Episode 149 The Various Aspects of Tax Planning

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SPEAKERS
Wade Pfau, Alex Murguia, 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. When it comes to taxes, the early bird catches the Roth conversion, Alex and Wade break down. Why timing your taxes could pay off in retirement.

Wade Pfau 00:51
Hey everyone. Welcome to retire with style. I'm Wade, and I'm here with my trusty co host, Alex. Say hello to everyone.

Alex Murguia 00:58
Hello everyone.

Wade Pfau 01:00
All right, and we're continuing our conversation today, Alex on tax planning, and specifically, we're tying up a few loose strings here, a few different issues that really don't fit together for well, they don't separate into episodes, but a couple minute conversations on a few different topics related to tax planning, including for the reasons to front load taxes. Talk about tax loss, harvesting, deduction bunching. Try to say that five times fast and donor advised funds and other charitable tools.

Alex Murguia 01:32
Wade. Let's, let's see deduction, bunching, deduction budgeting, deduction bunching. Oh my goodness. Before the episode, we were, I was specifically, I couldn't say it. But here we are in a bit

Wade Pfau 01:45
of a ton Twister deduction, bunching

Alex Murguia 01:49
in Spain while it rains on the plane.

Wade Pfau 01:52
But before getting into all that, anything new in your world? Alex,

Alex Murguia 01:57
yeah, I've had to take some time off from actively playing pickleball because of my wrist, but I've gone down a rabbit hole of pickleball paddles,

Wade Pfau 02:07
yeah, down the road of eBay, right for pickleball paddles,

Alex Murguia 02:13
yeah, that's right. When we were in Dallas, I was waiting on that auction, and my wife is getting on my case, like, Yeah, but why are you spending $100 on a paddle that you wouldn't be buying if it, you know, if you didn't need it anyways, you know, those kind of things. She doesn't understand. What kind of

Wade Pfau 02:29
money, right? Yeah,

Alex Murguia 02:32
exactly. It's for my it's for my personal development. It's a consumption cost for entertainment. No, no, no. But it's amazing how you can go down that rabbit hole. And I was gonna mention it, there's such a balance between like, it's effectively a balance between power and control, right? More power, the less control, the less control, the more power, the more control, the less power. And then you get pickleball paddles at a stock and then how are you gonna personalize it with weights at the on the edges, and there's a whole there's a whole rabbit hole around that topic, and I'm in it now. So that's what's been new, unfortunately. How about you Wade? Well,

Wade Pfau 03:15
I just had a busy Travel Week, and yes, we were in San Antonio together. You mentioned Dallas. I think you've lost track of we were in Dallas at one point too. We were talking about the pickleball, and we were together

Alex Murguia 03:26
in Dallas, and then a few days later in San Antonio,

Wade Pfau 03:30
yeah. And then after that, I was in Chicago, Omaha and Newport, Rhode Island, pretty much finishing up travel for the year at this point,

Alex Murguia 03:40
catching the Jazz Festival. Or is that in the spring?

Wade Pfau 03:45
No, no Jazz Festival this time of year, all right, but it was the fall. Foliage was in full force.

Alex Murguia 03:52
Newport was the first time my wife and I, when we were doing, got in the big of the first, like, official fight, if we were in college, and we were like, we take the summer and tour like the New England, since we were already there, and in Newport, it was one of those. But then we knew we survived, that we meant for each other, and the rest is history, but that those are my memories of Newport.

Wade Pfau 04:18
Did you do that walk along the cliff with all the mansions and, oh, the

Alex Murguia 04:21
Vanderbilts and stuff like that. Yeah, it's pretty impressive. And then I forgot if we went to Brown around that, since we were around there, I don't know how far Brown is. I think it's right there, right

Wade Pfau 04:33
brown up in Providence, I think not too far from Newport. I think that's the airport I used. It's a 30 minute drive, yeah,

Alex Murguia 04:40
and we did that, and just, just walked along the Tennis Hall of Fame. Don't they have that there? That was kind of interesting. I don't know. Oh my goodness, you

Wade Pfau 04:48
haven't live caball Hall of Fame. Yeah,

Alex Murguia 04:50
soon, soon, you haven't lived. Wait until you've experienced that. But taxes,

Wade Pfau 04:59
right? Yeah. Well, this was actually our take two and then take one. You said we're going to be more professional and not have small talk, so we

Alex Murguia 05:06
but you, you egged me on right now. You, you literally asked me so anything new, and if I say no, then then you hang in. So you're gonna, you're gonna hold this against me after I did something to humor you. You're now going to hold that against me. Thank you. Wait.

Wade Pfau 05:25
But actually, there's a pretty good outtake from that. The unaired take one of the episodes, yeah, there was

Alex Murguia 05:32
a couple of bombs dropped on that one. I don't know we can couple behind the membership wall or something.

Wade Pfau 05:41

Yeah, get on Patreon. Exactly, okay, but yeah, let's to give context. So we've had a series of episodes on tax planning. The last few episodes, we were talking about pitfalls, but we're ultimately heading towards you may want to pay taxes early on strategically to help increase after tax wealth over the long term, that can involve doing Roth conversions, and we've been talking about pitfalls with that, how it can impact social security, benefit taxation, Medicare premium surcharges, the stacking of preferential income on long term, on ordinary income, that sort of thing. But now let's just also consider three further reasons why, in spite of all that, you might want to front load your taxes in retirement. And the first of those is just this idea. And this is when you hear people talking about life insurance and that sort of thing. They'll put a lot of emphasis on this idea, whether you find this compelling or not, but to the extent that there may be tax changes in the future, the odds are they're more likely to increase tax rates will increase in the future versus decrease. That we may be at a point where, historically, this is a low level of taxation and even baked into the current law. In 2026 if Congress doesn't take action, the tax rates will reset to their levels from 2017 which are, for the most part, across most of the range of incomes, higher than they are today. And so the idea is, well, if you know you have to pay taxes at some point, you might want to lean towards paying more taxes today at lower rates, if you're just worried that in the future, tax rates will be higher than they are today.

Alex Murguia 07:20
Now, what for folks listening? What? How do you think about that philosophically? Because someone could say, you know, at the extreme, I may die tomorrow. So what was the point? Right? And so ultimately, that's a time value kind of question, or has echoes of it. How do you approach it personally? Oh, yeah, I'm gonna do it today, not even thinking that rates are gonna rise, just if the opportunity exists and it's there to take. Why not? Right? But I don't know what goes through your head when you're making that calculation.

Wade Pfau 07:54
Well, it's always we've talked about in past episodes, you want to pay taxes when you can do so at lower rates versus high rates. And the present value stuff can it doesn't really enter into that too much. It's really more about am I going to pay at a higher rate if I trigger the income today? Or would I pay at a higher rate if I wait into the future to trigger the income? And so to the extent that you're worried tax rates may be higher in the future, this just leans you in the direction of maybe being a little more excited about the idea of doing a Roth conversion today to help better set yourself up for avoiding taxes in the future, when you think rates might be higher, not that that's a prediction that it will happen, but with deficits and debts where they are and everything else, Most of the conversation around tax policy leans in the direction of taxes. Don't have any direction to go, but up at some point in the future. Okay, so that was point number one. There's three points in total with this. Point number two is an important issue for couples that when eventually there's only one surviving spouse in that couple, the year after the death of the first spouse, if you're married filing jointly, that survivor switches over to single filing and there's real implications as a single filer, where they even with some of the reduction Social Security benefits will decrease and so forth. RMDs don't change. RMDs are not based on a household. They're based on individuals. So they'll still have the same amount of RMDs, but and they may have less overall income coming in, but at the same time, federal tax brackets tend to drop in half or Well, depending on where you are the tax brackets, but they may drop in half. The Medicare surcharge levels tend to drop in about half for most of the thresholds. The Social Security tax torpedo doesn't drop in half. But overall, a single filer may end up with a higher tax bill than married filing jointly would have had two. Even with the loss of some of the social

security benefits or other pensions and things that the survivor was or that the person who passed away also had when they were alive. So you might have a higher tax tax bill as a single filer than married filing jointly, even after losing some of the income. That's a potential reason let's front load the taxes when we can do so married filing jointly, when we have more capacity to have ordinary income taxed still within lower rates versus a single filer. And our RMDs is a big part of that, because, again, RMDs are going to be the same for it doesn't matter how big the household is, it's based on the individual owner of the account.

Alex Murguia 10:46
I got you Okay.

Wade Pfau 10:48
And then point number three, about why you might want to consider front loading taxes is IRAs have embedded income tax liabilities. And this becomes a conversation around if you're at the point where you think you're going to leave an inheritance. Who should be paying the taxes you or your beneficiaries. Now, if your beneficiary is going to be a charity, go ahead and they pay tax at a 0% rate with a if they're a tax deductible. I mean, if they're a charity that's qualified to not pay taxes. But thinking about adult children beneficiaries in the past, they had a lifetime stretch. And the secure Act that was passed at the end of 2019, eliminated the lifetime stretch for many types of beneficiaries, of which adult children are one of the key examples, they now have a 10 year window to deplete. The IR the Roth IRA, sorry, the IRA inherited IRA, or Roth inherited IRA, they don't have to pay taxes on an inherited Roth. They just have to take the money out. The problem is, if they inherit an IRA now, instead of having that lifetime stretch, they have to get those funds out within 10 years. And if they inherit those accounts when they're in their peak earnings years. Say that your adult children are in their 50s when they inherit the IRA from you, they may have to deplete that over a 10 year window where they have the highest incomes of their lifetime and may be facing the highest tax rates of their lifetime. And so the question becomes, who could pay taxes at a lower rate? Could you, as a retiree, do the Roth conversion and pay tax at a lower rate, then your beneficiaries might ultimately have to pay if they receive that account, and then have a 10 year window to draw it down, and so that to the extent that we switched with the secure act, from the lifetime stretch to the 10 year window for many types of beneficiaries that can lean towards the when you're doing this sort of calculation, having the retiree do the Roth conversion and pay the tax today at a lower overall rate,

Alex Murguia 12:50
that's a great point about the tax, the taxes on the children, simply because, let's just say for argument's sake, the person passes away at 85 they had their first kids when they were in the early 30s. So yeah, their children are in that window where they're maximizing their income around that time period. So it's almost, it almost, yeah, I'm just results vary, obviously, but it seems that you're, yeah, you know, you're right in terms of the children part. It's usually going to catch them, as you know, in their peak income year window.

Wade Pfau 13:29
Yeah, that's the concern. You get this inherited IRA in your peak earnings years, and you have 10 years to draw it down. Yeah, it may create some unpleasant tax situations. All right. Now, of course, that's going to vary case by case, and also to the extent someone doesn't know how long they're going to live, they don't know how old their kids will be when they inherit the

account either. But you know, just as part of that planning, if you think you can pay the taxes at a lower rate than your children will have to, and you're pretty sure they're going to be inheriting it, it's much better for them to inherit a Roth and Ira than it is to inherit a an IRA with that embedded income tax liability. The

Alex Murguia 14:06
other the other thing, I want to be more precise. I wasn't as precise with the first question for you to get your personal thoughts you're talking about. You know, in case tax rates go up, in case tax rates go down. This is something that you may want to consider. And directionally, you're kind of recovering your angles right when you are to take a little bit of a separation from that topic, when you're doing planning and and you're entering tax rates, future tax rates and things like that. Do you change up rates based on where you think tax rates are going to be, or do you just look at the current rates and you just plug that in, even though there's a dollop of optimism that they'll go down or a dollop of pessimism that they'll go up, you still stick to what the rates are. And. It is what it is, you know, I mean, I'm trying to, I'm trying to get you, how do you balance making planning decisions on where you think the rates are going to be versus how they're just set to be into the future right now, if never, if nothing ever changes.

Wade Pfau 15:16
Yeah, I stick to current loss. So I use tax rates for 2024 and 2025 and then in 2026 I switched back to where current loss says they will be without further congressional action. I think we talked on a past episode how Bob French approach. He just wanted to stick with the current rates, but he's changed his view on that. He now agrees with me. That's when we changed up. I

Alex Murguia 15:42
subscribe to that as well. I just want to make sure that that's different, though, than when you're saying, you know, capitalize on these deduction bunching and things like that. It's just certain, certain, certain assumptions you can say with a lot more certainty that go beyond government policy, which is, when you retire, you're gonna not make as much money, hence your income will be lower. So you should plan for having a lower tax rate into the future. You know, I mean, like things like that, even though those are projections, those are, those are not the same type of projections, trying to out guess where the government is going with their policy, right?

Wade Pfau 16:15
There's no with what I'm talking about. There's not other than mentioning this idea that maybe tax rates will be higher in the future. That's not part of any sort of simulation or anything the story around you might be paying taxes at a lower rate in the future is just really based on assuming current law, you have less income when you're retired, and therefore you think you'll pay less taxes when you're retired. But the pitfalls, we got to be careful about that, because with all the pitfalls we talked about in past episodes, even though your federal income tax bracket might be lower, the effective marginal tax rate you're paying may not be lower. So there's a caveat to that, but that's the general conventional wisdom. Retirees will pay less taxes because their incomes are less assuming current tax rates are projected in the future. You could do some sort of scenario testing where you

Alex Murguia 17:04
I just wanted to make sure people understood that we're not making heroic assumptions here. We never do, not even with planning. The assumptions that we are making on potential

changes are not based on Nancy Pelosi proclivities or anything like that, or whoever the conservative analog is. I, you know, either way, it doesn't matter to me. These these adjustments are based more on the assumptions that are centered around just life milestones that everyone goes through

Wade Pfau 17:33
that's all right, right? And like I was mentioning, too, though, if you read some of the financial planning content out there, the supporters of life insurance will put a lot of emphasis on the idea that tax rates will be higher in the future. So then they explain how life insurance can be treated kind of like a Roth, but with unlimited contributions. So they really want to emphasize pay the taxes now, rather than in the future. All we're saying is, you know, that may be a consideration for some people, and if anything, tax rates may be higher in the future, but we're not really saying, Oh, you're this is going to absolutely be the case, so you better pay your taxes today.

Alex Murguia 18:13
Just amazing. Have you acted before? Because you did a great job. Oh, I better do good night. That was for people watching the video of this feed. Wow,

Wade Pfau 18:24
yeah, doing that whole Macbeth, yeah,

Alex Murguia 18:30
all right. Do it again. Do it again.

Wade Pfau 18:35
Oh, damn spot. Isn't that the lady? Macbeth,

Alex Murguia 18:38
actually, I don't know, but Throne

Wade Pfau 18:42
of Blood from Kurosawa. That's the his take on Macbeth.

Alex Murguia 18:47
Well, I think a lot of those, which is the one, the, what's it called? Why am I blanking out? Never mind. I'll stop around. Let's get to the taxes. I'll come back to it later.

Wade Pfau 19:01
Yeah, yeah. So those were three reasons why you might consider front loading taxes for what they're worth, and to the extent that they're relevant. In your case, it's three other considerations. Tax rates might be higher in the future. Single filers, widows, in this scenario, face a penalty compared to married filing jointly, so pay the taxes when you get that opportunity to get those benefits, is from married filing jointly, versus forcing that surviving spouse to pay taxes at a higher rate of when that time in life happens, and then, with the secure act the if adult beneficiaries are going to be the beneficiaries of your IRAs, that 10 year window can be onerous compared to the old lifetime stretch opportunities that were out there. Okay, okay, few other topics, one is just the idea of tax loss harvesting, and that can be more of a accumulation based

idea as well as retirement. So maybe we can let you tell everyone about tax loss harvesting. And Alex,

Bob French 20:02
let's take a moment to let the audience know that this show is sponsored by retirement researcher. You can learn more about retirement researcher at retirement researcher.com and subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement researcher is an online community devoted to helping you create the retirement income plan geared towards your goals.

Alex Murguia 20:29
All right. Oh, uh, Ron is the one I was thinking of. But that's not, that's not much bad. It's another uh King Lear.

Wade Pfau 20:40
Oh, yeah, I think that one wasn't on max. I haven't seen it yet. Wasn't that from the 80s, yeah?

Alex Murguia 20:47
Well, more recently, yeah, sure. Was wrong, yeah,

Wade Pfau 20:51
I saw the ones that were on max, okay,

Alex Murguia 20:52
tax loss harvesting, yeah. This is an interesting one. This, this, this plays a significant role in a lot of portfolio management characteristics here, and this goes on the play of where you can add value to a large extent, just in theory there just, just take a step back. There's two types of investment approaches, right? There's active where you think there's some inefficiency in the market, and you find some price anomaly that you think either the market is not pricing in unexpected growth of something that could be, you know, what have you in video right now, the market does not really appreciating the full impact of AI, so it's even going to go higher. You know, there's a mispricing, or the other way around, flip around Intel. You know, that one they've been talking about Nvidia buying Intel. Now, can you believe that way? Believe that way? And, you know, go back 20 years ago, and that's where the the market isn't valuing Intel. It's, I don't know what it's trading at, let's just say it's trading at 50, but it should be trading at 80. So there's more. You know, it's really worth $30 more. So I'm gonna buy so there's active and passive. If you're active, if you think there's inefficiencies, then tax loss harvesting, the opportunity for tax loss harvesting, you know, that's kind of a silver lining, because you'd rather not do that. That's where you take people. That's where a lot of folks will say, if you're tax loss harvesting, you got a problem, because you should be outperforming the markets at all times. You shouldn't have any losses. That's that Halcyon kind of idea, right? And so when you invest, to

Wade Pfau 22:24
do pretty company investor to expect they'll never have any Yeah, exactly No. But that's kind of you see that

Alex Murguia 22:29

every once in a while on CNBC, like, why harvest losses? You should always have win gains. If you're harvesting losses, that means you're a loser, you know, that kind of thing. And some extent, if you say you add value by having gains, and yeah, it's kind of, you know, besides that, how is the play? Mrs. Lincoln kind of comment. Now, if you're passive, that's fine, because what you're doing there is you're harvesting philosophically. You're just saying, I'm going to pick winners and losers. I'm going to get the aggregate of the market right. And so it's more palatable in that manner, and frankly, it fits into that philosophy. Anyone can obviously harvest losses. I'm just pointing out that a lot of times active folks should shoot poopoo that, or folks that are thinking about having a manager outperforming the market, that's the last thing they think about, because it's like, well, I should have gains. The reality is, everyone has losses, and look at the numbers, right? We don't need to talk about that right now. So what do you do when there's a loss? Well, harvesting losses. What you do effectively there is, let's take and tell if you bought it at 80 and it's 50 and you're like, Okay, I'm gonna sell it and you have a $30 loss, let's but let's say it's a $30,000 aggregate loss in that now you can, you can sell it. Once you have the cash for that sale, you can take it and buy something else, right? You can't buy Intel within 30 days of that, because then it doesn't count as you've harvested a $30,000 loss. Now you take that law that you take that money, you buy something else, and you have a portfolio, and I'll get to what you can do later. But in effect, at the end of the year, that $30,000 loss, you can apply 3000 of it to short term capital gains or income, right a year. And now what that well, the gains, you can do it, but the income, specifically, 3000 what you benefit there is, it's a higher it's an higher offset, you know, relative to the gains, then you can offset the rest with short term gains and short term losses on and on. If you don't have that, you could pretty much apply the 3000 to income until your losses are all used up. It's happened quite a bit where we've gotten we had prospects. We look at their taxes and they have losses and they haven't applied them to income for, let's say, five plus years, because they were waiting on applying them to future gains, offsetting them with future gains. But if you wait that long, you're. Capitalizing on, on the ability to, you know, to save money at that moment, right? So it's a great little tool for offsetting. Now, what you're really doing is, because you're offsetting, what that means is you're not paying taxes when you when you recognize gains. But if you build these up and build these up, to me, what you're doing philosophically is, is, at the end of the day, you're borrowing the tax liability from the government, right? And so you have to pay taxes. You don't do it. You've hard. You know, you have gains, right? But you're you keep on offsetting losses, and by keeping on off offsetting gains with losses is you're just delaying it. But over time, the portfolio will go up and up, and so eventually you will have to pay some sort of tax on it as the portfolio goes up and up, especially if you have passive portfolio and you're just tracking the market. The benefit of that is by pushing that tax liability and tax liability further and further down, you are effectively borrowing that tax liability from the government, and so your VIG effectively becomes the interest on what that tax liability is. That's theoretically where that extra bump in the return comes from, you know? And what I mean by bumping the return, it's after taxes. So if you had, you had gains of $100,000 right? But you're able to offset $50,000 of that with losses that you've had along the way, but you're always invested in the market. Well, that's, you know, the taxes on $50,000 let's just say it's a 20% to make the math easy, right? Your capital gains would be 20% it's 10 grand, right? And so you've effectively gotten, in effect 10 grand by not having to pay taxes. That's the benefit of just harvesting losses along the way, so then you can systematically use them to offset gains. And what that benefit is, ultimately, is that liability on the on the taxes that you pushed out and out and out the first few years, it ends up being like roughly 30 bit, 30 to 40 bips, depending on the volatility that you've had. You want a lot of volatility because it helps, right? But it's about 30, you know, 30 to 40 basis points off of a percent that gets lower and lower after about five years. Like I said, unless you have new infusions of cash where you can buy new positions and so forth, over time, markets go up, so after five years, you've kind of expended that. And so then what you have to watch out for is just the tracking error. And what I mean by that is, let's say you have a portfolio of of the S p5 100, right? And instead of buying the S p5 100, 500 stocks, you buy 200 stocks, and those stocks give you a good representation of the S, p5, 100 across all the industries. And let's say from the pharma for the pharmaceutical industry, you chose, I don't know, Pfizer, J and J Merc, Eli Lilly, Roche, and let's say Novartis. So you have six stocks, right? And that's going to represent the pharmaceutical industry, you know, as part of that 200 stock representation of the S p5 100. And let's say those 200 stocks can track the S P with a tracking error of 3% that means that your returns will be within, you know, 3% of the return of the S and p5, 100, not percentage point, but 3% right? And so that gives you more or less, you know, you're getting that beta of one or point nine, seven to point 103, all right? And you're good with that, right? That's the balance of not buying 500 stocks you do with 200 stocks. And it's more or less. And over time, you know, it'll that that tracking error compresses, you know, it's just in any given year, right? And so for the pharmaceutical industry, like I said, you had those six stocks, and let's say for the first quarter, and you have, for argument's sake, $50,000 in those companies to give you that representation. And let's say the first quarter happens. Something happens with some sort of public policy, right? And the pharmaceutical industry just takes a hit. And so you have a 20% loss in the first quarter. And so you were buying out of those six stocks. You had Pfizer, J and J and Roche, right? That gave you a tracking error of point nine, nine to the pharmaceutical industry. But you had that 20, you know, the they took the same hit as the everyone else in the pharmaceutical industry. So you're able to capture $10,000 of losses because you saw you sell one day to the next Pfizer J and J and Roche. The moment you sell, you have that amount in losses. You turn around and buy Merck, Eli Lilly and Novartis. So you now, you know, a minute later, you have the same representation of the pharmaceutical industry, but you lot. So if it goes up the next minute, the next day, you're fine. You still have that same return, but you've captured the loss of Pfizer, J and J and Roche, right? And so you have 10,000 a $10,000 loss, in your pocket that you can then apply later on. You can apply to. Distributions that you take from a portfolio, you can apply it from, let's say you know you're going to have a capital event in three to four years. From a planning standpoint, I'm going to sell a building, whatever you're going to have loss. You're going to have gains that you want to offset. You build, you keep, you build up this bank. And so you can take it to the point where, if you know you're gonna have $100,000 gain in four years, and you don't want to pay taxes on it. Well, you know, and you have, let's say, an a million dollars of an investable portfolio that's just tracking the SMP, and you do that with individual stocks. Let's say five years. Again, this is all hypothetical. You have $60,000 in losses. Well, you're only paying on $40,000 in long term gains. Then, because you can offset the $100,000 gain with $60,000 in losses, and you're still tracking the index, it becomes very interesting in that manner. And that's one example, but you can do many, many more with that. Now, what you want to keep track of is tracking error, no pun intended, which is at the end of the day, you don't want the tax tail to wag the dog, so you want to make sure that you're tracking and capturing the market. That's number one, right? You

Wade Pfau 31:07
can't have a substantially identical security. Yeah, there's

Alex Murguia 31:11

30 days. Yeah, you can't buy the same direction, yeah, yeah. So there's tracking error. You need to have the other piece where it trips people up. You have to wait that 30 days. But some people don't realize that they have a 401 K, and in their 401 K, they have the S p5 100 or something, right? Let's say it's the Vanguard S p5 100, and then in their taxable account there's a loss, and they sell the S P, but they forgot that they have, like, uh, automatic investment in their 401 k, so that doesn't count, then it can't be the same. Security can't be or, you know, something that's almost as it can't be in different accounts. Either, if you own it, you're going to have, you're going to run into issues, right? And

Wade Pfau 31:52
so if you automatically reinvest dividends or employee employer contract, yeah, there's got just Yeah. So would you want by 30 days before or after? Yeah.

Alex Murguia 32:03
I mean, we can do this at scale ourselves, because just softwares as a that's available to advisors is different than than what you have yourself. But just FYI you need to keep, you have to keep that into consideration. And there's all these like direct indexing strategies. Now that you know, there's a there's a place for them, but you especially with tax loss harvesting, that you need to make sure that they're speaking nicely with your other accounts, to make sure you're still on track with that. But in my view, I see tax loss harvesting from an investment standpoint, something that adds real value, but it wanes over time. You know, simply because stocks do go up over the long term. And again, this is if you have that passive philosophy. It's one of these things that after five years, if you don't have new new vintages of cash coming in, tracking error becomes problematic. And that's kind of an untold secret that all these separately managed accounts won't tell you about, like, tracking error can be problematic five plus years if there's a financial planning need, I think this becomes actually something for serious, serious consideration, because you get the investment piece, you get the tax planning piece to it that helps significantly, and then you get these kind of like little advantages along the way that we're talking about today, that that help out tremendously from that, from that, I think, way, without getting too much more into it, did that provide, since I was one doing the talking, you were, did that provide a nice sort of and now, you know, yeah,

Wade Pfau 33:34
knowing is half the battle, but yeah, and then also, just in retirement, if you're ultimately in a situation where you're not going to be ever spending all those taxable assets because you're probably somewhat overfunded for retirement, you do get that step up in basis at death as well that will erase those Yeah,

Alex Murguia 33:50
yeah, if you can push off taxes, because all you're doing are you doing is borrowing. So if you can push out the taxes and then flip it to the next one, you get stepped up. Oh my goodness. And this comes into play too, where, well, when you do the donations get, you know, doing the game, but that's different than it's a huge benefit. It's, it's just one of those that, from an investment standpoint, it does have a ceiling. You know, it's not the gift that keeps on giving forever and ever and ever. It could be problematic to unwind if, if the tracking error becomes unwieldy, and that's one of these things that they folks won't tell you this on day one. They'll tell you this on day 1000 you know, and then it can be problematic. But from, uh, for the purposes of what we're talking about today, it's something for serious consideration. Are you

Bob French 34:39
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 35:18
Great, great. Yeah. And so the next thing on the agenda here is deduction bunching. And this gets into the non linearity related to the itemizing versus the standard deduction, and especially in current law. And this is another fact that could be set in 2026 but the standard deduction is pretty big right now. It can be hard to itemize these days, and the idea just consider an example where maybe you'd like to donate $10,000 a year to charity. If you consistently donate $10,000 a year to charity, you may never get any tax benefit from that, because every year it's less than the standard deduction, and with other below the line deductions as well, you never get over the standard deduction. Deduction bunching. Would say, Let's make in this simple example here, instead of $10,000 a year in year one, Let's donate $50,000 and then in years 234, and five, we won't make a donation by donating the $50,000 in year one. That will get you over the standard deduction, so that you will be able to itemize and you'll get a tax benefit on the portion of that above the standard deduction that you would have never, never otherwise received any sort of tax benefit for. So deduction bunching is about grouping below the line deductions into one tax year. There's also at the margins, potentially, some room to play around with local if it's allowed where you live, the state and local taxes where there's that now ceiling of $10,000 if you're below that, and you're able to, say, pay your property taxes in December for the current year and then also prepay for the next year. Something along those lines. It may there may be more limited chances for that one but paying two years worth of state or local taxes in one year could be another way to deduction bunch at the margins, the charitable contributions is probably the much bigger opportunity with regard to deduction bunching.

Alex Murguia 37:19
Agree, I think this is something that we used to McLean, used to be at the, you know, used to chair the Investment Committee for the Community Foundation Northern Virginia. And this was one of these things that they would have us speak, speak to potential folks that are thinking about donating, specifically, you know, front loading the charity, because they wanted to make it over, over that hurdle, that $12,000 hurdle. And, yeah, you can do that. It helps a great deal. I mean, even within the soccer our Soccer Association, Alexandra Soccer Association, this is something that they're they're even promoting in their in their email things now, you know, talk about, like, getting sophisticated and ambitious, I guess at the same time. Yeah, well, you know what? You know what? They're gay, their their angle was, Hey, your kids most likely going to be here for, let's say they start at six, six through 16, right? For 10 years, seems like a mafia you can't get out 60, you know, they're there for 10 years. And you're going to donate 2000 you know, let's say 1000 a year. And some folks do that. It doesn't hurt to ask, right?

Wade Pfau 38:36

Yeah, yeah. And just a reminder about that below the line, deductions do not impact your adjusted gross income, which is the important number for a lot of those pitfalls we talked about in past episodes, Social Security, benefit, taxation, Irma surcharges and so forth. But then also, probably astute listeners are starting to scream out, why aren't they talking about donor advised funds? Let's mention that here as the practical way, if you're a deduction bench, and if I'm going to make five years of charitable contributions in one year, I may not be ready to do that directly to one charity all at one time. That's where the donor advised fund comes into play. I can donate that money to my donor advised fund, get the full deduct tax deduction this year, but then spread that out over time to multiple charities, and that can be the practical way to actually be able to do this in a manner that doesn't just mean making a huge contribution to one charity in one particular year. That's

Alex Murguia 39:32
when I was talking about the I almost got ahead of the plot, so I held back. That's when I was talking about the Community Foundation of Northern Virginia, that's effectively a donor advised fund. But then I was going to get into the details of you're right. A lot of folks want, well, donor advised funds come into play too, because a lot of folks have, you know, they've got a sizable chunk of money, and they talk about having their own charity. Yeah. I've got $5 million I want my own charity, which is understandable.

Wade Pfau 40:03
It's an easy way to have a family foundation type thing, exactly that. That's exactly

Alex Murguia 40:09
it. That's, that's the selling point. And they're, they're great opportunities around that. I even fidelity and Schwab have their own like for consumer directed consumers. I think they have a big donor advised fund, but yeah,

Wade Pfau 40:23
in 2017 when we still right before the standard deduction, shot up to take advantage of a big charitable contribution in 2017 Yeah,

Alex Murguia 40:32
and so many, many, many communities have donor advised funds. I would check into those, because what the benefit of that is, yeah, all of these financial planning things, but let's say, take the Alexander soccer example. I don't want to donate, like, $40,000 to a Soccer Association, right? I don't mind a little bit a donor advice fund can help with that, because you don't know where it's going just yet. You want to have this huge sort of impact, but you want to take your time with that. And you know, you know you want to do it this year, but you don't have time to give it the mental calories. And so donor life funds are a great way to go about doing that in that manner. And then, frankly, if there's new charities you can, you can simply try them out, see how organized they are. Because it's one thing to find a cause that you support. It's another thing to execute the money to a cause that you support efficiently, right? And so sometimes it just takes a lot of a lot of trial and error, if you will. And you're going to be working with these folks for a while, so you want to make sure that that you feel comfortable with them, aside from the planning issues that Wade is mentioning, but that being the case, they're great. I can't tell you how impactful those things have been, just from talking to people and Wade, we should, you know what we'll do? We'll bring in Jessica to speak about this. You know how to combine

it? Because she's she's now on the board of the Parkinson's foundation here in DC, and she deals with these issues, like the everyday issues. And I can't stress enough here, you know this, this tends to be about numbers, but the personal satisfaction when you get this right, the planning part, right? The you know, if it's more money is better than less money, right? So the personal financial planning piece correct, and then the impact, you know, putting it in the right place, and to be part of your your legacy. It's just, it's, it's truly amazing to see and and the beginning point, sometimes a Family Foundation doesn't make as much sense, simply because of the administrative headache that folks don't know what they're getting into. You know that sort of you don't know what you don't know. And once you know, donor advised fund makes a lot of sense.

Wade Pfau 42:49
Yeah, and it really can create something like a family foundation, but when we're talking about, like, 10s of $1,000 instead of hundreds of 1000s or millions of dollars, where it's just not practical to set up a formal Foundation, yeah, but

Alex Murguia 43:03
I would even say the barrier for a formal foundation is higher than I think people think.

Wade Pfau 43:09
And one other potential benefit of the donor advised fund is the ability to donate appreciated shares, which can be hard to do, to individual charities. But then, not only do you get that deduction, you're also eliminating the capital gains from the picture. So if I donate $30,000 in cash, well, I can apply that deduction to my taxes, but if I donate $30,000 of a stock that had a cost basis of $10,000 now that $20,000 capital gain, I'm never gonna have to pay taxes on that capital gain. And if, instead of, if I also had cash, I could have donated, instead of donating the cash, I donate the 30,000 in stock, and then I use that 30,000 cash to buy the same stock. This is not loss harvesting. This is like gains harvesting. Yeah, I know the stock with a reset cost basis at a higher level,

Alex Murguia 43:58
absolutely. Yeah. And so think about what he said. So you have 10,000 in cash, and you have the stock. You can give the cash, right, but then you still have that liability on the capital gains on the stock. If you instead give the stock, you can just turn around that moment and buy, buy the same stock, you know, buy the $10,000 worth of Nvidia. And what you've done is you've not only donated $10,000 worth of something, you've you've removed that tax liability at the same time, and that charity, they're not going to pay taxes on it. They can turn around, include it in their portfolio, or just sell it just the same and use the cash for the proceeds. Now, if you do it with smaller charities, they may not be equipped to deal with the stock transactions, as in that donor advised funds. That's just par for the course. That's almost a table stakes for them from an admin standpoint.

Wade Pfau 44:59
Yeah. Yeah, okay, so that really does infer today as, again, a couple of different strings of the conversation, but we wanted to cover that the next few episodes. We will talk to some advisors from McLean about kind of practical implementation of this. And then we still want to have that deeper we're part of the tax planning arc here. We're going to do that deeper dive into really digging into the Roth conversion story and the effective marginal tax rate management and how

to think about not just reducing lifetime taxes, but the important thing is increasing after tax, spending power and legacy. So that's still coming ahead on retire with style.

Alex Murguia 45:39
All right, Wade, thanks, man as always, and thank you all for listening. We do appreciate it and more to come

Wade Pfau 45:47
catch you next time.

Bob French 45:51
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.

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