Episode 143 The Importance of Asset Location and Asset Allocation

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SPEAKERS
Bob French, Alex Murguia, 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. Time to get ready for one of my favorite topics, asset location. No, seriously, I'm not even being sarcastic. I love asset location.

Alex Murguia 00:51
Hello everyone. Welcome to retire with Style. I'm here with Wade Pfau, my trusted companion, and I am Alex, and we are going to be all things tax efficiency, I don't know, all things taxes today, right Wade that

Wade Pfau 01:09
is right. And we're going to be talking about something that's an underappreciated member of the crew, the tax location. Yeah, allocation tends to get all the coverage. But tax location is an important topic too,

Alex Murguia 01:24
just like real estate, location, location, location, real quick. Wade, we last week's episode, you had the same shirt, and you mentioned that you used first in first that no last in, first out method for your for your shirt drawers, or your your closet, so I can see that you weren't lying to you actually do that? Interesting. Yeah, definitely

Wade Pfau 01:50
the same. Well, I don't put these shirts in drawers, but with T shirts, I definitely tend to. I may have 20 white t shirts, but it's always the same one that I'm wearing,

Alex Murguia 02:00
really, no one would know. No one would know. So I think that suffices for the small oh, by the way, you were in that podcast episode with Joe curry. Did he ask you about pull ups? I asked him to ask you as well. Yeah, although

Wade Pfau 02:16
I don't know if that one's been released yet, because a lot of podcasts have, they're more organized and have long backlogs of recordings. About

Alex Murguia 02:26
the pull ups, well, we don't like to record

Wade Pfau 02:32
that. I never got more than six at a time, but I'm working on it. That's

Alex Murguia 02:35
good. That's good. Don't forget, I got pickleball wrist, so I can't do anything for a while. I'm on the fifth physically unable to perform list like in football, so I need four weeks off before I before I get back at it. But I look today, we're talking about asset location and asset allocation, right? And these are one of these things that actually I think are important and flies under the radar again, in terms of put in the bucket of things you can control. I think TAC asset location is quite important in terms of being able to add, you know, 40 to 60 basis points, if you will, you know, to overall returns. If you do it systematically and correctly, and if you try not to, like, sometimes we get, we see statements from from prospects, right? And they want us to, hey, what you know as they're coming into McLean, and what, what gets me all the time is that you have an IRA, a taxable a tax defer, and they all have the same allocation within it, it just kind of mirror each other. And the reality is, I don't, I don't. That's not the way to do it on many levels, and that's what we're going to talk about today. Why not? And what are some, what are some main issues with it? And the first one is it's not really tax efficient from that vantage point. And the reality is, you should be looking at your household account, your household aggregate assets, not like each individual account is its own living and breathing thing.

Wade Pfau 04:10
Wade, yeah, that's true. You even really want to think about your your human capital, like if your work income is more bond related, oh, yeah, you might want to consider that as part of your bonds.

Alex Murguia 04:23
Yeah, and what he means by that is, we have a job that's like a government position where you almost have to try to get fired. You're probably going to be working there for the rest of your life, you know, assuming that it fits what you wanted to do, and you're going to have a pension, and so that's a pretty steady form of income, and that's what weight means. That's like a bond, if you will, whereas, if you're an entrepreneurial guy, let's say you're 100% salesperson, and 20% of your salary is base, and 80% is commission. It's a lot more variable. That's more stock, like, if you will. That's kind of what you're getting at. That and, yeah, Truly speaking, the irrational quote, unquote economists from the planet Vulcan would consider that as part of their allocation, their human capital piece.

Wade Pfau 05:15
Yeah, thanks for being the weight whisperer, but that was a reference to the RUS Docker. I Moshe milewski, he's the planet Vulcan.

Alex Murguia 05:23
I got it. Wade, thank

Wade Pfau 05:24
you very much. Yeah, thank you. Thank you for citing

Alex Murguia 05:29
what I told you.

Wade Pfau 05:34
It's prodigious output.

Alex Murguia 05:36
All right, let's, let's, let's nothing to but to do it. I guess that's my go to phrase for today. Fire away. What do we got here? Well,

Wade Pfau 05:47
we do have to put a caveat at the beginning that asset allocation is always most important. You don't, you don't let the asset location dog Wag the tail of asset allocation. Yeah, you choose your asset allocation, but then to the extent that you can, you'll follow these asset location principles, but you don't. It's like, well, if I hear that bonds should be in my tax deferred account and I don't have enough space for all my bonds in my tax deferred account, that means I can't hold bonds outside of it. That's not what we're saying. We're saying, First, choose an asset allocation that's right for your risk tolerance and risk composure and all that sort of thing. And then to the extent that you can start positioning the stocks and the bonds and the different assets in the different types of tax treated accounts in the most efficient manner that you can no

Alex Murguia 06:39
that makes sense. Hey, you said something that really caught me by surprise and merits further unpacking. You said dog, like dog or something as opposed to dog.

Wade Pfau 06:54
Dog

Alex Murguia 06:56
was that you trying to, trying to inject some personality in that.

Wade Pfau 07:04
No, weird,

Alex Murguia 07:07
no, no. I thought you were missing around. I thought you said the dog wagging the tail, you know, something like that.

Wade Pfau 07:12
I thought you Oh, I may have extended the syllable because I was trying to figure out if I was getting the analogy correct or backwards. The dog wags the tail or the tail wags the dog

Alex Murguia 07:24
for a second. So I thought I gotta point this out that, hey, you know, you're all missing

Wade Pfau 07:29
syllable as I thought about it, I thought you

Alex Murguia 07:31
were flexing that comedic muscle, which I lack, by the way, apparently, but that's fine.

Wade Pfau 07:36
The reviews are pretty consistent. Yeah,

Alex Murguia 07:38
pretty consistent, except

Wade Pfau 07:42
for the one from you. From your sons,

Alex Murguia 07:43
yes, all right, so tax efficiency spectrum between, well, no, you made the distinction between tax allocation and tax location. Yes, asset allocation is, is the go to, but there's a lot of value to be had when you layer in tax location to it.

Wade Pfau 08:01
The idea is, we want to think about the tax efficiency of each asset you're looking at, and then to the extent that you can, assets that are more tax efficient should go in the taxable account, where it's not such a big deal. They have to pay those taxes. Assets that are less tax efficient, you want to tend to put in tax advantaged accounts, which could and then we'll talk about tax deferred versus tax exempt. But by tax efficiency, we just mean how much are they kicking off taxable income on an ongoing basis, versus how much are they naturally providing tax deferral and so forth. And so let's just talk about different assets going from most tax efficient to least tax efficient. And the first one, I mean, we should just mention tax exempt bonds. We're not going to go into a deep discussion about municipal bonds or anything, but it's an obvious example of there's no purpose in holding those in a tax advantaged account, the only place they have any possible roles in a taxable account, they tend to offer lower yields because you're not going to have to pay taxes on interest payments. And so when you think about their pre tax yield, if you're in a higher tax bracket, and usually you have to be in one of the higher tax brackets before this makes sense, but you may get like a better pre tax yield when you're not having to pay taxes on that interest. So that's just the obvious one. The only place you'd even think about putting those is in a taxable account. Now there's some issues with tax exempt bonds, especially the rules that determine how Social Security gets taxed that determine Medicare premiums both require you to add that tax exempt interest, so it may indirectly trigger some taxes, but at least the idea is you're not having to pay taxes on the interest from tax exempt funds.

Alex Murguia 09:57
Okay, what would be next? On that, that hit list?

Wade Pfau 10:02
Yeah. So then we're really talking about like US stock index funds. They tend to be pretty tax efficient, especially if the dividend and the reason I'm saying US versus International, just right now, the dividend yield tends to be less on US versus International, so less ongoing dividends index funds are the reason we're saying index funds is because they're more tax efficient since they're not doing the internal trading actively managed funds, they may be buying and selling inside the fund that will lead you to get tax bills every year on those transactions. Index funds tend to not do a lot of trading like that. And so it really a lot of the benefit will be through the when you eventually sell the long term capital gains that get the better tax treatment, and you're otherwise getting tax deferral on those gains until you realize them, you are paying taxes on the ongoing dividends. Hopefully a lot of that will be qualified dividends. But, uh, just as we're listing from most tax efficient to least tax efficient, US stock index funds are right up there on the high tax efficiency list. Okay, so again, a natural place to put those would then be your taxable brokerage accounts.

Alex Murguia 11:16
So we're saying index funds. But what we're kind of getting at here, is it, you know, passive versus active, but I'll even go one more nuance. It's just index funds tend to have much lower tone over than like actively managed funds. But really it's the turnover that's causing the the tax within that. And so I guess you could conceivably have an active fund that holds 10 stocks and never trades it for 20 years. You know, I don't know. I'm not up to date on it, maybe dodging Cox or something like that. But the reality is, there could be a fund that's active and just they never trade the stocks. Sure, you may not have taxable like capital gains kind of thing from turnover, but you may have crappy performance. So stick with the index fund, is my thing, but I just wanted to make sure it's not necessarily. It's the attrition within the index fund. It's usually much lower than active funds. Yeah,

Wade Pfau 12:12
and if an active fund is not trading, they may be stretching the definition of active, but that's true too. Yeah, it's just they're not it's you may not buy or sell shares, but the shares that you own internally, the fund managers are buying and selling, and so they could be generating taxable income, and then that's reported to you, so that even though you didn't sell your shares, your shares, you're gonna have to pay taxes on gains from those shares on an ongoing annual basis in an and that just happens less there's less turnover, less trading with index funds,

Alex Murguia 12:47
okay, and then the coronavirus International, but the differentiation is just a higher yield, so it's a little less tax efficient. Yeah,

Wade Pfau 12:55
yeah, international stock index funds just same story as us, but they just haven't have a higher yield right now, higher yield that's more ongoing taxable income. And then there can be some annoying little quirks about they may be paying some foreign taxes, and then you have to deal with with that. But otherwise, pretty tax efficient. Okay, then we say cash and well, if the cat, if it's cash that's not earning any interest, then we're not that's not what we mean. But cash tends to have lower yields, but it's all taxable interest, so it's going to be less tax efficient. In that regard, all the return on cash to the extent that you're getting some yield on it will be taxed as

ordinary income on an ongoing basis. It's just they're more tax efficient than other fixed income options because they tend to yield less than other fixed income options.

Alex Murguia 13:55
Right? Then we have actively managed stock funds, which is, you know, it's a function of their turnover. Think about it, if an active manager is telling you, I can pick the best stocks, then you're the implicit thing is, I'm going to always be looking for the best opportunities, selling the ones that aren't hitting etc, etc. So you're naturally going to have a lot of turnover, and that just effectively causes, you know, a significant drag on the portfolio.

Wade Pfau 14:22
Yeah, and we didn't mention explicitly between short term capital gains and long term capital gains. It's if there's short term gains that's where that trading is happening. They owned an asset for less than a year before trading it. Short term gains are taxed as ordinary income. Long term gains on assets held for longer than a year, or what gets the preferential income treatment so actively managed funds, not only with the turnover generating more gains that you have to pay taxes on, but the possibility that more of those gains may also be short term gains that are taxed as ordinary income, but also a portion of that long term that's the reason this is still ranking higher than. What's coming on our list is they're still going to be giving you some hopefully, if they do a decent job, long term capital gains as well.

Alex Murguia 15:07
Yeah, okay, bond funds. Or is next government bond funds? Yeah,

Wade Pfau 15:14
we say government bond funds. The issue there is really just the interest is taxable on an ongoing basis, so that's less tax efficient. They could bond funds. Can have gains or losses as you sell shares and are not holding them to maturity. Those could be taxed as long term gains or losses if you've held for more than a year, but, uh, otherwise, a lot of that income is ordinary income generated on an ongoing basis through interest payments,

Alex Murguia 15:47
okay? Corporate bond funds, yeah,

Wade Pfau 15:50
the idea there is really, well, treasury bonds, you don't have to pay state income tax, right? And then corporate bonds, to the extent they have higher yields, and also you have to pay state income tax. They're just kind of below treasury bonds on the list

Alex Murguia 16:08
you ever wanted. And think cryptocurrencies,

Wade Pfau 16:13
that is not on my list. I'm

Alex Murguia 16:16
just giving you honest Wade, I didn't know if you were paying attention, but

Wade Pfau 16:19
I yeah, I don't know. I'm guessing they're not all that tax efficient, but I that's not an area I've realized

Alex Murguia 16:24
I don't know they're debating if it's a stock or a commodity or something like that. Yet, right? 100% I'm not up to speed on it, but

Wade Pfau 16:34
commodities is next on the list, and they do tend to be tax inefficient, just a lot of issues. And

Alex Murguia 16:42
then we rounded off with REITs, Real Estate Investment Trusts. Yeah, bottom of the barrel in terms of tax efficiency, just

Wade Pfau 16:50
a lot of the quirks of real estate. If you own REITs, you may face complicated tax issues and taxes on an ongoing basis through the distributions

Alex Murguia 17:00
reads a lot of the returns from REITs come from the dividends as well. I mean, if you look at the amount of dividends they kick off, it's, it's quite high. And so, you know, it's kind of like why international stocks are below US stock index funds, because, you know, they have a higher yield REITs, much of their returns, or, you know, comes from just the yield they provide. Now, wait, philosophically, okay, I see why this should be in the you know, these are the, you know, REITs are least tax efficient. So they should be in tax advantage accounts, right to the extent possible, yeah, to the extent possible. Us, index funds are the most tax efficient. You know, absent bonds, I'm not going to consider tax exit tips and stuff like that. I'm not going to think about right now. So US stock index funds should be in taxable accounts, but then somebody says, and I'm sure our listeners could be thinking, All right, so you're telling me to put the stock index funds in a taxable account, and then, by default, you also tell them, but you're telling me to put corporate bond funds to the extent possible in tax advantage accounts, right? But Wade intuitively, I have trouble reconciling this. Over the long term, stocks will perform, perform, what up what stocks will outperform corporate bond funds. So shouldn't I have this the index funds of stocks in a tax advantaged account, because it's going to grow tax deferred for many years, and then when I take it out, you know that pot of money will be so much higher than if I had put corporate bonds in there.

Bob French 18:34
Retirement spending, it's one of the trickiest parts of retirement planning. How much can you safely spend without running out of money? Join us for retirement researchers upcoming webinar with Christine Benz, morningstars, Director of personal finance, where she'll dive into five must knows about retirement spending. You'll learn how to adjust your spending in today's economic environment and discover key strategies to make your money last longer. Don't miss this opportunity to gain expert insights that can help you guide your retirement decisions. Head to resaprofile.com/podcast, to sign up now.

Wade Pfau 19:14

Well, yeah, it's a good point. Like you want your you want to expand and grow your tax advantaged accounts, but at the same time, with tax efficient like US stock index funds, you're getting a lot of tax deferral, because all the gains are deferred until you sell and then you get the long term capital gains treatment versus the ordinary income treatment. So if, if you have very tax efficient US stock index funds every year. Yes, you're going to have some dividends to deal with, but a lot of the returns and the dividend yields are low from a historical perspective, so a lot of the return ends up being long term capital gains, and that is tax deferred. So it's not that you're uniquely losing out on tax deferral, but. Having them in a taxable account. That's why they're tax efficient. They efficiently provide a lot of their return as long term capital gains that you're not taxed on until you realize through selling those shares. Yeah, so if you're really ahead of the game, you've got that step up and basis consideration, which you don't get with tax deferred accounts. We didn't explicitly say that before, but, yeah, you don't get you have now with secure act 2.0 the or two point 1.0 the 10 year window for adult beneficiaries to deplete those inherited IRAs. So,

Alex Murguia 20:33
so then I just want folks realizing so then the mental math that you're doing is, and I'm gonna make up numbers here, just to make it easier on the example, but let's say stocks are returning 10% a year. That doesn't happen. But just saying that stocks return 10% a year, but because an index fund is so efficient, you're not losing that much on a tax drag on a year to year basis. Let's say again, making this up. Let's say you keep 9.75% of the 10% return, right? Whereas a REIT fund, let's say, over the same time period, it returns 8% a year. But instead of, you know, just losing out on a quarter of a point because of tax direct, you only keep half of that so you only keep four to 5% of that return, right? And so, as opposed to keeping only four, four or 5% of that 8% return and taxable account, you stick it in a tax deferred account, and you you gain percentage points back. That's that's the the thinking when Wade said, you get to keep 100% of your return, 90% of your return, 95% whatever that number is. Wade, you wanna, did I miss something there, because I was doing that on

Wade Pfau 21:46
the fly. Well, just, you know, the dividend yield on US stock index funds is maybe, like one and a half to 2% in that ballpark. But yeah, if you're getting 10% a year, the other in that case, eight to eight and a half percent would effectively be deferred as long term gains until you finally sell those shares, and you may never have to pay, or your beneficiaries may never have to pay on that with a step up in basis if you hold that asset through debt.

Alex Murguia 22:13
Okay, just wanted to point out what's happening there from a dynamic standpoint.

Wade Pfau 22:20
Yeah, well, then the next issue I changed to this term tax advantaged. But there's the two tax advantaged accounts, the tax deferred and the tax exempt. So we should also talk about how to think about where to position less tax efficient asset classes, between the tax exempt Roth accounts and the tax deferred, Ira, 401, K type accounts. And the big punchline to that is assets that so less tax efficient but that you expect to have higher returns over the long run, that's a good option for the tax exempt accounts. And then assets that are less tax efficient and have lower expected returns over time. Those are good for the tax deferred account. And so what I'm really saying here is like bonds would be less tax efficient, lower expected returns over time,

that's tax deferred, your your emerging market funds, your small cap value, the different things that are not all that you're actively traded type funds in that area, not tax efficient, but also you're expecting a higher return on that over the long term, that would play a better role in the Roth account. So to kind of simplify that discussion so far, it's like US stock index funds in your taxable account, bonds and your tax deferred account, the kind of more wild stock type funds that you may have in your Roth account.

Alex Murguia 23:53
Now, how do you, how do you think about this in light of now, the practical and it could be later, for later discussion. But as you're taking distributions, you deplete certain accounts before the others, and in doing so, because you haven't equally distribute, you don't have an equally distributed allocation across every single account.

Wade Pfau 24:15
And yeah, that's a key punchline, as you don't have a the same allocation in each account. Philosophically, how do you think about that so that, well, when we start thinking about withdrawal, ordering in retirement, that concept works pretty well with the Roth, because we're saying you're putting in these, like more volatile, more risky, really, asset classes with higher expected returns. That's because they're more volatile. So those are funds you tend to want to hold over longer periods. And on average, the your Roth accounts are what you'll be holding on to the longest on average, with a tax efficient distribution strategy, so you it works quite well with that the less tax efficient, higher yielding, higher returning assets. I go in the Roth and they have the longest window for to benefit from that concept of stocks for the long run. So that part's Okay, okay, the other, the other advantage there too is, if I had the stocks in my tax deferred account, all the gains, all those long term capital gains, would be taxed as ordinary income instead of preferential income, and you avoid that by having them in the Roth account, because it's not the gains are not taxed at all, so you're getting all that growth tax free.

Alex Murguia 25:33
Okay, now I would say just this is me being devil's advocate, but Wade, you said asset allocation was the dog, and the asset location was the tail. But now I'm 75 or whatever, and I just have a Roth IRA, and in that, I only have emerging markets. So I'm a 75 year old with $2 million in emerging market fund, and that's it.

Wade Pfau 25:59
Well, you may need to make some adjustments over time, because asset allocation always comes first, and then the other point too is, well, you as we get into the retirement distributions, it's generally no with exceptions, and we'll dig a lot into that, but you tend to spend taxable accounts first, then tax deferred, then tax exempt. So, yeah, you're creating this problem of spending down my US stock index funds first, then my bonds, then my emerging market funds or something

Alex Murguia 26:30
like that. But, but then, you know, and then the extension is, Hey, these are tax deferred and tax exempt accounts. You can sell whatever you have in there and and buy whatever you need to diversify. And it's, it's not a taxable event, right? And, you know, that's, that's the other you can always just do that, right? There's nothing stopping you from, okay? You're 75 and you know your RMDs is, is, you know, just destroyed. You're not destroyed, but depleted, your tax

deferred account. And now you all that has, all you have left is the Roth Well, there's nothing stopping you from just selling funds, selling all of your emerging markets to diversify,

Wade Pfau 27:11
right? And then there's also the point that money that you're going to spend soon, you're you're not supposed to have in the stock market, bonds, so that, like in practical terms, another overlay may be you want some cash in your taxable accounts as well to manage spending from so that you're not being forced to sell all your US stock index funds to meet expense needs when you're otherwise following the idea that you should be spending from your taxable accounts first, And also just having the less growth in your tax deferred account just is, is a nice consideration from the perspective of they're the least tax efficient in terms of having all those embedded income taxes for your beneficiaries as well. You're not leaving your beneficiaries embedded income taxes with a taxable account due to the step up in basis or with the Roth account, you are leaving them with an embedded income tax with the IRA assets. So to the extent that your asset allocation calls for holding bonds, putting those in the account with the least kind of the least advantages for your beneficiaries can make sense from the perspective of just having less growth in those accounts. If you're of the belief that stocks will, over time, grow faster than bonds, of course.

Alex Murguia 28:33
Okay, so then, just to tie a bow on this, you know the headline is taxable accounts. You put in the most tax efficient assets, tax deferred, which are regular IRAs, things like that, tax inefficient assets with lower expected returns, tax free, the Roths of the world. Tax inefficient assets, but the high returns, the higher expected returns, and I think we're golden. Go, yeah, all right,

Wade Pfau 29:04
let's go to the next there is another topic while we're on the issue of asset location, and I mentioned in the last episode, if you're a diligent saver, you may not have enough, you may fill up your available capacity in your tax deferred and Roth accounts, so you're forced to also save in a taxable account, even if you didn't really want to, but we can talk about some of the other options available that may create some tax efficiency for you in your taxable account as well.

Alex Murguia 29:34
Fair enough. Okay,

Wade Pfau 29:37
yeah, so to get into that, there's three tax advantages you can receive in the tax code, and different accounts have different combinations of these. So one tax advantage, you get a tax deduction on the contribution that reduces your adjusted gross income. It's an above the line deduction lower adjusted gross income if you're in a high tax bracket. Less taxes. A second possible advantage is gains can accumulate on a tax deferred basis until the realized, until distributions or sales are realized. And the third one is gains can be distributed on a tax free basis. So this is different, because different accounts have different combinations of these. So to kind of use those principles, a brokerage account, you don't get the tax deduction you're putting in after tax money. You don't get tax deferral like an IRA would provide you. We did talk about you're getting some implicit tax deferral on long term capital gains, but we're not going to fully say tax deferral on brokerage accounts, and you don't get tax redistributions either. All gains are going to be taxed. IRAs 401, K is what we call tax deferred accounts. Yes on the tax

deduction, yes on the tax deferral, no on tax redistributions. It all comes out as ordinary income. The Roth, no on the tax deduction, yes on the tax deferral, yes on the tax redistributions. Okay, so then we can talk about some other things. So five to nine plans for for college. What features do they have? Well, with tax deduction, you don't there's no federal tax deduction, but some states will provide a tax deduction on the state income tax, at least for contributions to the five to nine plan. Then you do get tax deferral. And then if you're taking for qualified education expenses, you do get tax redistributions, so they have similar properties to Roth accounts. In that regard, as long as you're taking the distributions for qualified education expenses, then we have the health savings accounts, which is your favorite. So you want to mention their advantages.

Alex Murguia 32:01
It's the trifecta. Effectively. You know how, when Wade was going through these, he was saying, yes, yes, no, yes, no, yes, that kind of thing. The Health Savings Account is yes, yes, yes, yes, yes, yes. That's my that's my medical expenses. Yeah, yeah. For medical expenses does that. And if you keep receipts before you qualify, you can apply them when you do qualify.

Wade Pfau 32:28
No, you it's because no. The point of that is, if you just want to let the account grow to benefit from the tax deferral and tax redistributions you you don't want to take that money out today to compensate you for the medical expense, but you saved in

Alex Murguia 32:45
my head. The way I meant it is, I'm not planning on touching Yes, I could touch it now, but I'm not planning on touching it until I'm like, 6570 it's kind of like my quasi health insurance booster, if you will, right? So I can apply it or not, but, yeah, I don't want to touch it because it's tax free, tax defer, right? And so for me, let's just say my wife and I say, yeah, when we're 65 we can start tapping into it, or when we're 75 whatever date we want, right? And then the reality is, if you keep receipts now, you know, even though I physically don't want to, you know, apply until I'm 65 to these things. I can use receipts from when I was 55 years old, or

Wade Pfau 33:28
when you're 40 years old, yeah, when

Alex Murguia 33:29
I'm 40 Yeah, when I'm 40 years old. That's where I was using in my head this sort of demarcation on age. But that's a self imposed one to allow growth,

Wade Pfau 33:38
that tax free Growth and Tax Free distributions on the growth,

Alex Murguia 33:43
yeah. So it's yes, yes, yes across the board, I bonds, e bonds, next one, yeah,

Wade Pfau 33:51
yeah, that's something you'd buy in your taxable brokerage account. Specifically, you need an account at Treasury direct, but no on the tax deduction, but yes on the tax deferral. So that's

great. Compared to taxable bonds, you get tax deferral on I bonds and E bonds, no on the tax redistributions. When you sell those, all the interest will then be realized as gains for that year.

Alex Murguia 34:15
And you mentioned it earlier, the tax exempt bonds, which are usually muni bonds, but what was that about? You said you're talking about interest. You know, they're applied on your social security, etc, etc,

Wade Pfau 34:27
yeah, yeah. So no tax deduction, yes on the tax deferral, yes on the tax redistributions. But however, those that interest in the calculations, those modified adjusted gross income measures that we'll be talking about in later episodes, those measures on how Social Security is taxed and how Medicare premium surcharges are determined, will include tax exempt interest as part of your income, so you can be indirectly taxed by having to pay taxes on. More of your Social Security or having to pay higher Medicare premiums.

Alex Murguia 35:06
Okay? And then what would you say for these other two? There's two more on our list. You hear it all the time. Never put an annuity in a tax deferred account, this or that, but I'm exaggerating here. What you want to just talk about annuities, non qualified annuities.

Wade Pfau 35:27
Yeah, so non qualified annuities, that's the annuities you hold in a taxable brokerage account. You didn't buy inside of a qualified plan. They provide tax deferral. So that's the point about not having them in a qualified plan, you get tax deferral there anyway. So you don't need the annuity to have the tax deferral this. So you would never the living benefits. I'm just talking, yeah, you do it if you're the purpose is for income, and then it's, can be, I mean, there's you just, you may want the income, so you may want the annuity in the qualified plan. The only point is, you're not uniquely getting tax deferral by having it in a qualified plan, but if you do buy it outside of your retirement plans, and this is where we're talking about, if you don't have enough space and you want more tax benefits, you might consider a non qualified annuity for tax deferral, no no on the tax deduction, yes On the tax deferral, no on the tax redistributions qualified annuities and

Alex Murguia 36:24
then, because we leave no stone unturned, what about cash value of a life insurance policy?

Wade Pfau 36:31
Yeah, so when you start listening to life insurance sales pitches, they'll kind of describe it as almost like a Roth account, and talk about how taxes are going to go up in the future. And so the end of the pitch there is with the cash value of life insurance would be no on the tax deduction, yes on the tax deferral, and then yes on the tax redistributions, but with an asterisk, subject to the policy as properly structured, and you're not avoiding or not violating any of the rules that you're allowed to take proceeds from a loan or return of principal and being able to generate spending power without generating taxable income. So yet tax redistributions when structured properly. So the we're getting no, yes, yes, and that's the same characteristics of a Roth account. And so that's why they're sometimes pitched as Roths with no earnings

contribution limits. You can just fill up life insurance as much as you want. And in many cases, it's pitched with that sort of tax advantage in mind. All

Alex Murguia 37:39
right. Well, wait, I think this gets us to the table set, you know, from the vantage point of the next episode in which we'll talk about just withdrawals, and you know how to do that, from tax advantage plans, etc, etc. Wouldn't you say, or did Is there any something that we could be missing here in table setting?

Wade Pfau 38:01
No, I guess we can mention the like with the health savings accounts. If you take a distribution for a non qualified medical expense, there is a 20% penalty. So keep that in mind. But otherwise, and you do have to be enrolled in a high eligible, high deductible health plan to make those work. Otherwise, just seeing if there's any other interesting notes to point out, looks like we're pretty good. We've got the asset location under control, and later episodes are ready to start really digging into that withdrawal phase of we're going

Alex Murguia 38:36
to break our rule of, why go? Why go 45 minutes, when you can go 37 minutes? All right,

Wade Pfau 38:45
get a few minutes back today.

Alex Murguia 38:47
All right, everyone. Well, thank you for listening in. Now we'll, now that we've set the stage, we will talk about withdrawals, you know, from a retirement income standpoint, you know, taking all of this into consideration. All righty Wade,

Wade Pfau 39:01
okay, thanks. Everyone catch you next time

Bob French 39:05
bye. 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 you.