Episode 225: 3 Tax Strategies to Improve Retirement Income Efficiency

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Retirement income, tax efficiency, tax planning, retirement guidebook, deed in lieu, reverse mortgage, credit report, tax deductions, adjusted gross income, taxable income, tax deferred, tax exempt, Roth accounts, HSAs, tax diversification.

SPEAKERS

Wade Pfau, Alex Murguia, Briana Corbin, Speaker 1

Briana Corbin 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 retire with style.com/style, and sign up to take the industry's first financial personality tool for retirement planning. Welcome back to retire with style, where today Wade and Alex are tackling the topic everyone loves to avoid taxes, and they're walking through how to squeeze every bit of efficiency out of the tax code in retirement, and they even recorded it on tax day for that extra bit of authenticity.

Alex Murguia 01:00
Hey, everyone, welcome to retire with style. I'm Wade, and I'm here with my good buddy, Wade Pfau, and today we're continuing our tour of the retirement planning guidebook with what chapter are we covering? Today

Wade Pfau 01:15
we're up to chapter 10, and you had a little blooper there. I don't know if you've been caught what you said, but we'll let it go. What did I say?

Alex Murguia 01:21
What'd I say? What I say?

Wade Pfau 01:22
You said that you're Wade and you're here with Wade.

Alex Murguia 01:27
One, can only dream one. Oh, no, you just

Wade Pfau 01:30
didn't realize it.

Alex Murguia 01:32
Yes, I am Alex.

Wade Pfau 01:37
That's right, you are Alex.

Alex Murguia 01:40
All right, maybe because I was looking at you in the zoom thing, I don't know, whatever. Well, continuing along with chapter are we covering today?

Wade Pfau 01:50
Yeah, we are now. We're on our series going through the retirement planning guidebook, and we're up to chapter 10 on efficient tax planning for retirement before we dig in, though, we do

Speaker 1 02:01
have

Alex Murguia 02:02
that. Here we go. You wanted to follow up on something,

Wade Pfau 02:05
yeah, with our last episode, you asked me about if you do a deed in lieu of foreclosure with a reverse mortgage, which is, it's a non recourse loan, so if the loan balance due exceeds the value, you could sell the home for you don't have to worry about it. You can do a deed in lieu of foreclosure. And you asked, Would would that cause, if this were the beneficiaries doing it, would that be a ding on their credit report? And I thought the answer was no, but I said, I usually need to confer with folks. And I did hear from Dan holquist, who I mentioned, the the expert out there on anything related to reverse mortgages, and also Rob Kenya, who's a reverse mortgage lender, and they both assured me that what I said was correct. No, you would not it would not impact your credit report. Since it's a non recourse loan, there's no concerns about that. Dan did mention, though, that this would be reported to K verse, which is a system that looks at like federally insured loans, and so if you do a deed in lieu of foreclosure, you would not be eligible for a federally insured loan for a three year period after that. So that could cause an issue if you're about to buy a house or something along those lines, but it would not have any negative impact on your credit

Alex Murguia 03:18
report. So there

Wade Pfau 03:20
is something to watch

Alex Murguia 03:23
for, and any Well, we're recording this on tax day. So yes,

Wade Pfau 03:30
yeah, we are. It's appropriate, right in our world, but this will be coming out the following week.

Alex Murguia 03:35
Did you file an extension? Wade, like always, never get your stuff done on

Wade Pfau 03:38
time. I got my taxes filed a couple weeks back,

Alex Murguia 03:41
a couple weeks back, although

Wade Pfau 03:43
I ended up having to pay more taxes than I had anticipated.

Alex Murguia 03:46
Oh, what happened? Something off with your numbers or the windfall of the book just was too much.

Wade Pfau 03:52
Yeah, more income than I expected. Now, I don't know. It's hard to calibrate.

Alex Murguia 03:59
You're really a man of the people with that statement,

Wade Pfau 04:03
a little bit of an interest penalty on not I do my estimated taxes, but I didn't send enough estimated taxes this year.

Alex Murguia 04:10
Oh, really,

Wade Pfau 04:11
it's tragic,

Alex Murguia 04:12
tragic, tragic, tragedy like the Bee Gees and any any good news to report

Wade Pfau 04:19
on the tax side. No,

Speaker 1 04:20
no,

Alex Murguia 04:21
buddy, come on.

Wade Pfau 04:24
Tax season was rough this year. Hopefully get things.

Alex Murguia 04:27
What good news about the podcast?

Wade Pfau 04:30
Oh yeah, we achieved 1 million downloads in the history of the retire with style podcast. So that's quite a an achievement. So congratulations, Alex and

Alex Murguia 04:40
no congratulations. Thank you. Thank you

Wade Pfau 04:42
to the listeners for making that possible. You've got the crowd cheers. Very dead. That kind of didn't sound as impressive as I. At least on my I think your microphone might have blocked it out. I could hear a light hissing, but

Alex Murguia 05:05
I'm playing with the soundboard of this

Wade Pfau 05:07
is where your your microphones too powerful. It blocked it all out,

Alex Murguia 05:12
damn it.

Wade Pfau 05:13
It was not as impressive sounding.

Speaker 1 05:15
It

Wade Pfau 05:17
nothing. Now that

Alex Murguia 05:18
was a drum roll. Oh, that sucks.

Wade Pfau 05:20
No, you're got a powerful microphone. It's good for cutting out background noise if you have landscapers outside. But,

Alex Murguia 05:27
well, they're, they're doing a doing this from my house. This is they leveled that two houses down for me. They leveled it and they're just rebuilding it back up, and they're pouring concrete today. It's pretty loud, but you can't hear it, then I guess it's not,

Wade Pfau 05:43
no. And I thought you lived in a historic district.

Speaker 1 05:46
I

Alex Murguia 05:46
do, I do. But my house, yes, but I guess the people two houses town? No, yeah, my house is like, from 1911 or something. I can't touch my house. Oh, well, all right, so back to back to taxes, back to taxes,

Wade Pfau 06:03
right?

Alex Murguia 06:04
Let's ask the, let me throw you a softball here. How can people achieve tax efficiency for their retirement assets?

Speaker 1 06:11
Well,

Wade Pfau 06:12
that's a pretty broad question. It's a

Alex Murguia 06:15
very it's a beach ball.

Wade Pfau 06:18
Yeah, I think that's really what we we want to unpack, and that's what chapter 10 of the retirement planning guidebook is all about, just helping people understand how taxes work, and then using the features of the tax code to to get more efficiency, so that you have more after tax spending power. The idea for tax

Speaker 1 06:35
plan is

Alex Murguia 06:35
using, when you say, using the features of the tax code for more efficiency, is that another way of saying finding loopholes, tell you

Wade Pfau 06:42
not loopholes, but just working within the rules too.

Speaker 1 06:45
There

Alex Murguia 06:45
you go, and

Wade Pfau 06:46

not paying unnecessary interest because your estimated taxes weren't high enough, but that, that's a whole separate issue. But no just working within like understanding how long term capital gains and qualified dividends stack on top of ordinary income, and how that can impact your taxes, understanding how Social Security is taxed, understanding how there can be Medicare surcharges related to your adjusted gross income if you're using the Affordable Care Act and now if you your income exceeds 400% of the federal poverty line, your adjusted modified adjusted gross income, including 100% of your Social Security benefits. How costly that can be in terms of loss subsidies. Now we have all these tax deductions that phase out with income, whether it's those new age 65 plus bonus deductions, whether it's the state and local tax that can now you deduct up to 40,500 this year, but that phases out down to 10,000 is your income that that one doesn't start impacting you till over $500,000 of income. But

Alex Murguia 07:47
so just so I'm just trying to make sense of it. So what are the main pillars of how to achieve tax efficiencies? Because it's something you were rattling off. You can do this, this and that, but I think they're clustered. And so I want to make sure that I can conceptually

Speaker 1 08:00
think, yeah.

Wade Pfau 08:00
Well, first it's important to understand the basic idea of you have your total taxable income, and then you have above the line, deductions, things like contributions to retirement accounts or HSAs, and that gets you to your adjusted gross income.

Alex Murguia 08:15
You say, above the line, I'm going to call you on this just because we're in this world. But somebody listening may not know what above the line means,

Wade Pfau 08:22
well above the line of your adjusted gross income, so your total like taxable income sources, then you can subtract above the line deductions to get your adjusted gross income. And this is a really important point, because a lot of the tax quirks link to your adjusted gross income, but then you have below the line deductions, which is the bigger of your standard deduction, or if your itemized deductions add up to more than the standard deduction your itemized deductions, you subtract those, and then you get your taxable income. And then that's what the tax tables, they apply to your taxable income. But below the line, deductions don't save you for any of the tax quirks that link to your adjusted gross income, because it's whether you have to pay more tax on your

Speaker 1 09:07
income

Alex Murguia 09:08
before the

Wade Pfau 09:09

Yeah, before the below the line deductions, which, again, is either your standard deduction, whether

Alex Murguia 09:14
someone may say, Well, how do the below the line deductions help you?

Speaker 1 09:18
Well,

Wade Pfau 09:18
they they can lower your taxable income so that you pay less tax at the end, but you might still get hit by these non linearities in the tax code.

Speaker 1 09:27
Yeah,

Alex Murguia 09:27
because you it may help you with taxes, but then, because your adjustable gross income is XYZ, now your taxable income, your adjustable gross income, then you cross some threshold in some other area that they're going to get you for. That's kind of what

Wade Pfau 09:40
you're saying. Yes, you can, and you can reduce your adjusted gross income with above the line deductions. Although when you're retired, it can be you may not have any above the line deductions after retirement. The other option is just to try to defer any income that you might be able to wait until next year to receive versus receiving in this taxable. Total tax year. Those are really the only kind of options available to keep your total income lower, all right? I mean your adjusted gross income lower,

Alex Murguia 10:09
okay. And so then, what are the pillars around these above the line, you know, AGI kind of items that you were talking about. And then we can move on to the below the line. You know, taxable income that affects taxable income?

Wade Pfau 10:23
Well, it's, yeah, I mean the above the line, deductions, it's just usually things like your retirement, qualified retirement account, contributions, student loan interest can fit into that. Health Savings Accounts, contributions, those are the big ones. I think that it's kind of the there's not, there's always a few minor categories as well, but those would be the big ones. Oh, net capital losses, up to $3,000 if you had, if you're like, selling assets at a loss, yeah. Oh, self employment, payroll tax, health insurance costs for the self employed. Sorry, the deductible part of your self, employment, payroll tax, those are the main above the line deductions.

Alex Murguia 11:08
Okay, so that would be a way to start achieving tax efficiency taking advantage of those,

Wade Pfau 11:12

yeah, which primarily the easiest way to do that is if you're working to make those qualified contributions to a retirement plan and or health savings account.

Alex Murguia 11:24
Okay?

Wade Pfau 11:25
Otherwise, there's not much planning you can do around the others, other than potentially loss harvesting so that you can take advantage of up to $3,000 of losses that year. Now, below the line deductions. That's mainly the most people are just going to take the standard deduction, because it can be difficult to itemize and get an amount higher than the standard deduction.

Alex Murguia 11:48
What's just? What's the amount again?

Wade Pfau 11:50
Well, for a couple, it's going to be 32,200 if you're under age 65 and then you do get those bonuses if you're over 65 so in this current year that we're talking about 32,200 and then if you're over 65 plus 3300 plus 12,000 I mean, if both people are over 65 in a couple, if you're married filing jointly, that gets you Up to 47,500 and if you're a single filer, this year, it's going to be 16,100 plus. Then if you're over 65 2050 and then another 6000

Alex Murguia 12:33
Okay, so let me just put this in the audience heads, or they're doing some mental math, right? You take in your top of the line, stuff, your adjusted growth gross income is $100,000 then you're married, and you take the standard deduction. You said 32,000 I think you said

Wade Pfau 12:51
32,200 32,200

Alex Murguia 12:53
for couples, what does that mean? Now their adjusted gross income that was 100,000 now becomes 100,000 minus 32,000

Speaker 1 13:01
and so then

Alex Murguia 13:01
they only pay, and let's just say, 30,000 just to make the math easy for everyone listening, so then they're only paying taxes on $70,000 worth of income, hence, taxable income?

Wade Pfau 13:11
Yeah, yeah, their taxable income would be around 70,000 and

Alex Murguia 13:14
you're saying the only time not to do that is if you've itemized everything, and they happen to be higher. For this particular case happened to be higher than 32,200 something

Wade Pfau 13:25
like that, and that would be things like well, charitable contributions, health expenses that exceed seven and a half percent of your adjusted gross income, mortgage insurance on acquisition debt and interest, mortgage interest on acquisition debt.

Alex Murguia 13:45
What is acquisition debt like

Wade Pfau 13:47
if you have a home loan because you bought the house or something specific?

Speaker 1 13:51
Now,

Wade Pfau 13:51
if you just have, like a HELOC home equity alone and you're using it to buy things unrelated to improving your home, you don't get to deduct that interest, but if you're using the loan to purchase or substantially improve the home, that's deductible

Alex Murguia 14:08
got you

Wade Pfau 14:10
and state and local income taxes would be another big one for that below the line. And that used to be up to $10,000 but now we have this temporary period where it's increasing each year, but it's up to more than $40,000

Alex Murguia 14:24
so in this example, just to make sure people are listening to it correctly, $100,000 filing jointly, we take the standard deduction, which is 32,200 I'm just gonna call it 30,000 for right now, that's $70,000 but if I itemize, you know, and added all the things you just said, and that ends up being $40,000 I'm going to take those instead of the standard deduction,

Wade Pfau 14:52
yes,

Alex Murguia 14:53
and by state income, just to be clear, that means that the state of Virginia charges me 34 $5,000 in taxes. I want to make sure people understand, what does that mean. I apply that to my taxable income on my federal or No,

Wade Pfau 15:09
yeah, you could deduct the if you paid $35,000 in state income tax, you could deduct that so you're now above your standard deduction, and then as long that will phase out at high income levels,

Alex Murguia 15:20
I just want people listening in. I kind of want

Speaker 1 15:24
to

Alex Murguia 15:24
just, you know, conceptualizing it as they're driving and trying, you know, listening to it at two and a half times speed or whatnot,

Speaker 1 15:31
okay,

Wade Pfau 15:36
and that's if you're under 65 So

Alex Murguia 15:38
are you saying it's, we should actually move. We should all move to New York, because the state tax is so high that we can just claim that deduction instead of the claim that as a deduction, instead of the standard deduction.

Wade Pfau 15:53
Well, but temporary thing though, like in 2029 I believe you're back to capping it at $10,000

Speaker 1 16:00
No,

Alex Murguia 16:01
and I was kidding. I mean, it's phased out anyways, at income levels. I was trying to make a joke that didn't land, unfortunately, like many of them, all right,

Briana Corbin 16:12
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Alex Murguia 16:38
all right now, so that's that's brought up in the chapter. That's sort of that broad base of these are the kind of not cheat codes, but these are the, these are the way to optimize the tax code, and the way to be thinking about it, the above the line deductions, and then you have your AGI adjustable gross income. And then what are the below the line stuff you could take? Does it add up more than the standard you know, you figure out that math, and then you land on your taxable income. And at every level, there's things you could be doing which you outline in your book, correct.

Wade Pfau 17:13

And also with this new age 65 plus bonus deduction that's 6000 per person 65 and older that exists outside of the standard deduction, so you don't have to worry about exceeding, like I said earlier, with a couple of your

Speaker 1 17:27
47

Alex Murguia 17:28
that's below the AGI, right?

Wade Pfau 17:30
It's below but it's not part of the standard deduction. So you get that even if you're itemizing, you still get your 6000 on top of that for being 65 or older.

Alex Murguia 17:40
Gotcha. Gotcha. Okay, all right. And then another thing that comes up quite a bit. You see this in our dialogs and things like that, tax diversification. What are your thoughts? Soup to nuts on on that topic,

Wade Pfau 17:56
right? Dad, there's three general types of tax treatment for investment assets, and so tax diversification is about just having some of all three, and it's taxable brokerage accounts, tax deferred retirement accounts, and then tax exempt or Roth retirement accounts. So tax diversification is about all three, but they each have different properties and different levels of tax efficiency, and they all kind of are part of the strategy around retirement savings and getting the most after tax from your retirement savings. So like in an ideal world, you could just put everything in a Roth because it would be all after tax money, and you never have to pay.

Alex Murguia 18:40
I have to interrupt Wade. This is just a side note. We had our McLean meeting, right? And we were in our Investment Committee meeting, not an investment committee meeting, the advisor meeting on yesterday, and we were, you know, we for those folks who are listening in and more consumers. Let's say advisors have like Transition Plans. A prospect comes in, what's the transition plan to, you know, to a portfolio that we would recommend, etc, etc. And we, you know, we're creating on little like transition app, if you will. And within that, we're really injecting all of the best practices, you know, from the book and the like and the things like that, into into the software to begin to kick out, you know, operationalize as much as possible, the tax efficiency from a transition standpoint, largely on, on the work that we've done. And when I say we, I really mean, you great, which is kind of cool. Yeah, I digress. Go ahead.

Wade Pfau 19:41
Okay. Oh, yeah. So well, tax, taxable, tax deferred, tax, exempt your tax classes. That's like, what you put in a brokerage account. You just open up a brokerage account with one of the big brokers out there. The don't need to name them by name, but kind of, no, you

Alex Murguia 19:58
know who you are. Yeah.

Wade Pfau 20:00
Yeah, those are taxable assets, and so you pay ongoing taxes on any interest or dividends generated each year, but your any capital gains will be deferred until you realize them. So unrealized gains are tax deferred. Now, what do

Alex Murguia 20:16
you say the argument when someone says, you know, if you're not going to trade, if you're gonna buy a bunch of index ETFs and leave it alone. That's actually the most effective account. And you should The hell with everything else, because you really don't have access to a lot of the other things until you retire. You kind of get that a lot on social media, you know, where they start poo pooing the Why would you put money in a 401, K plan? You're an idiot. Or, why would you put money in an IRA? You're an idiot. You should keep it in a taxable account.

Wade Pfau 20:46
I guess I don't spend as much time on social media. I've not seen those. I've seen people saying, like, use life insurance instead of retirement accounts.

Alex Murguia 20:52
But no, I've seen a lot of it's monthly clickbait, like trying to get you to just like, I don't know

Speaker 1 20:58
if they

Wade Pfau 20:58
don't click on the clickbait,

Alex Murguia 21:00
they get me all the time. I'm personally keeping temu in business myself.

Wade Pfau 21:09
Yeah, there's also the asset location that we can get into as part of asset diversification, like the taxable brokerage accounts that's the best place to keep tax efficient, like stock index funds that don't generate a lot of ongoing realized capital gains, because you can take advantage of qualified dividends and long term capital gains, get preferred tax treatment. They're taxed at the zero, 15 or 20% rates and then plus the 3.8% surtax so that can be an advantage like I mean, in an ideal world, everything could be in a retirement account, but you're not, not allowed to do that. So when you're thinking about where to position different assets, the taxable brokerage accounts will be best suited for low cost type stock index funds that will generate more qualified dividends and also have those unrealized long term capital gains from when they get a step up, step up in basis at death, where all those embedded long term capital gains, your beneficiaries will not have to pay tax on that the basis of the account steps up to the account value at your death, so your beneficiaries get that full account value free of any sort of income tax. Now, there may be a state tax if you have a really large estate, but no income tax on inherited taxable brokerage accounts, so that that's a nice feature. Now, you compare that to tax deferred retirement accounts. That's the the IRAs, the 401 K's of the world for those, you get a tax deduction on contributions for up to like, qualified limits, and then those assets grow tax deferred, and then the distributions are all taxed as ordinary income. So maybe some of that clickbait you're talking about would say your long term capital gains get taxed as ordinary

income coming out of an IRA, whereas they get that long term capital gains treatment coming out of a taxable brokerage account.

Alex Murguia 23:07
No, it's definitely that. It's definitely that. And then, I mean, there's a real financial planning reason, and then that has to do more with access to capital. You know, that you may need before you retire. You don't have to pay a penalty. Yeah,

Speaker 1 23:18
there can be

Wade Pfau 23:21
before 59 and a half, although there's usually some rules around, at least you can get contributions out and things penalty free, but yeah, if, if this is money you're These are meant to be retirement accounts, so you're meant to hold them over the long term until retirement. If you are thinking you may need these funds earlier, that could speak to a reason to hold them in a brokerage account, taxable brokerage account instead.

Alex Murguia 23:45
Okay, so you have the taxable accounts, which is your standard brokerage accounts, but not brokerage because you can have an IRA that's in a brokerage account. You mean just, you know, individual account, a joint account, that kind of thing you have that the benefit is, you know, you have access to the capital and if you you do pull money out, you're paying capital gains. Now, the flip side of that you're paying capital gains is that you contributed with after tax money, so you've been taxed on it, you know, by your income kind of thing. The other one are tax deferred accounts, which are 401, K's things along those lines. Now the benefit there is, it's pre tax money going in, so you haven't been taxed on that money, but when you do take it on in retirement, it'll be taxed as income. The good, you know, hopefully, the good news is that your income is your income bracket is low, so it's, you know, a little more palatable, but because it's growing tax deferred, the benefit there is that it's going to really compound, and you're not going to get dinged every year by 1000 paper cuts of dividends and things like that. Or if you do have to trade you it won't, won't bother you. Then there's tax free, right?

Wade Pfau 24:59
Well, the other thing. About the tax deferred accounts, they have the required minimum distributions starting at either 73 or 75 which can force out ordinary income that you don't really want to spend, and that can push you into worse tax situations. But and then also, that's if your beneficiaries inherit those tax deferred accounts. That's now where, unless they have a qualification or an eligibility to get the old lifetime stretch, they have to pull those assets out over a 10 year window. And if you have adult children inheriting those accounts when they're in their peak years of earnings, they might pay a much higher tax rate than you could have paid as a retiree on those accounts,

Alex Murguia 25:40
100% 100% and then the last bucket of one, the last bucket of accounts, are tax free accounts you want to go into that,

Wade Pfau 25:51

yeah, so Roth accounts you put in after tax funds so you've already paid the tax on your contributions. But then for quality, what's going to be qualified distributions, which, if you get in those so you've had the account open for at least five years, and you're over 59 and a half, and there's some other kind of exceptions that can get you access. But otherwise it's all, all growth, all account growth comes out tax free. You never have to pay taxes again on those funds,

Alex Murguia 26:19
because you paid tax, you paid income tax with the money that you've contributed into there. Unlike

Speaker 1 26:25
you

Wade Pfau 26:25
paid taxes on the contributions already, and then all the growth is tax free,

Alex Murguia 26:30
and that goes into that. That's where you get the terms like a Roth IRA things along those lines, and what's the new account Wade for folks regarding health so folks also recognize that it's a great deal as well. And I'm not so sure it comes with RMDs the HSAs.

Wade Pfau 26:49
Yeah. So HSAs are the health savings accounts, and they have features of both tax deferred and Roth accounts. They have that triple whammy where if you're going to use it for qualifying medical expenses. You get the tax deduction on the contributions the tax deferred growth and the tax exempt distributions. So you get the benefits of both tax deferred and tax exempt accounts. That makes them pretty special,

Speaker 1 27:17
yeah. And then

Wade Pfau 27:19
with Ross there's no RMDs either no required minimum distributions, and inherited Roths do have required minimum distributions, but it's not taxable, so it's not going to cause a big tax problem for your adult child beneficiaries.

Alex Murguia 27:34
Okay? And I think this leads people to think about Roth conversions and things like that, but we can begin to touch upon that in the next episode. What do you think?

Wade Pfau 27:43
Wade, yeah, that sounds good.

Alex Murguia 27:44
All right, everyone, thank you for listening in on retire with style, and we'll catch you next week as we continue our way through Wade's retirement planning guidebook. Any parting thoughts? Wade,

Speaker 1 27:57
no.

Wade Pfau 27:58
Thanks, everyone. We'll catch you next time on retire with style, take care.

Briana Corbin 28:04
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 the risk, including Risk of Loss past performance does not guarantee future results.