Episode 145 Mastering Tax-Efficient Withdrawals

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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. Which matters more, what you can spend or what's on your statement? Well, today we're going to be talking about getting your money out of your statement and into your wallet.

Alex Murguia 00:50
Hey everyone, welcome to retire with style. I'm Alex, and I'm here with Wade, and today we're going to start a mini arc within the larger arc on on tax efficiency. Here we're going to be focusing on withdraw order sequencing as part of tax efficient retirement distribution strategies,

Wade Pfau 01:13
and introducing the topic. This is really to fully complete the discussion on the topic. We need to talk a lot more about some of the pitfalls that you run into, but this will be introducing the concepts of withdrawal order sequencing, and

Alex Murguia 01:27
this is something that I would say has been in the forefront over the last five years. Advisors even have access to there's some softwares that are dedicated just for withdraw order sequencing and optimizing that simply our hobby horse has been taxes are something you can manage, and if you do this efficiently, you'd be surprised how much quote, unquote, alpha you can extract, and not by finding hidden gems, but really from just being smart about how you handle your taxes, it does lead to a big bottom line number, as opposed to saving one year on such and such. It has a compounding effect, because it's more money that you're leaving investing.

Wade Pfau 02:13

It's just the idea we have to pay taxes at some point for so looking for opportunities where we can pay them at a lower rate than at a higher rate, and that adds up over time, and can have a big impact on long term planning. For sure, we've seen these kind of tax alpha type numbers, point 3.4% which means, like on an after tax basis, the investment returns you're getting through these tax efficiency It's like another 30 or 40 basis points of annual returns on your investments? Yeah, so that's big. Again,

Alex Murguia 02:45
1% is 100 basis points, so 30 to 40 basis point this, you know, point 30 or point 40 of a percent. So it adds up and and I gotta point the irony of all ironies is folks over engineer distribution rates quite a bit, where the is the 4% strategy working? Or can I do 4.3% this year? Or can I do 3.7% this year? I I don't know who it is, Morning Star Vanguard. Somebody loves to sort of throw out the new number this year is drum roll. You know, 3.57 you know, that kind of thing. And the reality is, it's the amount that you can really save just from the doing this tax efficiently adds, again, 30 to 40 bips to a potential distribution strategy. And that falls on deaf ears a lot of times.

Wade Pfau 03:38
Yeah, I guess the maybe the irony there is most of the studies about safe spending rates ignore taxes. It's not part of the analysis, so they're pinpointing very precise numbers while ignoring something that is a really because what you really care about is your after tax spending, not your pre tax spending, and this can have a big impact on your after tax spending. And

Alex Murguia 04:01
there it is, all right, so withdraw sequencing weight. And I know we've spoken about this on previous episodes, the types of accounts, but because folks just you know they want to jump in, jump out of certain episodes, maybe we do a little bit of a preamble with regards to the the types of accounts that there are before we go through their their sequencing order. What say you, good sir,

Wade Pfau 04:28
that sounds great. Yeah. So in past episodes, a few episodes back, we talked about, talked about the three broad types of accounts in the US tax code you've got your taxable brokerage accounts, which you pay taxes on an ongoing basis on any interest or dividends. You do get deferral for long term gains until they're realized, until you sell the asset, and you get preferential tax treatment for qualified dividends and long term gains. It's a different and lower set of tax. Rates, and also you get a step up in basis on any long term gains at death, but, uh, so in the long run, it can have advantages, but it's really the least efficient on an ongoing basis, because it's the only one of the accounts that's forcing income to be taxable every year, just as your investments are paying either interest or dividends. So that's the taxable brokerage accounts. Then you've got the tax deferred accounts. These are where the government's incentivizing retirement savings by incentivizing you to save money for retirement. So you get to deduct up to limits the amount you put into these tax deferred accounts. These are IRAs, 401, KS, that sort of thing, you get tax deferral. And then when the distributions come out, they're taxed as ordinary income, which is a disadvantage if you have, like stocks and things that have a lot of long term capital gains, they'll come out as ordinary income instead of long term capital gains. And then these accounts are the ones that are impacted by the RMDs that was the subject of our previous episode, but that's the tax deferred accounts. And then you have the tax exempt or Roth accounts, which are a newer innovation, and they're very nice. The you do put

after tax money into these accounts, so you don't get any tax deduction on the money going into the tax exempt accounts, but then you get you never pay taxes again on qualified distributions. You get tax deferral, and the distributions are not taxable either. They do not go into the adjusted gross income. So they're a really handy resource for being able to meet spending needs without generating any sort of adjusted gross income. Those are your Roth accounts, Roth IRAs, Roth 401, K's, that sort of thing. So those are the three account types that we're generally talking about in retirement. How do we want to spend from those accounts now to have more tax efficiency? Did

Alex Murguia 06:51
you say them in that order on purpose, or you were just using the Holy Spirit to guide you?

Wade Pfau 07:00
That's the same order we covered them in the previous episode. But I suppose there is sign

Alex Murguia 07:04
from a sequencing standpoint, that's kind of the order. Yeah, that's

Wade Pfau 07:08
so as it as it happens to be the case the the conventional wisdom and the we're going to do better than the conventional wisdom in the podcast, but we're still going to be tied, in spirit, to the conventional wisdom is that you spend down the taxable accounts first, then you spend down the tax deferred accounts, and then you spend down the tax exempt accounts. Now we'll improve upon that, but still, that's a guiding sort of framework. It really the answer is you spend a blend of taxable and tax deferred first, and then once taxable is gone, you'll spend a blend of tax deferred and tax exempt, but you still have that basic withdrawal order sequencing of taxables, getting the biggest priority to come out first, then tax deferred and then tax exempt at the end.

Alex Murguia 07:55
Now someone may say, why? And just for me, it's you have less of a tax drag if you get rid of the taxable, if you spend from the taxable first, because there's always you're getting tax on dividends. You're getting etc, etc, etc, and you don't, you don't have that from the tax deferred or tax exempt. Hence, it could, it makes a lot of sense from that you may have some assets within it that are tax efficient. But that's okay, you could always because let me backtrack that here. When you do your allocation, it's going to be a household allocation like the taxable account. Shouldn't mirror the allocation of the tax deferred account. It shouldn't mirror the allocation of the tax exempt account. A lot of folks do that, I think it's suboptimal. It may mentally help them, but it's it's suboptimal on a lot of levels, from a return standpoint, specifically. And so from that standpoint, you want to look at all of these three accounts as one household allocation. And so different holdings will be in different types of accounts. We covered that in previous episodes. But what happens, though, it's in your taxable account, you're going to have some underlying holdings inside of that account that may be tax inefficient on a yearly basis, so to the degree, which means, effectively, if an asset returns 5% a year, but it's tax efficient, you may only see two and a half percent of that return kind of thing. I'm just throwing out numbers. And so to the extent that you're taking monies from those accounts, first, you're going to have less future tax drag on your the entirety of your portfolio going forward. Wade, is there a more concise way you can potentially say that? Oh, I'm sure, right, why don't you say that more, more concisely?

Wade Pfau 09:43
Yeah, the taxable accounts are spitting off taxable income every year, so they're creating a tax drag, and that's why, generally, points to trying to spend them down first. Now, the exception to that would be, if you're at the point where you're going to be leaving a legacy, you're not going to be running. Out of money. In particular, you might be in a position where you could also be quest a large amount of taxable assets. You might want to stop generating those long term capital gains by selling shares to cover your spending because of that step up in basis that would be available to your beneficiaries at death. But for the common person who's not going to have a huge legacy and still have their taxable accounts at that late in life point, that's where the most efficient approach is, go ahead and spend those down more quickly to get that ongoing tax drag out of your tax picture, especially before RMDs later start on the tax deferred accounts.

Alex Murguia 10:41
Okay, and so this is a tax driven theme we're running here. Yeah.

Wade Pfau 10:48
And so after that, you mentioned the asset location. After our asset location episode, what we talked about there was usually like, your stock index funds are in your taxable accounts, your bonds are in your tax deferred accounts, and your less tax efficient growth assets are in your Roth accounts, and that really from the withdrawal order sequencing the Roth accounts make sense. You're it's going to be the longest period of time before you spend those so you want your kind of riskiest, longest time horizon type assets there, but there is a issue. Usually we want to be spending from bonds, but we're saying, Put your stock index funds and your taxable accounts and your bonds and your tax deferred accounts. But we're also saying, spend your taxable accounts first, spend your tax deferred accounts later. So there's a conflict there, and we had a couple of folks write in asking about that conflict. I think the kind of the basic answer to it is what we talked about in that episode, asset allocation should always drive. Be the driver, not asset location. You have to think about your asset allocation first here probably like withdrawal order sequencing should be the driver. And what it really means is, even though it may be less tax efficient to have bonds, or really we may be talking about shorter term fixed income assets in your taxable account, you might want a bucket of short term fixed income assets in your taxable account to help manage that sequence of returns risk, because that's what you'll use to cover your spending, even though the asset location argument is all your bonds should be in your tax deferred account, the practical implication of wanting to be able to spend in an efficient manner in retirement might tell you you really better have some fixed income in your taxable account to cover those upcoming spending needs, then the rest of The taxable account, I mean, then you can follow asset location at that point. So the rest of the taxable account is your tax efficient index funds for stocks and so forth, and your tax deferred account would be the remainder of your fixed income allocation, everything else being the same, and so on and so forth.

Alex Murguia 13:00
Okay? Now as we start this and and again, if you, if any listeners have questions while we're, you know, discussing it, send them in. If we can work them into these episodes, we'll happy to do so. If not, we'll probably set up a YouTube Live session where we just do, like a Q A kind of traditional radio call in show. But okay, when we talk about the next phase, how do you recommend it goes about, how we go about doing it and this, this touches on marginal rate tax

management and the like. You know, what's a good starting point? But how can we improve upon that? Yeah,

Wade Pfau 13:39
so the guiding principle as we move away from the conventional wisdom effective marginal tax rate management, and it's really a concept developed by Joe Elsa. He's an advisor based out of Omaha, and he's developed software. It's for financial advisors. He's got the covis suite of software that includes tools that can do the same sort of analysis that I'm describing in these podcasts. It's effective marginal tax rate management. So it accounts for the fact that we do have to pay taxes, as we talked about in the very first episode of the arc. We have a progressive tax system in the US. So generally, your taxes go up as your income goes up, the tax rate goes up as your income goes up the marginal tax rate. But we also have all these nonlinearities. We have how drawing income can also cause more social security to be taxed. Can lead to higher Medicare premiums. Can lead to the loss of subsidies if you get your health insurance to the Affordable Care Act can push your long term gains from the 0% bracket into the 15% bracket. There's all these other things that can happen as you generate income. And so the effective marginal tax rate is like, what's it's not just the federal income tax brackets at this point, but if I take another dollar out of my IRA, how much total taxes am I going to have to pay on that dollar after account? Money for all these other aspects of the tax code, and we'll we've introduced all that, but we'll have future episodes where we dig more into the Social Security Rules, taxation rules, the Medicare premium rules and so forth. That'll be coming in further episodes, but that's going to be the structure where, when we say we have to pay taxes, let's look for opportunities to do it at lower rates, to avoid having to pay taxes at higher rates. That analysis, this effective marginal tax rate analysis, is implicitly including all those other factors in the discussion. Wade

Alex Murguia 15:35
something you mentioned, because this is where we're at a bit of a imbalance here, where we're talking about how to do it, but we're pointing out softwares that advisors have access to because they don't. If they presented it to consumers, I don't think they'd be a market for it, although maybe our users are think our listeners are thinking, Yeah, of course, I would use it. But the reality is, it gets very difficult from a Client Servicing standpoint and the like. And so they go through advisors, because it just scales, frankly, a lot better. But this, I just want to take a moment. This is when we thinking about planning, what happens within a financial plan and the like. This is specifically a lot of the meat to the sandwich when you're talking about a retirement income distribution plan, what goes into it and things along those lines, really is, this is one of the main components of it, if you're a consumer but don't have access to an advisor, is, you know, are we kind of like teasing them a little bit by talking about what they should be doing, but without access, without the ability to do something like that. And I know I'm going off script, but I'm thinking of consumers that are listening in, wondering, Yeah, but how do I do that? How do I do that? And obviously Listen, call us at McLean. You know, there's that kind of thing, but I'm just curious, what would you say to them?

Bob French 16:57
Are you getting close to or are you in retirement? Well, investing during retirement is a little bit different than during your working years. Your investments are there to help you pay for retirement, and now is when they need to earn their keep to make sure you're on the right track. Download retirement researchers eight tips to becoming a retirement income investor by heading over to retirement. Researcher.com/eight tips again, get retirement. Researchers eight

tips becoming a retirement income investor by going to retirement. Researcher.com/eight tips. That's the number eight tips.

Wade Pfau 17:36
Yeah, I do feel bad when I get the emails saying, Okay, I read your chapter in your book. How can I do this myself? And the reality is, I've written programs to do all this, but they're not interactive programs. They don't have a user interface, and they only can work with specific scenarios, like whenever with my programs, if there's two people, you always have to list the older person first, like it's not generalizable there. It'd be easy to break the program if I tried to make it available to others, because they'd put in scenarios that were not accounted for in the program.

Alex Murguia 18:11
So I mean this without making it seem like an ad, though, listen, if everyone is is this is something that's a significant pain point, and you're thinking, Man, I would just like to have this a tax analysis of distributions or whatever. Give us a holler over at retirement researcher.com or McLean am.com and we do have just a standalone planning service. I know it sounds like an in stream ad, if you will, but the reality is, I want to, I want to address this now. So folks are not like having trepidation, why they're listening to you about, oh my God, how do I do this myself? The reality is, I would, if I'm a consumer, I would then listen to this with a mindset of, this is what's available within a professional relationship if you want to take your tax efficiency to the next level, which you know, frankly, the savings justified. I'll leave it at that, and you can continue with your thought process. I just wanted to throw that out

Wade Pfau 19:08
there. And also, even if you're not doing the full lifetime analytical plan about exactly how much to convert every year, still there's a lot of value in just understanding the principles at work and some of these concepts just as you are thinking about your 1040 not drawing income in an unnecessary manner that triggers really unfortunate side effects, like higher Medicare premiums, or you got to remember that that 0% long term capital gains bracket When you start pushing capital gains into the 15% bracket, that's really a double whammy on your taxes. And so just being aware of these kinds of things and managing that on a year to year basis, there's still a lot of value in that, even if you're not taking it to the next iteration of here's a full lifetime tax analysis. So. Which consumer facing software doesn't really do a good job with other than there isn't. I have not fully analyzed. Larry kotlikows maxify. It may be the one consumer because he's very technical. I think his software may do a good job, yeah, but none of the other consumer facing software can do what we're talking about. Yeah, and it's not

Alex Murguia 20:19
that they don't want to. It's just it. There's not a strong enough business case to do that, because the moment they do that, there'll be a lot of user error. And within that, you know, they would have to load up their their margins would disappear. So they just don't even bother, you know, from that perspective, and they provide it to advisors, because, you know, advisors are certified to do that. And, you know, the CFP, ricp, etc, etc. And so they figured, if we provide it to advisors, it's a much more seamless process for us as a business,

Wade Pfau 20:52

okay, but yeah, I mean, the idea that we're going to start getting into is, when you start doing tax efficient analysis, the idea is, generally, it's true for everything. With retirement income planning, short term sacrifice creates long term benefits. And it's the same with this tax efficient discussion, because it may require things like Roth conversions, which really mean you're just paying taxes sooner than you had to, but you do that because this helps set up the opportunity to pay. And it's not just less taxes over your lifetime, but it's more have higher after tax wealth over your lifetime. Because, of course, one way to minimize your taxes, if you talk about a tax free retirement, you just destroy your asset base, do some terrible investments. You don't have any money, you're not going to pay any taxes. So we're not talking about just minimizing taxes, to be clear, we're talking about getting the most after tax wealth, and short term tax payments can help lay that foundation for greater long term after tax wealth. So that's really what we're talking about here. And to do that, you fill up, you generate taxable income when you can do it, relatively low effective marginal tax rates. And then once you get to the point where you want more money to spend, but if you generate more taxable income to do that, the effective marginal tax rate could be quite high. So you put the brakes on taking it from taxable income sources, and you instead draw from sources that create less taxable income, whether that is the Roth, which does not go into Adjusted Gross Income district qualified distributions from a Roth IRA, or 401 K or whether that's selling some of your shares in a taxable brokerage account, which part of that will be a cost basis that's not taxed. And then part of that, if you've held the shares for at least a year, will be the long term capital gains that are taxed at a lower rate than ordinary income.

Alex Murguia 22:48
Okay? And you said it earlier, and we did do a little preamble on the types of accounts, but when it comes to tax rates, just as a quick, quick and dirty remember, it starts at 10% tax rate, it can go all the way to 37% and and there's an incremental, you know, it goes, it goes up incrementally, especially from 22 to 24 to 3235 37 but the key here is at the lower rates. That's when you see these like gap ups in rates. And you had said it earlier in a sentence, but I think that's, that's where the game is at in terms of really trying to, on a proportionate level, eke out those savings. Because, yeah, you're right, you pay less in taxes, but really what it's about, it's not getting your account to zero. So you can say, I don't, I don't have any taxes to pay. It's really, the less you pay in taxes, the more remains invent vested, the more that remains invested, the more compounding you have, hence a virtuous cycle. But you may want to jump in on that, how the taxes at the lower rates really gap up. And so it's important to keep that in mind.

Wade Pfau 23:53
Yeah, yeah, these episodes are really for, like, the middle class, mass affluent type retirees who have saved some money. If you don't, haven't saved anything, there's not much to do, but who've got some savings. But we're not talking about like the ultra high net worth type individuals, because, yeah, when you do get to the higher tax brackets, the additional increases are relatively small, so that there's not going to be as big of impact available. But for middle class folks managing that jump from the 12% bracket to the 22% bracket, which if the tax law, if there's not any change in current tax rates in 2026 it'll be the same sort of jump. But from 15% to 25% that's a huge jump, and that happens this year at 47,000 $150 of taxable income for single people. 94,300 for for married filing jointly. So it's kind of middle class, upper middle class. I think that the kinds of folks that are probably tending to listen to the podcast where being able to manage that divide, like filling up the 12. Percent to stay out of the 22% in the following

years. That's that's a big advantage, and very close to those same levels. It's not exactly the same for whatever reason, but very close to there $125 difference for singles, $250 difference for couples is where the long term, or the the preferential income taxes switch from the 0% bracket to the 15% bracket. So 47,025 for singles, $94,050 for married filing jointly, so generating long term capital gains up to those thresholds where there's no other secondary non linear factors yet. But if it was just that you can you're generating taxable income, but you'll pay at a 0% rate, and then that can help, perhaps, to avoid, in later years, having to pay more of those gains at a 15% rate. So staying in zero to avoid 15, or staying in 12 to avoid 22 there's potentially a lot of value in that, and that's where this discussion has the most relevance. When we talk about that tax alpha, those numbers, that 30 or 40 basis point type idea, that's really in these kinds of scenarios where we're able to manage these divides and also potentially manage not paying taxes on the full 85% of the Social Security benefits, that's where you can see the most value, and that's more of a middle class consideration than it is kind of a high net worth types. It's

Alex Murguia 26:26
not to say that you ignore it at the high net worth, because nominally, it's still a lot of money. It's just proportionate to the overall wealth.

Wade Pfau 26:35
I get it, you know, and it may be that $1,000

Alex Murguia 26:39
put it in the kitchen table and just watch it burn for the hell of it. You know, I mean, no matter how much money you have,

Wade Pfau 26:47
but it's just a tax alpha, maybe more, like 10 basis points.

Alex Murguia 26:50
No, no, I get it, but that 10 basis points

Wade Pfau 26:53
are smaller

Alex Murguia 26:54
is a lot,

Wade Pfau 26:56
yeah, yeah, yeah. Well, yeah, you never it's nothing to sneeze out. So it's not to be clear. We're not just doing these episodes for the ultra wealthy that it's it's most relevant for the not ultra wealthy, yes, kind of dark there,

Alex Murguia 27:14
all right. And so with that, you may does it make sense? Then you know, if you're taking it from the taxable at the beginning. Are there some, are there some sort of sacrifices that are made because you were saying you're paying now, you know, to save in the future. That's really,

you're just paying more in taxes right now. But over time, there's going to be a break even that'll that you you know, you'll see that. It's going to make a lot more sense. Yeah.

Wade Pfau 27:40
And actually, that break even may not even exist if you've got a lot of IRAs and you're thinking the beneficiaries will be your adult children, and maybe they're high earners, and they're likely to inherit these when they're in their 50s, they may face much higher tax rates on an inherited IRA than you would face doing the Roth conversion, and if that's the scenario you're talking about, there is no kind of break even, or there is no short term sacrifice. You are paying taxes sooner than necessary, but you're doing that because immediately you're increasing the after tax legacy value of those assets. You don't have to wait for the long term if you did a Roth conversion this year and passed away the following year, the after tax legacy value would be higher because you did a Roth conversion at a lower rate than your these new, inherited IRA owners would be paying as they distribute over that 10 year window.

Alex Murguia 28:36
That is the transition I was looking for. But, you know, I want to make sure we're not being confusing to the audience as we brought up that little caveat,

Wade Pfau 28:50
yeah. And I mean, if it's if we're not talking about the beneficiaries, then it's back to short term sacrifice for long term gain. Is maybe in the short run, I would have less after tax wealth, but by then being able to really manage lower taxes in the future, eventually I break even and I have more after tax wealth, okay? And may have to live to a certain age before I see those long term benefits. Okay?

Alex Murguia 29:15
So then conceptually, we've spoken about it. What are three like techniques people can do to generate taxable income.

Wade Pfau 29:22
Okay, so you gotta meet spending needs, and we talked about the conventional wisdom, as you spend on taxable first, then until it's zero, then you switch to tax deferred, spend that down till it's zero, then switch to tax exempt, and spend that down till it's zero. So three techniques to shift away from that. One is no Roth conversions. You just simply, I'll lower my distributions from my taxable account and offset that with increased distributions from my tax deferred account. That would generally increase my taxable income, because all that money coming out of the tax deferred like if I reduce my tax. Distribution by 10,000 increase my tax deferred distribution by 10,000 that 10,000 of the tax deferred is 100% ordinary income. 10 10,000 out of my taxable account. I was probably selling shares to do that in the scenario I'm describing, because you can't avoid qualified dividends. So I was selling some shares, maybe the cost basis of that 10,000 was 7000 so seven of that 7000 that came out tax free, the other 3000 of that maybe is long term capital gains. So I'd have 3000 of long term gains. But I now, I don't take, I don't sell those shares out of the taxable I reduce the taxable income by 3000 I instead cover that $10,000 spending need through a distribution from my tax deferred account that increases my taxable income by $10,000 so that's one option. That's not going to be the solution, ultimately, but that's an option. The second option is the idea of Roth conversions. I cover all my spending from my taxable account, and then I voluntarily convert from my IRA to my Roth IRA to generate

more taxable income that will increase my tax bill. And I also just simply pay the tax bill through a further distribution from my taxable account so it could accelerate spending down the taxable account as I pay those additional taxes as well. But in the meantime, I'm moving it's because I wanted to generate more taxable income, because I'm doing this, because apparently I can do it at a lower rate right now, lower effective marginal tax rate. So I generate more taxable income by voluntarily distributing from the Roth IRA as a, I'm sorry, from the IRA as a conversion, direct conversion, to the Roth IRA, and then that gets money over to the Roth to give me that flexibility in the future, where, when I take that Roth distribution, when it's qualified, it does not add to My taxable income. So I want to generate that taxable income now, because apparently I can do it at a lower rate, and then in the future, I can spend without generating taxes at a higher rate. So that's that, that's the Roth conversions, and that we'll spend more time on that, because that is really the the answer that we're looking for here. And then the third option is long term capital gains harvesting. Usually we talks about talk about tax loss harvesting. Now we're talking about gains harvesting which doesn't have any of the wash sale rules or anything I can sell and then immediately repurchase the asset, which then forces me to pay, create taxable income, and gains will short term if it's less than a year, long term if it's greater than a year, probably mostly want to focus on long term gains when doing that, because especially if I'm still in the 0% bracket with that preferential income stacked on my ordinary income, I didn't have much ordinary income, I Still have a window where I can generate preferential income at the 0% bracket before jumping into the 15% bracket. So I go ahead and generate that income. It's taxable. I pay taxes, but it's at a 0% rate. I've really just increased my cost basis, which will lower the tax pressures in the future if I have to say, just

Alex Murguia 33:21
to again, make it completely obvious, why would you do that? It's the last statement that he's that he said, Because you're resetting your cost basis. So then, if you're not gonna, if the taxes that you're gonna have on an asset are going to be de minimis over the course of the year, because you're gonna be at the 0% tax bracket, you know, as opposed to in the following three years, you know, you have income coming in, and it's gonna bump you up two or three back brackets above that, then it makes a lot of sense from the present value of present value calculation to take that, to take that hit. Now, at the at the zero, at the 0% tax bracket, simply put, and you reset, you reset your entire, or as much as you want, your capital base for taxable accounts, so because you're going to benefit significantly going forward.

Wade Pfau 34:16
Yeah, and I do get questions about this sometimes asking, like, what should be the priority, should I do Roth conversions, or should I do gains harvesting? And it's tough to answer. You could probably dream up a scenario where it would be better to do the gains harvesting before the Roth conversions. But I think in general, without further analysis, it's probably the case that Roth conversions should be a higher priority. It's like, well, if I could either do a Roth conversion or I could harvest gains, probably in in most situations, Roth conversions would be a higher priority than gains. Intuitively, my

Alex Murguia 34:54
mind went right to Roth conversions. But this is without even like looking at an Excel sheet or anything. I just. Yeah, that's just me, but I agree with with with your intuition there as well, but I'm sure you have spreadsheets to back that up as well. Or at least,

Wade Pfau 35:09
you could create a spreadsheet where it'd be better to do the gains harvesting first, but I think that would be the less common edge case.

Alex Murguia 35:16
I think I, you know, I

Wade Pfau 35:17
think it's an edge case, but I it's, I don't even know where to begin with, trying to figure out what edges that would be,

Alex Murguia 35:26
Fair enough. Fair enough. Okay, wait something I just like to say for all of these things that you were mentioning in terms of spending first from this and that, just to echo on previous episodes at the end of the day, though, the most important thing is to maintain the integrity of your asset allocation. So if you are selling from your taxable account, first, most likely that's going to be equity driven holdings such as an S, p5 100 index fund or a small cap value index or something like that, right? And so you want to make sure on your tax deferred and on your tax free accounts that you know, as you're selling certain asset classes, you're you're kind of proportionately adjusting the portfolio on the other side there, you know, since it's a tax deferred or tax free account, there aren't going to be taxable gains on that as you as you rebalance. But that's important. You don't just, like, blow through your taxable account and do not touch the allocation on your other ones, because then you're effectively going to be, you know, met completely off on your allocation. Wait,

Wade Pfau 36:37
that's a great point. You can you always want the asset allocation to come first before asset location, because otherwise, late in retirement, if you're kind of down to just having a Roth IRA left, well, the asset allocation argument is that's where all your emerging market small, small cap value type funds are. But by that point, no you probably have to deviate from the asset location principles to make sure you have enough fixed income or other assets to for a comfortable asset allocation, even if that has to be in the Roth, absolutely

Alex Murguia 37:12
All right, any other thing that we missed here today?

Wade Pfau 37:17
No, I think we we got a good foundation for then in future episodes, we'll dig into those, the pitfalls with the Social Security and Medicare and that sort of thing, and then we'll really revisit this again for how to most effectively think about a Roth conversion strategy. So I think we, we got the foundation in place.

Alex Murguia 37:34
All right, everyone, thank you for listening in, and we bid you

Wade Pfau 37:40
ad until next time on retire with style.

Bob French 37:44
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 a risk, including Risk of Loss past performance does not guarantee future results. You