Episode 158: Retire with Style Live (not really) Q&A: Part 2

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retirement income, financial personality, RMD calculation, Secure Act 2.0, annuity aggregation, inflation protection, Social Security suspension, Roth IRA contributions, tax implications, market returns, variable annuities, TIPS benefits, retirement strategies, financial planning, retirement income planning

SPEAKERS
Briana Corbin, Bob French, Wade Pfau, Alex Murguia

Bob French 00:00
The purpose of retire with style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to resaprofile.com/style and sign up to take the industry's first financial personality tool for retirement planning.

Briana Corbin 00:41
Tis the season for good company, great questions and better retirement strategies. Wade and Alex are here with the next part of our Q and A series to help you wrap up the year with confidence.

Alex Murguia 00:51
Okay. Uh, okay, so we got one from Suzanne here, and it says, for planning purposes, how do I calculate the future value of a spear. I want to estimate the impact of my combined deferred accounts, RMD for my five year plan. Can you give an example of the calculation?

Wade Pfau 01:15
Okay, this question is actually a cousin to another question on our list that actually explained the problem correctly, but then asked us if their explanation was correct. So maybe we should read that other question, and then come back to this question, because it lays more the situation of what's going on. I could read the question. Okay, so this is this question is about something in secure, act 2.0 which is beneficial for owners of spias in IRAs. So let me read this other question. It'll provide more context. Then we'll come back to this question too. Okay, could you say something about the new RMD rules for people who own a qualified annuity that has been annuitized and also own a traditional IRA that is subject to an RMD requirement. I understand that new IRS rules finalized this past summer, allow annuitants to aggregate the December 31 account value of the annuitized annuity with the December 31 account value of the IRA for the purposes of determining the combined annuity and Ira RMD requirement, dollar for dollar. And because the annuity payout on on the annuity account balance will be, or will frequently exceed,

the RMD amount that would be required on the same balance under the IRS tables, you will end up with a lower aggregate RMD if you aggregate the annuity balance together with the IRA balance for the purposes of determining the total R and D, instead of using the alternative method of applying the annuity distributions to satisfy the RMD requirement separately using Ira distributions to satisfy the IRA RMD requirement. Okay, do I understand all this correctly? And are there any pitfalls? So first for

Alex Murguia 03:02
those, yeah, like myself, I think what you're the question ultimately is, is, hey, we can now combine accounts. Would that have an annuity in that, like an IRA account without annuity in them, buying that account value with another one, with another IRA, and have a combined RMD together, as opposed to taking RMDs independently from those two different accounts? No,

Wade Pfau 03:25
because it's about spias, I can explain more context. Okay, so first of all, if you were able to follow I didn't read that very well, but yes, what I read was correct. So that answers the first part of the question. What was that saying? So secure act 2.0 added a nice provision for individuals that own spias in IRAs to clarify why it's a nice provision. In the old days, suppose, okay, let's say, you know, I've got $500,000 in my IRA. I take half of that, maybe I'm making up weird numbers, but I'll take half of that and put that in a spea. The spea will provide me monthly payments for the rest of my life. It's very likely the case that the spea payment would be higher than the RMD would have been on that 200,200 $50,000 I just put into the SPIA in the old days, this was bad, because I couldn't count any of that SPIA payment against the RMDs due on the other $250,000 left in the account. So I ended up having to take out more. I had to get my spea payment that covered the RMD just for this be a premium, and then I still had to take my RMDs on the remaining IRA assets. The new rule with secure act 2.0 and that's what was being described in this paragraph. Is every year there'll be a calculation done that on the present value of your. Remaining spea payments, and then you calculate the RMD on that present value, and it's probably going to be less than your spea payment, but you take the RMD on the present value of the remaining annuity payments, plus the RMD on your other IRA assets, and that's your total RMD due. But now you can apply the excess via payments against the RMDs due on the non annuity assets as well. So it lowers the amount you're required to take out of your IRA. It's very, a very nice provision. So with that first question, yes, that individual stated it correctly. They also asked, Are there any pitfalls to be aware of before using this method? And the answer is no, not really. Every year your the annuity insurance company will have to send you a form telling you what this number is, what this present value is, to be able to then know what the RMD on it will be. So now the other question is understood all this, and is now getting to the question of, okay, well, how do I know what the present value of my spea payments is so that I can estimate what those RMDs will be over the next five years? That one, it's a present value calculation you consider over your remaining life expectancy. Well, how much are you expected to receive from the SPIA? And then looking at current interest rates, what's the present value of that amount? That's going to be what the SPIA is, its present value. That's what the insurance company is going to be doing. If you really want to get precise about it, you can find the IRS rules about how to do those present value calculations. They have their life tables showing you how many years are you expected to receive this via payment, and then, based on the interest rates that you use, you get that present value. Now that being said, if you want just the back of the envelope type calculation, so that you can get an idea about this, you could, this isn't going to be correct, but as a, again, as a 80% of the way to the answer, just before you

started receiving spea payments, just assume the RMD. I mean, the sphere value was the premium you put into it, and then each year, subtract what those via payments you received are. So if at a $300,000 premium into this via, initially, you can calculate the RBF with $300,000 in the first year, I get $40,000 of payments from the SPS. So subtract that from now I have $260,000 as a rough estimate I could treat the present value of remaining speed payments is that the next year, subtract the next $40,000 I received $220,000 left. That's a rough estimate that will give you some idea about this. The the present value is never going to be higher than the premium you paid well, unless interest rates dramatically change, but you can probably set that aside to the most part, and that's going to give you a rough estimate beyond that. Yeah, the IRS does have information about based on the interest rates and giving you the life tables based on how many years you received this via payment, you could use Excel to calculate the present value of those via payments, and then that would be an estimate that you use to calculate the RMB.

Alex Murguia 08:31
Now, Wade, when I want to make sure I got it right myself, when I was listening to the question, I was specifically answering the first part, not how to calculate the present value of a SP or anything like that. And isn't the new law effectively, like, isn't that what you just did? I get it wrong because you're combining both accounts to then, you know,

Wade Pfau 08:52
get it. You're talking about aggregate, yeah, technically you are aggregating. Well, it might be in the same IRA, yeah.

Alex Murguia 08:58
Okay, okay, sure, they're in the same area, but if you have two annuity and one of them is like a regular investment account, you can aggregate those. And that's all I was yeah, you

Wade Pfau 09:07
can aggregate different IRAs. Okay, that's a correct statement, but it just doesn't have anything to do with this question. I mean, it does at the extreme, but that's not the main thrust of No,

Alex Murguia 09:22
no, no. The main thrust was the value. And I get that now, don't I was kind of like on ramping Don't you need? Does the insurance help you? Does the insurance company help you at all with the value itself, like year end statement or something like that?

Wade Pfau 09:37
Yeah, they'll need to send you a form that will tell you what the present value of your spea is, so that you can calculate its RMD. Okay, if they don't, there are guidelines about how to do those calculations. But I can't give the exact explanation. I. On a podcast.

Alex Murguia 10:02
Okay, let's do the next one. My and my husband's four 3b plan miscalculated our automatic RMD withdrawals for the past five years. Who do you think is responsible for fixing this?

Wade Pfau 10:22

Okay? That's ultimately something you may want to speak with a lawyer about. I'm assuming the problem is they under calculated. And so now the IRS wants to apply a penalty for not taking out the full RMD amounts, and

Alex Murguia 10:36
the penalty goes to everything. If I'm correct, right,

Wade Pfau 10:40
it accumulates with interest at a pretty steep rate, but the secure act did reduce the penalties. Used to be extreme, like even 50% penalties on the amount you didn't distribute. It is the case that, and this would qualify at least as a valid excuse, that I think you could get the penalty down to 10% at this point. But I think the argument here is, we don't feel like you should pay the 10% penalty, the the your plan sponsor should pay the 10% penalty. And that one that's really going to be a legal type argument.

Alex Murguia 11:17
Yeah. I mean, there's, there are plenty of ERISA lawyers that would be able to deal with that specifically. But yeah, it seems there's an error somewhere along the path. There could be many variables. I don't know if it's an input error and output error or what have you, but yeah, that's for that's for another legal that's for a legal podcast. I would imagine at this point,

Wade Pfau 11:45
if the mistake went the other way and they just had you take out more than you needed to, there's probably not going to be much recourse for that. I mean, unfortunately, you could have had more tax deferral, but I don't know how that anything could be resolved. It's more the issue of, if they told you you could take out less than what's required. Okay, and there's penalties involved in you might also take it up with the IRS about not having those penalties applied due to a mistake that was not really your fault.

Alex Murguia 12:19
Yeah. I mean, other thing I would add to that is, Maureen, Look, I I feel for you in those situations. We've had many, you know, new clients come to us because of things like this, and unwinding that or fixing that is some of the things, you know, kind of get get involved in, and it's never pleasant. So I, I do feel for you in that regard, but I don't know if we can point a finger at one way or the other, not because we don't want to. It's just we don't. It's beyond the purview of this podcast other than like, yeah, call on a recent attorney and lay down the case and see, see what they say. All right, we've got one retiring at 50. What contracts or market assets can protect my late life income floor against decade long inflation of 10% and negative real market returns, ie stagflation Japan,

Wade Pfau 13:20
usually usually where tips enter the conversation. Now, treasury inflation protected securities provide you an inflation adjusted rate of return. It's currently for longer maturities, in the ballpark of 2% real plus inflation on top of that, that would protect if you bought a 30 year tips that would give you inflation adjusted purchasing protection for the next 30 years. So if you're retiring at 50, that would get you to 80. So the question is more about, I think, with late life income floor, you don't have anything beyond a JD, they're really there's no way to get protection against long term inflation that goes beyond the end of the yield curve, which would be 30 years. You can't

get protection beyond 30 years. You can hope that 30 years from now, you could roll that money into a new tips. But who knows what that would look like in 30 years. I think ultimately, though, it's just speaking to the need to be flexibility, because there's nothing that's truly going to protect against every contingency over a long time horizon.

Alex Murguia 14:32
And this, they continued this question, or maybe they thought of other things, just this changes the answer here they also, I'm considering buying tips today at a payout to pay out at age 80, then buying a spea with 2% cola adjustments, but that seems a very expensive approach that doesn't really protect against high inflation after age 80, also, the tips plus spea approach forego is 30 plus years of money. Market returns. For example, is there any sort of variable annuity available with cola adjustment just before I you chime in Wade, while you're thinking about the answer here. And so this is where I would also ask, just in terms of the linearity of your thought and making sure that it's consistent, not that it's not but this is a very emotional thing, and I want to be able to parcel out everything here. And so the statement started with, I need to protect my late life income floor against a decade long inflation of 10% a decade long inflation of 10% I assume you mean yearly, not just from one year, year one year 10, it's increased 10% so right off the bat,

15:45
it's,

Alex Murguia 15:48
I mean, this is the, the last thing you're going to be thinking about if this happens is, is, like the distribution, I think there's going to be a lot of issues going on with the country If you're talking about 10% inflation, you know? And then, in addition to that, you're saying you want to predict against negative real market returns, right? And so it's hard to juxtapose that statement within the last statement being but I may miss out on market return. I may miss out on market returns if I invest in tips and a spear, which I don't disagree with that statement. It's just, you can't have it both ways. Is just the issue. I just want to point out. And I'm not being prescriptive. I'm just kind of my observations from the questions, as we're doing these the questions actually are quite insightful from the standpoint of how the the thinking works for this particular person, right? And so obviously that first statement is, I am scared. Maybe it's, you know, the we just, were just coming off an election, so, and maybe you're on the other side of things, and it's like, oh my goodness. And it would have been the same way if the Democrats won. I'm sure we would have had Republicans coming in and this and that. So it's, and I don't even saying that's you, but that's that happens a lot right now. And so I would temper that with just, you know, a decade long inflation of 10% and then negative real returns. On top of that, we're going to have significantly greater problems going on if that happens. But that being the case, you took Wade's advice ahead of him, saying, Okay, I consider about, well, not Wade's advice. So this is an advice, but just Wade's point about considering buying tips at a payout rate than a spea with 2% cola adjustment, you know, etc, but that seems very expensive. And then it ends with the, also the tips plus b approach forgoes, 30 plus years of market returns. Yeah. So then is there a sort of variable annuity available with cola adjustments? So I'm just addressing the thinking in that question seems, seems to meander a little bit

Bob French 17:56

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Alex Murguia 18:24
Wade now

Wade Pfau 18:26
for the specific answer. Well, so a spill with 2% cost of living adjustments doesn't protect you against inflation. Exactly. It's giving you an annual step up of 2% but if you're worried about high inflation, 10% you're missing eight not helping Now, if you're talking about like having the tips for 30 years and then at 80 purchasing something else, who knows what kind of financial products we'll have at that point, it could be a completely different world. But then maybe there will be inflation adjusted SPS, they've existed in the past, true CPI indexed spias, the last one left the market in january 2020, and no one's been back in the market since. I mean,

Alex Murguia 19:11
let's just forget the assumptions and just, you know, treat it as is. What about the strategy? I'm more inclined to think about it like tips I get, okay, inflation protection and I'm worried about inflation. Forget the numbers that that were put out there. Just in general, I'm worried about inflation and the like, I like the the tips, I would probably forego the spear. And since this is long term, because, you know, you're thinking at age 80, so I'm thinking 80 ish is the the time frame they're thinking about, like, locking down. I'm thinking like, instead of a spear,

Wade Pfau 19:43
yeah, I mean a culac inside of the IRA. You lock that in now. So that's the other option. You purchase a deeply deferred income annuity today, and then you can make that worthwhile, but then you miss out on any sort of inflation protection for that. You. Because if there's this high inflation in the next 30 years, you locked in today, they

Alex Murguia 20:05
lock it down. Okay? They're talking about 80 maybe when they turn 60 or 65 when they turn 65 they consider the cue. And

Wade Pfau 20:11
there are like we may see financial innovations. There is already, and I don't know if we can really say the names of companies in this context, but there's a provider out there who has, it's not truly an inflation adjusted annuity, because it would stop payments at age 100 and it's not fully guaranteed three you can

Alex Murguia 20:30
mention that name. We're going to do a podcast on it as well, and we did a study on it. And I think they have, they can't talk about

Wade Pfau 20:39
you say it, then you're the compliance officer.

Alex Murguia 20:44
No, there are some ETF companies that are coming out with interesting solutions, not ETF companies. There are some investment companies that are offering ETFs with some pretty interesting solutions that have to do with structured outcomes from the income standpoint, that are taking, I would say, some interesting qualities from annuities and marrying that with interesting qualities with markets to create more structured products, but that are liquid, more liquid in nature and ETF driven. And that's, I'm not saying it, that's the company to get, but I think it's Wade's point is innovation is really coming in. Is going to start to come in fast and heavy within these products, because everyone knows that it's peak 65 all these folks and all these investment companies are looking in a mirror thinking, all right, we've done a great job over the last 25 years with accumulation products, and we'll continue to do so, because there's people born Every day, but we need to really start focusing on decumulation products, because there's a real gap there. Even from a business standpoint, there's a gap in the offering. And so you're seeing a lot of stuff coming in through there,

Wade Pfau 21:54
yeah. And so that is the life fix. It does have that inflation adjusted version. I don't think it's available at age 50, I'd have to double check. There's a age band. I have to double check. But I'm thinking like 55 to 75 is when I

Alex Murguia 22:09
forget. They just changed some things up to be in an ETF structure, as opposed to a mutual fund structure. And I don't, I don't remember. We'll

Wade Pfau 22:16
have a podcast about that at some point, because it is a financial innovation that speaks to this question. Because the other part of the question, for example, is there any sort of variable annuity available with a cola adjustment? But again, it's it's not. If you're worried about high inflation, COVID, if

Alex Murguia 22:34
you worry about low market return, then who cares about a variable annuity? Well,

Wade Pfau 22:38
and also, well that too, but also just call adjustments. Don't provide inflation protection. They provide a fixed annual cost of living adjustment, regardless of whether inflation is 1% or 20% so if there's high inflation, yes, you'll get a little bit more purchasing power, but it's not that's baked into the pricing. You start with a lower payout, because it's going to step up over time you really want some sort of CPI protection. And I'm not aware of any variable annuity that had a CPI adjusted benefit attached to

Alex Murguia 23:09
it. It'd be too expensive. Because how are they going to protect themselves from that

Wade Pfau 23:16
risk? Yeah, especially when they allow individuals to invest as they wish in the sub accounts. Well,

Alex Murguia 23:22
that goes back to another point, another this is now a little nerdiness here, but variable annuities may not be the right chassis for you as well. It could be more along the lines of a RYLA could be a better annuity. Yeah, if you're using this kind of thinking, than maybe a registered index linked annuity, you know, a RYLA would be kind of a preferred choice, perhaps, than a variable annuity. You're seeing them less and less popular because of the inefficiencies and structural stuff that Wade mentioned within the variable annuity world. Okay, okay, there was

Wade Pfau 24:02
another live question there on the and this one, I think can be a shorter answer, because it is an easier question. Finally, a nice, easy question after full retirement age to optimize Social Security monthly retirement payments or that I'm already drawing, can I just voluntarily pause until age 70. Yes, after full retirement age, you're allowed to suspend your benefit if you had claimed earlier, and then realize, in hindsight you wish you hadn't done that. You can pause after full retirement age and then be begin collecting delayed retirement credits to offset some of that loss. So if you if you claimed at 62 and then you pause at full retirement age, and then you delay until 70, and suppose your full retirement age is 67 you'd get a 24% boost on that lower benefit you're getting from having claimed early that May. Set and get you closer to where the full retirement age benefit would have been. So yes, file or suspending at full retirement age is allowed, you'll begin collecting delayed credits on that lower benefit amount that you have because you claimed early, but that can help offset some of those lower benefits for you,

Alex Murguia 25:22
alrighty, then yo, Okay, any questions for me Wade just to just we had the right answer weekend, or do you want to?

Wade Pfau 25:31
Yeah, I think from our big question list, we were ready to start question number three from that at this point. Okay, yeah. So Alex, oh, and I combined two questions here together that are variations on a theme, but I think they can just be addressed together. So the first question, Should I lump sum a Roth IRA in January, or dollar cost average throughout the year? And so to be clear, this is when I'm adding new contributions. Should I make my full Roth IRA contribution in January or spread it throughout the year? Second question now this is now I'm taking distributions. So when it comes to receiving distributions from a tax deferred account, is there an optimal approach? Is it better to take the annual distribution as a lump sum in January or in December, or spread it out, monthly dollar cost, averaging it out, what are the tax implications? Or is this simply based on an individual's needs in personal circumstance? It's an

Alex Murguia 26:32
interesting question. It's good. You know what? It's showing you me that the question we would get asked all the time, and we're getting asked this question with more and more but it's a similar type of question, is, I have money to invest in the market? Do I put it all in at once? Or do I dollar cost average into the market? Right? And this is kind of the inverse of that, but theoretically, it's kind of asking the same thing, right? Like, do to do it all out? What do I take my money out all at once? Or do I dollar cost average out of it? Other, you know, dollar cost averaging? Or do I take it out on a monthly basis, proportionally? I I think there's outlines, there's there's two nuance, two perspectives I want to share, and that, if you take it out monthly, as opposed to all at once, and the markets go up. I think it was like point eight a month, point

8% a month, or something like that, whatever adds up to like 10% a year, right? And so if the markets go up over the long term, and you're going to be taking distributions for, let's say 25 years, assuming you're a total return investor, then you're probably better off. Well, your best answer would be, wait till December all the time, right? But you're probably better off, kind of just smoothing it out because more money will stay in. Let's say you take your distributions for January. You still have February's through December's distribution invested in the market, right? Etc, etc. So if you smooth it out that way, I think that's a better that that's better for you from an investment perspective, simply because you're removing the the vagaries, the vagaries of just short term volatility, and you're capturing the longer term moments where the markets will, you know, meander forward, if you will, the upward drift, if you will. So you're able to capture it like that. And you know, that's a similar answer to lump sum or, or contributions. Do I put all at once? Or lump sum it there? You would do the lump sum, because the markets go up. Or the long term, the sooner it's invested, the better, you know that kind of thing. So here it's the it's the same thinking, but it's the inverse, where I would just fume it out, frankly myself. Now that being the case, it does give you a lot more flexibility fuming it out from a retirement income standpoint, if you're now doing the bracket management, wait and what I mean by that, if you take everything out at the beginning of the year. Sure, the money's there, but let's say there's a windfall. There's, you know, you're already touching a bracket. It doesn't give you a lot of flexibility, or, you know, it pushes you over something that you didn't want to because now you can't control it. You already took it out, whereas, if you've been taking out money over the course of the year, and then come October, you realize that, you know what, if I take out more money here, I'm going to push myself into another bracket because of some other variable that happened that I wasn't expecting. Now you have flexibility to hold off on those you know, to hold off on those distributions and still maintain attacks the tax efficiency of it that, to me, you just it gives you a lot more optionality. You're in the market a little longer, you know, over the time period. And I think can help you manage your taxes a lot more as you go along, as opposed to, like, it's too late, it's January. You already did this. There's no coming back from this at this point. Uh, when you're doing those things. And just to remember, right when we did the the stuff on the the tax stuff, there's a lot of things that can flip you over the top, the Irma, the Irma surcharges, etc, etc, etc. And so you want to make sure that you're giving yourself cushion from an income standpoint. Wade,

Wade Pfau 30:20
yeah, yeah. And so assuming, like, liquidity is not an issue, the need for spending and all that right is because markets do tend to go up over time, and this is something you're going to be doing every year, the odds are in your favor that, in the case of making contributions, make your Roth IRA contributions in January, in the case of taking distributions from and I guess we're probably talking more about the RMDs from your tax deferred account, wait till later in the year just to get the most tax advantage growth. I definitely make my Roth IRA contributions in January. Start saving up previous years so that after January 1. I'm ready to Okay, let's hit these things right at the start of the year. That gives you the best long term growth prospects. If you're worried about if, like, the dollar cost averaging resonates with you. There's no big problem with spreading it out more. It's at the end of the day, if markets grow, it might be a little bit less efficient for you, but it's not really going to make that much difference in the long term. The only other caveat, though, on RMDs that are we're saying like, wait until December to take out your RMDs. There is a problem if you pass away that year. In the year someone passes away, their beneficiaries have to make sure that they take out any required arm, any RMD for that year. So if it's you pass away December 20, and this is a major shock to your family, and you haven't't

taken your RMD yet, if your family doesn't act and get that RMD out by December 31 there's going to be a penalty involved, not taking out the required amount for the year. So for that reason, you may think about taking out that RMD sooner in the year, to give your family sufficient, sufficient runway to not have this be one more thing to worry about late in the year. But other than that, it's I would think, yeah, contribute early in the year, distribute later in the year is the way to over the long term to get the most tax advantage. What?

Alex Murguia 32:22
So you're that's different than my I would, I would do it just during the year, like slowly, you're saying back loaded. You would personally backload, which mathematically on Excel sheet. That would work, because markets go up. The reason I like to kind of smooth it out myself, personally, is because it gives me the discipline without thinking about it. I think that there's plenty of people that once you give yourself the autonomy to kind of make intuitive, what you feel are intuitive decisions like, Oh, I think this is going to happen. So I'm going to do I think you start running into problems from a behavior standpoint. And so I personally like to, I don't like to do it all at once. I don't like to do it at the end of January, at the end of December either. I just, you know, I would prorate of that thing across the year and call it a day. And so I guess technically, it's like if I did it in the middle of the summer, a one time thing in the middle of the summer on average. But I just like to do it throughout, simply because it's automated and I don't even think about it. I wouldn't think about it. That's that would be my game.

Briana Corbin 33:24
Thanks for tuning in. Don't forget, we'll be back next week with part three of our Q and A series. So keep those retirement questions. Come in and we'll keep the answers rolling. See you there. Wade

Bob French 33:35
and Alex are both principals of McLean Asset Management and retirement researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only, and are not intended to provide specific advice or recommendations for any individual or on any specific securities to determine which investments may be appropriate for you consult your financial advisor. All investing comes with a risk, including Risk of Loss past performance does not guarantee future results. You