Episode 148: Tax-Efficient Income Stacking

Wed, Oct 16, 2024 9:56AM • 28:07

SUMMARY KEYWORDS
retirement income, financial personality, tax-efficient stacking, ordinary income, preferential income, tax brackets, long-term capital gains, qualified dividends, net investment tax, Roth conversion, Medicare surcharge, financial planning, retirement income planning, tax planning software, behavioral finance

SPEAKERS
Alex Murguia, Wade Pfau, Bob French

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. It's not just about how much you make. It's also about when you make it. Join Alex and Wade as they break down the art of tax efficient income stacking in retirement.

Wade Pfau 00:53
Hey everyone, welcome to retire with style. I'm Wade, and I'm here with my trusted co host, Alex, and we're ready to bring you an action packed episode on Pitfall The final one of the pitfalls that we're looking at about we may want to voluntarily generate taxable income to have a more tax efficient retirement, but there are things outside of income tax brackets that can be impacted by generating taxable income, And the final one of those, Alex, is this idea of preferential income stacking. Yes,

Alex Murguia 01:25
yes. Anything that stacks. I'm all about

Wade Pfau 01:27
Big Tetris player, huh?

Alex Murguia 01:31
Yes, actually, you see that movie? There was a movie on Tetris. Did you see that? No, like some, I don't know. It's the Japanese company that ultimately got it. They, like, went into Russia to buy this was during the Cold War, as the wall was, you know, coming down. Or, I don't even know if it was because that's Germany. It was like Russia was crumbling, if you will, those last days. And it was kind of wild. Just the previews itself. I haven't seen it, so check it out. But that's not the question I have for you. The question I have for you is, how do you define action packed? Well, make this an action packed episode.

Wade Pfau 02:12

Yeah, we're gonna, well, it's something that, something that you may not have thought about, but actually can have a really big impact on your taxes and so but,

Alex Murguia 02:22
but how is it packed with action?

Wade Pfau 02:25
It generates a lot of action and incitement in your mind as you realize you may be paying more taxes than necessary. I suppose

Alex Murguia 02:34
that is good enough to know what your primary definition of action packed was That's it, all right. Well, as we say here, nothing to it but to do it right.

Wade Pfau 02:49
That's right. Alex, okay, and we have introduced the idea in past episodes. But to quickly refresh everyone's memory, there's two different kinds of taxable income in the United States, the good and the ordinary income.

Alex Murguia 03:07
I said the good and the bad and no, the bad and the worst. Sorry, my bad. Yeah,

Wade Pfau 03:16
exactly you've got, yeah, ordinary income are most income sources, your wages, interest on bonds, short term capital gains, anything else that's coming in, it's taxes, ordinary income in the US, we also have preferential income, which are specifically on a taxable brokerage account, realized long term capital gains when You're selling shares that you've held more than a year and then qualified dividends, which get a special their dividends, but they get a special track tax treatment if you've held those assets for more than a year and so forth, those have a separate set of tax rates. There's seven different tax brackets for ordinary income, going up from from 10% up to 37% there's just two different tax brackets for well, then there's an extra thing we'll talk about, the net investment income tax but the basic preferential income tax brackets are either 15% or 20% so and they come in at different levels, and so

Alex Murguia 04:16
preferential income has nothing to do about The income that you generate from things you like doing.

Wade Pfau 04:25
Well, you could get a correlation, because this is where the capitalist comes into play. Once you have a big pot of assets, you can enjoy generating income from them. So it's all preference.

Alex Murguia 04:38
At that point, it's all preferential, okay, I get, yeah, you're not working

Wade Pfau 04:42
to earn this income. It's, it's being spit off of assets that you've accumulated. So it's preferential in that regard. Okay, okay, and that's the incentive to invest your your assets the we talked

about. The I don't know why they don't align these up, but just about the same spot where the 12% bracket becomes a 22% bracket on ordinary income, the 0% bracket becomes a 15% bracket on preferential income. There's a for singles, $125 difference between the two thresholds. I don't know why. And for married filing jointly, there's a $250 difference. They're

Alex Murguia 05:23
probably just determined independently. They weren't determined, you know, they didn't do these together. And so different steering committees or whatnot

Wade Pfau 05:31
could be, could be. But the other point to this too is your preferential income is stacked on top of your ordinary income to determine how it gets taxed. So maybe the easiest way to really treat this is to give an example. Suppose you're a single filer and you have $49,025 of income, your taxable income on your 1040 but it's when you break that down, that includes $45,025 of ordinary income and $4,000 of preferential income, long term capital gains or qualifying dividends. Okay, so the if you had just $49,025 of ordinary income, and that would be in the 22% bracket. But that, again, we it's not all ordinary income, the 45,025 you're still in the 12% bracket on ordinary income. And then you stack the 4000 on top of that. And when you look at where that zero to 15% threshold comes into play, it's at $47,025 so half the 2000 of your long term gains are still in the 0% bracket, and the other 2000 are in the 15% bracket. Okay, so you've got 45,025 still in the 12% bracket, ordinary income. On top of that, you're adding your preference income, 2000 of that's in 0% 2000 of that is in 15% now the issue is, let's suppose I I'd earn another dollar of income. I go back to work and I earn another dollar. How much tax will I pay on that dollar? So that dollar ordinary income, it's going to get taxed at 12% I'm still in that 12% bracket for ordinary income. But the other thing that dollar does is now only there's only room for $1,999 of my gains to be in the 0% bracket. $2,001 of my gains are in the 15% bracket. So that just

Alex Murguia 07:46
to say there was $4,000 of altogether long term gains,

Wade Pfau 07:50
yeah, $4,000 of long term gains, and they crossed the threshold between zero and 15% so that dollar, I'm paying 12% on that dollar, but I'm also uniquely now having to pay another 15% on the dollar of my gains. So my effective marginal tax rate on that dollar of income is 27% 12% ordinary income tax, 15% preferential income the tax after stacking that preferential income on ordinary income. So I thought, I'm in the 12% bracket with my ordinary income, and I was, but I'm paying 27% on that dollar.

Alex Murguia 08:35
Yeah. So anything above that now you start getting clipped at a very heavy rate,

Wade Pfau 08:40
yeah. And that will continue until all $4,000 of long term capital gains are getting taxed at 15% then when that happens, I still, for the next $125 I'm still in the 12% bracket on ordinary income, then I enter into the 22% bracket on ordinary income. But there's no more preferential income stacking problem until later, when, well, when I get to the 20% bracket, I'm going to have the same problem where I'm pushing income from 15% to 20% but also before that, we run into the

net investment income tax as well, which is an additional 3.8% surcharge that comes into play at $200,000 for singles and $250,000 for couples. So when that happens, it's just my 15% is getting pushed up to 18.8%

Alex Murguia 09:39
in this Medicare, one that came out during the, I want to say the Obama administration, right? So it's not something that's been around forever and ever,

Wade Pfau 09:48
right, right? It's to help with the Affordable Care Act. Or no, no, it's actually Medicare. But it's, yeah, you're right. It came into. The Obama administration, I forget exactly what it was earmarked to cover, but yes, it's an additional tax to help with covering health insurance for Americans. Now that one, we can make a few more comments about it, because when we talk about nonlinearities in the tax code, this is another nonlinearity, because it applies on the lesser of two numbers. It's not that you automatically have your long term gains getting taxed at an extra 3.8% it's that once you exceed those thresholds, they look at what's a smaller number, your modified adjusted gross income in excess of those thresholds, or your net investment income, and then whichever is smaller, that chunk gets taxed at three an additional 3.8% your net investment income includes capital gains, interest, dividends On Assets and taxable accounts, royalties, rents and amongst other things, the taxable portion of non qualified annuity distributions.

Alex Murguia 11:06
So that this, this, this scenario that we're pointing out is a little different when we're talking about Social Security. The torpedo we were always saying, watch out how much income you're making, like work, working Medicare. The last episode on Medicare was the same thing. You got to be careful how much income you're making here it's you got to be careful what your gains are. You know, how much of your gains you're kind of recognizing in any given year. Is that a correct assessment?

Wade Pfau 11:34
Well, that that's part of it. But also, if I'm thinking about doing a Roth conversion,

Alex Murguia 11:40
oh, the right way. That's right, we're building up towards a rod. So there's that in the background, Sorry, go on,

Wade Pfau 11:45
yeah, if I'm thinking about doing a Roth conversion, this actually can be the trigger that stops the Roth conversion, because if I'm like, thinking why I want to pay taxes whenever I can do so at, say, less than a 20% effective marginal rate, and I'm in kind of the scenario I was describing before, where I'm still in the 12% bracket, but I do have these long term gains that are still in the 0% bracket, as I'm doing those Roth conversions and paying tax at 12% I'm going to eventually start pushing my gains into The 15% bracket too. And so my 12% effective marginal tax rate becomes 27% and if I'm only wanting to pay taxes when I can do so and say less than 20% if I was only looking at ordinary income being taxed at 12% I'd keep going. But if I look at this holistic your words, if I look at the holistic picture here, yes, the holistic picture, yeah, I'd be paying taxes at 27% and then I'd want to put the brakes on and stop doing those Roth

conversions. And I think this, this aspect of preferential income stacking, it doesn't get talked about very much. It. It does get mentioned from time to time, but I don't think people who are doing tax planning, it may not be natural for them to incorporating this into their planning. Why not?

Alex Murguia 13:12
Because this is like standard for it when you're doing the financial plan with us. Why wouldn't this be I

Wade Pfau 13:17
think it's confusing. It's you got to go a couple levels deep here with it's not just looking at your federal income tax brackets and your ordinary income. It's recognizing at the same time, I also have to keep track of my preferential income and how it's moving through its own different set of tax brackets. I got like two levels deep.

Alex Murguia 13:37
Yeah, this is where I think the consumer's a little up the creeks. It's just tough to for them to get a, yeah, I don't know. Maybe you can just chat GBT this, but I don't think so, at least right now, not in this era, as of right now. Maybe a way to get the nuclear powered data centers, they can, they can crank out the the bandwidth, or something like that. But this is where financial planning tools, you know, begin to do that trick a little more efficiently. That's why I was like, why not? Why? Why wouldn't folks consider this? But when I'm asking, why not, I mean more professionals, financial professionals, as opposed to individuals, individuals, a lot of balls to kind of have in the air and figure out

Bob French 14:18
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Wade Pfau 14:48
Yeah, you need good tax planning software to also keep track of this. But it also speaks to your point, just generating more long term capital gains actually.

Alex Murguia 20:00
A mortar.

Wade Pfau 20:05
As a part of tax planning, you might be able to eat one of those Irma surcharges and still keep yourself under again. For that $1 you're way going to be way over any threshold, because it's like a 99,400% marginal rate. But then, as you go beyond that and continue to add income, you might be able to get that overall rate low enough that it was worth eating a surcharge, and then that if instead, you're, you're you've already taken care of, I'm delaying Social Security so I don't have it yet. I'm still below the levels where I have to worry about Irma surcharges. The issue that may become relevant is the capital gains stacking, the preferential income stacking. So then I may do Roth conversions up into the point where I would also be pushing my long term capital gains or qualified dividends from the zero to 15% bracket. So bracket, and then that might be

the the point where I stop with the ROB conversions. Those are all all, well, the there's no clear stopping point with Social Security, because pretty much by the time you're out of the standard deduction, you're already dealing with the Social Security tax torpedo, but stopping at either where the preferential income stacking becomes a problem or where a Medicare surcharge becomes a problem, those are pretty realistic targets that might be more more effective to consider than just, say, filling up my 12% bracket or filling up my 24% bracket. I got 22 I should say, or 22% which would come first, and,

Alex Murguia 21:47
sorry, wait, I got a sneeze in between there. So it's holding back on me. I'm sort of letting you fly solo here for a little bit. Why you're where you're speaking, like when you're detailing these, what keeps going through my head is how important, you know, we talk about the fragile decade from an investment standpoint, and that's effectively, you know, the five years leading up to your official kind of retirement and the five years after, if you're taking a sustainable withdrawal rate, that ends up being, it disproportionately is, it's more influential, if you will, to your success. Then, like any other point of time as you start doing these. And so we focus on that. But there's a fragile decade which is kind of probably very similar of financial planning for retirement income planning, and it's really aligning all of these things up. You know, people are that transition from working paycheck to retirement income, paycheck, right? It's you don't just flip the switch. Okay, I'm retired now, boom. Let's do this there, there's a, there's a, yeah, I it just becomes second major, do we? But now, listening to you and just just forcing myself back, I'm not so sure. Folks realize these items that need to be checked off as you enter retirement. You know, from the standpoint of just having a smooth transition, as opposed to bracing for impact, right? Because we worry so much about all these like retirement income strategies, but it's what you keep and in many ways, having to do these things is is not an optional thing. You're going to make a decision on this, whether you make that decision or not yourself, somebody's going to make a decision for you on on how much these payments are made. And so getting this right in this time period is, is essential. Really. I don't think there's hyperbole in that. In that statement, it's just one of those things you have to do when you're listening to it. There's it's not just leaving it up to anyone's devices or however fortune lands. I mean, there's things you can actively do to make sure that you keep as much as humanly possible, with regards to your own personal retirement income, paycheck.

Wade Pfau 23:55
Yeah, it's really about this inefficiency argument, like, I guess. I mean, the worst case scenario with all this is if you're paying more taxes than you need it to, and therefore you're have less

Alex Murguia 24:07
after these are the same people that they complain about, like whatever, something peanuts, if you will, my Netflix subscription, I need to cancel it, right? You know, because they want to save 20 bucks a month, or whatever. 20 bucks more a month, not the net. Netflix is more that. But, you know, I'm getting it like you worry about the pennies when there's, there's somewhat dollars here to be had and and, you know, with Barbara pally, you'll, you'll take care of that.

Wade Pfau 24:36
Yeah, yeah, that's part of that behavioral finance, where people will put more effort into a $20 decision when they're overlooking just a little bit of effort, how they could be saving 1000s of

dollars somewhere else? Yeah, there's a category of where you could potentially be saving 1000s of dollars. To me, this

Alex Murguia 24:55
is like the equivalent of somebody like when they're investing and they have a mutual. So fun that they bought and it's charging them, I don't know, 1.5 a year, 1.5% a year, and only twice about it, because they don't see it. And they just assume, well, you know, this guy, this person, is good, they're gonna outperform the markets and whatever they call it a day, right? But they don't. And then that same person, you know, skimps on everything else. You know, I'm not going to the movies, I'm not buying popcorn or whatever, right? This kind of, that equivalent for the retirement stage, where it's like, pay attention to these things, because these things will matter over time, not the latte a day thing in retirement. You know, that just boggles my mind every time. And listening to you kind of like, line these things up. I'm like, why are more people paying attention to this?

Wade Pfau 25:45
Yeah, yeah, well, now that you're listening to retirement style, you'll have the style to pay attention to now you

Alex Murguia 25:51
know, and that's why it's the eighth most important life altering event, and

Wade Pfau 25:54
knowing is half the battle. There you go.

Alex Murguia 25:59
All right? And we have some more to discuss, right? But we can do that in our next episode. Some more for you to think about.

Wade Pfau 26:07
We want to talk about a few other planning ideas just as part of that conversation, and then getting into case studies, and at some point, we're going to bring in some advisors as well. Yeah, we're

Alex Murguia 26:19
kind of trying to lay down the language and the definitional stuff and the higher level stuff that way, when we bring in advisors that talk about case studies, yeah, there's more familiarity with these terms. All right, everyone. Thank you for listening in, and we'll catch you next time on

Wade Pfau 26:36
retire with style, dude. We're

Alex Murguia 26:40
like Captain and Tamil. They

Wade Pfau 26:43
finish each other's sentences.

Alex Murguia 26:46
Wow, look at that. All right. Catch you later. Everyone but Wade

Bob French 26:52
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