Episode 142 Tax-Efficient Retirement Strategies

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SPEAKERS
Alex Murguia, Bob French, Wade Pfau

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 about investment diversification? Yes, but what about tax diversification?

Alex Murguia 00:47
Hello, everyone. Welcome to retire with Style. I'm here. I'm Alex, and I'm here with Wade Pfau, and we're here to talk to you today about drum roll, tax efficient retirement strategies, everyone's favorite topic, right way?

Wade Pfau 01:06
Yeah, that's right, it is actually, I know you say that facetiously, but it's a popular topic out there. So

Alex Murguia 01:13
surreptitiously, I say it surreptitiously, not facetiously,

Wade Pfau 01:17
ironically, sarcastically.

Alex Murguia 01:22
What other word can we throw in there that doesn't really fit, but it sounds like it does, all right? Wade and high level, you said it is actually people's favorite topic,

Wade Pfau 01:38
yeah, I think, well, I don't know if it's the favorite topic, but it's, it's one that people are interested to learn more about, and we're here to provide that education. So, all right, excited to be doing

Alex Murguia 01:49
this, yeah, all right, okay, man, on a level of excitement, what are you from? From one to 10, one being no excitement, 10 being a lot of excitement. What do you think? Through the roof, through the roof, through the roof. I'm a solid seven on this one, right through the roof. But all right, okay, man, let nothing too right? Let's go right at it.

Wade Pfau 02:11
Yeah, we're part of an arc, and so tax efficient retirement distributions is a general theme for more than one episode today, we're going to look more specifically we're still kind of setting up for the post retirement phase. So we'll look at tax diversification and talk about the different tax treatment available in the tax code, and how diversifying between your taxable brokerage accounts, your tax deferred IRAs and 401 Ks, your tax exempt or tax free, Roth accounts, can really lay that foundation for more tax efficiency post retirement as well. So

Alex Murguia 02:44
then, just from a Q A standpoint, what is tax diversification and why would you Why is it important?

Wade Pfau 02:54
Well, it's this idea that there's three broad types of at a basic level, three broad types of tax treatments in the tax code and setting yourself up for retirement, it can be useful to have some in each of the three categories, so that you have more flexibility thinking about things like Roth conversions and so forth. You want to make sure you've got a Roth IRA set up at some point that's been around for at least five years. Is one of the rules to make to allow for qualified distributions, for instance. So you just want to be anticipating and planning in advance that you have assets that are subject to a variety of tax treatments, so that you then have more flexibility about where to draw from, draw from, to get better control over your tax bill income. And

Alex Murguia 03:39
so what are the what are the candidates of tax diversification? What are those accounts? What types of accounts would you say those are? Well,

Wade Pfau 03:47
you've got your traditional taxable brokerage accounts. First. This is just anything that is taxable, and we'll talk more about the specifics in just a moment. But here we're talking about your checking in accounts, savings accounts, CDs, brokerage accounts, the places where you hold your mutual funds, ETFs, maybe individual securities that are all taxed just the traditional they don't get any tax benefits. It's a taxable account, and that's where you are with that then to incentivize people to save for retirement. Over the years, the government has created different tax advantages, and so you have your qualified plans that we'll call tax deferred accounts. These include individual retirement accounts or IRAs. It includes 401 Ks, 403 Bs, and then all the variety of other SEP IRAs, SIMPLE IRAs and so forth that give you tax deferral. And we'll talk about also the main purpose is a tax deduction on eligible contributions. And then the third broad category we can call Roth, we could call tax exempt after tax, tax free. This is going to give you tax deferred. Growth and then tax redistributions unqualified, but you generally wouldn't get a tax deduction at the beginning. Sure?

Alex Murguia 05:08

Yeah. And so theoretically, what? The way I always look at it, theoretically between tax deferred and tax exempt accounts, absent the HSAs. HSAs are kind of a unicorn, if you will. It helps savings accounts, tax deferred. What it is is the government on the front end is, is giving you a loan on the tax burden. They're not charging you the taxes on the front end. They'll chart, they'll they'll charge it on the back end, and they'll charge it on the back end as income. All right, when you start taking deferrals, tax exempt accounts, effectively, you'll get taxed at the beginning, but not at the end, you know, from that vantage point. So that's very beneficial. What do you see sometimes? This is a kind of a you see on social media for whatever reason. I don't know how it started, but it's becoming a thing, this whole idea about tax diversification and all of that. And what I mean by that is, have equal amounts in every category, or it's to the other extreme, don't have equal amounts in every category, make everything taxable and don't trade off a bit so it'll be tax efficient in and of itself, etc, etc. You know, you have these kind of plays where folks start telling you, don't put anything in your 401, K plan. I'm exaggerating to make the point, but not so much, because you do see this every once in a while on not so much, advisors, but all of a sudden, financial influencers that are on social media. What? Well, how do you mark that up when you run when, when you run across that?

Wade Pfau 06:39
I guess I don't spend as much time on social media as you do, because I'm not really aware of this kind you haven't lived my friend, yeah, I can imagine, well, the idea you just want to have equal amounts in each that just really wouldn't make sense. Everyone's going to have a unique situation. There could be situations where that might be decent, but you wouldn't really try to target that, because you generally gonna have a different asset allocation in each account, which we'll talk about more in the next episode. So even if you put equal amounts in each they're not going to grow at the same rate. So you would not really be able to manage having equal amounts in each over time very easily. And then beyond that, with I guess I have seen people complain about tax deferred accounts, and we'll talk about the characteristics. But at the very least, if there's an employer match where you have to contribute a certain amount to get the employer match, that's free money, and it'd be really hard to argue that you should give that up because you somehow don't like the characteristics, no, I agreed account,

Alex Murguia 07:42
I think, where sometimes folks not run into trouble, but a lot of folks really front load as much as humanly possible their tax deferred accounts or tax exempt accounts, which I can totally see why for long term, and they have very little available and taxable accounts beyond just cash savings.

Wade Pfau 08:02
Oh, yeah, you could definitely overdo it that sure that that

Alex Murguia 08:05
could be an issue from, uh, just liquidity, you know about why you're, why you're, why you're accumulating assets,

Wade Pfau 08:14
and then also the we'll talk about required minimum distributions, but yes, if you've been putting everything into a tax deferred account and then just living your life, you may be in for a big

surprise at either age 73 or 75 now, depending on your birth year, when you have to start taking required distributions and paying taxes on that.

Alex Murguia 08:35
All right, so that being the case, how can and Well, one thing that I think the there's there's, we're at the point now that the podcast has different types of listeners. There's those that are somewhat savvy, and then those that are just beginning to learn and and sometimes I take for granted when we're saying taxable accounts, tax deferred account and tax exempt accounts, think of this as the container that holds the individual investments. It's not different from an investment accounts. These are all investment accounts. It's just the tax treatment of that container holding the investments, right? All right? Because I've run into folks where they literally are like, I have a Charles Schwab account. How is that different from a fidelity account? And you're like, you know, you're like, well, in the beginning, you know that that kind of and it's normal, if you're just learning. I get it right. But okay, these are, these are accounts that if you were to open a Schwab account, or if you would open a fidelity account, or whatever, there, I have no, no skin in the game, whether Schwab fidelity, formerly, TD, AmeriTrade, etc, etc. It doesn't matter me, those accounts you have to open up, they're either going to be taxable, they're going to be tax deferred, or they're going to be tax exempt. You know, this is and then within that, that's where you have your holdings, if you will. And so we're talking about the container that's going to hold the investments, if for. From that vanish,

Wade Pfau 10:00
right? And you can have multiple So you log into your account, and then you have to set up. There'll be they'll have different account numbers here. You could have your brokerage account. Could have an IRA set up. You could have a Roth IRA set up. So you may, as you scroll down your holdings, it'll be separated into these three different buckets of categories. So each account will be its own, its own thing, with its own tax treatment. So that's where, if you say, Oh, I have a fidelity account, what is that? It could be any of the above. You could have a brokerage account there, you could have an IRA there. You could have a Roth IRA there. So it's, you have to really kind of figure out what, what we're talking about with, what type of account it is. And then any of those accounts can hold the same stocks, mutual funds, ETFs, that sort of thing. And we'll get to

Alex Murguia 10:46
a little bit of that later. With regards to there's asset allocation, which is, you know, if you view your household as a single holding, you know, what's your allocation? I have a 6040, stock to bond portfolio, but within that, there's asset location, which is, how is that diversified across your accounts? Like, maybe it's better to have the bonds in a specific type of account, because you'll get the returns plus the tax efficiency that's inherent in those you know there, there's that kind of back and forth that we'll get to. We're just, yes, we're just planting seeds right now on things to be thinking about.

Wade Pfau 11:24
Yeah, I've got that as a topic for the next episode. Yeah, location question,

Alex Murguia 11:30
so I'll leave that alone. But I just, I'm kind of like, just trying to set the stage here a little bit. So how can individuals determine where to save for tax efficient retirement?

Wade Pfau 11:39
Well, to do that, I think it's worth just going into a bit more depth about the characteristics of each type of account. So yeah, we could. We could start with taxable brokerage accounts, or taxable accounts more generally. These are generally considered the least tax efficient, though they do have some beneficial properties too. So that's where it's depending on circumstances. The traditional advice post retirement that we'll be eventually talking about later in the series is you spend taxable accounts first. There could be exceptions to that, but the reason that argument is made is because these are the only accounts that are kicking off every year taxable income, you may reinvest interest payments and dividends, but you still have to pay taxes on that every year. Now, your long term capital gains are deferred, in a sense, until you sell and realize, although if you own mutual funds internally, they may trigger sales that lead to long term capital gains, even though you haven't sold any shares, but you are paying, well every year you're going to be paying taxes on something, and that's not true with tax deferred or tax exempt, unless you're at the age where you have required minimum distributions from tax deferred. You said dividends,

Alex Murguia 12:50
Wade, and this is a term that comes up a lot. Can you talk about the difference between qualified dividends and

Wade Pfau 12:58
dividends? Yes, so the dividends, they're either ordinary or qualified dividends, and your statements that you get from the company that you hold the account at will indicate what percentages each but the qualified dividends, along with long term capital gains, are taxed at those preferential tax rates we talked about in the last episode, the 0% 15% 20% 20% with a potential 3.8% net investment income tax added on so they qualified dividends get better tax treatment than ordinary dividends. And if you're a long term investor, you may, over time, think see that a lot of your dividends are paid as qualified now, interest is always taxed as ordinary income, so bond funds will tend to kick off interest every year that will be taxable again as ordinary income, and then your your stocks may be kicking off a ratio of qualified to ordinary dividends, but over time, hopefully a bigger chunk of that's going to be the qualified dividends with better tax treatment. Then other characteristics, when you take distributions, the cost basis is returned, and you can have some control over how much is gains, how much is cost basis, but you don't have to pay tax on cost basis, because you've already paid tax on it. The money you put into a taxable brokerage account is after tax money you already had to pay taxes on your income. And then after that, if you're deciding to save something that's after tax money going into the taxable account, that's a big part of the cost basis. That's just what, what did you pay for all the investments held in the account? Cost basis comes out tax free. It's not part of your adjusted gross income. So when you're spending from taxable accounts, you get some boost there with I can when I take a distribution, the full amount of that distribution won't be taxable. Also, there's a step up in basis at death, and that's where. So for people who think they may never actually they're well over funded for retirement, they may never actually spend down their taxable accounts, even though they're following a strategy of emphasizing spending from taxable accounts first, if it looks like they're never going to spend it all down, they might want to save that low cost basis with a lot of embedded capital gains the shares that have that, because when they die, you can get that step up in basis, and the cost basis is reset to the value of the account at death, so that then the beneficiary kind of gets to start fresh, and all those embedded

capital gains will disappear. So that's there are advantages of taxable accounts, the preferential income treatment, long term gains, qualified dividends, and then the step up in basis at death. But the disadvantage is just every year, they're kicking off taxable income, which can be burdensome when you're trying to have a tax efficient retirement strategy. There's

Alex Murguia 15:59
also the, you know, just rebalancing portfolios, just portfolio upkeep, makes it a little more challenging from a tax drag perspective.

Wade Pfau 16:10
And then also you can, as you're taking distributions or managing taxes, you can try to, you have control. There's different, three different ways to manage the cost basis when you're taking distributions, but if you're being careful about it, you can control which shares you're selling so that you can offset gains and losses and that sort of thing, although with any losses that you realizing, well, you have to be careful about the wash sale rules. Perfect with

Alex Murguia 16:36
that little sneak preview. What are the three ways to keep track of cost basis.

Wade Pfau 16:42
Well, the easiest would always just be to use the average so you take what was the cost basis of the whole account, what's the total value of the whole account, and then if I sell some shares, I just that percentage. The if 70% is cost basis, the other 30% is gains for the whole account. Whenever I sell shares, I apply that and say, okay, 70% was not taxable income. It's return on my basis. The other 30% is now taxable income. For me, that's the easiest, because you don't really have to keep track of anything. The second option that's available is that you do a first in, first out, which is whatever, whenever you sell shares, it's always the going back in history to the shares you bought first that are considered the ones sold. Now, if markets go up over time, those are probably going to be the shares that have the highest cost, I'm sorry, lowest cost basis, highest, highest amount of taxable income that would be generated. So you may, from a tax perspective, not want to do that, but that is one of the allowed methods. Just go in reverse historical order. Whenever you're selling shares, it's the oldest shares that are being sold. The third approach, and of course, the one that I use, because I keep spreadsheets, is every time you make purchases, that's a tax lot, and so you have your whole history of here's all the purchases I made in the past. This was the cost basis of that purchase. Here for that's the current price of the asset. Here, it's current price. These are the gains on it. These are the or the losses on it, if, if the market's gone down, and I'm you can individually pick which lots you're going to sell. And with the brokerage account, I have it, it's really they also have that. So can double check each other's work. But they let me just go in and say, Okay, here's all the lots. Pick the ones you want to sell.

Alex Murguia 18:39
Yeah. So just to keep track. Because, if I'm listening, I'm also thinking, you know, if you're, you're not a somebody that has your, your sort of temperament, weight, that's, that's a, that's a tough ask, right? I mean, look, you used to, you still keep your HSA receipts. And you just, you're in your 40s, and you're keeping HSA receipts in preparation. By the way, I told my, wife about that, that we need to start keeping receipts ASAP. If Wade's doing it, I'm already behind.

But that being the case, how do you do your sock drawer, your T shirt drawer? Is it first in first out or last in first out?

Wade Pfau 19:16
It's more last in first out? Yeah, I don't organization there.

Alex Murguia 19:20
Oh, you don't apply the same level of I've seen that blue stripe pinstripe shirt a lot lately. All right, so one point to keep track of this. Yeah, this is facilitated by many brokerages and the like. So you don't, you know Wade is sort of comparing the two. Do you find a lot of mistakes? By the way?

Wade Pfau 19:43
No, no, I mean, and actually, I wouldn't really need to keep my own spreadsheet, because the brokerage account's doing fine. The only issue is, if you ever did accidentally trigger wash sale rules, then things get really complicated.

Alex Murguia 19:55
I'm almost thinking, though, if you do get audited or something like that, and let's say. You feel that you're absolutely right and the brokerage statements have it wrong. It's like the IRS gets a duplicate statements from the brokerage account. So it's almost like you don't want to fight city hall a little bit because you'll be in there forever. It's not like you're going to say, I'm way fouled that you know who I am, trust me, my Excel sheet is correct. Not not fidelity. But a side note is, can you move around? How you identify these if you started with FIFO, first in, first out, can you all of a sudden switch to tax law basis?

Bob French 20:34
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Wade Pfau 21:02
I think that would be hard in practice. I don't actually this is a good question I had, oh,

Alex Murguia 21:07
my goodness, you have to remain consistent. You have to be consistent.

Wade Pfau 21:12
Yeah, yeah, holding, or if you're gonna change, you have, it's gonna be that's a nightmare. There's some work involved in figuring out how to, yeah,

Alex Murguia 21:19
it's almost like you have to be consistent for that holding, you know, switching around is, is a recipe for a disaster. So there you go, Wade once you grow on, yeah,

Wade Pfau 21:30

right, because they're the brokerage account records would not match your own records. If they thought you were using a different treatment, you can just go in and change treatment you have listed with them, and

Alex Murguia 21:41
by me saying is disaster is signal for this is not tax advice. This is a podcast. Please refer to your CPA for taxable advice. We just, you know are doing an arc, because we're going to lead to distributions, tax efficient distributions, and things like that. But we have to sort of set the table, all right, anything else on the on the taxable stuff, other than like gone,

Wade Pfau 22:07
we emphasize it's the least tax efficient. But the reason for that is simply, if it's paying interest and dividends that you're reinvesting, the fact that you have to pay taxes on those on an ongoing basis is reducing your compounded growth because you have kind of, because you're paying taxes, you're getting to reinvest less, kind of, assuming you're paying taxes out of the interest and dividends. So over time, that can have a real impact on growth, and you can really start to lag behind when you lose some of that compounding power through the money that's being diverted into taxes rather than being tax deferred. I

Alex Murguia 22:45
agree, if you run a simple spreadsheet, you know, one that has a tax drag and one that's like tax deferred, it's tax for, you know, tax exempt. You can't it's hard to justify, on an Excel why you would commit to a taxable account. You know, once you go out 356, years, it's really hard the so from, from my vantage point, though, and this is anecdotal, because it's really a preference. I've seen many of our clients, though, have, let's say millions of dollars in tax deferred account. And then, I don't know, I'm making it up now, but let's say 200,000 in a taxable account, and that's effectively like cash equivalents, or 20,000 I've seen it at extremes, because it's they're religious about, like sending it sending it away, right? But then life happens, and all of a sudden they have a cash crunch. And, you know, it's hard to get credit. Try to get line of credits and things like that just off of your tax deferred accounts, or 401, KS, in fact, they don't even consider it, you know, a majority of the time. And so just the the basic necessities of life suggest that, you know, for that reason alone, forget the tax drag. It makes a lot of sense from a financial planning standpoint, to have, you know, a good slug of taxable money simply because you're going to need it, you're going to need to apply, you're going to need to draw from it, invariably during the course of your life. I mean, have you found that way for yourself or not?

Wade Pfau 24:18
Yeah, you want the liquidity and so tax bill assets are definitely going to be more liquid, especially as we start to talk more about tax deferred accounts. If you want to take withdrawals before age 59 and a half, unless you have a qualifying reason, which can be complicated, there's a 10% penalty, but you pay taxes on the distribution plus a 10% penalty, yeah,

Alex Murguia 24:43
but absent of those that reason like life happens, kind of reason to have gunpowder, it's very hard to justify not putting, well, I can't, I can't justify why you would overemphasize the taxable versus a tax deferred attack. Exempt the math, just as is that powerful,

Wade Pfau 25:04

right? Well, and for the very diligent savers in the audience, they may there's going to be limits on how much you can put into tax exempt. So they may meet those limits, and then the bucket for everything else that you the only place, the only option you have is the taxable account. Got

Alex Murguia 25:21
it. So that's good point. Okay, anything else on the taxable?

Wade Pfau 25:29
No, that's the taxable, tax deferred. Next on the list

Alex Murguia 25:33
tax deferred, it is fire away,

Wade Pfau 25:36
man, so contributions are generally tax deductible. You are, in certain cases, allowed to make non deductible contributions. That may be because you've exceeded income levels, allowed to have deductible contributions. And well, we'll talk about the backdoor Roth in a moment, or Yeah, but generally speaking, to make things simpler, we'll kind of start from the idea that you're getting a tax deduction on your contributions. And as we talked about in the last episode, that's an above the line deduction. So if I contribute $5,000 to my IRA, and it's a deductible contribution because my income didn't exceed the allowed levels for that, if I earned $80,000 now, my adjusted gross income would be $75,000 I get to deduct that from my total income. Now, that money then grows tax deferred the underlying it's like we were talking about earlier. You may have mutual funds ETFs in your tax deferred account. They may be kicking off interest and dividends, but you just generally reinvest those inside the account that's not taxable income to you at the time. It's only going to become taxable when you take a distribution from the account. Otherwise, everything is growing tax deferred.

Alex Murguia 26:55
And let me, let me take a quick moment just because of we referred to a little bit the past episode, when you're saying tax deductible and above the line, this means that this is not that one that the what was it the 29,200 standard deduction. That's not as this has nothing to do with the standard deduction, which is below, quote, unquote, the line, the line you're talking specifically above the line deductions. And if you want to know more about that, listen to the previous episode. Sorry, right? Just I wanted to make sure people know exactly when we use the term deduction, that it's not applying to the roughly. You know, if you're married, 29,000 something, what is it? Exactly? 29,200 or something, if you're married.

Wade Pfau 27:43
So that stating that it's an above the line deduction is important because it does lower your adjusted gross income, and a lot of the tax rules are linked to adjusted gross income. So that even if you had below the line deductions that reduce your taxable income, it's still you're impacted. Your adjusted gross income is what's feeding into everything else. Now. You have to have employment income to make you can't, yeah, you can't put you can't be retired and not working at all and making contributions to these accounts, because you have to have at least as much employment income as what you're contributing. So that's not a loophole. Have you

Alex Murguia 28:22

given your your kids like jobs so you can make contributions? No,

Wade Pfau 28:28
I have not done that. I know that's a popular strategy out there, but I haven't done it either. You may think I do a lot of weird stuff, like collecting HSA receipts, but I have not set up jobs. I

Alex Murguia 28:40
don't think there's anything wrong with collecting HSA receipts. I think that's an actual good strategy. I'm just like, like, I don't know, I don't know what the writer non plus, because I don't know how to react that you, you started in your 40s already. But hey, that's why you're special, right?

Wade Pfau 29:01
I think at this point, if something happened to both my wife and I had saved the kids more than $10,000 on taxes with those. Hey,

Alex Murguia 29:08
absolutely I'm not. You're 100% right, like I said yesterday, hey, it begins today.

Wade Pfau 29:19
At this point, created jobs for my kids so I could do retirement accounts. But you kind of hear

Alex Murguia 29:25
that every once in a while, I don't have the it's too much time for me to do that, you know,

Wade Pfau 29:32
I haven't really researched how, if that's really on the level or not,

Alex Murguia 29:36
no no job, it's like, let's say they work for the podcast, you know, I mean, and they're actually doing work, you know, that kind of stuff. I'm sure we can send

Wade Pfau 29:47
a fair, marketable salary. I'm

Alex Murguia 29:48
sure we can 1099, them,

Wade Pfau 29:52
right? I suppose you should look into that. I don't know.

Alex Murguia 29:57
All right, all right. We miss. Year tax deferred accounts. Oh, well,

Wade Pfau 30:01
the logic of it is no there's a disadvantage everything, the distributions come out all as ordinary income. Now this will fit into our asset location conversation for the next episode. But if you have all these very tax efficient stock index funds that mostly would have been generating long term

capital gains that are taxed at lower rates. Well, when you eventually take the distribution, you don't get that long term gains treatment. It's taxed as ordinary income. So that is a disadvantage, but then that's where the asset location conversation will come into play, where you don't necessarily want to have tax efficient stock funds in your tax deferred accounts in the first place, but you may not have any choice in some situations as well, but that's something to keep in mind. But the reason you do this, then, is because you think that that deduct, the tax deduction today, is more valuable to you, because when you do eventually take those distributions, they'll be taxed at a lower rate than they would today. So when you're in your peak earnings years, it's usually going to make more sense. If you're thinking about, should I do the Roth or the tax deferred? Go with the tax deferred. But that's really just based on the idea that you do that, because you think in the future, when you take the money out, you can do so at a lower tax rate, and

Alex Murguia 31:21
that's the math that's hard to get around when compared to a taxable the tax deferred, even with that wins, yeah, in an Excel sheet that the tax deferred just wins, even

Wade Pfau 31:36
with that disadvantage that it may have came out of the taxable account as long term gains, And it's coming out as ordinary income, but it's still that tax deferral is valuable, and if you're doing it with bonds, especially interest, is ordinary income anyway, so you really get value out of the tax deferral. Okay? Now, the other caveat of tax deferred accounts is they have required minimum distributions that used to start at 70 and a half, and then I got switched to 72 now it's 73 if you were born before 1960 and 75 if you're born in 1960 or later, and that's going to require you to take money out of these accounts. And that's one of the biggest shocks people may face is they may not want to spend they're required to take distributions. The government wants you to pay taxes at some point, they may not want to spend that money, and they're not required to spend it. You can reinvest it in a taxable brokerage account, to be clear. The trouble is, though, that you don't have to pay taxes on it, and so the R and D is forcing money to go into your adjusted gross income, which can then cause all these other tax problems that we will be discussing throughout the arc. Now

Alex Murguia 32:49
these are one of these things that I think is somewhat misunderstood, and trust me, I'm not a big government guy or anything like that, but the reality is the government effectively didn't charge you that didn't, you know, you put the money in tax free, you know, tax deferred better said, yeah, you put the money in tax deferred to Wade's point, at some point, the government does want to collect on those taxes, because, if not, everyone would just hold it till they die, you know, that kind of thing, if they could, obviously, but it's, I think it's fair for the government to Say, Okay, at this age, let's start. Let's start figuring out if we were to pay an equal amount relative to how long you expected to live, which, you know, we're back to being whole, if you will. I think that's reasonable, believe it or not. I mean just philosophically that,

Wade Pfau 33:35
oh yeah, the

Alex Murguia 33:37
government screwing us, or anything like that. Right

Wade Pfau 33:40
now, the philosophical idea of RMDs makes perfect sense. Yeah, yeah.

Alex Murguia 33:47
And to your point, I can't tell you how many folks are clients or prospect, you know, McLean, etc, and they don't realize what you said, which is, you can still reinvest it afterwards. You don't have right? You're gonna see that a lot like distributions. They're not forcing you to spend it, right? It's just, you just have to take it out, pay taxes, and then you can turn around and put it in a taxable

Wade Pfau 34:08
account. And I've seen a lot of people say, I don't want to spend this money. Why is the government making me take it out? And right? Exactly, you don't have to spend it, but you do have to pay taxes on it. That that's the thing. Okay,

Alex Murguia 34:22
perfect. I know, I don't know. We just see those questions a lot, and it's like, let's just objection handle as we go. Now,

Wade Pfau 34:31
IRAs are a type of tax deferred account. Those are the individual retirement accounts, and then 401 K or other qualified employer related plans. Now with 401 k's and the like, you may get an employer match where, just for an example, if I contribute 3% of my salary to the 401 k at my work, the employer will match three up to 3% something along those lines. So that's free money from your perspective, going into your. Qualified retirement plan, there may be vesting rules about you have to work a certain number of years before you actually get to keep it, or whatever the case may be, but that's free money that you're leaving on the table if you're not contributing enough to get your full employer match. Okay, there it is. And also before age 59 and a half, if, or there's an early withdrawal penalty if, if you take money out whenever you're taking distributions, you have to pay tax on it. You may also have to pay a 10, an additional 10% penalty if you don't have a qualifying reason to take it out and you're younger than 59 and a half.

Alex Murguia 35:38
Okay. Think that's all we have there for the tax deferred. Any special differences between the tax deferred versus tax exempt? Yeah, so

Wade Pfau 35:51
tax exempt, and you'll hear us use a bunch of different names for that. Roth would be probably the most common. So Roth tax exempt, tax free after tax. Those are all possible names that might refer to Roth accounts. So let's just probably start calling them Roth or or tax exempt. There's Roth versions of IRAs. There's Roth versions of 401, K's, and these are it's going back for to the tax deferred. The idea is you get a tax deduction now, so I don't have to pay taxes on my income today, because I put it into the account, but then in the future, when I take that contribution out, plus any gains on that contribution, that's all taxed. Roth is sort of the opposite. I've already paid taxes on my income that I'm then putting into the Roth, but now that money is never taxed again, the contributions and any growth are never going to be taxed, as long as I'm taking out as a qualified distribution, which, if you've only account for at least five years and you're at least 59 and a half, it's pretty straightforward about taking qualified distributions so that

you're getting those tax free income. The Roth distribution that's qualified does not enter into your adjusted gross income. So it's a valuable source of spending for retirees that won't create other tax burdens for them. So it's a very nice account to have. The trouble is there are income limits on how much you can put into the Roth, especially Roth IRA and a lot of employers may not have had Roth 401, K's in the past, although I think we're seeing a change where now more and more employers may have a Roth 401, K option. So then you have to make that decision. If, if you're earning in your peak earnings years, you have to decide, do I want to put into my 401 K, or my Roth? 401 K, it's really this, again, the answer to that is, well, do I have to, well, I pay less taxes, or will I have to pay more taxes if I put it into the Roth today, versus would I pay at a higher tax rate when I take that distribution out at some future date?

Alex Murguia 38:01
Yeah, this is one where the math is much trickier, like tax deferred versus tax exempt. And I think that one is so predicated on what what your tax rate is right now and what you expect to be in the future, that there you do have some wiggle room around finding an optimal one.

Wade Pfau 38:22
So now Roths are nice, because that's really you can consider all that account as yours, whereas the government kind of has dibs on some share of your tax deferred accounts. What that percentage is depends on how efficient you are taking the money out, but you've the entire Roth is yours, and Roths do not have RMDs.

Alex Murguia 38:43
Well, philosophically, just to make sure people got that joke, remember, you've already paid taxes on the front end before, you know, before the contributions. So you've already paid the Piper, if you will, so you're not obligated. There's no There's no obligation, like legal obligation to pay taxes afterwards, because it's already been paid you already

Wade Pfau 39:02
been paid. But in the past, Roth 401, K's did have RMDs, although secure act 2.0 as of this year, they no longer have RMDs. And then Roth IRAs never had RMDs, so we can now just say no RMDs.

Alex Murguia 39:16
Thank God we recorded this now and not a year ago.

Wade Pfau 39:19
Yeah, a year ago, we'd have to put in the caveat for the rest of this year. But then the advice was always so you can get around that by just doing a rollover from your Roth 401, k into a Roth IRA, then you wouldn't have to worry about RMDs. But now you don't have to worry about it either way. So that's nice.

Alex Murguia 39:39
That's not nice, very nice, very, very nice, very nice. All right, and so then, okay, so I think rod's pretty. The tax exempt. We did the tax deferred, we did the taxable you were sort of signaling and socializing or previewing, or whatever word you want to say. Okay, that we were missing around earlier, backdoor Roth contributions.

Wade Pfau 40:06
Yeah, yes. So there are more extreme limits, at least with a Roth IRA, and this is where the backdoor Roth contribution becomes a relevant conversation. I have employment, income, I want to put it into my Roth IRA, but I can't, because my income exceeds the allowed thresholds for making Roth IRA contributions. So something that people were talking about for a long time, and it wasn't 100% clear whether it was on the level, but the IRS has since clarified it is fine to do is a backdoor Roth contribution, which your income may be too high to even make a deductible IRA contribution. Just to

Alex Murguia 40:47
be clear, though the income you're talking

Wade Pfau 40:51
employment or all your your perfect, okay, perfect. Adjusted Gross, like, yeah, your your taxable income? Yes. So Roth IRAs have limits, deductible IRA contributions have limits, but you can always make your non deductible IRA contribution, and then you can wait a few days, and then you can convert that to the Roth IRA. Now this works best if you don't have any other money in the IRA, because then if I put in a non deductible contribution, 100% of that can be converted over to the Roth IRA as non taxable. And it's, it's called a backdoor Roth contribution, because it's, ultimately, it's doing the same thing as contributing directly to the Roth IRA. It's just a two step process. You first make a non deductible contribution to your IRA, then you wait a few days, and then you convert that to the Roth IRA. Now if you also had other money in the IRA, you have the pro rata rule. You don't get to control which funds you convert to the Roth IRA, it's just the percentage of your total Ira that's was deductible. That's going to be that percentage is going to be taxed on any conversion, and then only a small percentage, perhaps, of your non deductible contribution would make it over without being taxed. So this works best if you don't have any other IRA assets.

Alex Murguia 42:24
I will say this. This is, we're throwing out some terms such as non deductible IRA and things along those lines. And truthfully, a backdoor Roth strategy is a episode in and of itself, if not one or two, I would say

Wade Pfau 42:41
so. And it's also

Alex Murguia 42:45
as a placeholder, back burner thing, that there's more here. I don't, I don't want to give the audience a sense of and now you're ready for backdoor Roth contribution workflow, you know, yeah,

Wade Pfau 42:56
because we're really laying the foundation for tax efficient retirement distribution. So this is a, really an aside to some for the the underlying purpose of the episode, but, yeah, it's a way to get money into a Roth IRA, even if you exceed income limits. We can kind of leave it

Alex Murguia 43:14
at that. There we go.

Wade Pfau 43:18
Okay, so we kind of talked about the point, you know, do you contribute to tax deferred or tax exempt? It's really a conversation around, when can you pay less taxes? If you can pay less taxes today was, how should no if you'd have to pay more taxes today, I should say, make the contribution to the tax deferred account. If you think you could pay less taxes today, go ahead and put it in the Roth and pay those taxes today. Right? I was starting to say something backwards. I think, well,

Alex Murguia 43:54
the other way to think about it, too, in my world, is philosophically. If you look at the taxable, if you look at the Roth, and if you look at the tax deferred, and you said this earlier, but I want to, I want to drill down here. Let's say you're 70 years old, and you're looking at your net worth, and you think, Oh, I'm worth a million bucks, and it's 500,000 in a tax deferred, 250 in taxable, and 250 and in Roth, right? Well, you don't really have that much money, in that sense, because of the 500 that's tax deferred the government. Quote, unquote, you have an obligation to the government, quote, unquote, on whatever your your income, yet your bracket is, you know, and so you have to keep that in mind in terms of looking at your whole net worth, and that can have carry on effects too, with regards to your allocation, et cetera, et cetera.

Wade Pfau 44:50
Yeah, and this is actually another area where you think I do a lot of crazy financial stuff, but I don't do the like when Bill rickenstein talks to. About, yeah, this idea I have say, whatever, 100,000 in an IRA, 100,000 in a taxable account. When I'm considering my asset allocation, I really should discount what I have in the IRA to account for the portion that I don't really own, since the government has dibs on it, and so I may not have the asset allocation I think I have when I consider how part of my assets are owned by the government. And

Alex Murguia 45:27
again, this is in line with the back door Roth, where this is kind of a whole episode series as well. But we just want to kind of put, put, you know, things to think about as we're as we're going through this. Now, the beauty of to me, taxes, the reason I, I pay a lot of attention to this, because in the investing world, especially when you we get into the retirement income part, these are one of the few things that you can actually control. Well, subject to change in government, tax rates, and, you know, all that kind of political football that they play. Put that aside. To me, tax efficiency is something that you can control, that there's alpha to be had. And if you play this game right, you can benefit tremendously. And it's boring as heck, in my view, because it's just, you know, spreadsheets and levers that you want to pull, etc, etc. But these are the ones. This is something you can control, that can have significance.

Wade Pfau 46:27
That's right. And so maybe one final point to sure leave us on a cliffhanger, because it's the retirement tax cliff. Oh, I

Alex Murguia 46:35
see what you did there. You didn't run that one by me at the beginning. Let's go

Wade Pfau 46:39

the retirement tax cliff. Is this idea about RMDs and their unexpected consequences if you hadn't really thought much about that. So just to give a couple of examples, like, suppose you had a million dollars in your IRA on December 31 of the previous year. It's now the year you turn 73 your RMD is going to be $37,736 you now have to realize that it's going into your adjusted gross income. No control over that. You again, you don't have to spend it. You could reinvest in a taxable account, but you have no control over this fact that you have to at least have that much in your adjusted gross income. If you had a million dollars still when you're 90, the RMD on that would have been $81,967 and so RMDs can cause real surprises. If you have a really big IRA, if you have, like, 3 million in your IRA, and say you're 80 years old, it kept growing during your retirement that the RMD on that would be $148,515 just this is all again, money that you're forced to include in your adjusted gross income, even if you have no intention to spend that amount. Okay?

Alex Murguia 47:56
And then I'll end it with a couple of numbers as well. Wade Just because we had talked about contribution, I mean income limits for for Roth, and things along those lines. So for those of you who are driving, listening to this, or running and you're like, Well, is this something for me to even consider? You know that kind of thing, Roth, if you're single filing the Roth contribution, you know that no contributions allowed if you're making more than 161 all right, 160 it's 161,000 if you're married filing jointly, that number is 240,000 so if your income members above that can't contribute, but you're a candidate for backdoor Roths, if you Will. If you're below that fire away. I think it makes a lot of sense. But again, this is not advice. This is, this is a podcast

Wade Pfau 48:50
for educational purposes,

Alex Murguia 48:52
yes, for educational purposes. And the other piece that I would look into, because you said it, we're not going to go down the list. But you know what? You can get distributions from these tax deferred accounts before 59 and a half for certain events. I would look into them because they're they're important to know, because you what you want to do is you want to make sure that you have everything available to yourself at the earliest time possible. So that's something I would, I would do a quick Google check, as opposed to listening to Wade, and I just spit out, like 10 points, you know, in rapid succession.

Wade Pfau 49:30
I think that's good Wade, right? Or, yeah, just, well, plug for my book. This is the content. It's the longest chapter of retirement planning guidebook, chapter 10 on tax planning. So if you do want a deeper dive. Recommend that as a

Alex Murguia 49:43
resource as well. It's the longest chapter, technically speaking, but it feels like it's the fastest once you read it. It's so riveting that way, 70

Wade Pfau 49:51
pages long. Thanks for the review.

Alex Murguia 49:55

All right. All right, everyone. Thank you, and we'll catch you next week on. To retire with style as we talk about, what do we talk about tax advantages and distribution strategies

Wade Pfau 50:06
and specifically asset location. And

Alex Murguia 50:09
specifically asset location, all right, everyone, take care. You.

Bob French 50:24
Are you waiting for me? 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 the risk, including Risk of Loss past performance, does not guarantee future results. You