Episode 141 Tax-Efficient Retirement Distributions

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SPEAKERS
Wade Pfau, Bob French, Alex Murguia

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. You know, what's more fun than getting ready for a long weekend? That's right, talking about tax efficient distribution strategies. So here's Alex and Wade.

Alex Murguia 00:52
Hi everyone. Welcome to retire with style. I'm Alex, and I'm here with my very trusted companion, Wade Pfau, and we're gonna be sorry. Wade, go on.

Wade Pfau 01:05
How do you do?

Alex Murguia 01:08
Is that it just for me or for the audience or the audience? Oh, there we go. There we go. And today we'll be kicking off a brand new arc. Wade, you want to tell us a little bit about that before we go into details.

Wade Pfau 01:21
Yeah, that's right, we haven't had an arc in a while, but we never. We've talked about tax planning and tax efficient retirement distributions in past episodes, but we haven't formally. We always said, Well, there's a lot more to it that we'll eventually get to. We're going to start that arc on tax efficient retirement distributions, talking about the different tax treatment and the tax code, the basics of income taxes, and then starting to think about the whole conversation with Roth conversions, and if you have tax diversification, where you're getting closer to retirement with your brokerage accounts, your tax deferred, IRAs, 401, KS, Your tax exempt. Roth type accounts, how to structure distributions from those in a manner that can get you the most after tax, wealth and spending and wealth, and it can have a big impact. So we want to spend a lot of time on that, and talk about all the different aspects of the tax code that contribute to a very

complicated picture, but that you can ultimately navigate through to to have a better, tax efficient retirement income plan. That's what this arc is going to be all about.

Alex Murguia 02:26
Now, Wade, remember when we saw the outline of this arc and what we're going to cover? My first comment to you was, this is too much excitement for one arc. Are you sure? Are you sure our audience can handle this?

Wade Pfau 02:36
Yeah, right. We didn't know. Is this going to be a 20 episode arc or

Alex Murguia 02:43
No, no, you're right. I'll say one thing before we get started, is these are one of the things you can control. I mean, a lot of folks spend so much of their time thinking about investing frankly, and also retirement income in the weeds for things that are somewhat out of their control, such as, is this stock going to hit? Or, you know, is the 4.375% rule better than the 4.555% rule? Yeah, that kind of thing. To me, these are one of the things you can control, and you can add definitive value to your bottom line. And so while it may not seem as exciting as picking the next Nvidia or things along those lines. It's, it really is actually quite palpable, the amount of value that you can bring to the table, to your bottom line. So I think it's one of those things that's immensely important, agree or disagree way, yeah,

Wade Pfau 03:38
absolutely. And maybe just to clarify, like, what we're going for. So a lot of time when we talk about tax efficient retirement planning, the it's framed as you want to minimize your lifetime taxes. But to be clear, that's not the objective. It's if you want to maximize your after tax spending and wealth, if your investments do better, if you have tax efficient approaches to this, you might end up paying more lifetime taxes. But that's not the criteria. It's well, after paying more lifetime taxes, you have more after tax wealth. And that's really the objective, and that's where as you're seeing, you can have a big impact. You can really however you frame it with either your portfolio will last for longer support more years of retirement spending, or you'll be able to meet your retirement spending goal through a particular age, and at that point have more after tax wealth remaining, either for yourself or for any beneficiaries that you may have in mind. And

Alex Murguia 04:31
there we are, well, as I learned when I was in high school after crashing my mom's car and I had to work at Chili's as a line cook to pay for the repairs, the wisdom of Kenny, the taco fry line cook. When everything's got busy, he would say, there's nothing to it but to do it. And so with this arc, Wade, there's nothing to it but to do it. So let's get cracking. Yeah,

Wade Pfau 04:54
yeah. Let's dive in, and we'll start with that. With this episode, really just talking about some of the basic. Fundamentals of this is not a course on becoming an accountant or anything, but kind of the basic concepts and the tax code that we're going to be working with throughout the arc to build a more tax efficient strategy, but to just level, set and lay that foundation. That's what this particular episode is all about, the basic building blocks.

Alex Murguia 05:19
So step one, the basics

Wade Pfau 05:20
one, so in the United States, and the whole reason that we have this conversation, and this is true throughout the world, so it's not just Yes, we have a progressive tax system and a progressive tax system. What does that mean? Alex, you

Alex Murguia 05:37
didn't say there was gonna be a quiz well pay taxes when rates are low, avoid them when they're high, but you're talking about the brackets and how you're taxed on the bracket, and then it goes up and up and

Wade Pfau 05:51
up, yes, yeah. But as your income increases, your tax rate goes up, yeah, but Yeah,

Alex Murguia 05:56
real quick. This is something for the uninitiated, and there are many actually, I'm not surprised, because why would you, but there's many folks that come in prospects and even clients, and they talk about their tax rate, and let's say they're, they're at a certain tax rate, they assume, you know, let's say, Oh, I'm at the 35% tax rate. They assume they're paying 35% on every penny. And in a progressive tax rate, it's, you know, there's brackets like from, let's say the 12% bracket kicks out at whether you're filing single or married. Let's just say 11,000 or 23,000 the first 11,600 or the first 23,200 you pay 12% if you make more than that, you pay 22% on the next bracket and the next, like tranche of income, and so forth. So it gets increasing, it increases. So let's say you, you hit that 37% tax bracket, and you're single, you're filing single, you're not paying, you know, on the full $610,000 you're not paying the full 37% you're paying the lower brackets, and it's just incrementally going up on the next tranche and so forth, that were you going forward? Yeah,

Wade Pfau 07:06
yeah. And that's a really important point to make, because a lot of people do make that mistake. And if that were true, that would be a huge non linearity, that would even be more complicated than what we're going to be dealing with that you really would, at all costs, want to avoid a higher tax bracket if it caused all of your income to be taxed at that rate? But no, we're, yeah, we're talking about this idea of marginal tax rates. As your income increases, the taxes paid on each additional dollar of income will eventually kick into higher rates that we have seven different tax brackets currently and also in the current law. We'll talk about how the tax rates are projected to change in 2026 but they'll still be seven. And once you get to that standard deduction area, it's, you've got a 10% bracket. And then it starts working. It's, it's way up in 12, 22% and so on. Up to 37% right now is the highest federal income tax bracket now.

Alex Murguia 07:59
Now Wade this. This wasn't part of the air, but I just thought of this as you were saying. Were saying, because when we're doing this live, they start thinking about questions that could potentially coming in. This is a personal opinion kind of thing, but I think people would be interested in listening to you. What about the audience members that are listening? And say,

and this is the problem with the whole tax system. It's overly complicated. With brackets. People game it. Why don't we just do a flat tax and call it a day?

Wade Pfau 08:26
Yeah, I don't necessarily oppose simplifying the tax code. The longest chapter in my retirement planning guidebook is about this tax planning topic, because it is complicated, and then I get negative Amazon reviews saying my book is too complicated. Okay, well, let's simplify the tax code, and then the book doesn't have to be as complicated. I'm I'm all for simplifying things. And when we talk later in the arc about how Social Security gets taxed, that's truly one of the most complicated creations ever of how you do determine what percentage of your Social Security benefits will be taxed. It's complicated. So I'm in. I'm fine with simplifying the tax code, definitely, and that may make it less progressive, although usually if we talk about some sort of flat tax rate, there's going to be some sort of exemption amount where you'd have a 0% tax and then the flat tax would kick in. So that would still create a progressive tax system with the idea that as your income increases, the the average tax you paid on your income would go up, but in terms of the marginal tax rates, if there's only one, the one instead of seven, well margin and these tax brackets are only part of the conversation of what we're getting into, but at least for Now, there's seven different tax brackets. As your income increases, it doesn't cause all of your income to be taxed at the higher rates, but you'll enter into new tax brackets and start well,

Alex Murguia 09:48
wait, I learned two things, that you're not against the flat tax and that you actually read my review. Very interesting.

Wade Pfau 09:57
Yes, on Amazon. So. Yeah, no. Lately, overall, the reviews are good, of course, but, well, not of course. But lately, there's been one star reviews just saying, Oh, I can't read this book. It's too complicated.

Alex Murguia 10:09
It is what it is usually for certain folks, and that's fine, you know, like we are. So 90%

Wade Pfau 10:20
of the books about retirement planning are just fluff. So that's not that hard to find. Yeah,

Alex Murguia 10:27
exactly. That's not what you do. So it is what it is, all right. So marginal and effective. What do we have there? I was, I sort of took us off a little bit on the flat tax philosophy.

Wade Pfau 10:38
I mean, this progressive idea is important, because if there was a flat tax ultimately, it wouldn't matter when you pay taxes so much. But because the tax system is progressive, we're always going to be working towards some sort of idea of smoothing our taxable income over time with just a general philosophy. Maybe sometimes you have opportunities, it's kind of inevitable we have to pay taxes, but we have some control over when we pay taxes. So if we can take advantage of paying taxes at lower rates, we might want to do that, and that may then help to not have to pay taxes at higher rates, and so generating taxable income at times when the that can be done at a lower overall effective tax rate on considering not just federal income brackets,

but also all these other aspects, the way Social Security is taxed, the prospect of higher surcharges on Medicare premiums, the way long term capital gains and qualified dividends get stacked on top of your ordinary income, the net investment income tax, if you're using the Affordable Care Act, the loss of subsidies as your taxable income goes up, or your adjusted gross income, modified adjusted gross income goes up, trying to control paying taxes when we can do so again at lower rates, to avoid having to pay taxes at higher rates. And that's much of retirement income planning is about short term sacrifice for long term gain. And that's really the theme here. Is going to be short term sacrifice of paying more taxes than necessary, potentially at some points, to avoid paying more taxes later at higher rates, which will then translate into higher after tax spending and wealth. What?

Alex Murguia 12:23
What? What? Specifically, and this is, again, the danger is always assuming that folks are speaking the jargon that we use on, on, you know, for this topic, what do you mean when you use the word marginal tax rate versus average tax rate?

Wade Pfau 12:42
Yeah, and this is an important question too, because a lot of times people in, like in a Principles of Economics class, you focus on what happens at the margin. The marginal tax rate is the tax rate you're paying on that last dollar of income. So if my taxable income is $50,000 and I decide to take out another dollar from my IRA. What's the marginal tax rate? Is just what tax rate am I paying on that last dollar I took out of the IRA, and in terms of my decision making about whether or not I should do that, it's based on the marginal rate on that last dollar. A lot of times people want to just think in terms of average tax rates. Like, well, if I take another dollar out my average even though they because the marginal rate may be higher, would increase my average tax rate, but by a minuscule amount. So it may not look like a big deal, but that's not how decision making is done. It's almost like whatever you did before that dollar is a sunk cost. At that point you really want to make your decisions on what happens with that next dollar that you're taking out. So that's the idea of marginal tax rates, marginal analysis, making decisions based on that next dollar, not on the overall average tax rate paid on all of your income, but the tax implications of that next dollar. That's that's the marginal tax rate. That's what our focus is going to be throughout. Now we'll talk later about because of the complications in the tax code. You might not just look at it dollar by dollar, so you might look at chunks of income, but ultimately, what is the tax rate you're paying on that chunk of income, that's where the decision making comes in, not on the the average tax rate paid on all of your income.

Alex Murguia 14:28
I mean, the only it's not a counter, but the only thing that to balance out is, how much effort do you spend, you know, to stay, you know, below those margin, to stay below that, the lowest possible bracket when you're right to make the example, if it's an extra dollar and that flips you over to the next tax bracket, it's really not gonna affect you overall. So I wouldn't spend 100 hours of your own time trying to get there, just for the hell of it. You follow what I'm getting

Wade Pfau 14:55
at. Yeah, yeah. And so it's not a big deal to just go over a little. Bit and pay a higher tax rate on a few dollars. Now, the Medicare is the one issue where, yes, we'll talk about later, $1 too much, and you may, as a couple, be facing $2,000 of additional Medicare premiums for the year. Fine.

Alex Murguia 15:11
I'm just sensitive to the the, you know, the the tax tail wagging the dog, you know, that kind of thing. But okay, so there's that marginal we did at marginal average, then a couple of more things to level set on as federal and state income taxes, because it's more than just what's your bracket? Yeah,

Wade Pfau 15:33
so there's a parallel conversation with state income taxes. Most, most states with an income tax, and there are some states that don't have income taxes, but those that do generally also have a progressive system that may some in some way, just parallel the general concept of federal income taxes. So this whole conversation we're having can also be applied at the state level, but because there's 50 different states and 50 different tax systems, we're not getting into any specifics about states we can for the context of this podcast series will just generally focus on the federal income tax system. You can assume then you're living in a state with no state income tax, or just where we're not adding in the additional implications of state income taxes with our conversation, everything we're talking about will be at the federal level. And

Alex Murguia 16:22
I think there's a whole arc on just California.

Wade Pfau 16:26
California would be one of the more complicated and high, higher state income tax

Alex Murguia 16:33
that you could have, all right, and then so marginal average federal state the next one, filing options, What? What? What are those about the single jointly, etc.

Wade Pfau 16:46
Yeah, we don't need to get too deep into the weeds, but yeah, there's different filing options. Whether you file as a single, individual, married filing jointly, those are the two we'll generally use in examples throughout the arc. You can also be married filing separately, filing as a head of household or as a qualifying widow or widower with dependent children. But we're going to focus primarily either on, well, both single, married filing jointly, because also part of the conversation is in retirement at some point after the death of the first spouse, that married filing jointly couple in the following year is going to have to switch to single filing and there can be implications from that. And so we'll we'll talk about all that throughout the series, but we'll just generally assume, if you're a single person, you file as a single filer. If you're married, you're married filing jointly. There may be exceptions, but that's where this is not a full in depth accounting based series. It's more about the general concepts and tax planning.

Alex Murguia 17:47
Yeah, really it's to be an informed consumer so you can ask the right questions. All right, so what are them? What are damn brackets? Wait, well,

Wade Pfau 17:57
yeah, yeah. So we have seven federal income tax brackets. There's, we don't really call it a tax bracket, but first, it's a 0% and that's kind of the standard deduction, or if you're able to itemize, whatever you have in that deductible part, that's technically a 0% tax rate, but that's not one of

the seven. Then once you get through your deduction, you get into the 10% bracket, and then 12% 22% that's the biggest jump, and that's for many kind of middle class folks, that division between 12 and 22% is an important one, because then after that, there's not as big of jumps. It's 22% and 24% smaller jump, then up to 32% then 35% and then 37% those are the seven federal income brackets this year, 2024 next year, 2025 and under current legislation, not in 2026 and 2026 we will change back to the tax brackets that existed in 2017 which in many cases were a bit higher, but not always. The 12% bracket will become the 15% bracket. 22% will become 25% there's other various adjustments along the way, but then the highest tax bracket in 2026 would be the 39.6% bracket, and that would kick in at a lower level of income than the 37% bracket currently kicks in

Bob French 19:25
the retirement researcher. Retirement Income Challenge has gotten started, and we had a really great first day yesterday, but if you missed your chance to take part, don't worry. You can join our retirement income challenge wait list so you don't miss out next time and make sure that you're going to be able to join Wade. Alex Jason and I to sign up for the challenge. Head over to resoprofile.com/podcast again, That's resaprofile.com/podcast See you in the challenge next time, at least. What

Alex Murguia 19:59
would you tell. Tell somebody when, if they're doing tax planning right now, from a philosophical perspective, in terms of projecting their taxes into the future, do they would you suggest they keep the current rate in perpetuity? Or would you suggest they consider that it's set to return, it's set to resume in 2026 and try to guess where it's going, like, oh, it's going to stay the same. I know it will, or it'll go back up, because that's just what's in law. And, you know, they try to play the who's going to win the president

Wade Pfau 20:30
game, right? Right? Well, yeah, I think there's no easy answer there. And that's actually so Bob French, part of our team here at retirement, researcher and McLean and Risa. He even though current law says we're going to change tax rates in 2026 he's more comfortable just using today's tax rates and extrapolating them into the future. I've always taken the position that we we don't want to, like assume any sort of policy changes. So current law says there's going to be higher tax rates in 2026 so I want to assume the higher tax rates in 2026 I guess there's really no right answer about that, but I want to stick to the current law. He would like to stick to the current rates. I suppose either can be justified with some argumentation behind it, but that's a situation. Of course. It's more conservative with planning assumptions, to assume higher rates will kick in in 2026 and again, that's the current loss. So that's why I really feel more comfortable taking that. I

Alex Murguia 21:29
subscribe to Team weight on that one as well. Okay, well,

Wade Pfau 21:33
we'll have to have Bob on the show to defend

Alex Murguia 21:39
it'll be a quick conversation. Yeah. Go on?

Wade Pfau 21:48
Well, no, no, that's that's the lay of the land at that point. Now, just when you are retired, you can knowing your average tax rate is useful because if you're just doing a simplified projection, you might want to do something like, Well, I know that I my income gets kicked into the 32% tax bracket, but if I look back at my history, usually when I add up all the taxes I paid, it's about 20% of my income. So that would be an average tax rate, and that can be a simple way to Okay, I just will assume 20, 20% of my income is the tax bill. And so to have a basic projection of how much taxes I'm going to pay, I'd use that sort of average tax rate. That's where it can be useful, just a simplified planning approach. And then in retirement, because income starts to work differently, and that's where an accountant often will say retirement income planning is really misnamed, because income has meaning in a tax sense of like taxable income, and there's a lot of sources of cash flows and spending in retirement that aren't technically income. So if all of my assets are in a Roth IRA. We talk about generating income through distributions from the Roth IRA, but that's really not taxable income. I'd have, like, if all my income came from the Roth IRA, I would have no income on my tax form, that nothing from there would go into my adjusted gross income. So then it's not clear what my tax situation is. So that's where you might also in retirement. If you just want a sense of what's my average tax rate, well, it's how much taxes did I pay divided by my total spending. That could be just another way to frame a simplification around what's a simple projection of my tax is going to be as a percentage of my spending, and it, it could be quite a bit lower if you are generating quote, unquote income from sources that are not part of the adjusted gross income.

Alex Murguia 23:51
Yeah. I mean, I agree with you. I mean, when it's good to get the blended rate, just if you're doing a quick and dirty Excel, you know, it's not a cash flow based plan, you know, but you want to just begin to ballpark things at least pre retirement, because there's less considerations around social security income and, you know, potential conversions that you may do later. It, it kind of usually does the trick, if I'm, you know, just to get a good North Star, if you will. But obviously it's worth looking at it from the marginal tax rate point of view, the analysis simply because it's still you know when you need to make that actual decision, precision usually helps,

Wade Pfau 24:31
right? Yeah, but and then also that average tax rate, that total taxes paid divided by total income. You might also call that an effective tax rate too. It's an average or effective tax rate. And again, if you reframe that as total taxes paid divided by total spending, call that an effective or an average tax rate as well, just in retirement. That might be more meaningful towards projecting at a more simplified level, what your taxes. Might look like in the future.

Alex Murguia 25:01
Now, in terms of the different types of taxes, we talked about income, we talked about the, you know, you're retiring, you're getting distributions from a qualified account. What about other types of taxes that could be, maybe not in your face, but you're paying them, such as Social Security and things along those from a payroll tax perspective. Yeah,

Wade Pfau 25:24
well, while you're working so employment based income may have additional taxes beyond the federal income tax brackets, and that's where, if you're not generating income from non

employment sources, you won't have to pay the Social Security payroll tax anymore. You won't have to pay Medicare payroll taxes anymore. Well, then there's also the state and local income taxes. You may property taxes are always going to be there unless you have some. Live in an area where there's some benefit to retirees, either freezing their property taxes or whatever the case may be, but at least when you're no longer employed, Social Security, payroll tax and Medicare, payroll taxes would fall by the wayside, and that can be significant, especially for the self employed. They can average up to 15.3% overall for people who work at a company, the those payroll taxes get split between the employer and the employee, so it's 7.65% for each. And then the Social Security part 6.2% for each, 12.4% overall. That only goes up to the limit, which in 2024 was 100 and I'm not gonna remember the exact number, and I'm not seeing it on our notes, 160,800 I want to say for Social Security, yeah. What's the cap? Oh, yeah, 168,000 Yeah. It changes every year. But, but so you pay 12% 12.4% overall, split between employee employer, up to 168,600 and then the 2.9% for Medicare, split between employee and employer are fully on the self employed that's not capped, that goes up to all the income to infinity. And then also at higher levels of income, there's another point 9% Medicare surcharge tax,

Alex Murguia 27:19
and for those of you listening to our Social Security arc, these are one of the that cap. Just releasing that cap and making it a higher than 168 six could go a long way towards, you know, buttressing Social Security. That's another that's food for another conversation.

Wade Pfau 27:39
Yeah, that's a potential reform option. That's if, for the self employed that's adding an additional 15.3% or No, I started only 12.4% tax on all that income above the cap, which could be burdensome, but whether or not that's a good idea is kind of beyond the scope of our conversation today.

Alex Murguia 28:00
So then all in total income, what are we talking about, basic components?

Wade Pfau 28:05
Well, when we're talking about like the taxable types of income sources, we've got the this is pre retirement, or if you're part time working, or whatever the case may be, but any salary and wages, self employment, earnings, rental or other passive income. We're talking about ordinary taxable income here. So short term capital gains from investments, distributions from your retirement accounts, that qualified retirement accounts, IRAs, 401, KS, those tax deferred accounts, distributions from those count as ordinary income. A portion of your Social Security benefits will be taxed. That's where determining what portion that is is complicated. We'll talk about that later. If you have non qualified annuities. So these are annuities that you purchased from a brokerage or checking or savings account, rather than from a qualified retirement plan. A portion of those will be taxed. The other portion is just return of your principal, and then any qualified dividends and long term capital gains are going to be taxable income as well. But we'll talk about they're not taxed as ordinary income. They have a whole parallel set of tax rates that's going to be really important to the tax planning conversation as we go along.

Alex Murguia 29:21
Okay? And other issues for total income I can see here being bonds and qualified dividends you want to

Wade Pfau 29:32
Yeah, yeah. So well, there's, of course, some bonds that have tax exempting interest, municipal bonds and so forth. Though, there's a caveat on that. When we start talking about how Medicare and Social Security, Medicare premium increases, Social Security benefit taxation, both will count any tax exempt interest as part of your calculations. Then if treasury bonds, they're not taxed at the state or local level, but they are federally. Taxed interest on Treasury bonds, and like I was saying as well, and we'll spend more time drilling into this, but qualified dividends and long term capital gains are not taxed as ordinary income. They have a different set of parallel tax rates that are lower than the seven tax brackets that we were talking about earlier there. Well, to get to that punchline, there 0% 15% 20% and then there's also a potential 3.8% net investment income tax. Okay, okay, so we should talk a little bit about just the basics of what the 1040 is showing at a very basic level, you add up all your total income, taxable income sources, and then you may have above the line deductions. We'll explain what those are, summarizing that. And then you get so total income minus above the line deductions gives your adjusted gross income, and then from your adjusted gross income, you can have below the line deductions, and that's either your standard deduction, or if you're itemizing, whatever that works out to be, and then that leads to your taxable income. Now, one point to just make here, because it's really important for the arc, and it's something that I think is easy to forget. A lot of the complications in the tax code that we talk about are linked to your adjusted gross income. And what that means is below the line deductions will not save you from these problems. You can get your taxable income down with below the line deductions, but all these other triggers and thresholds and things are linked to the adjusted gross income, which is calculated before looking at below the line deductions,

Alex Murguia 31:48
okay. And so what are some above the line deductions?

Wade Pfau 31:51
Yeah, yeah. And so these may be less relevant post retirement, but if you're making deductible contributions to qualified retirement plans, that's one of the big benefits of doing so. So contributions to traditional IRAs, deductible contributions that are allowed, deductible contributions to 401, K plans, all that sort of thing, you get to take that out of the adjusted gross income so it lowers, lowers your adjusted gross income. Making contribution to Health Savings Accounts lowers your adjusted gross income. Now, once you're on Medicare, that won't be a possibility. But pre Medicare, a lot of folks use health insurance that allows for health savings accounts, which give you that triple whammy, tax deductible contributions, tax deferred growth and then tax free distributions when used for qualified medical expenses.

Alex Murguia 32:44
Yeah, I think the HS like, I think we did this in the healthcare arc when we're discussing healthcare and retirement, or I'm actually, you know, we have it for our company, and this is something that I'm maximizing to the large extent possible, because it is I'm using it for a strong consideration in terms of funding a lot of healthcare stuff as I get older, because it's just, it's just too good not to take advantage of it.

Wade Pfau 33:07

Yeah, it's really powerful part of the tax code. Now there is a bit of a caveat on that, just to keep in mind. So no issue like if your spouse is the beneficiary, it goes to the spouse, they can treat it as their own. The problem is other types of beneficiaries. It's not great to receive health savings accounts as like an adult child beneficiary, that sort of thing. You have one year to get all that money taken out, and it's going to be taxable all in that year. So one very important trick there is if if you're kind of using your health savings account as a way to build up a tax exempt pot of assets, save all your medical receipts, put them all in a folder and provide clear guidance to your beneficiaries that they have one year to apply all these receipts against the account to get eligible distributions from the account so that those distributions won't be taxed.

Alex Murguia 34:04
So I just want to make sure that when you say, save receipts, because they could be thinking, What do you mean receipts when I was 50 years old? Yeah, that, you know, I was just buying whatever cholesterol medication, and I've accumulated $2,000 worth of receipts. You mean I can apply them when I'm 70? Yes,

Wade Pfau 34:21
that's exactly what I mean. I've got a folder here in my file cabinet where I'm just putting all the medical receipts, and I'm listing them in an Excel spreadsheet.

Alex Murguia 34:29
Are you really doing that right now? I swear. Are you really doing that right now? Yes. Oh my God. You see, I'm, how old are you man? Exactly?

Wade Pfau 34:39
I'm 47

Alex Murguia 34:40
I'm 51 and I was like, I'll start doing that when I'm 55 you're already doing it. I gotta change my ideation. And now for those of you listening to the podcast, Wade actually pulled out one of those hanging folders that you. Put in the metal file cabinets like many moons ago, and he just showed him to me, Hey,

Wade Pfau 35:07
I'll save my adult children, child beneficiaries, 10s of 1000s of dollars of taxes. I

Alex Murguia 35:11
just figured at 55 and for it, I'll have more than enough to cover whatever is accumulated. Good for you. Wade, good for you.

Wade Pfau 35:25
That's important, and you can only do that once you had the HSA, so, but once you got an HSA, yeah, if you're not using it to pay for medical expenses, save those receipts.

Alex Murguia 35:38
Does your wife have an HSA? Is it just you?

Wade Pfau 35:41

It's a family one, so, oh, sorry, sorry. And also, she's the primary beneficiary, so if something happens to me, and then it's her account, no problem. It's when something happens to both of us. Then whoever that money goes to, they've got one year to take it out, and it's taxable unless they have eligible receipts to So

Alex Murguia 35:59
to be clear your your wife could actually apply the the knee brace you bought at CVS when she's 70.

Wade Pfau 36:10
Oh yeah, yeah. I mean, it's a family HSA, so all my

Alex Murguia 36:13
just making it clear when what that means when you're saying that, okay, perfect. So HSA is the way to go. I mean, it really is one of these, like, under the radar things, although I'm seeing the past, I want to say the last 18 months, I've seen a lot of stories come out, like, like, it's not clickbait, but it's more like, you need to take advantage of this vehicle. Now, you know that kind of thing. So it's getting a lot of heat lately,

Wade Pfau 36:40
well, and yeah, it seems like maybe a lot of employees are also only offering HSA option health plans. So I think it's getting more prominence too, but there's annual limits on how much you can contribute. It's, I don't have these numbers memorized, but somewhere in the ballpark of $8,000 for Yeah,

Alex Murguia 36:58
it's in that range. It's not quite 10, but it's definitely in that range, and it goes up a little bit each year, and

Wade Pfau 37:04
it's about half that for a single person with single health plan. But yeah, that's one of the above the line deductions. Just to finish the list there, the other main ones would be, if you're self employed, part of that self employment payroll tax is deductible above the line, and then also student loan interest is above the line, deductible. There's other small things, but those are the highlights that probably would cover 80% or more of the situations people will face.

Alex Murguia 37:37
Okay? And then you do that, you get your AGI adjusted gross income,

Wade Pfau 37:44
yes. And so when post retirement, you may have less options there, especially you may not be able to if you're on Medicare, you can't contribute to an HSA. If you're not working, you can't contribute to qualified retirement plans. If you're not working, you won't have self employment tax. And if, now I know there's more Americans entering retirement with student loan debt, they can still get those deductions. But if the time you're retired, you've already paid off any student loan debts. You may not have above the line deductions in retirement, but yeah, any anything you can take off there, then you get your adjusted gross income. And that, again, is the key for many of these non linearities we'll be talking about in future episodes. All right,

Alex Murguia 38:26
and so then we got AGIS. What can you do below the line?

Wade Pfau 38:30
Well, so that's the tax cuts and Jobs Act in 2017 in many ways, made us a lot of people won't itemize, because it raised the standard deduction so that you would need a lot more deductions before you itemize. It removed exemptions. It changed the rules for many deductions. So this is all again in 2026 this is currently scheduled to change, but right now, the main below the line deductions would be mortgage interest, but now only on acquisition debt. So if you have a mortgage as a part of acquiring a home, that's deductible, if you're just borrowing against the home, that's no longer deductible. State

Alex Murguia 39:11
that would be just, to be clear, a HELOC versus a normal mortgage,

Wade Pfau 39:15
right? So a HELOC is not acquisition debt. If you're if you're borrowing from the home to just spend money, it's not just

Alex Murguia 39:23
to be clear, I shouldn't have used like an acronym. If you'd have a home equity line of credit, a HELOC that

Wade Pfau 39:29
you're just using to fund other types of expenses, then it would not be deductible state and local income taxes. But now that's capped. So for a joint it's a $10,000 maximum deduction, which, because of the higher standard deductions, there's still a lot further you need to go before you get out of the standard deduction. And so states with high state and local income taxes were kind of penalized by that, because there's the cap on their. Deductions, medical and dental expenses, the amount in excess of seven and a half percent of the adjusted gross income are deductible below the line. And then charitable donations qualified charitable donations are deductible below the line. But this is one of the nonlinearities in the tax code that we'll talk about, which is just whatever deductions you have, if they add up to less than the standard deduction, you're not getting any benefit from them because you just used a standard deduction. So this can lead to strategies like deduction bunching, where instead of contributing to the charity every year, I'll make five years worth of contributions in year one, and then skip the contributions for the next four years. And that could be a way where I actually get above the standard deduction and can deduct something, get, get meaningful tax benefits from that. What we're looking at with standard deductions for singles this year in 2024 it's 14,600 for singles, and 29,200 for married filing jointly. So that's that's a big number. In terms of your state and local income taxes, you can only apply up to $10,000 so then with everything else, the medical expenses, mortgage interest, charitable donations, would still have to add up to over $29,200 before you get a benefit. And if you're 65 and older, you get a higher standard deduction. It increases by $1,950 for single folks, and by $1,550 per person for those who are 65 or older when married filing jointly.

Alex Murguia 41:40

Okay, and just to be clear, because when you said increase, deduction increases, just do the math for somebody, as they're listening in. So somebody, let's say they're 65 plus married filing jointly, the 55 the 1500 the $1,550 you is applied to the the 29,200 standard deduction, correct?

Wade Pfau 42:07
Yeah. So if both individuals are over 665, or older, we're looking at $3,100 that combined for the two added to the 29,200 so that's what, 32,300

Alex Murguia 42:23
whatever it is, just whatever. 29,000 plus the 3000 for the purposes of this podcast, yeah, I just want standard collection.

Wade Pfau 42:36
And again, that will all currently, that's all currently legislated to change in 2026 but if we take the Bob French approach, we'll assume that will never happen. So yeah, that's enough for now. All right,

Alex Murguia 42:49
so in terms of tax prep, you know, don't worry about it if you only have $10,000 worth of expenses, but our deduction potential itemized deductions. But if you think you're getting to that ballpark, then it's probably worth busting out the old Excel and receipts to see if you if you hit that line,

Wade Pfau 43:09
yeah, and to try to just be strategic about when you realize those deductions, so that you may get the chance to itemize occasionally. You may not itemize every year, but maybe you can pull off, well, you can everything in one year. You used

Alex Murguia 43:23
a good example with with charitable planning there, there's many clients we have that are charitably inclined, and that definitely is a strategy. And in terms of front loaded or back loaded, however, you want to

Wade Pfau 43:33
have a donor advice fund, so you, yeah, make a big contribution to that, you get a tax deduction, and then you can, you can still spread out your contributions to charities each year, but by putting it all in one year into the donor advised fund, you may actually be able to get a tax deduction

Alex Murguia 43:52
Perfect, all right, and is there a lot of tax planning to do around These itemized deductions?

Wade Pfau 44:00
Well, for many folks, it may just not really be possible to itemize under the current law, but if, if you are, well, if you do have major medical expenses, or if you do make a lot of charitable contributions, yeah, there may be opportunities to realize some benefit from tax planning. For a lot of folks, it just you take the standard deduction, and that's really all there is to do on that particular issue. I agree.

Alex Murguia 44:28
Okay, and so we did cover payroll tax already, just

Wade Pfau 44:33
Yeah, so the other, maybe the other kind of basic concept for today was just to get a little bit deeper into the qualified dividends and long term capital gains. They have their own set of tax brackets. I mentioned 0% 15% 20% and those numbers are higher than well, those tax rates are lower, but they apply to higher levels of income, so the 15% bracket doesn't. Kick in until it's not the same as when the 22% income tax bracket starts. But it's close. It's $125 different for singles, $250 different for married filing jointly. You would think they could have just like, made them the same. Yeah, exactly, and it wouldn't be as fun. But these are higher numbers, which means if you don't have other taxable ordinary income, you might realize a lot of capital gains and still be paying 0% taxes on that. So you can sort of reset your cost basis. It's often we talk about capital loss harvesting, where you harvest losses to try to get a tax deduction. Gains harvesting, just realize the gains, sell and then immediately repurchase the asset to raise your cost basis and generate taxable income. But the point is, if you're still in the 0% bracket for that income, it can be worth doing.

Alex Murguia 45:55
Yeah. Now you said gains harvesting. You could sell gains and buy them immediately. Yeah, different loss harvesting, just in case somebody gets confused. You may want to run through that just in case, because of the wash sale, I don't want people to confuse that loss harvesting. Loss

Wade Pfau 46:09
harvesting is a lot more complicated and has a lot more rules about you can't buy and sell within 30 days of the same asset, that sort of thing. We won't get into that whole discussion right now, but the gains don't have the same rules. I'm allowed to sell to realize a gain and then immediately repurchase a second later. It doesn't cause any problem. It's I'm voluntarily paying taxes by doing that. And the reason I might be attracted to that again, is if I'm still able to pay at a 0% rate on that, I'm generating taxable income. I pay taxes 0% I'm happy the government, they may not be happy, but that's the tax code as it exists, and so I'm just working within the tax code to realize that income and then the net investment income tax is a 3.8% additional tax added to those rates. That applies for single folks when the modified adjusted gross income is over $200,000 and for married filing jointly, when it's over $250,000 so that can make that 15% rate become 18.8% the 20% rate can become 23.8%

Alex Murguia 47:27
and you used a new term which has modified adjusted gross income. Those are, those are, that's the adjusted gross income after you've done the below the line deductions. Well,

Wade Pfau 47:37
that's, you take the adjusted gross income and you make some modifications to it. But in the tax code, every time some new concept is introduced, you have a new mod way to calculate modified adjusted gross income. So there's not just one way to say, this is how you modify your adjusted gross income. We'll talk about different versions of modified adjusted gross incomes. The for this particular issue we're talking about right now with the net investment income tax the

technical definition of the modified adjusted gross income gets pretty darn complicated, and it's really just reading tax code and stuff. So that's really talking about this definition is more we should we should. We should leave that to the account.

Alex Murguia 48:21
All right, so we'll leave it alone. We'll drop it like it's hot, as the kids say. All right, we're by. We're hitting 47 minutes. That's kind of our sweet spot. Any anything you want to have as a parting thought before the next

Wade Pfau 48:35
well, we didn't yet really talk about the implications of your your these preferential income sources that you have go on top of your ordinary income. So maybe just a quick example about that. Yeah. So, I mean, let's just say we're a single filer. Our taxable income is $49,150 if that were all ordinary income, that would now be in the 22% bracket. But it's not all ordinary. It's for 45,150 is ordinary, still in the 12% bracket. $4,000 is long term capital gains. So the way that's taxed is you calculate the tax on the ordinary income by just applying it to the 45,150 and then when you look at the preferential income brackets, you add the long term gains on top of the ordinary income, and look at where that falls. And so in this case, the reason those numbers sound strange, it was designed so that with that $4,000 of long term capital gains, 2000 of that is still in the 0% preferential bracket. 2000 of that is in the 15% bracket. And I call that preferential income stacking. There was recently a really popular story in The New York Times that mentioned my book, but they talked about the same concept, and called it the capital gains bump zone. I don't know where that. That term came from. And I don't know where the term I felt to use is preferential income stacking. They both mean the same thing is this idea of you add the preferential income on top of the ordinary income, and then look at the tax rates for that, and that's going to be one of the important nonlinearities as we start digging into the tax planning and subsequent episodes. So that's probably a good place to stop. Well,

Alex Murguia 50:23
yeah, I just have one question, as people are listening, because it's a lot of things to conceptualize without, like looking at a flow chart. So I want to make sure people understand what you meant by tooth. You have a 4040 $5,000 regular income. 45,150 regular income, 12% tax bracket. That 4000 why is that split? 2000 in the 0% bracket and 2000 in the 15% bracket?

Wade Pfau 50:48
Well, because we're talking about a single filer and so with the preferential tax brackets, single filers pay 0% up to 47,025 oh, I may not have updated that for the current tax year. The idea was one of these tables is not updated. But the idea was 2000 of that still is below the threshold where 15% starts, and then 2000 of that falls above the threshold where 15% starts,

Alex Murguia 51:24
yeah. So it has, regardless of the math it has to do with the income tax bracket, since that person was effectively $2,000 below the next bump up, you split the capital gains into two, half of it in the 0% bracket, and the other in the in a bracket that it bumps them into with, yeah, and

Wade Pfau 51:42
just as a as a enticing lead into why this matters, then, what if I take another dollar out of my IRA? It would be taxed at 12% but it's also going to push $1 of my capital gains to go from the

zero to 15% bracket, so I end up paying 27 cents of tax on that dollar I took out of the IRA even though I thought I was being taxed at 12% my effective marginal tax rate is 27% and if that blows your mind, I think that's a good

Alex Murguia 52:14
place to and that's one to grow on.

Wade Pfau 52:17
Yeah, that's one of the things that's gonna really drive a lot of our discussion and subsequent episodes the impacts of preferential income stacking.

Alex Murguia 52:25
All right, perfect. And there we are. All

Wade Pfau 52:31
right, so thanks everyone, and we'll catch you next time on retire with style where

Alex Murguia 52:35
tax diversification is the name of the game. All right, take it easy, everyone. Bye

Bob French 52:42
Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, 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 risk, including Risk of Loss past performance does not guarantee future results. So