# Episode 155: Navigating Roth Conversions: Key Strategies and Insights

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**SUMMARY KEYWORDS**

retirement income, Roth conversions, tax planning, financial personality, hedging strategy, taxable accounts, tax deferred, tax exempt, Social Security, Medicare surcharges, effective marginal tax rate, legacy value, tax mapping, preferential income, tax torpedo

**SPEAKERS**

Alex Murguia, Wade Pfau, Bob French, Briana Corbin

**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.

**Briana Corbin** 00:41
Think Roth conversions are just about moving money. Well, think again. This week, we're mapping out the when, how and why to keep your retirement plan flexible and your taxes in check.

**Alex Murguia** 00:54
Hey everyone, welcome to retire with style. I'm Alex, and I'm here with my good buddy, Wade Pfau And hello, hello. And it's Roth-a-Palooza, part two, right? Wade

**Wade Pfau** 01:08
or three, or three. Oh

**Alex Murguia** 01:11
yeah, Rob did too, yeah, or three. It's

**Wade Pfau** 01:17
really not a part three. It's its own distinct issue today. It's

**Alex Murguia** 01:20
its own distinct issue today. So I was gonna say Triple Shot Thursday, but so much for that. No, it should be Tuesday, right? Because we released a podcast on Tuesday, Triple Shot, Tuesday,

**Wade Pfau** 01:29
It's not Thursday, as we record either. So

**Alex Murguia** 01:32
a September to remember. Remember the classic rock channels.

**Wade Pfau** 01:37
Oh yeah, when I was in high school, that was still a thing, seems like,

**Alex Murguia** 01:41
growing up, they had, you know, they always had, like, double shot Tuesdays or Triple Shot Thursday type of thing. And, and did they ever have September, like they all played just Zeplin and nothing else. I

**Wade Pfau** 01:53
don't specifically remember that on our Des Moines classic rock station, 94.9 I can't remember the call it is right now, but kg, go with Isaac.

**Alex Murguia** 02:05
I had K rock in boss, I think in Boston and in Miami. What did I Miami? Wasn't big rock. 103, she Yeah,

**Wade Pfau** 02:15
Des Moines classic rock station.

**Alex Murguia** 02:17
There you go. All right, all right. All right, so I think Rob just, you know, he put on a master class over two episodes on the Roth conversion decision, well, obviously, you contributed heavily. I was just happy to be there. Wade. So Rob and Wade put on a master class. And two takeaways that I got from this, Wade, and I think it's a good segue, is that it's not do as much as you want. I mean, do as much as humanly possible, from the get go and front load it, because it's such a great deal that there's issues around that. And then the next concept that I think bears mentioning, not I think bears mentioning, and for consideration and analysis is it's ultimately a hedging strategy. You know, going back to Rob's example, betting on the World Series 40 years from now, you don't really know, so you kind of hedge your bets a little bit. Uh, what do you think? Agree, disagree? I

**Wade Pfau** 03:16
think those are really important points, and it actually kind of reflects how I had thought about Roth conversions, but never really specifically explained it as the hedging strategy. But I thought, oh,

**Alex Murguia** 03:27
so it was originally your idea. Is what you're saying, coming

**Wade Pfau** 03:34
at it from a different angle. I think Rob and I have some overlap there, and it's more as we get into the discussion today, it's really the topic is like, how much should I convert in a year if I'm

thinking about doing a Roth conversion, how much should it be? And of course, we can't answer your specific case point with a podcast episode. But really, to talk about what you need to be thinking about in as much detail as possible without, like, using software. Okay?

**Alex Murguia** 04:05
And so let's push the boundaries of what we can do in a podcast,

**Wade Pfau** 04:10
and what we can do before, and

**Alex Murguia** 04:13
what we can do conceptually with thinking about that question big picture. Because you're right. I mean, our listeners are wondering, okay, I get it. Hedging strategy, don't front load it, because things happen. Okay, now, what do I do? Right? And so how would someone go about analyzing, I guess, directionally, which is the best we can do here? Roth strategy, amounts and things along those lines,

**Wade Pfau** 04:41
yeah, and something that came up in the previous episode we mentioned, like, if you knew the future, you could figure out how much to convert each year. And that's you know exactly how long you're going to live. You knew exactly how much you want to spend each year.

**Alex Murguia** 04:57
I disagree. Wade if I need a future the last. Damn thing that I would be thinking about was how much to convert in the Roth because we would have so much money, it wouldn't matter but

**Wade Pfau** 05:12
buying call options and things,

**Alex Murguia** 05:14
how many naked puts I would have out there on the market right now?

**Wade Pfau** 05:19
Yeah, you wouldn't have to worry about taxes, exactly, but absent. I have a lot of taxes do, but you won't have to worry about it.

**Alex Murguia** 05:27
Life is good, absent of that, though. Wade continue. Yes.

**Wade Pfau** 05:32
So back to like, if you knew how long you're going to live, how much you want to spend each year, including how much would be deductible healthcare expenses for the purposes of itemization, what market returns are going to be every year, what the tax rules were going to be, or what the tax code would look like every year in the future. Then you could figure out the exact answer. This is how much I should convert each year. Now, given that we don't know any of those things, the best we can do is make a guess and then update each year as we go along. So the way I presented in the retirement planning guidebook, the case study about all this, I do create an example where all these things are known that you're planning through age 95 you

This is how much you want to spend each year. You've got your Go, go. Years spending decreases after age 85 late in life, you have health, long term care, expenses. We know what the market returns were, and we base them on a conservative projection for market returns. We know what the future tax code is. So in that case study, I can get a precise answer, but again, we don't know all those variables, so you can get a answer for this year. But as you move along, and as you go along, you'll you'll update things and make changes. That being said, though, I think where I start to align with how Rob explained things. So just coming at it from a different direction using a conservative rate of research return assumption, I use that more for making sure that you've your plan is going to work. If your plan can work with a low rate of return, you should be in good shape. And then I also do the Roth conversion analysis. Assuming a lower rate of return, with a lower rate of return, you're going to end up targeting less Roth conversions, because your money's not going to grow as fast. So it's okay to have to delay things into the future, because you'll have less growth going into the future. If you assumed a higher rate of return, you'd probably target a higher level of Roth conversions throughout. So this hedges that if market returns end up being higher than you projected for your your analysis, well, you probably should have been doing more Roth conversions today, but it's okay you end up having more money than you anticipated. You have to pay more taxes in the future, but things are going to work out okay if, if returns end up being lower than what you anticipate, you really kind of want to delay Roth conversions, because you'd rather wait until the markets go down and then do the Roth conversions, and you may be in lower tax brackets throughout, so you may be able to target lower levels anyway. So if you do the analysis based on a lower rate of return assumption, I think you pick up and practice that sort of hedging that Rob was talking about with his examples, you have a conservative approach to Roth conversions, so you'll be doing Roth conversions potentially, but maybe at less than the truly optimal level. Although, again, you don't know what the truly optimal level would be, because you don't know what any of these variables will actually be in the future.

**Alex Murguia** 08:34
Sure. No, that makes sense. So if you're going to err is the wrong word, but if you're going to err on the side, you're going to err on the side of conservatives. Yeah. Caution, thank you. I didn't know how many syllables I had in that conservative visit. I was just gonna mumble it and go on to the next thought, okay, and so what we're gonna go over are the examples in your book, or just generally, yeah, could somebody could refer to somebody could refer to somebody to the retirement planning guidebook, and if they wanted to, they can hit pause, go, get the book and then follow along. Or are these on

**Wade Pfau** 09:11
yeah for yeah some of it, let me refer to the page numbers here to lead people on the right track. Yeah, for those listening, we've gotten

**Alex Murguia** 09:23
some comments about, Oh, do you have slides for this, or do you have notes for this? And the reality is, we're taking Wade's book and repurposing it into a podcast. And so I highly encourage everyone to pick up a copy of retirement planning guidebook. I say that because Wade is never going to say that, and I can say it for him. It's a great resource. It's a great handbook to, you know, to answer all these questions, and it's full of examples, and so it was great, fertile ground for us to discuss things like that in the podcast. But go on. Wait.

**Wade Pfau** 10:01
Well, thank you, Alex, yes, retirement planning guidebook is the source. And yeah, what I'm be talking about today, I'll be explaining what you see in Exhibit. This is from the 2024 edition exhibit, 1020 and then exhibits actually 1021 1022 1023 those are the visuals for mostly what we'll be talking about here. Okay,

**Alex Murguia** 10:25
and we'll put a link in the show notes for the book. Why not? Right? We gotta forget that always be closing,

**Wade Pfau** 10:34
get that book ordered and

**Alex Murguia** 10:37
wherever books are sold. Or what do you what's that phrase that you say, wherever available at Amazon, or wherever your books are sold,

**Wade Pfau** 10:44
or your favorite book retailers.

**Alex Murguia** 10:46
Oh, your favorite book retailers. All right, there you go. All right. Copy,

**Wade Pfau** 10:50
Amazon, if you like an E cop electronic copy, it's actually, there's a lot of places that you can get it from, but the paperbacks are hard covers are through Amazon. Okay, that that being said, you want to pitch. You

**Alex Murguia** 11:05
want to talk about that new product you have. I think Flex Seal. Are you selling? Flex Seal? No, okay,

**Wade Pfau** 11:15
no, but, uh, so now, okay, now we're kind of starting to address this question, how much should I Roth convert in a given year? So you have to think about constraints that are going to affect this affect this decision. One of those constraints, of course, is this whole idea of how much money do you have in your taxable accounts, your tax deferred accounts, and your tax exempt accounts, if you have plenty of assets in your taxable accounts, it does make it easier, because you can cover all your spending needs through the taxable accounts, and then you can use the tax deferred accounts more for Roth conversions. If you've depleted your taxable accounts, the money coming out of your tax deferred accounts tends to contribute more quickly to your adjusted gross income, especially if you have some cost basis in your taxable accounts. Selling shares allows you to have more spending than your income taxable income would suggest, because part of your spending is the return of your initial investment to you. So when you have taxable accounts, it can be easier. But of course, you need tax deferred accounts for this to even be relevant, because we're talking about converting some of those to a Roth and then just do you have tax exempt accounts available as well? Another constraint on your decision making is, how much income will you be forced to have? Like? What does your adjusted gross income

look like that's forced upon you before you even have any choice to do anything discretionary. So that includes, if you're post RMD age, RMDs come out of the tax deferred accounts. First you have to pay taxes on them. You're not allowed to Roth convert RMDs. So that would be a big constraint that you have to get over before you can even think about Roth conversions, and then any other taxable income that you have, you have to account for that before you start thinking about Roth conversions. Are you collecting Social Security? Are you doing part time work so you have still some sort of labor income? Your taxable accounts are kicking off interest in dividends, some of that will be well interest is ordinary income, ordinary dividends or ordinary income. Qualified dividends are the get that preferential income treatment. But what are you generating as income that you have to pay taxes on? Even if you're not taking it out of your brokerage account, you still have to pay taxes on. What those taxable accounts are kicking off. You can reinvest it. Maybe you automatically reinvest it, but you do have to pay taxes on it and any other taxable income sources. So if you have pensions, or if you have annuities that make payments or or any other just whatever it may be, but anything else, rental income, anything that's entering into your adjusted gross income, that's telling you the starting point that this is how much taxable income I have to generate before I even think about anything else. And so can I then, is it worthwhile to do Roth conversions about that amount? And

**Alex Murguia** 14:10
let me state the obvious. When you're saying how much income you need and this and that, that's kind of you backing into that number. It's not No one's forcing you to take anything out other than RMDs. But the other piece would just be, you know, what is your budget dictating that you need?

**Wade Pfau** 14:22
No, well, that that's kind of the next issue I want to talk about, because, like, social if you're collecting Social Security, yeah, no one's maybe this is money receiving without but it

**Alex Murguia** 14:35
comes, yeah, like you're getting it, but it could be a surplus, it could be a deficit. You don't mean that kind of thing. Yeah,

**Wade Pfau** 14:41
if you're collecting money from a pension, it's taxable income. If you're getting royalties from something, this is all money that you're going to have to pay taxes on, even if you don't need to spend it. But that the next variable is like, how much do you actually want to spend? And that's a different conversation from how much taxable income are you being forced to. Generate because maybe RMDs. You don't want to spend the RMDs, but you still have to generate that taxable income. And

**Alex Murguia** 15:06
we say it every time. You can always reinvest your R and DS. You don't need to spend it, just it's almost like click your seat belt when you get in the car,

**Wade Pfau** 15:17
pay taxes on it, and you have to before you can think about doing Roth conversions. You need to cover your spending needs. So if I want to spend $70,000 this year pre tax, I have to figure out how to distribute that now that would come from any of these required taxable income

sources I just mentioned. But then beyond that, then you need to start thinking about taking distributions. Do I need to sell taxable assets to fund my additional spending? Need Do I need to take distributions from my IRA to fund my spending? Need Do I need to take from the Roth? Although, if we're taking from the Roth, we're not going to be doing a Roth conversion in that scenario. But how much do I need to be distributing in excess of any income that I had from outside of my investments to meet my spending need. Those are all constraints that we have to consider. And then, given that now, we're ready to look at, can we voluntarily generate additional taxable income through a Roth conversion in a manner that proves fruitful, because we think we're able to now pay taxes on that at a lower rate today than we may have to in the future. Okay, so that's kind of the basis. How much income are we required to generate? How much do we want to spend? So then, if we want to spend more than that required income, where are we going to distribute from to cover that spending need? If our required income is greater than what we want to spend, we'll reinvest the surplus. And do we want to do Roth conversions? But, but we got to kind of figure out what that is before we can enter the Roth conversion conversation.

**Bob French** 16:58
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. Got a

**Alex Murguia** 17:39
something that you were, you were saying it's a bit past, but I think it's worth mentioning because it comes up in the social media sort of suggestions. And I brought it up before, but when you were talking about at the very beginning, and you said that one of the main constraints is availability of taxable, tax deferred and tax exempt assets. And to me, this is the reason, one of the main reasons, why you want more of a diversified set of accounts, because it just gives you a lot of financial planning optionality, if you will, once you get to once you're in that fragile decade of things you can do, you know. And so for me, I think even some advisors get it wrong, frankly, about how they view this, and they're very specific. I think if you get a healthy slug, if you happen to be able to generate a healthy slug of monies, and these three, these three accounts, I think long term, it helps you with decision, decisions that you can make from a financial planning perspective, such as this one. I don't know there's any precise number, or there's any like optimized Excel amount, I don't think so. I think that's probably more of an individual thing than a basic rule of thumb. But I just wanted to point that out. That's why it's important, in my view, to be able to access accounts from varying tax treatments. I don't know if I phrased that right, but yeah, that makes sense the way I phrased it, that they end there,

**Wade Pfau** 19:05
right, right? And definitely you're constrained. You can't, you don't have full discretion over that, because suppose you're a very vigorous, rigorous you save quite a bit, and you have well, by the way, but go on the higher income, you save quite a bit, you're going to be filling that Roth space, maybe through a backdoor Roth if you're not eligible for directly or through contributions to a Roth employer plan. And then you may even be filling up your tax deferred capacity as well

between IRAs and then any employer plans. And then if you're still saving beyond that, you're kind of forced to put that into a taxable account. So if you save quite a bit, you're probably going to have your biggest assets going to be taxable assets, even after filling up the capacity in those other types of accounts. The mistake that can be made, though, is, well, maybe you are you save quite a bit, but like it's you're at a point. Point where most of that ends up in a tax deferred environment, so you get closer to retirement without much in the way of taxable accounts, with most of your assets in the tax deferred environment. And maybe you haven't started a Roth IRA yet. Now it's important to open a Roth IRA as soon as possible, because you do need to, even if you're 70 years old, it needs to be open for five years before you can take a qualified distribution, any any Roth IRA. So one of those general financial planning suggestions is get a Roth open even if you're not contributing a whole lot to it, just so you can get through that five year clock that if you're then over 59 and a half as well, you can ensure your ability to have qualifying distributions.

20:44
Are you sure about that? No,

**Wade Pfau** 20:50
this five year rule we're talking about is pretty clear cut.

**Alex Murguia** 20:58
I wanted to see you see Wade and I are looking at each other on video, so I just wanted to see his reaction when I said,

**Wade Pfau** 21:05
every once in a while related to Roth conversions, that's more controversial, but my view is, once you're over 59 and a half, you don't have to worry about the second uh, Roth five year rule, okay?

**Alex Murguia** 21:17
And and, before we get into your case study, something that, because the first time you mentioned it, it was intriguing, but it took me a while. You know, you just don't pick it up immediately, you know, because it's a new concept, and it's something that I think has changed your view about how you you see certain things. But I think it's worth you getting into what the whole tax mapping concept is, as you get into the case study, you do it however you want to do it. But I think table setting, that concept a little bit will help. As I've you know, as I kind of look through the examples before the podcast,

**Wade Pfau** 21:54
yeah, in my book, there's a lot of tax maps, and that's one of those things that it's hard to just what is a tax map. Like, what

**Alex Murguia** 22:00
is a tax map? Yeah, it's

**Wade Pfau** 22:02
a concept, actually. So Joel Sasser in Omaha, he's a financial advisor, and he created, so when you get into the question of, is there software to do this for you,

**Alex Murguia** 22:13
which is yes, but it's not really for consumers, right? It's weird,

**Wade Pfau** 22:16
but not direct to consumers. Asymmetry, or what do

**Alex Murguia** 22:19
you call that in economics, when, like, not everyone has everyone has the same information kind of thing? Asymmetrical? Yeah? Asymmetric

**Wade Pfau** 22:27
information, yeah. Well, consumers, I guess, could license it, but it's expensive because it's designed for an advisor who can use with many and then Joe's

**Alex Murguia** 22:37
business model isn't geared towards having 1000 customer service reps,

**Wade Pfau** 22:41
right, right. Like, if it were direct to consumers, just the customer service that would be necessary, it's just not economically feasible. So that kind of answers the question, why do why is software out there that's only available? Well, it's, I mean, it's just expensive because it's intended for advisors, not intended for consumers. But anyway, if you aren't,

**Alex Murguia** 23:03
you know, it's for consumers your book. No, all right, fire away, man.

**Wade Pfau** 23:12
But yeah, he developed the idea of tax maps, and it really lays out how to think about how much to rob, convert. And so what I'm going to talk about next is actually really just walking through the tax map, but then it's how you can be thinking about what your what he Well, and also he developed the idea of the effective marginal tax rate, which I've adapted in my book, is one of the things that changed with my book. With the 2024 edition, that's the third iteration of the book. There was a first edition and then a second edition from 2023 and then the second edition 2024 update in each of those, the method I used for this tax planning discussion changed, so I finally stumbled upon Joel Sasser tax maps and effective marginal tax rates. Adapted that for the newest version of the book, and I'm pretty sure I'll be sticking with that, because I think he's cracked the code. He's kind of figured this out. So this is the method to be using. You're muted Alex. So Alex is talking right now. I can see him, but I don't hear anything, so I'll keep talking while I see Alex continuing to talk without did I lose sound? Oh,

**Alex Murguia** 24:25
I think it was me. No, no, you're right. I must have hit a keyboard thing or something. Sorry. Yeah, these

**Wade Pfau** 24:31
episodes are not edited, so it

**Alex Murguia** 24:33
was a terrible joke anyway, so didn't matter.

**Wade Pfau** 24:36
You censored yourself. Yeah? Okay, but yeah, the tax map idea, it's you map as I generate more tax more ordinary income, we're going to make a distinction because of that Social Security tax torpedo. And we had an old whole episode about that, and also because preferential income is treated. Separately, and think we had a significant part of an episode about that the tax maps, map your ordinary income, so not including preferential income, not including the taxable portion of Social Security, against the effective marginal tax rate on each dollar of income. And so that effective marginal tax rate includes the federal income tax brackets, but it also can get bumped around due to Social Security the Social Security tax torpedo, the preferential income stacking issue we've all we've had episodes on all this, the Irma surcharges, the net investment income tax. And so I just kind of want to walk people through as you generate more ordinary income, what's happening? So we start? Well, suppose we can start from zero, though we have to apply that constraint. If you have taxable income that you can't control, you're not starting from zero. But if you were to start from zero, you first start walking your way through the standard deduction. Now, if you're claiming Social Security already, the first thing that's going to hit you is, even before you leave the standard deduction, part of your social security is going to start becoming taxable due to that very complicated provisional income conversation we had in a past episode. So you're in the you're in the 0% rate with the standard deduction. But then as you generate more ordinary income, suddenly you're getting bumped to, well, you're in the 10% bracket. But because $1 is also triggering, at this point, already 85 cents of Social Security to be taxed, you face an 18.5% marginal tax rate. Then eventually you may enter into the 12% bracket, and then that becomes, I think, 22.7% as an effective marginal tax rate. And then assuming your preferential income isn't too large, so that you get an overlap, although some people may get an overlap, no overlap for now, then you drop you get through the tax torpedo. The first thing you do is work your way through the tax torpedo. Then you get back down to the 12% bracket again. Then the next thing you're going to run into is the preferential income stacking issue, which is what

**Alex Murguia** 27:14
I will say. Wade, just in case, I'm asking you, you know, a hot take here. Let's, let's see about putting these slides on the show notes so someone can potentially download them, and then, if they wanted to, they can also follow along. You follow you see what I'm saying, right? Every once in a while, yeah, right. Hey, I'm adding value. Adding value. Wade, adding value, right? But that right? So if you wanted to hit the show notes, download the slides, that kind of thing, and then follow along. And so Wade it. Just assume people are following along with the slides. Because I was trying to do it in my head, just putting myself in and I was like, You know what? I need to look at the slides. There's no way I can do it without that. So just, you know, just, you can refer to the slides, because we'll just do that.

**Wade Pfau** 28:07
Yeah, okay, so yeah, we were, we're in 0% with the standard deduction, but then we jump to 18 and a half percent and 22.7% then back down to 12% and that's the Social Security tax torpedo. Then if we have some long term gains or qualified dividends before we get to the 22% bracket, we now start pushing all of our all those gains from 0% to 15% so then we have an effective marginal rate of 27% while we're in the 12% bracket, plus the 15% on long term gains. We work

our way through that. That's kind of the next issue we're working through. Then once we finish that, if we're married filing jointly, we now have another $250 gap where we're back down to 12% then we enter the 22% federal income tax bracket, and we're moving along. And then at some point, we're gonna meet Irma. This is if we're at least 63 years old and we're going to begin Medicare at 65 the your income from two years prior affects whether you're going to have Medicare surcharges two years later. So at some point we hit a the first Irma surcharge. But so that's going to spike for that $1 where the spike happens, that's going to spike our taxes. So it's not technically a tax, but we're going to pay more than, or around $1,000 per person more, Medicare premiums. Two years later, then we come back down and we're still in the 22% bracket. Then we get closer to where that net investment income tax is going to come into play, where that 3.8% on your net investment income. That's going to add on top of the 22% bracket, there's going to be an Irma surcharge in that same general area as well. So for a while we end up paying that the well that's going to then also get us into the 24% bracket. So 27.8% So then we come back down to the 24% bracket again, and then we're moving along. And then we hit another Irma bracket, and there's five Irma brackets in total. We're going to, as we just generate more and more income, we're going to move into the higher federal income tax brackets eventually as well, we're going to hit the where our long term gains are being taxed at 20% instead of 15% or at this point, probably really because of the investment income tax 23.8% instead of 18.8% so that's now we have. That's kind of the reason this tax map is important is because this is giving the contours of helping us decide how much income do we want to voluntarily generate to do Roth conversions. So based on where we have to start from the tax map, can we then move beyond that point and generate more taxable income in a manner that leads to taxes that we find reasonably low relative to what we might have to pay in the future to motivate us to go ahead and want to do that. So then, of course, the next question that comes up is, and again, the answer of, if you really want to do this with your personal situation, it's the only commercial software out there that can do this is the COVID some his income insights and tax clarity programs, advisors that use them, you know, somebody advisor, yeah, or well, or advisors who use these software packages, but yeah, it's what he's doing. And so in my book, and then I guess with the slides we'll post as well, just kind of showing what's happening behind the scenes of that software. You evaluate, should I should I target a 15% effective marginal tax rate, or should I target at 22% or 23 actually can be any number because, because of the non linearities in the tax code, you don't just look at federal income tax rates like the 12 or 22 or 1012, 20 220-432-3537, you don't look at just those. And

**Alex Murguia** 32:08
I was getting more depressed, like, oh my god,

**Wade Pfau** 32:13
tax rates gone. Then in 2026 those all change.

**Alex Murguia** 32:18
It keeps you in business with 1015, business. Version, edition 2026. Is going to be huge. Yeah,

**Wade Pfau** 32:27
if we go back to the tax rate, that's going to be a significant but possible

**Alex Murguia** 32:34

we might keep the current rates. You want to give some examples. Okay, so you laid the when you did your sort of math earlier, you're just laying out. These are the hurdles that you're going to face right now you want to go through exactly.

**Wade Pfau** 32:46
Now we're going to try to evaluate how many of those hurdles Do you want to break through?

**Alex Murguia** 32:50
Yeah, exactly. There you go. Fire away, all of them, as many as possible.

**Wade Pfau** 32:57
Well, that's the that's kind of the thing the software is going to evaluate each tax rate target over the lifetime of your financial plan. That's we said. We're making some assumption about future market returns, how long we're going to live, and so forth. So we evaluate each tax rate target and then see which one supports. Well, hopefully you're going to meet your spending goals so there's money left over at the end, if you have a shortfall, that's a whole nother conversation. But assuming you have enough money to make the plan work, which one of these is going to give you the most after tax legacy at the end of retirement?

**Alex Murguia** 33:31
Okay? So somebody listening in, and even, you know, intuitively, you would say, Well, I always want to have the target is always the lowest tax rate. What would I want to be in the you know? Why would I want to be in the 28% effective marginal tax rate? Put me always in the 15% effective marginal tax rate. What you're saying is that may not always be the most optimal

**Wade Pfau** 33:54
right, right that just never doing a Roth conversion. The conventional wisdom isn't not usually any. You don't have to be perfect, but any sort of planning strategy is going to work better than the conventional wisdom. The conventional wisdom is very inefficient, because it just has you spend on your taxable account first, and then you only spend from your tax deferred account, which is very tax inefficient, and then eventually, if that runs out, then you only spend from your Roth, which is also potentially quite tax inefficient, because you may not even be taking advantage of your standard deduction, where you could have generated taxable income at a 0% rate. So any sort of like any optimal strategy, what it's going to end up doing is, while you have taxable assets, you're going to blend distributions between the taxable account and the tax deferred account. And then eventually, if the taxable assets deplete, you switch to you're going to blend distributions from your tax deferred account and your tax exempt account.

**Alex Murguia** 34:58
That's an interesting point, and it's. Worth repeating, because even we have, I'm sure, I think with Bob or whatnot, we've probably done, and we didn't do this with the eye towards Roth, right? Just straight up. We did sort of dispense that conventional wisdom. Why it makes sense. But again, that's, that's high level. What you're realizing is, when you take into consideration the Social Security tax torpedo, the Irma stuff from Medicare, whatever, all the lions, tigers and bear kind of thing that you'll run into, the NIT, etc, etc. It may not, it may not come out to just this, this linear order. It may be you're saying it's actually quite optimal to blend, okay? And do you want to go through a specific example and then somebody can kind of that shows, okay, wow, this I see it now because I think we're still in the conceptual thing, right? Or am I off?

**Wade Pfau** 35:56
Yeah, so we're not going to try to walk through the whole case study, because there's a whole case study that shows what's happening to all your accounts and taxes and everything every year of retirement, and that's virtually impossible to try to describe in a podcast, but yeah, the attitude way, but there are some charts that we can still what I want to focus on is not the actual case study for a particular couple, but more this question of, okay, what do I need to be thinking about? Okay, in this year? How much should I convert this year? All right, yeah. And so what any software is doing? What? And what I'm doing in the case study is I'm evaluating different and the software would be evaluating, what if you target each of these different effective marginal tax rates, what's going to give you the largest legacy at the end of retirement? Whichever tax rate target gives you the large and it also checks the conventional wisdom, but it's usually not going to be anywhere close to optimal. Whichever effective marginal tax rate target gives you the highest legacy at the end that's, well, there's your answer. That's what you should be doing, and then you follow what steps need to be taken each year to manage that effective marginal tax rate target. Okay? So that, that being said, we just really want to talk about, you know what, what? Well, what would be happening if you target different effective marginal tax rates, and I think a number that, oh, now I remember what I was trying to say, too. So, so the the legacy value of assets at the end of retirement. I defined the legacy value as what's ever left in the taxable account, because with the step up at basis, your beneficiaries would get all of your taxable funds, plus there's an embedded tax liability in your tax deferred account. So I tend to assume your adult children beneficiaries will be taxed at a 25% rate, but you can change that number. And also, like, like the COVID sum software lets you pick an effect, a tax that your beneficiaries would pay, so that they would be paying. It's like, if they're in their peak earnings years, and they're in the 25% bracket, and assuming, you know, in a few years, we're back right now, 25 doesn't exist, but it will in 2026 under current law, they're in that bracket. And then Roth assets also pass 100% his legacy. They still have to take those out of the inherited Roth IRA within 10 years, but they don't have to pay any taxes on that. And so immediately you can see if, if I'm assuming my beneficiary is going to be taxed at 25% on any Ira they receive from me. If I can pay the taxes on a Roth conversion at less than 25% I'm immediately increasing the after tax legacy value of my assets. So if I target, say, a 15% bracket, it's we run into potential problems. We're going to hit if so, we haven't claimed Social Security yet, we don't have to worry about the tax torpedo. The first thing we'd run into is the preferential income stacking, which would be pushing us to a 27% effective marginal tax rate, and then we'd drop down to 12% briefly, but then run 22% so the constraint would be, if my income that I'm starting with is otherwise less than where adding my preferential income would push me into the 15% bracket for that preferential income, then I've got some spare capacity, and I would do Roth conversions until the tip of my preferential income hits the beginning of the 15% bracket on preferential income, and that would give me the answer of this is how much more income I could generate as a Roth conversion to stay under the 15% effective marginal tax rate this year. And I do. At by working my way up to the beginning of preferential income stacking, and that would be the answer to that situation. Now is 15% the right target. I do find in a lot of case studies I've done, it tends to work fairly well for people who may you know $3 million or less type of investment case scenarios, as you start to get to higher wealth numbers, you might really start targeting higher effective marginal tax rates, and this would be also part of that hedging conversation. I'm assuming a low rate of return based on tips yields, so that then tends to push to a lower effective marginal tax rate as well. But yeah, 15% there you go. You wouldn't really go beyond that point. But if you decided you wanted to target higher, whether it's

22% whether it's 2528 whatever the case may be, it's just eventually you're going to run into something that stops you and what the Insight Joe had because of this, non linearities in the tax the non linearities in the tax code. Tax rates may go up, but then they may come back down again. So you kind of want to check beyond just the point where the tax rate goes up to see if you could draw more desirable income before you hit another barrier. And so you're kind of working through, well, you hit the preference well, you if you have Social Security, you hit the tax torpedo barrier. If you have taxable assets, you'll hit the preferential income barrier. If you're still working your way through that and deciding it's worth having more Roth conversions beyond that eventually, then you hit the Irma search. Well, if you're 63 or older, you hit the Irma surcharge barrier. If you're not yet 63 you don't have to worry about Irma. Then you hit the net investment income tax barrier, then there's more Irma surcharge barriers and federal income tax brackets continue to increase, so you just kind of keep working your way through until you hit a barrier and then deciding, okay, I think it's going to be worth it to do Roth conversions and to pay the taxes now, because the taxes I can pay on that chunk of income that I'm converting is lower than what I deem to be a reasonable target to use. And so I'll do it, and then next year I'll re evaluate and reassess and figure out if I should do another Roth conversion the next year,

**Alex Murguia** 42:14
that point about the next year, that's another great thing that Rob was saying, You're not like it's not a marriage. You're not committed to this strategy and having do it every year, you know it, but if there's a year where it makes sense, you do it. And even if the even if the financial planning software, you know, indicates that, hey, look, you should do this over the next 10 years, you can say yes and start doing it. But it doesn't mean that you know you have to do it in year 2345, if it doesn't work out, it is a case of course correction, because life happens, right? So just know that that it this, this idea of just analyze it. Is it worth it this year? If the answer is yes, then go ahead. Even though you may have a 10 year plan, you still look at it, at it one year at a time.

**Wade Pfau** 42:58
Wait, yeah. And the best opportunity to do this tends to be for people who are retired and have a runway where they're retired before Social Security starts. I could claim Social Security. It gets more complicated.

**Alex Murguia** 43:13
I think there's another time. And I this is it hit me too speaking with Rob, I was like, Yeah, you know, you're right. I think for folks that are changing careers, or they're in between jobs, and for whatever reason, they're like taking on a gap year, if you will, right? And they know that this year, it's going to be a I don't know, they're going to be in the lowest tax bracket, because they're not, they're not high income earners that year. And even though they could be 45 years old and Roth conversions and all that kind of stuff is the last thing they think about. There is an opportunity Wade

**Wade Pfau** 43:49
low income years, years with high medical expense. That's deductible. Yeah, those could be other opportunities too. I was just kind of going in the direction of saying, once you claim Social Security, it's not that that would put a break on all potential Roth conversions, especially at higher wealth levels, but it gets harder to do Roth conversions once Social Security starts, and then, especially once RMD start, because you can't Roth convert an RMD. So it's like you still

you have a much higher starting point after the RMD. Is it worth still going beyond that with Roth conversions, and the answer could be yes, but it's just much less likely to be yes than years where you get to start from a much lower number, because you don't have work income, you don't have social security, you don't have RMDs. That's going to start you at a lower number and give you more excess spare capacity, where a Roth conversion might be worthwhile and may be able to be done at a lower effective marginal tax rate. Okay? And I think that's kind of as detailed as we can get without really being able to go into a lot of visuals, yeah.

**Alex Murguia** 44:54
And so if you see it, what we'll have in the downloads is we'll have we'll. Have, you know, little cheat sheets in terms of how you back into it at the differing tax rates and and the Gremlins that could happen, you know, in certain years, and if they happen, what does that do with your tax rate, with with corresponding income levels,

**Wade Pfau** 45:19
and also the retirement planning guide, but has a detailed explanation alongside many charts and exhibits and things too. So yeah, if you want to exactly,

**Alex Murguia** 45:29
so if you, if you still want to find out more about this, because even if you look at the charts, you may want a little more context, there's the book as well.

**Wade Pfau** 45:40
Yeah, right. I didn't really use the terms desirable income or undesirable income that show up in the charts, but that's that's the Joel Sasser methodology, that you look at these chunks of income based on where you went from less than to more than your tax rate target, and you evaluate how much taxes would you pay on each of those chunks of income. And it's desirable if you can pay those taxes at below the target, it's undesirable if the average tax rate on that chunk would be above the target. I don't

**Alex Murguia** 46:07
know who you are. Wayne, undesirable income. That those two words don't go together. It's not are you an American? What's going on here?

**Wade Pfau** 46:19
Yes, there's context to that phrase, because we're talking about voluntary Roth conversion.

**Alex Murguia** 46:24
Thank you for clarifying. Thank you for clarifying.

**Wade Pfau** 46:29
All right. Man, kick me out of context.

**Alex Murguia** 46:31
Yes, yes, yes. All right. All right. Man, as always a pleasure. Thank you everyone for listening in any parting thoughts. Wait,

**Wade Pfau** 46:44

no, no. But yeah, we've completed the tax planning arc. So I think next we're going to look to having Q a and Q A after we've already done the live session, but I

**Alex Murguia** 46:57
will do some interviews too. We got some interviews backed up that that people have been wanting to hop on, like Jason and the gang. So figma, right? Yeah, we did a show runner. We're gonna need a show runner. Wait,

**Wade Pfau** 47:17
all right. Everyone confirmed him well enough to announce it publicly, but I saw you, no, I

**Alex Murguia** 47:21
didn't confirm it. Soon. I'm assuming the sale. All right, everyone, take care, and if you're listening, Jason, we'll see you soon.

**Bob French** 47:34
Bye. Wade and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities to determine which investments may be appropriate for you consult your financial advisor. All investing comes with a risk, including Risk of Loss past performance does not guarantee future results.