as well as retirees. I call it preferential income stacking. And earlier today, when we're talking about that you needed some clarification on what that's even talking about. So we should probably unpack what I mean by this.

Alex Murguia 17:58
Who's you referring to me? Yes,

Wade Pfau 18:01
yes. Yeah, it's just this is not standard terminology. I don't know what to really call it. There is no standard terminology for it.

Alex Murguia 18:07
Yeah, I don't think so. That's why I was like, what is that again? Because it was like your like, your own kind of lexicon there.

Wade Pfau 18:14

Yeah, yeah. So your taxable income consists of ordinary income plus preferential income. By preferential income, I mean, long term capital gains and or a qualified dividends from a taxable account. Those have a separate system of tax brackets. That doesn't match exactly. And it's really odd why they don't match exactly, but right where ordinary income shifts will taxable income shifts from 12% to 22% is where preferential income shifts from 0% to 15%. And so if you have a taxable account, you don't have any control over the fact that it's going to at least kick off some qualified dividends. So this becomes preferential income, that stacks on top of ordinary income. And so what's going to happen in this case study, they're married filing jointly. So I am talking about a couple here, though, there's some odd differences that happen for single people widows, they can get into much higher effective marginal tax rates, but set that aside for now. I think I'm in the 22% bracket. I've got some preferential income, I've got some qualified dividends. I'm doing a Roth conversion. So I'm voluntarily taking money out of my IRA. My total income is still in the 22%. bracket, but I'm gonna get to a point where that preferential income stacks on top of my ordinary income, and it's going to eventually start to get kicked from each time I generate from the ordinary ordinary income from the IRA is now going to start pushing dollars of preferential income from the 0% bracket into the 15% bracket. Am I saying that 22% bracket before, but this actually can work depends how much preferential income you have. No. And so you're going to be in the 12% bracket when this is an issue, sorry. So you're you're in the 12% Federal income bracket. And then you're starting to push preferential income to be taxed at 15% instead of 0%. So $1 of ordinary income is taxed at 12%. Plus it uniquely causes $1 of your qualified dividends to be taxed at 15% instead of 0%. That's a 27% effective marginal tax rate. And it's an issue that comes up because preferential income stacks on top of ordinary income. Now, there's also the net investment income tax of 3.8%. That starts to kick in at closer to 200,000, for singles 250,000, for a couple. So Rob was talking about that last week, that's the thing I

Alex Murguia 20:52
want everyone to just when you were doing the math, just because I'm envisioning, I'm always envisioning someone listening, trying to conceptualize the math, these are additive rates, that's why you're going 10% here and 10% there, you get 20%. They're not like they don't net out or anything like that they're additive to each other.

Wade Pfau 21:12
No, I like, say you have $4,000 of qualified dividends. So when you get up to the point where you're 4000, or even, you're like $4,000 less than that threshold with ordinary income. That's where you're you take another dollar of ordinary income 5% tax on that dollar. Plus, because of this different set of tax rates, $1 of your gain long term gains or qualified dividends is getting pushed into the 15% bracket too. So then you get 12% plus 15%, directly. And then with the this also impacts in an investment income tax. So what I was saying was in this particular case study, they're not wealthy enough for the net investment income tax to be an issue, but it is an issue in the the other second article will be coming out with later in a couple of weeks. Then the final issue is required minimum distributions. So in this case study, they're going to start at age 75. Currently that the RMD start age is 73. But for individuals born in 1960, or later, the RMD start at 75. And at some level, they shouldn't be an issue a big issue. That is you have to pay taxes on your RMDs. But you can always reinvest the remaining funds into your taxable brokerage account, you're not forced to spend the RMDs. However, the problem is, with all these nonlinearities related to social security and Medicare and the preferential income stacking the

RMD is forced you to generate ordinary income, which can be taxed at much higher effective marginal rates and the federal income tax brackets. And that's where RMDs can create a surprise, where you're kind of going along fine in retirement, and suddenly you hit the age where RMD start, and you get this big surprise, you have to take a big chunk out of your IRA, that can cause some serious damage in terms of how much taxes you end up having to pay on that. And part of this tax planning ideas that by paying tax by doing Roth conversions in advance, when RMDs do begin, hopefully, they're not going to be so onerous at that point. And that also becomes a big part of what this case study why it's able to add a lot of value to their retirement plan is being able to get a better handle on these. Okay, so then a one IRA distributions at that phase of retirement. So

Alex Murguia 23:41
then the in terms of the environment that you've laid out, okay, you have a certain tax rate. Great, right. But because of these potential non linearity, you may bump into items that inadvertently shoot up your tax rate by more than you ever envisioned. And then you're surprised at the end, in terms of, you know, I've made a terrible mistake, what just happened here? Right. And so that's why you're sort of pointing out there's, there's these Gremlins that you want to, you know, always keep it to consideration when you're when you're when you're taking your distributions. And those Gremlins tend to accentuate themselves, if you will, if you just follow traditional standard method of tax free, I mean, taxable tax deferred tax free. And so, you know, to take distributions, and so it's not always that simple. Hence the case study to show you why. Correct?

Wade Pfau 24:42
Yeah, and let me also just mention the widows penalty here because the single filer and this could happen the year after a death with when you weren't married filing jointly, single filer because the Social Security thresholds are not half The first single people have compared to couples, you're in the 22% bracket. But you're in that 85% range of the Social Security tax torpedo, and you have some preferential income. So I take $1 out of my IRA, maybe because of an RMD. that's causing 85 cents of Social Security to be taxed. So 22% on the dollar, now 22% on another 85 cents of Social Security. And now I've got $1.85 More taxable income because of this, that then if I have preferential income stacked on top of that, that's getting pushed into the 15%. bracket, I'm paying 15% on another dollar 85. I was single person who thought I was in a 22% bracket. In this scenario I'm describing that's a 49.95%, effective marginal tax rate, because of the Social Security impact and the preferential income stacking impact combo.

Alex Murguia 25:54
So you're saying the government should do take a bite?

Wade Pfau 25:59
Well, yes, and that you may think you're in a lower tax bracket in retirement, and you may be in a lower federal income tax bracket. But when you add these nonlinearities, in, that it's more of an issue in retirement because these are more they specifically the Social Security, Medicare RMD is very much retirement specific. Preferential income stacking applies both pre and post retirement. So

Alex Murguia 26:21

we're looking to manage here, how did the case study manage it?

Wade Pfau 26:25
Okay, yeah, so getting into that. Now, I never know like, what's a good wealth level to to look at. So this case study we're seeing is a mass affluent couple, they have one and a half million dollars of investment assets, which, for some listeners, that may be shockingly high. For the listeners that may be like lower than what they have. So we will have another case study with $5.5 million. But for now, we'll talk about this one and a half million dollar investable assets are both aged 60 to 400,000, in a brokerage account, a million in an IRA 100,000. In a Roth IRA, they're going to delay Social Security at age 70, the primary insurance amount on the high earners, $2,500. And so this is going to translate into in today's dollars 52,200 of Social Security benefits at age 70. And their retirement budget in today's dollars 90,000. After Tax, they want to before considering taxes, they want to spend $90,000 a year plus inflation. And because that spending budget is lower than the arrma, thresholds and so forth, that's really the only possible way they could cause themselves to hit an Irma threshold is by just doing a huge Roth conversion. And that's not going to be part of the optimal strategy for them. They're looking at the conventional wisdom, if they follow the conventional wisdom, the spend on the taxable account first, then they're going to spend a long time covering all spending, other than what Social Security provides to their IRA, and then eventually later get into the Roth IRA, they get to age 95, they want their plan to work through age 95, they'll have $37,000 left in today's purchasing power 20 $23. Now we look at different effective marginal tax rate targets. Now, I guess I should explain what these are exactly. Because of these nonlinearities, your marginal tax rate is going to be going your effective marginal tax rate including all these nonlinearities is going to actually go up and down as you generate more income. So when we say have a 15%, effective marginal tax rate target, we're going to look for all the cases where the marginal rates going either from less than or more than 15% or more than to less than 15%. And we're going to check for each of those segments, can I generate that income, and then pay an average tax rate on that of less than the 15% target. This can allow for temporarily having a higher than 15% rate. If by doing that you then get yourself into a position where you get a much longer runway of a lower than 15% rate so that when you average it together, you're you're still under 15%. But we look for different thresholds. And this is part when we get into well, how can you do this without tax planning software? I think this 15% effective marginal tax rate threshold is fairly generalizable for and I don't yet have the exact wealth levels yet but I mean a million dollars up to two, two and a half million dollars, maybe even $3 million, you might still generally find this to be close at least to the the appropriate target. Now in the case with five and a half million dollars. This is no longer the target for that case study we found 28% was the effective marginal tax rate that would optimize their after tax wealth. But for this range, we're talking about the A again, one and a half million dollars 15% effective marginal tax rate that allowed them to generate an after tax legacy of $160,000. So quite a bit more than the conventional wisdom. And again, what it is, is they're going to generate they're going to voluntarily generate taxable income. If they can do so and pay a tax on that 15% or less, if generating more income and cause them to have to pay taxes above that amount. They're gonna say, No, thank you not going to generate any more voluntary income. Okay, and then I think we should talk about the tax alpha of this, because in this case study, yeah, the gross return, but the nominal return is 5.06%. It's a combination of 3% inflation and 2% real interest, real growth on the assets. And then when you combine those together, that's 5.06% a year. Now, we can calculate the internal rate of return on cash flows, they're meeting their spending goal, and then their legacy and age 95. Since that legacy is

smaller at age 95. With the conventional wisdom, it turns out, their after tax rate of return is 4.17%. So the tax by that's 44.17%,

Alex Murguia 31:18
doing the standard, blindly, just naively doing the taxable tax deferred tax exempt, you're taking the assets out like that, that's which

Wade Pfau 31:29
will still, yeah, that still will work better than other options than random that that's the relatively efficient approach before putting much more thought into it. Yeah, so after taxes, your your 5.06% return drops to 4.17%. Now, if you calculate the internal rate of return on the cash flows with the higher legacy, through the more tax efficient strategy of managing 15% as an effective marginal rate target, that increases your after tax rate of return to 4.58%. That's 41% basis points more point four 1%. And that's tax Alpha. It's a the tax alpha term. It's like alpha with investing

Alex Murguia 32:13
that this is not total. This is annualized for how many annualized over

Wade Pfau 32:16
a 34 year investing horizon. Have

Bob French 32:20
you signed up for retirement researchers retirement income challenge yet it starts next week, Monday, December 4, at noon, Eastern and it's filling up fast. Don't miss your chance to join Wade, Alex and I in this free four day challenge where we walk with you and discover how you approach retirement income, where you stand relative to your retirement goals, and what you can be doing to bridge that gap. And make sure that your retirement is on track. Think of it like a pop quiz for your retirement plan. We can only accept a limited number of participants for this challenge, and we're filling up fast. So head over to resource profile.com/podcast. To learn more, and find out how you can join Wade, Alex and I, again, that's Risa profile.com/podcast. See in the

Alex Murguia 33:10
challenge. Okay, so if, um, let me pose it to you this way. I'm somebody that's I'm going to present to an investment theme. Hey, I'm great at identifying opportunities in the stock market. And relative to the market performance, whether up or down, I have a system that I am going to give you an extra 41 basis points, which is 50 basis points. 1% is 100 basis points, half a percent 50 basis points. Point 4% is 40 basis points. So we're talking here an annualized benefit of point of 41 basis points, point four 1%. I'm, I'm somebody that, you know, figured out how the markets work. And I'm going to present to you the ability to be able to outperform the market by point four 1% every year. But point four 1% of you wait, how would I be esteemed? You know, how would my colleagues view me after 30 years of outperforming the market by almost half a percent a year, annualized? Well, if

Wade Pfau 34:13

for time after the fact that you're actually able to achieve this, yeah, after Forbes magazine, if you were telling me this before the fact that you found this system impulse, I would assume you're a huckster or a shyster because as Bob, yeah, not consistently outperform the market in this manner. You would be an investing superstar, having 41 basis points more than the index. And so the

Alex Murguia 34:37
point is, I think folks lose sight of this, you know, you're not going to see this in Power Lunch ever. Hey, look at this tax distributions. You're not gonna see that, you know, you're gonna see something about Tesla or something about whatever in video or whatever, right? The reality is that this is within your control. There's some complication behind this, but it's well worth doing. In the work, because it's it's within your control, and it becomes more of an engineering exercise, then then some sort of, you know, investment savant characteristic that you need. And so to me, this is where the focus should be on in terms of adding value beyond what the market is providing. I think this is where effort should be guided on not necessarily. Yeah, again, the invidious of the world and those kinds of conversations, what do you think what? Yeah,

Wade Pfau 35:29
you have some control. It's we have to pay taxes, but we have some control over when we pay those taxes. And by being smart about it, we can use those after tax returns on our investments, which is what matters that the pre tax investment return is not the number we should really be looking at. It's the post tax return that's going to matter to our our nest egg over the long term. And 41 basis points, annualized. That extra additional return over 34 years is nothing to sneeze at.

Alex Murguia 36:00
No, not at all. That's why I'd like that alone is the reason why you should do this, as opposed to just Oh, yeah, this is just two guys nerding out and really you because you're the one like you providing the content for today. But it's, it's not just, Hey, look at this cool little wrinkle that, you know, I don't want anyone just to listen to you and think well, that's not worth the effort. No, it absolutely is worth the effort. You know, in fact, I would venture to say 90% of the people listening to this podcast, probably spend their efforts on things that don't move the needle at all. This moves the needle.

Wade Pfau 36:33
Yeah, and may not even be thinking about this. Yeah, exactly. But, right, this is where we want to really unpack this thing. So let's kind of walk through what they're doing in the case study to to achieve this result. And like I said, this, we looked at different effective marginal rate targets, and 15% was the one that did the best job. So one area where you need software's to know what is that effective margin rate target. But I do think this 15% Number is pretty generalizable for wealth in this general range. And so they're 62 years old. This is how they go about achieving an A 15%, effective marginal tax rate target. So they're going to cover all their spending through the taxable account while they can, that's meeting their budget, also paying any taxes. And then if they have the opportunity, they'll do Roth conversions in excess of that to generate more taxable income. And that's what happens while they have a taxable account, and this case study, this process that we're describing, they're going to deplete their taxable account between ages 62 and 66. By 66, that's they're going to draw out the rest of their taxable account. So during those years, they cover all their spending to the taxable account, and then they start

doing Roth conversions. And to manage the 15% effective marginal rate, what's happening is the preferential income stacking becomes the constraint, they're in the 12% bracket, or in a few years, they'll be in the 15% bracket. And then because they still have the taxable account, throwing off dividends and capital gains, they've got preferential income. And so as soon as that preferential income would start to get pushed from 0% to 15%, that's where their marginal tax rate is going to increase to 27% for the next two years, and then 30% and 2026, and later, so that's where they put on the brakes, to do Roth conversions until they hit the preferential income stacking issue, then, by age 67, they don't have taxable assets anymore. So now part of the issue is now they have to use what at this point for the rest of their retirement, they're going to do a blend of Ira distributions and Roth IRA distributions. This is why you want tax diversification in the first place. But before they can think about Roth conversions, they first have to cover their spending need. So in this case, between the ages of 67 and 69. They're now in a period where there's not Social Security yet. So no tax torpedo, there is the Irma surcharge issue. But that's a much higher income level than what we're talking about. They don't have preferential income anymore, they don't have RMDs. They actually get to manage the 15% federal income tax bracket for a few years. And that lets them cover all their spending goal and do small Roth conversions until they get to the top of the 15% bracket. Then at age 70, Social Security starts. And this is changing the picture because they're going to immediately run into the tax torpedo they've got they have their standard deduction to work with at this point. They can't just take an IRA distribution equal to the standard deduction because that will also trigger part of their Social Security to be taxable, but what they're going to be able to do between the ages of 70 74 is between their IRA distribution and the taxable portion of Social Security. They keep that inside their standard deduction. And they don't want to go $1. Above that, because they have the 15% effective marginal rate target. And going $1 above the standard deduction with with the Social Security benefit that they have, is going to push them into the 85% portion of the tax torpedo. So instead of entering into the well, they enter into the 10% Federal income bracket. But with the Social Security tax torpedo added to that, it's an 18.5% effective marginal tax rate. So they basically fill their standard deduction and stop. And then even though part of their Social Security is taxable, at these ages, it's still inside the standard deduction, they're not going to pay any taxes between the ages of 70 and 74. Then they get to 75. In RMDs, kick in part of the reason why this strategy ended up being the best strategy was it got their IRA balance down low enough that you don't want your IRA balance at zero, because you're gonna waste standard deduction, if you do, so, they want some Ira balance, and this is at a level, it's not perfect, there, RMDs are gonna push them just slightly into the 10% bracket, which with Social Security is really an 18.5% effective marginal rate. So they are going to be paying a little bit of taxes at these ages, but not a whole lot, they're mainly still taking the RMD, giving their Social Security benefit, and then covering the rest of their spending through the Roth IRA distributions. And that way, they're not they're not voluntarily generating any more Ira distributions, because it would have to be done at a higher than 15% rate. And there's no opportunities once they're through the tax torpedo to salvage that and to keep going, so they put on the brakes. But this what it what it does is it front loads their taxes into those early years when they still have the taxable account. And then it keeps our taxes quite low after age 70. Versus the conventional wisdom, which didn't have any taxes while there was a taxable account, because at all, all those long term gains and qualified dividends were still below the preferential income threshold, and they didn't have any ordinary income. But then, once they're now taking all their distributions out of the IRA, plus Social Security, that led to a lot more taxes, that this, the main driving factor that causes improvement for this couple was they were able to dramatically reduce how much of their Social Security is taxed.

Instead of being in the ballpark of 85%, it was significantly lower throughout the retirement horizon like more on the ball, it increases over time, because the Social Security brackets are not inflation adjusted. So just gradually, over time, more and more of Social Security is getting taxed. But it was a substantial reduction, which is a substantial tax savings, they they pay higher taxes for the first few years to have dramatically lower taxes, once they get to age 70 For the rest of their life. And this has been striving to better outcomes.

Alex Murguia 43:14
Yeah, and this happened by pulling away from the normal order of operations of distributions to kind of use your what you said earlier, Paul, these this tax mapping strategy helps begin to guide strategies on on how you should sort of have that there's a line of demarcation that you always want to stay below,

Wade Pfau 43:32
if you will, and it's a blending, it's yeah, in the early years he spent from the taxable and then do Roth conversions. So Ira distributions, and then once the tax was gone, you're gonna then have a blend of IRA and Roth IRA instead of just doing one at a time.

Alex Murguia 43:46
That's it, that's all I wanted to point out how difficult obviously, the figuring out part is a little more challenging than not because of the resources available to consumers. So so it's a two part question. How difficult is this to implement without a financial professional, and I say that knowing that we're principals of McLean asset management, so without trying to sound like a commercial as well? How difficult is this? No, it's the truth, right? Because we do have consumers and you know, I want them to come out of this with something, regardless of what happens. So how difficult is this for somebody to implement on their own? And with regards to that, what are some potential shortcuts that could help them directionally make some decisions?

Wade Pfau 44:36
Yeah, I'm always sensitive to because there's a lot of ways you could be I don't know, I mean, so that's fine, too. I mean, there's a lot of books about retirement planning that are really just commercials to say, this is so complicated, you have to hire an advisor. Yeah, of course, it's great if people want to work with McLean asset management, but I want this to also be accessible to people that do want to do this on your own. And so it really becomes like when you or you're looking at your tax situation and thinking about should I do a Roth conversion, you got a couple of things, at least in the current year to be tracking, which are, if you have if you claim Social Security already, how's that going to impact social security benefit taxes, and it is a lot harder to do Roth conversions once Social Security begins. If you're at least 63 years old, you have to be thinking about the impact on the Irma surcharges. Now, it's not the end of the world, if you might pay an Irma surcharge once or twice, because they're not permanent. It's just for one time, each time you exceed the thresholds that you want to be tracking, I don't want to accidentally go over those thresholds. Now, you won't know what those thresholds are until two years later. But as a conservative assumption, I just kind of use this year's thresholds. When I'm thinking about managing the income levels as a way to build in a buffer for two years later, they'll probably be higher than they are this year. And then you just want to keep track of the preferential income stacking and then net investment income tax where well, how much ordinary income can I

generate before I start to cause problems with how my mind preferential income is taxed? And then over the longer term as well, you need to be thinking about where will you be once RMDs begin? And are you on a path where RMDs are not going to be onerous in terms of forcing you to pay taxes at high effective marginal rates. Because of all these complications, it really does speak to front loading, taxes in retirement, and especially also to help protect a spouse in the case of the widows penalty. It is complicated. We do have a lot of our audience may be engineers. And so if you're handy with a spreadsheet, you can certainly create a spreadsheet to do these types of calculations. But But yeah, I mean, at the end of the day, if you're more of a delegator, someone who would rather just offload this, certainly a good financial professional financial adviser is going to have software available and is going to be able to help you work through this or help work through this for you. And as exactly what Rob was talking about last week, this really become Roth conversions, you really kind of have to wait till later in the year, because you have to know what are your other income sources going to be? Before you can then engineer exactly how much Roth conversion you want to have to control that overall level of taxable income. So it can't be done. And I what I want to do is explain how to do it. And certainly

Alex Murguia 47:30
100%, I just want to give, I just want to work, I just want to live in reality as well. You know, I don't think anyone listening to this podcast or even then memorizing Jarocho is going to be equipped with being able to do the analysis. But what they are going to be able to have now that they didn't have before is the knowledge that this conventional wisdom is taking distributions from a portfolio in the order of taxable text for tax exempt. And that works better than randomly doing it or just, you know, picking whatever, right? That being the case, if you give some thought with regards to how you pull money out, in consideration of your entire financial planning situation, you could potentially be adding in the realm of 41 basis points, annualized, by doing this in a smart way, because you're keeping more of your returns than not, and that is significant many times in our profession, at least I find myself say, No, that's stupid, that's silly. It's not worth the effort or it's not really there. It's not whatever it is something in the negative it's really it's really like discounting things. This is not this is not one of those things this is one of these things that it's well within your control to do and it's well worth the calories to spend because point four of a percent a year annualized is significant. If you translate that to investment acumen you would like there put a statue of you in Wall Street get out so I think this is well worth the time this is one of those things that's well worth the time that I'll leave it I'll leave it at that

Wade Pfau 49:15
so go forth and rough convert

Alex Murguia 49:21
Irma for me alright everyone thank you for this episode for listening in on this episode. Wait thanks for the article will have a link to the article below if you have any questions obviously we'll have links to contact us and we'll can take it from there. All right, thank you and obviously I hope everyone had a great Thanksgiving. We know we did wait.

Wade Pfau 49:46
Everyone and we'll catch you next time on retire with style. Take care.

Alex Murguia 49:51
Bye

Bob French 49:53
Wade and Alex are both principals and McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with a risk including risk of loss. Past performance does not guarantee future results.