

Episode 226: 5 Tax Planning Mistakes that can Reduce Your Retirement Income

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SUMMARY KEYWORDS

Retirement income, tax planning, asset location, taxable accounts, tax deferred, tax exempt, Roth accounts, Social Security tax torpedo, preferential income, Medicare surcharges, buffer assets, tax map calculator, Roth conversions, income tax brackets, long-term capital gains.

SPEAKERS

Alex Murguia, Speaker 1, Wade Pfau, Briana Corbin

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 retirewithstyle.com/style, and sign up to take the industry's first financial personality tool for retirement planning. Welcome back to retire with style. Wade and Alex are back with part two of their tax planning series covering everything from asset location to the Social Security tax torpedo. They also somehow find time to debate whether Van Halen counts as classic rock. So there is something for everyone.

Wade Pfau 00:58

Hey, everyone, welcome to retire with style. I'm Wade, and I'm here with my trusty co host, Alex. Hi, Alex,

Alex Murguia 01:06

hello,

Wade Pfau 01:07

and we're continuing with our series on the retirement planning guidebook, celebrating the launch of the third edition that happened at this point back in January. But it's a long series, because there's a lot in the retirement planning guidebook, and we're continuing this week with our look at tax planning in chapter 10 of the retirement planning guidebook, Alex,

Alex Murguia 01:27

yeah, I don't know if you noticed Wade, but you did the same mistake I did in the last episode.

Wade Pfau 01:31

Did I

Alex Murguia 01:32

Yeah?

Wade Pfau 01:32

No, I didn't catch it. I said,

Alex Murguia 01:35

Yeah. You said, I'm Alex, and I'm here with Alex.

Speaker 1 01:37

All right.

Alex Murguia 01:38

You believe that

Wade Pfau 01:39

symmetry?

Alex Murguia 01:40

No, no, no, no. Wade doesn't make mistakes. He's a one take kind of guy.

Wade Pfau 01:47

One take lead,

Alex Murguia 01:48

one take weight. There we go. Actually, we kid. But people don't know this. But Wade does all of these things, and when we go back into our studio, he does all of these in one shot. He doesn't mess around.

Wade Pfau 01:59

Yeah, I don't like retakes.

Alex Murguia 02:02

Yes, you can't upset the talent everyone. You can't have set the talent. He's a little prima donna backstage, right? What do you want? Like, four, four cubes of ice for every eight ounces of water, something like that. You're like Van Halen, only green. Eminem,

Wade Pfau 02:21

yeah,

Alex Murguia 02:23

actually, I read a thing on that, or no, like, no brown M M's, and that was their cue for it's not that they cared. It was more that if the if the place that we're playing at went through the trouble of making sure there were no brown M M's in their like, Eminem jar or whatever, then they could rest assured that everything else was taken care of.

Wade Pfau 02:42

Yeah? Somebody actually read the contract, right?

Alex Murguia 02:46

Yeah, something like that, you know, but maybe that's apocryphal. I don't know.

Wade Pfau 02:51

Makes sense.

Alex Murguia 02:51

Are you Van Halen fan?

Wade Pfau 02:54

Not in particular, but they're no. Nothing against them. I

Alex Murguia 02:58

thought you were like a classic rock guy,

Wade Pfau 03:02

yeah, though they can all that today

Alex Murguia 03:05

kind of worth transitioning. They're more like, no, no, no. They were kind of in between, right,

Wade Pfau 03:13

yeah. And today, the the classic rock, I think, goes up in a grunge and everything. But when I, when I was a teenager, they were not considered classic rock,

Alex Murguia 03:20

yeah, no, me neither. That was more like, you know, Zeppelin and Floyd and stuff like that.

Speaker 1 03:27

Yeah,

Alex Murguia 03:28

yes, yes,

Speaker 1 03:31

represent

Alex Murguia 03:31

your big Ram Jam guy,

Wade Pfau 03:35

Jimi Hendrix.

Alex Murguia 03:37

All right, here we go. Taxes, tax, let's knuckle down as we get ready to talk about taxes. All right, so in the last episode, we got into the different types of it. Well, we talked about, you know, what are the things you can do, above the line, below the line, etc. And then we moved on to the different types of accounts, taxable, tax deferred, tax free, and the like. And we didn't give

enough treatment to asset location, like among those, among those accounts, what assets are more efficient? What assets are more efficient in the different types of accounts

Speaker 1 04:18

when

Alex Murguia 04:19

you're looking at your portfolio? Because I'll say this a lot of times when, let's say a prospect comes over to McLean or whatnot, and we see their statements, and they have, let's say a 401, K, an IRA and a taxable account. There's not a lot of complementary pieces across those three accounts. Those accounts tend to maybe mirror each other. You know, I've got the same types of holdings in this account, in that account, and in the other account. And the thinking is, well, yeah, that's good, because I'm consistent. What's your take on that in light of that? I know you don't, don't laugh, right? Actually, it happens. Man, it really

Speaker 1 04:57

does.

Alex Murguia 04:58

What's your take. Take on an asset location and how to think about this three body problem. Yeah,

Wade Pfau 05:09

yeah, you can do better than just having the same asset allocation in each account. And an asset allocation always comes first. That's you're choosing. Like, how much stocks should I hold? How much bonds should I hold? That's the first priority. And so if it means not following the asset location principles, you don't you do asset allocation first and then asset location. But with asset location, we talked about with taxable brokerage accounts, that's really where you want to have your most tax efficient asset classes that are going to be generating the most preferential income, meaning qualified dividends and or long term capital gains, because, why

Alex Murguia 05:47

is that preferential, as opposed to other What is it, though? Why is it called preferential?

Wade Pfau 05:52

Because it's taxed at lower rates than ordinary income.

Alex Murguia 05:56

Okay,

Wade Pfau 05:57

when we talk about pitfalls in retirement, we'll talk about how that stacks on top of ordinary income. But that's instead of having the tax rates running the 1012, 2224 up to 37 you just have the zero and the 15 and then 20 plus a 3.8% surcharge. So you have lower tax rates for that income, and you have a higher threshold, the 15% bracket for that starts in the same ballpark as where the 22% bracket starts on ordinary income. So you're already getting taxed on ordinary income with a 1012, and then 22% bracket, but you're riding through a 0% bracket up until around that same ballpark with the fit, where 15% kicks in on your preferential

Alex Murguia 06:46
income,

Wade Pfau 06:46
so tax efficient asset classes generating growth with long term capital gains and the like best for taxable for the tax deferred accounts, everything comes out as ordinary income. So that's really a good place to think about, like your bonds, whatever you want to hold in bonds, the first choice of where to put them would be in your your tax deferred accounts.

Alex Murguia 07:10
I would take it beyond just bonds, and I would even include like, dividend generating holdings. Bonds comes first, but I'm just thinking REITs as well?

Wade Pfau 07:21
Yeah, yeah, that's a REITs is another good option. It's when we think about so we're now in we've got taxable accounts, and then we have your tax advantage accounts, and that's the tax deferred and tax exempt. So when you're thinking about the tax deferred versus tax exempt, it's really the, well, tax inefficient asset classes, but then those with lower returns tend to be more for the tax deferred account. Those with the higher potential returns tend to be better suited for the Roth account. They may generate a lot more growth that would have been otherwise, and maybe it's tax inefficient, so you'd rather have them in the Roth, but you don't have to worry about losing that long term capital gains treatment in the Roth, since it's not taxed anyway,

Alex Murguia 08:04
okay? And to be clear, you want those high growth ones in the Roth because the RMD that you can just let them grow. You can just let them grow and grow

Wade Pfau 08:13
and grow. Yeah, you they. You don't have to worry about RMDs. Roth accounts tend to be more back loaded in the retirement spending like when you're doing tax efficient retirement distributions, on average, you're going to be holding Roth assets longer than you might hold taxable or tax deferred assets. So longer window more growth opportunities, and just having all that growth be tax free and going to beneficiaries potentially as well, tax free. Potentially.

Alex Murguia 08:41
Can you make the same argument that the Roth and the HSA should be thought of in the same vein, from an investment standpoint, even though the purpose of HSA is to use it up for health related expenses?

Wade Pfau 08:51
Yeah, the HSA, well, if you're thinking to spend it soon, so maybe you're already in retirement and using it for health expenses. You may not want to be as aggressive with it,

Alex Murguia 09:03
that's true,

Wade Pfau 09:04

but yeah, if it's still a long term holding, you could think about going with more growth oriented assets. It really just depends on the time horizon you're looking at now. And to be clear about the HSA, it's not a good account to leave to beneficiaries, because that transforms it into more like an IRA, where the beneficiaries have to pay taxes on the the account, and they only have a one year window to do that.

Alex Murguia 09:30

No. And for me, I'm thinking of it more like, you know, we were talking about long term care policies in previous episodes, and you said you can get a Q LAC and have that cover it well, you know, that's where you can, kind of like, let that HSA accumulate and use it then, you know, for those kind of things. But your point's well taken. Now, somebody that is listening in, I don't know if they caught or not, could be saying, But wait, you just said in the taxable accounts, put. The equity stuff,

Wade Pfau 10:01

or tax efficient equities,

Alex Murguia 10:03

okay, yeah, tax efficient equity stuff to let it grow. You know that kind of Aren't you just making that same argument now for the Roth?

Wade Pfau 10:12

Well, these are the less tax efficient equities. So if you have, like, emerging market funds or small

Alex Murguia 10:20

you have two growth component, if you have two growth equities, you know, you know, ETF a, that's a growth one, and ETF B, that's a growth one. And, you know,

Wade Pfau 10:30

yeah. Like, you know

Alex Murguia 10:30

which one's gonna outgrow the other. You're just guessing at that point. Put the one that's the most tax efficient in the taxable and the one that's the least tax efficient in the Roth,

Wade Pfau 10:41

yeah, yeah. So like, if you have the s, p5 100 or total US market, or even total world market index funds, those lean more towards the taxable account, whereas if you have any actively managed stock funds, or you have just less tax efficient emerging markets might have more foreign taxes and things that sort of thing, lean more towards the rough.

Alex Murguia 11:04

So let's say, just so I'm gonna go. I'm using an extreme example because I want you to, you know, somebody thinking their head, hey, what about this example? Right? And it's an extreme one. Granted, I have \$99,000 I'm gonna because I don't do the math, I have 99 you know where I'm going with this. I have \$99,000 I'm gonna put 33,000 in the SMP ETF index, in a taxable account. I'm gonna put 33,000 in a mix of half REITs and half aggregate bond index, and I'm

gonna put 33,000 in small cap ETF, since it's, you know, less tax now that let's use your emerging markets. I'm gonna put 33,000 in the emerging market thing. So you have, effectively, three accounts. The taxable is holding the s, p, the tax deferred is holding income yield kind of stuff. And the tax free is holding emerging markets, and that would have been your ideal allocation anyways, 33% 33% 33% it's just you want it for whatever reason you want it held. You know that's your allocation that you want. And you those three accounts. Is that something that's recommended to that extreme? Or are you like, yeah, I don't know about

Speaker 1 12:20

that.

Wade Pfau 12:22

No, if your accounts were each that size, then you've got it all lined up. The reality is, usually you're not going to have that match that you'd like. So I

Speaker 1 12:31

agree.

Alex Murguia 12:31

Again, I want people to conceptualize this as they're listening. Yeah,

Wade Pfau 12:35

asset allocation comes first. So if you want that third, third, third, for asset allocation reasons. That's your strategic asset allocation. That's the priority of what you want to follow. And then just to the extent that you can, you line that up in the Available accounts. So you probably don't have the account size that you probably don't have, 33,000 in your IRA, 33,000 in your Roth, 33 in your taxable account. So you just lean to the direction that you can if you have \$10,000 available in the Roth Well, yeah, you'd put the less tax efficient stocks for that 10,000 the other 23,000 you'd have to decide where it best fits. It just depends. You lean in the direction of these asset location principles to the extent you have the capacity available to do so, but you don't let that guide your asset allocation. Now, agreed.

Alex Murguia 13:30

I just want people to think about this as they're listening. So that's a better option than having 33% 33% 33% of those three things in a taxable account, 33% 33% you know, in a tax deferred and then the same thing in a tax free. Now I'm going to give my answer why, and then you can fill it in. The reason that's better is, let's take the REIT example. REITs, let's say, by law, over 90% of the revenues have to be kicked out in dividends, so they themselves have tax free status. You know that goes for private REITs and public. Remember, somebody wrote in once. But so if you have a public REIT, a publicly traded REIT, and let's say you have a taxable account, and you put it in a taxable account, and let's say the return of the REIT is 10% for the year. A lot of that is going to come in the form of dividends or whatever, because they have to kick it out. And I'm just making up numbers. Now, you know whatever your tax rate on dividends is, let's say the return is 10% but because you're going to get taxed on it, you only realize that 10% seven percentage points of it. So you lost three percentage points to taxes on the return, whereas, if it was and so remember, that doesn't compound then the next year and the next year and the next year, whereas, if that was in a tax deferred account, you would receive the full

10% and not pay taxes on it, since it's tax deferred. Is that a proper assessment? Wade you want to add to that, take away from that, etc.

Wade Pfau 15:00

Yeah, yeah. That's the problem with the taxable account, is you have to pay taxes each year on interest, dividends and realized capital gains, and that's if the you may not have sold any shares. But if the mutual fund or ETF internally is doing rolling over, changing its positions, your your tax statement may show up with some capital gains, and you have to pay taxes on an ongoing basis, and so if you pay the taxes through the investment account, that money is now gone and doesn't get to enjoy future compounded growth, and

Alex Murguia 15:34

you see that with REITs. But, you know, I don't subscribe to this. I knew that this way, but a lot of folks are income, you know, retirement income investors view like dividend paying stocks as an option for income. We've talked about that at nauseam. Why that's not the most optimal, but that's for another day as well. But if you're going to do that, you know, you're not going to recognize all of those gains. You're not going to actually, they're not going to manifest in your account, because you're going to get taxed on them, maybe having a taxable account, as opposed to in a deferred account.

Briana Corbin 16:06

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 your copy of retirement researchers, eight tips to becoming a retirement income investor by going to retirement. Researcher.com/eight tips. That's the number eight tips.

Wade Pfau 16:45

Yeah, then you avoid paying taxes every year and eating into the future growth the you pay the taxes, and then that money is out of the account, and so you don't get any growth on that money anymore. That's why tax deferral can really be an improvement over a taxable account, which is then, when we talk about spending in retirement, the conventional advice, which is directionally correct, is you spend your taxable brokerage account assets first then tax deferred accounts and then tax exempt accounts. Now we can improve upon that a lot, but that general framework works because taxable brokerage accounts are generating all that ongoing taxation. So getting that out of the way first tends to give you a better outcome.

Alex Murguia 17:34

Now, if someone says, Yeah, but why am I getting rid of my higher growth assets? First, I want to get rid of those last

Wade Pfau 17:40

well, that's where then whatever your asset allocation should be, you have to start making those adjustments. So if you don't have any taxable brokerage accounts, that means your tax efficient stock funds now are held in a retirement advantage tax advantaged account, which would lean more towards the Roth to the extent you have the capacity

Alex Murguia 17:58

and and the reality is, you can rebalance in a tax deferred and tax free account without any like capital gains or anything like that. It's just executing a trade at that point. And so it's much easier to maintain your stock to bond allocation. You know, you can, well, you can do two things if you're constantly taken from taxable, but you want to be more conservative on the allocation. Guess what? You know if your taxable has the highest you know expected returning assets, it's most likely going to be equity driven. So you're you're kind of lowering your your equity allocation, but if you're doing it to the degree that you feel it's too much of an extreme, and you want to stay still with a healthy equity exposure, you still sell from the taxable, but you trade in the tax deferred or the tax free account, because you're not going to get any you're not going to be taxed on any capital gains or anything like

Wade Pfau 18:48

that. Yeah, yeah. Rebalancing, that's another problem with taxable accounts. Rebalancing is generating taxable income for you, but you can rebalance in tax advantage accounts without generating taxable income.

Alex Murguia 19:02

Okay, another

Wade Pfau 19:02

way of saying that

Alex Murguia 19:05

probably a better way too.

Speaker 1 19:06

All

Alex Murguia 19:12

right, what pitfalls do people face from a tax perspective, in retirement?

Wade Pfau 19:19

So now we're really getting into, really the justification for things like Roth conversions and whatnot, but it's the this gets into the tax maps in the chapter, and that's the the concept that Joel Sasser developed. It's how to think about the effective marginal tax rate, where, when, when you pay taxes. You're not just paying like the income tax bracket that you're in, there's all these other aspects of the tax code that can add to your tax bill, and that's what we mean by the pitfalls. Want to talk about things like how generating income can also cause social security to be taxable, how it can lead to surcharges on Medicare premiums.

Speaker 1 19:59

How.

Wade Pfau 20:00

How it can push your long term capital gains from into higher tax brackets as well, how it can lead to the loss of affordable care act subsidies, how it can lead to the phase out of below the line tax deductions. Are there?

Alex Murguia 20:14

Your your breath of fresh air?

Wade Pfau 20:17

But these are all the things that I will say

Alex Murguia 20:21

why I'm disappointed. Wait, I had on my bingo card that you would use the term Irma when you were talking about Medicare, and you failed to do that. I think this is the first time ever you have not said Irma when you when you're talking about Medicare. Damn you. Wait, damn you. I was ready to, like, go bingo and you mess me up.

Wade Pfau 20:42

But those are the income related monthly adjustment amounts, and those are surcharges on Medicare premiums when your income exceeds certain thresholds and it impacts you two years later. But,

Alex Murguia 20:52

uh, okay, so you have, you have that the Social Security tax torpedo, yeah, potentially the Irma, which is related to Medicare, and what was the last one before I started talking around? Say it again.

Wade Pfau 21:06

There are a lot more. There's not Oh,

Speaker 1 21:08

and

Alex Murguia 21:08

then fire away.

Wade Pfau 21:09

Irma, the preferential income stacking is the idea that your long term gains and qualified dividends get pushed into higher tax brackets.

Alex Murguia 21:19

Talk to me about that, because I don't think people recognize that as much as they can.

Wade Pfau 21:25

Okay, so suppose I'm in the 12% ordinary income bracket, like 12% bracket, how we usually think about things. I take \$1 out of my IRA pay tax at 12% but I also have some long term capital gains. Those long term capital gains, add on top of my ordinary income, and then apply the Zero, 15 or 20% brackets, so I could take \$1 out of my IRA, and then if that also uniquely causes another dollar of my gains to get pushed from the 0% bracket into the 15% bracket, I'm

now actually paying a 27% effective marginal tax rate on that dollar, I took out of my IRA 12% on that dollar, plus another 15% on the dollar of my long term capital gains. That's the preferential income stacking problem. And when you're doing Roth conversions and things,

Alex Murguia 22:16

walk me through the 12 what the initial 12% is for your

Speaker 1 22:20

income rate?

Alex Murguia 22:21

What's the initial and on top of the income you're paying, why are you paying that much more? I wanted to be like, like a two year old kind of

Speaker 1 22:29

thing,

Wade Pfau 22:29

yeah. So I've got, let's say I've got \$50,000 of long term capital gains. If I didn't have

Alex Murguia 22:36

any from the IRA that you're taking money out of,

Wade Pfau 22:38

yeah, this is from my tax.

Alex Murguia 22:39

But I wanted to

Wade Pfau 22:41

so if I didn't have any ordinary income, that would all fit into the 0% long term gains preferential income bracket. But now I start taking out from the IRA I have ordinary income. I'm always adding the \$50,000 on top of my ordinary income to see how it's taxed. And eventually I'll get to the point where, as I keep taking money out of the IRA, it's going to cause that \$50,000 to start to slide. So \$1 is going to slide from it no longer fitting in the 0% bracket anymore, it's going to get pushed into the 15% bracket. And that's the preferential income stacking problem. When it's binding it's I could be in the depending on how much gains I have, I could even be in the zero, still in the standard deduction, or I could be in the 10 or 12% brackets. But if I take another dollar out, so I have another dollar of ordinary income, not only is it getting taxed at that zero, 10 or 12% but it's also pushing another dollar of those gains to now get above that threshold. So it's taxed at 15% instead of 0%

Speaker 1 23:50

also,

Alex Murguia 23:50

capital gains go from zero to 15 because you took income.

Wade Pfau 23:54

So it's causing it's I pay 12% on the dollar of ordinary income, plus I pay 15% on \$1 of my long term capital gains because I took that dollar of ordinary

Alex Murguia 24:05

income.

Wade Pfau 24:07

That's the preferential income stacking problem that can lead to that 27% effective marginal tax rate, and that's one of the big spikes to watch out for on the tax map at

Alex Murguia 24:19

now is to be clear, though, if someone's listening, all right, the dollar of income, fine, that's taxed at, what'd you say, 12%

Speaker 1 24:29

all right,

Alex Murguia 24:30

but that's just 12% on that dollar. The capital gains is going to get taxed at 15% it's not going to get taxed on 15% plus 12%

Wade Pfau 24:41

Well, it really means that I'm paying an effective marginal tax rate of 27% on my dollar, because taking that dollar is causing me to pay another 27 cents of tax

Alex Murguia 24:55

on that dollar. Oh, yeah, yeah. I see what you mean. I see what you. It because you you got in the Yeah, you wouldn't have been taxed at all otherwise,

Wade Pfau 25:05

yeah, yeah, tax at 12% but it's also uniquely causing \$1 in my gains to be taxed at 15 instead of zero. Also,

Alex Murguia 25:15

yeah, so you apply that 50% on the dollar, and there you have the 27 I got you.

Wade Pfau 25:21

You got it?

Alex Murguia 25:22

No, you got it. I

Wade Pfau 25:24

love seeing that, haha. Moment when somebody Well,

Alex Murguia 25:28

I'm just playing along, like, if I understand,

Speaker 1 25:30

I'm

Alex Murguia 25:30

just moving to the next topic, to not belabor the point.

Speaker 1 25:35

But when

Wade Pfau 25:35

people are doing Roth conversions, this can be one of the common stopping points. And that's where a lot of the basic planning software out there, even from providers who talk up how they do Roth conversions, they completely ignore stuff like that. They will have tax brackets. It's like if you fill up, they say, Okay, go ahead and fill up your 12% bracket till you get to the 22%

Speaker 1 25:59

bracket.

Wade Pfau 26:00

Well, you could do that, but then you could all your long term capital gains. You have this big chunk where you're really paying at a 27% rate when you thought you were paying at a 12% rate, and if you were trying to only pay taxes at a 12% rate, you wouldn't want to fill up your 12% bracket. You'd want to stop well before then. And

Alex Murguia 26:18

do you have something that lets people have figured that

Wade Pfau 26:21

out. Well, the book talks about how to think about this with the tax maps. Now if with our retirement researcher Academy, we do have the tax map calculator that lets you see this for the current tax year and lets you plug in this is the tax rate I'm willing to pay. And then how could I consider doing Roth conversions or harvesting capital gains in a manner that would allow me to stay below that threshold of what I'm trying to manage. Wait,

Alex Murguia 26:48

it would be cool if we had something for consumers that they could like see online and run things like this for themselves, right? What did you think that'd be a good idea?

Wade Pfau 26:57

Yeah, that's what the tax map calculator

Alex Murguia 26:59

is. Come on,

Alex Murguia 27:01

man, I'm

Wade Pfau 27:01

trying to set you up. Yeah, the tax map calculator at the retirement researcher Academy lets you do that.

Alex Murguia 27:08

Yeah, okay, all right, any other pitfalls that people face from a tax perspective in retirement?

Wade Pfau 27:16

Well, yeah, there's the Social Security, there's the Irma, if we're going in order, usually social security comes up before the preferential income stacking that we just talked about. So the Social Security tax torpedo is how between zero and 85% of your Social Security benefits are taxed. And it's the same kind of idea where I could take \$1 out of my IRA, it could be taxed at 10 or 12% but it can also uniquely cause another 85 cents of my social security, for 50 or 85 cents of my Social Security to be taxed. But for most people, by the time they leave the standard deduction, they're already into the range where 85% 85 cents of another dollar of Social Security. Would be taxed. So say I'm I'm in the 12% bracket, I take \$1 out of my IRA. It's taxed at 12% but if I'm in the Social Security tax torpedo, it's also causing another 85 cents of my Social Security to be taxed at 12% so I'm actually having \$1.85 tax at 12% that's an effective marginal tax rate of 22.2%

Speaker 1 28:26

so

Alex Murguia 28:28

what do you want to do about this, to avoid this?

Wade Pfau 28:31

Well, it's like sometimes you have no control. This is about, Do I want to voluntarily generate income?

Alex Murguia 28:37

Yeah. Do

Wade Pfau 28:39

I want to take money out of my IRA, either to cover expenses or a Roth conversion,

Speaker 1 28:43

or

Alex Murguia 28:43

thinking like so people bridge Social Security, that kind of stuff.

Wade Pfau 28:47

Well, yeah, the usually it's hard to do things like Roth conversions after you've begun Social Security. Not always, sometimes, but yeah, before Social Security starts, this can be a great opportunity to do things like Roth conversions, because you don't have to worry about the Social Security tax torpedo, and that could help set you up so you're not paying tax on a full 85% of your Social Security later on, even now, if you're a higher net worth in terms of multi

million dollars, you're probably going to be paying taxes on 85% of your Social Security no matter what you do. But even someone with a couple million dollars of assets with tax planning, you're not going to pay 0% Social Security is taxed at 0% but if you can get from 85% down to 45% that can be significant tax savings 100%

Alex Murguia 29:36

and Irma, What's the broad brush on the Irma?

Wade Pfau 29:42

Yes, so Irma then comes later. It's at higher income levels, because it's now, this year for singles, modified adjusted gross income at \$109,000 for couples, \$218,000 so we are getting beyond the like middle, middle class type American.

Speaker 1 30:00

Reasons

Wade Pfau 30:00

wouldn't you have to start worrying about Irma. But what Irma does is, if my income exceeds certain thresholds, then two years later, I have to pay surcharges on my Medicare premiums. And there's five different thresholds where it can be another 1000 1500 per person, depending on which threshold we're talking about, where my Medicare premiums will go up, like if I my dollar, if, if I had an adjusted gross income of \$218,000 I just pay my standard Medicare premiums. If my adjusted, my modified adjusted gross income was \$218,001 I would have to pay my standard Medicare premiums, plus another couple \$1,000 more than \$1,000 per person, on my Medicare premiums. So it's a huge tax, effective marginal tax impact. It's a spike \$1 of income causes these big tax spikes as I have to pay significantly more Medicare premiums because of that.

Alex Murguia 31:03

And to me, this goes into the benefit of really tax planning, right? Like everyone, I mean, we're doing this these episodes. We're recording them, we're batching them in. We're doing this in 415 today, batching a few episodes. And if you get to this day and then recognize, man, I paid a lot in taxes. Obviously, sometimes that's a good thing, congratulations. But a lot of a lot of things could be structured properly with just proper tax planning. And these, these are one of these things that you don't want it to come back and bite you later. It's just simply because you weren't paying attention to it. What do you recommend for somebody that right now. Is, is, is like, did you ever see Raising Arizona, the movie Raising Arizona

Wade Pfau 31:46

I did in the 80s, and I know

Alex Murguia 31:47

there's a scene where he gets his check and he's looking at it in disbelief. And I don't know the clerk order says government sure do take a bite, something like that. So many people are probably thinking this over the past week or so. I mean, the people that are, you know, we don't want to make this, I told you so episode or Aha, you know, you should have thought about this. What could they be doing for next year, to beginning to, you know, to begin to think about this

appropriately. Obviously, there's the tax mapping, which, I guess it sounds like a plug, but the reality is, you should do that every year. You know that kind of thing, yeah? Because,

Wade Pfau 32:26

right, this works for not just Roth conversions, but also tax efficient strategies. Can blend. Like I mentioned, the conventional wisdom, you spend taxable, and then tax deferred, and then tax exempt. But the better approach is you blend. So if you're getting you're taken out of your IRA, suppose you already spent your taxable account. If you take another dollar out of that, if that's going to trigger some problem, you stop, and you cover the rest of your spending through the Roth or this is where, like things like Roth conversion, reverse mortgages, anything reverse mortgages, proceeds from a loan, non taxed income sources, things that don't add to your adjusted gross income can also allow you to meet expenses without adding to the Adjusted Gross Income and therefore not triggering tax problems.

Alex Murguia 33:16

Could this be where you have good buffer assets? I know buffer assets, you think about them for emergency reasons. But could this be a good sort of arrow to have in your qui quiver, in the buffer asset quiver for the you know, moving stuff around?

Wade Pfau 33:30

Yeah, the buffer assets that we talk about that temporary spending resources that will help you not have to sell from a portfolio when it's losing value. Those buffer assets are generally tax exempt income, not incomes tax exempt spending sources, so they don't add your adjusted gross income. It's the reverse mortgage. It's proceeds from a loan, so it's not in your adjusted gross income. If you're borrowing from a life insurance policy, it's again, a loan, so it doesn't go in your adjusted gross income. And if you just have a pile of cash, if you're not triggering any capital gains or anything because you're spending from the cash, it's a way to meet expenses without generating taxable income. So you could also use them as kind of a quote, unquote tax buffer at the same time.

Alex Murguia 34:17

All right, everyone, thank you for listening in on this week on retire with style, and we'll be signing off and we'll catch you next week as we continue down this path on taxes, taxes and

Alex Murguia 34:30

taxes, taxes, there we go. All right, everyone, catch you next week. Bye.

Briana Corbin 34:36

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.