# Episode 237: Should You Spend Your HSA or Let It Grow?

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**SUMMARY KEYWORDS**
Roth conversions, HSA strategy, annuity RMDs, tax planning, effective marginal tax rate, retirement income, financial personality, HSA spending, tax deferral, Medicare age, inherited HSA, deferred annuity, living benefit, contract value, guaranteed income.

**SPEAKERS**
Alex Murguia, Briana Corbin, Wade Pfau

**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. Wade's HSA might be quietly funding his ever-rotating glasses collection. Okay, we can't confirm that, but we can confirm today's Q and A tackles Roth conversions, HSA strategy, and annuity RMDs. Save your receipts, people.

**Alex Murguia** 00:58
Hey everyone, welcome to Retire with Style. I'm Alex, and I'm here with my good buddy

**Wade Pfau** 01:04
Wade,

**Alex Murguia** 01:06
and we are continuing our Q and A series that was spawned from the live YouTube session that we had. Right, Wade?

**Wade Pfau** 01:16
That's right, Alex. And we're recording a bit later now, so we're in the midst of the World Cup, but yeah, we're we're continuing along with that Q and A series.

**Alex Murguia** 01:24
Yeah, have you been watching the World Cup way?

**Wade Pfau** 01:26
I have been. Yeah, tell me what

**Alex Murguia** 01:28
you're in for before we get into that question. All the teams I've

**Wade Pfau** 01:31
been rooting for have been eliminated at this point.

**Alex Murguia** 01:34
Oh, really? Although by the

**Wade Pfau** 01:34
time this episode airs, I think we're just waiting for the the finals. Yeah, but you had all

**Alex Murguia** 01:38
your money on Senegal.

**Wade Pfau** 01:39
No, no, I started with Japan, moved down from there. Team US. Japan was. I

**Alex Murguia** 01:45
mean, they played. They played tough. They played tough. They didn't work out, but yeah, so it goes. So it goes. Yeah. No, we made you see the game yesterday. I mean, as of this recording, yesterday was Egypt and Argentina.

**Wade Pfau** 01:58
Yeah, I saw that. That kind of got me less excited about FIFA as an organization, but oh, you're talking

**Alex Murguia** 02:03
about the file that was the same like FIFA had to

**Wade Pfau** 02:07
fix in for Argentina to win that game. But yeah, man, the file was a

**Alex Murguia** 02:12
file.

**Wade Pfau** 02:12
He touched his toe. He slightly stepped on his toe by just one millimeter or something.

**Alex Murguia** 02:19
Well, I heard the Egyptian president put a call into Infantino, the hunt guy from FIFA, but he didn't get the same results. He didn't get the same results. That's right. All right, enough soccer. We'll continue to row like the Norwegians. All right, so we got today the we we've collected a bunch of questions today, and they're centered around tax planning, and so we'll hit on a couple of those, and we'll take it from there. Does that sound like a plan, Wade?

**Wade Pfau** 02:52
Sure does. Yeah, yeah. These are going to be more tax planning centric questions for today.

**Alex Murguia** 02:56

Okay, so let's start with the first one from Charles. Hi guys, for a long time listener, first time caller. All right, you ready? Here we go. From Charles, making a Roth conversion for legacy beneficiaries in the 24% bracket pushes my client into the 40% bracket. Oh wow! Is an advisor asking us a question?

**Wade Pfau** 03:26
That's right.

**Alex Murguia** 03:27
I didn't pick up on that at the beginning. All right, all right. Let's let's do this again. Making a Roth conversion for legacy beneficiaries in the 24% bracket pushes me into the 40% bracket, including federal, state, Medicare, Irma, net investment income tax, NIT tax, taxes, and regular taxes. Conventional wisdom is not to convert. Ed Slot recommends converting for reasons of number one tax-free growth during the client lifetime plus the 10-year distribution period after death. Number two, tax brackets are at a historical low and will increase because of the need to reduce the federal debt and the interest paid on it. Period. What is your recommendation?

**Wade Pfau** 04:15
Yeah, and and so there's not going to just be a simple answer of to convert or not to convert because you really do need to to work through the math of is it reasonable to move forward. So this individuals they're in the 24% bracket right now, but I think what the question is really saying if they start converting, they're going to be facing an effective marginal tax rate of 40% on the conversion due to not just the 24% ordinary income bracket, but the way that can push more of those long-term gains to have the net investment income tax, triggering Irma surcharges. Those are the main things they mention, and so they may be looking at a 40% tax rate. So then, saying, well, the conventional wisdom is that a 40% effective marginal rate is too high. And I don't know if that's necessarily true. I think the the question writer is correct in the sense that Ed Slot is pretty bullish on on Roth conversions, but I don't think he would necessarily endorse them in every in any case, because it really the the question is, what's the tax rate you'd be paying in that conversion today versus if you don't convert, and then if RMDs trigger taxes on those funds later, what's the tax rate you'd pay on them at that time? If 40% today is less than what you would face in the future, go ahead and convert. If paying at a 40% rate on it is more than you'd have to pay in the future, then don't convert. And that's really the question. With with Ed's last points, yeah, the the taxes may be higher in the future to help fund government debt, but we've been predicting that sort of thing for a long time. It's hard to know when it may happen or or what future tax rates would look like. Certainly, if you are of the belief that tax rates will be higher in the future, maybe it is worthwhile to do that conversion now, even at a 40% effective marginal rate. But we can't just give a blanket answer of it's okay to pay 40% or not, because it really just depends what what you'd be paying in the future if you waited, or what your beneficiaries would be paying in the future if you waited, now if you convert, yeah, anything in the Roth that goes to a beneficiary, they can now just wait an additional 10 years before they take that full distribution out. It's not taxable to them; they can reinvest it in a taxable brokerage account at that time. But if they're in peak earnings years when they inherit that those funds, they might be a lot better off receiving it in Roth form rather than IRA form. If you can pay taxes at a lower rate than they will be paying, yeah, you go ahead and convert. It's just a question of well, is if you're going to be paying at a 40% rate, is that going to be less than they will be? You mean

**Alex Murguia** 06:52
leaving it in an IRA as opposed to a Roth?

**Wade Pfau** 06:55
Yeah. Well, the whenever the money comes out of the IRA, whether I convert it now

**Alex Murguia** 07:00
or whether

**Wade Pfau** 07:00
it's inherited, and then they, if it's in a regular IRA, then they have that 10-year window where they have to take. If you're past, if you're already past your RMD begin required beginning date when you pass away, they have to take out distributions for all 10 of those years, and anything remaining has to be fully out of there by year 10. And with an IRA, with an inherited IRA, that's how fully taxable as ordinary income. So that can be damaging to to a high earning child to receive an IRA as an inheritance. That might speak to going ahead and converting, but I don't think there really is a conventional wisdom on this particular scenario of which way to go. I know for folks who have multi million dollars worth of assets, it very well may be the case that they can look towards an effective marginal tax rate, even at 30-2% or higher. 40% does seem kind of high, but if they're wealth enough, 40% might be quite reasonable to consider for Roth conversions. It's it's really just there's no simple answer to this question. You you ultimately want to think about if I wait, could I can me or my heirs pay at a lower rate in the future than that 40% style effective marginal tax rate I'd be looking at if I convert today? How could someone go about doing this analysis? Well, there there's software out there, and I learned the the tax map idea from Joel Sasser, who created Cobasum, and his software is effectively what I do in my book when I simulate like what sort of effective marginal tax rate should you manage. You test all the different options and see because it's so nonlinear. You can't just solve it mathematically. You have to really test. What if I manage a 20% effective margin rate? 22% 24% 26% Which one gives me the best outcome? And then that's kind of the answer that you come up with.

**Alex Murguia** 08:51
I'm just thinking for somebody at home could be listening to you and say and say, okay, great. So the question I should be asking is, what's my tax rate today versus what could be my tax rate in the years that I'm getting RMDs, and if my tax rate when I'm subject to RMDs is much higher, it makes sense to convert now. That that kind of Brigama, but then

**Wade Pfau** 09:14
right,

**Alex Murguia** 09:14
that's easy conceptually. But then it's like, okay, how do I now do the numbers? So COVID, but that's a that's what that's that's a B 2b software. It goes to that's so consumer, and now it stands to reason most of our listeners are not advisors. Although this question is from an advisor, what what would you recommend that they go about doing it? Besides, you know, obviously you can always say speak to an advisor and run a financial plan for this particular situation. Absent of that, how would you recommend they sort of figure it out?

**Wade Pfau** 09:48

Well, if you're not going to go down the route of creating your own software, and it took me a this was like the hardest programming challenge I've ever faced was programming this kind of lifetime solver on effective margin. Tax rates. So without that, it's back to the the rules of thumb that I've talked about on the show before, which is really if you have less than $2 million maybe even getting close to $3 million of investment assets, you could potentially get away with 12% as a reasonable effective marginal tax rate target, and then as you start getting well above $3 million you might start stepping things up. If you're getting to like closer to maybe seven or $8 million in that ballpark, you might be looking at a 30-2% effective marginal tax rate target. Gotcha. So it it's but that's rules of thumb to just help provide some guidance because actually solving this is extremely complicated and really requires good software. And most of the Roth conversion software that's out there on the market is is not doing it the right way. It's, I think, with some of these questions, we can get more into the mistakes software is making. So there is no easy answer about how to figure out what is the the proper effective marginal tax rate target? And even then, too, if you solve for that, it's still based on all kinds of assumptions. You're making assumptions about how long you live, what investment returns your portfolio will earn, and what your future expenses are. Now, if all those assumptions are right, then you can solve. Here is the effective marginal tax rate that will support the largest after-tax legacy for my assets to the extent that any of those assumptions are wrong. You may not be giving yourself the best answer, even with all the programming needed to test which gives you the best answer under those assumptions.

**Alex Murguia** 11:34
And then the second part of this question, I agree with your point, but I think there's an underlying message that it's good for our readers to hear, which which you the the second point was for doing this would be taxes are at a historical low right now, you know, and will increase because of the need to reduce our federal debt, interest paid on it, etc. How do you react in general to to to these statements, which you know they they there's they could be group, they could be, it could be uncannily accurate in so many years, or they could be off. We, we don't know, and so how do you consider these kind of variables when they, when, when they bubble up in your analysis?

**Wade Pfau** 12:20
Yeah, for the tax planning, I do tend to prefer just assuming today's tax law won't be changed. So today's tax rates, as they are set for the future, will also apply in the future. Now, there's a pretty large group of advisors out there who do talk a lot about the national debt and how taxes have to go up in the future, and often that gets linked to well, well, like just maximizing Roth conversions. Because if if you really do believe tax rates are going to be a lot higher in the future, it makes it a lot easier to justify doing Roth conversions today. But then that also is often used as a marketing ploy for life insurance as well to get the with life insurance with properly structured policies. You're not looking at income taxes on distributions from the life insurance. So it's often that kind of argument is taxes are going to be a lot higher in the future. So prepare yourself with life insurance. That that can get kind of marketing in terms of the orientation of the message. But yeah, certainly there's a good chance taxes will go up at some point in the future. I'm also thinking: look, if you're talking about a time period of roughly 10 to 20 years,

**Alex Murguia** 13:30
you could have a couple of cycles of up and down taxes. Who knows? Yeah, could go up for you know over the next administration, and then magically goes down in the one after that, and

and the music continues. So from that standpoint, it's tough to know how it's going to be when the actual moment of truth arrives. You know what what what cycle we're in, and so to your point too, it's the same conclusion, but just at the other extreme, which is it's you know taxes can cycle in and out so fast that why even play that game? Okay. Next question: We are a 50-six-year-old couple planning to both retire in 2020-six Six more months, five, five more months. We have loved your book and podcast to help us understand withdrawal strategies, we have approximately this asset profile: $2 million in taxable, 700,000 of which are capital gains, comma 3 million in tax deferred, comma 1 million in tax free accounts, comma Oxford comma, and 1 million in our house that we live in. Period. Our current allocation in total is 60-3% stocks, 30-7% bonds. Period. We expect our spending to be $250,000 for the next 10 years. Go go years. I assume that means yearly as well.

**Wade Pfau** 15:03
Yeah, yearly, and then they're saying it's higher for the next 10 years as they enjoy the go-go years,

**Alex Murguia** 15:08
and would like to use the special tax window, ages 50-six to 60-five, to reduce future RMDs and optimize our lifetime effective marginal rate taxes. We're concerned the RMD will put us in an undesirable tax bracket. How do we use your blending techniques and know how much out of each category to blend? So I think this will benefit from level setting. A couple of the concepts here.

**Wade Pfau** 15:35
Yeah, yeah. So they've got like a $7 million net worth, of which 2 million in taxable, 3 million in tax deferred. They're getting well beyond that point I talked about in the previous question. That 12% is probably not going to be their EMR target. They may be looking at you know 32 or something in that ballpark. Blending, and this is where we're getting into some discussion around blending because Roth conversions isn't the only thing you consider with tax planning. It's really about income blending and and what that is. So we can talk about this first when there's taxable investment assets left, and then second when they're because you you spend down the taxable first, or at least you're working in that direction even with blending, so then later in retirement there just may be tax deferred and and Roth accounts left. But blend it works well. Roth conversions the idea it works both ways. Roth conversions are when you spend from your taxable account to cover your expenses, and you still have some excess capacity where you could pay some more taxes at a level below your effective marginal tax rate target, and then you do a Roth conversion as a way to fulfill that. If just meet, you have to first meet your expenses before you get to even think about Roth conversions. If in the process of meeting your expenses you're already going above where you want to be, then the blending works the other way. It's you spend the taxable assets first. They generally generate less taxable income because part of that is you got the cost basis. First, you spend any interest and dividends, and then if you have to sell shares, you have a cost basis. So that's not entirely taxable, and if it's hopefully then long-term capital gains on the shares that you're selling, you're taxed at those preferential rates for that income. But if that's already pushing you higher than your effective marginal tax rate target, the blending would be cover what you can through the taxable account, but to avoid getting hit by these additional taxes that push you too high, draw from the Roth IRA to cover the difference. That's how you blend when they're still taxable assets. But otherwise, the idea is you spend taxable assets first, and then you do Roth conversions if you have spare

capacity. Now, when your taxable assets run out, lending is-I have to cover my expenses through the tax deferred account if I still have some excess capacity after doing that, which admittedly will be harder because everything coming out of that tax deferred account is taxable for the most part, unless you had some non deductible funds in there. But for most people, be mostly fully taxable. It's going to be harder to justify Roth conversions on top of that. So what may happen is, as you're taking distributions to meet your spending needs, you're already getting pushed higher, and RMDs are accounted for in this. You're already getting pushed higher than you want to be. So blending in this scenario, and this is what all this-not all, but what a lot of the software out there ignores completely, blending is: I'll take from the tax deferred account up to the the effective marginal tax rate target, and then to avoid exceeding that, I'll cover the rest of my spending through the Roth IRA. So I'm blending distributions from the tax deferred account and the Roth IRA.

**Alex Murguia** 19:00
Now, someone listening to this may say, "Wait, but if I take from the Roth, I don't know if that works out because is it better to pay a higher rate, effective marginal tax rate, on X amount of money, as opposed to taking money out, as opposed to just letting the Roth compound tax-free, and you know, being able to distribute it as such later on. But that-that's where we're back with the previous question. You need software to test this. I-I just wanted-I'm just someone is at home listening, and so they could be thinking that. So, what would be the response? I agree. I'm just kind of thinking, how should they be thinking about it?

**Wade Pfau** 19:44
That if the software told you that your optimal effective marginal tax rate target is 24, and so you're drawing from your IRA, but if you keep and RMDs are covered already, but if you keep taking more out of the IRA to meet your spending goal. It's pushing your effective marginal rate above 24% Then the math is telling you you don't want to do that. So then it is justifiable to put the brakes on the IRA distributions and cover that rest of the spending need through the Roth IRA distributions. That you can't know that without working through the the problem of solving mathematically for it, but if you have done, if you know that the target, the right target to use, yeah, it's okay to then spend from the the Roth IRA. Now, what most of the and at least consumer facing Roth conversion software does is it really just stacks Roth conversions on top of the conventional wisdom, the conventional wisdom is you spend your taxable account first, then your tax deferred account, then your Roth account, and all the consumer facing software does is look at when I still have taxable funds, should I Roth convert on top of that, and then I still even after doing that, I don't blend. I go ahead and then otherwise spend tax taxable, then tax deferred, then tax exempt. And what that does is create an even bigger window at the end of your retirement, where all you have left are Roth assets. You may not even have income to fill your standard deduction. It's really inefficient to have all of your investments only in Roths when you are paying taxes along the way to set that up because now you could be paying taxes at a 0% rate even to fill your standard deduction, but you don't have anything left to even fill your standard deduction. So you want to always be blending. You want to once all you have once your taxable account is gone. You don't necessarily want to just take all that money out of the tax deferred account. You want to take it up to your target, and then cover any remaining need for spending through a Roth IRA distribution.

**Alex Murguia** 22:01
Perfect. Goes without saying, you have all of these things set up.

**Briana Corbin** 22:04
The retirement income challenge with Retirement Researcher has already started up, and we had a great first day yesterday. But if you missed your chance to take part, don't worry. You can join the retirement income challenge waitlist so that you don't miss out next time, and make sure that you're able to join Wade and Alex. To sign up for the waitlist, head over to retirewithstyle.com/waitlist. Again, that's retirewithstyle.com/waitlist. We'll see you in the challenge next time, at least.

**Wade Pfau** 22:35
Yeah, it's just unfortunately this is complicated. We need more good consumer facing. No, no, but it's funny, right?

**Alex Murguia** 22:42
It's someone could be thinking, "Well, let them eat kick. I just don't have to have. I, I don't happen to have a Roth IRA in my back pocket that I can just use for you know to make a yeah, right? That's life to some extent.

**Wade Pfau** 22:55
Yeah, if you don't have anything in a Roth IRA, this is now we're back to the whole before you even get to this point, tax diversification. When you're saving for retirement, it's nice to have some funds in all three types of accounts, and especially with the Roth IRA, it's good to just get one set up because there is a rule that you have to have some Roth IRA open for at least five years before you could take qualified distributions.

**Alex Murguia** 23:20
That's a good point. You may want to state one more time because I I think people lose lose track of that that there is a vintage on on on a Roth.

**Wade Pfau** 23:29
Yeah, and it doesn't have to be just any Roth. You have to have a Roth in your name open for a Roth IRA open for at least five years before you can have a qualified distribution from a Roth IRA. So if you never had a Roth and you start doing Roth conversions, and so you're setting up your very first Roth IRA for that Roth conversion, even if you're 70 years old when you do that, you're going to have to wait five years before you can have a qualified distribution from your Roth. Now there's two different sets of five-year rules. I'm talking about the five-year rule that just says, no matter what your age is, you need to have had a Roth IRA open for at least five years before you're able to to take qualifying distributions.

**Alex Murguia** 24:11
Is there a difference between opened account and funded account?

**Wade Pfau** 24:16
I no right. You have to

**Alex Murguia** 24:20
fund it with something. I think you probably,

**Wade Pfau** 24:22
I don't know, you just open it, but never put any money in it. I don't know if you could get away with. I don't think we need either. This could be one of those

**Alex Murguia** 24:29
questions that I ask that we. Oh my God, we have to get back to you. At least,

**Wade Pfau** 24:32
yeah, at least put $1,000 in it or something to make sure. Yeah, I'm almost

**Alex Murguia** 24:37
curious if somebody could just like, hey, it was open. Yeah. All right. All right. Next question. I think it's an important one. This is one of these accounts that fly under the radar. They've been getting more and more press for good reason. And here we go from Megan. My question is about HSAs. Health savings accounts. I was lucky enough to say to have saved in an HSA in my early 30s, and the investment account is now over $100,000 Period. In my, I'm in my, I'm in my 50s now and in good health. Given that heirs do not inherit HSAs at a stepped up basis, comma. How should I decide when to start spending this money? It seems I could just let it grow for decades. I'm likely to live into my 90s, but the balance could be quite large by then.

**Wade Pfau** 25:35
Yeah, and so this is the the classic question of to spend or not to spend from the HSA. Good

**Alex Murguia** 25:40
problem to have, by the way,

**Wade Pfau** 25:42
and we've talked about this before. So, if you and your well, first, yeah, the the tax bill is like when a inherited health savings account is going to anyone other than a spouse. So, like if your adult children inherit your HSA, it now works like an inherited IRA, but with a one-year window. Basically, anything in the HSA comes out as taxable ordinary income within that first year. You can't spread it out over time, so it could create a big tax hit. It's not a very tax-efficient account to leave for a beneficiary. However, if you and your beneficiaries are extremely organized, you can save all your medical receipts since the time you opened your HSA. Give those to your beneficiary, and they can take anything that they have a qualified receipt to apply. They can take all those funds out without it being taxable.

**Alex Murguia** 26:40
So let me get this straight. I I know this to be the case, but I always assumed it was I can apply my own receipts to my HSA account. What you're saying there is, if I die with a big HSA account and it goes to my kids, and I have a shoebox full of receipts from the last 10 years, you know how many ice packs I bought for my knees for my whatever they can effectively turn those in.

**Wade Pfau** 27:06
Yeah, yeah, your receipts they can't. Yeah, they can turn in my

**Alex Murguia** 27:09
receipts even

**Wade Pfau** 27:10
since you had the HSA open. But if that's a big ask in terms of the organization needed to pull this off the cup, oh, you can always just

**Alex Murguia** 27:20
why? Why would it be a big organizational thing? I mean, you're keeping receipts right now. You can just have a whole shoebox, honestly, and just say, "Here you go, Junior, have at it.

**Wade Pfau** 27:29
Well, and your your beneficiary needs enough financial sophistication to follow through on what they need to do to. They can't help you there.

**Alex Murguia** 27:39
I mean, yeah, yes, okay, yes, you're right.

**Wade Pfau** 27:42
you're worried that might be like tough to pull off in practice, yeah, the compromises at some point you just start spending from the HSA. You know, the the longer you wait, the more tax deferral you could potentially get. But you know, maybe a rule of thumb is once you get to Medicare age, just as a part of transitioning to Medicare, you've decided now you'll cover your medical expenses through your HSA. That could be a compromise. And then I included this question in our tax planning discussion because you could also strategically use the HSA as part of your tax planning. We talked about blending distributions. Well, in years where your spending's high enough that it might be pushing you into high effective marginal rates, you avoid having that income by covering your health expenses through HSA distributions.

**Alex Murguia** 28:30
And especially if you save those receipts for the last 10 years, you should always have enough money. Can you really take 30 seconds just to talk about how HSAs are taxed for the uninitiated that could be hearing.

**Wade Pfau** 28:41
Oh yeah, yeah. So like, way back to the basics on HSAs.

**Alex Murguia** 28:45
Yeah, at this point, it's the only account that does this.

**Wade Pfau** 28:47
Yeah, it's give you. It has a triple whammy of tax benefits. If you have a medical health plan that qualifies high deductible plan, you can make tax free contribution or tax deductible contributions up to an annual limit; those funds grow tax deferred, and then if they're distributed for qualified medical expenses, the the distributions are tax free. So it has properties of both IRAs and Roth IRAs. It's the only kind of account that gives you tax deductions, tax deferral, and tax redistributions when used for qualified medical expenses, so it's a very powerful account to have if you qualify with the high deductible health insurance plan, which more and more people have these days because with healthcare giving so expensive, high deductibles a way to help save on premiums as well. So more and more people are becoming eligible to have HSAs, and

they started. We we looked this up. They started in in 2004 so that is a a 22 year window to have. Sounds like Megan was there right at the early stages. I know.

**Alex Murguia** 29:51
I when we were reading this question, and I saw that she did in her 30s, and she's more or less my age now. I was like, have you been around that long?

**Wade Pfau** 29:58
And and yes, 20. Years,

**Alex Murguia** 30:01
yeah. Talk about like you know an overnight success, 20 years in the making or something.

**Wade Pfau** 30:06
But but yeah, you could use it as part of the tax planning. Where if you don't want any more taxable income, cover medical expenses through HSA distributions. If you may not really be able to do Roth conversions anymore, but if you have an opportunity that you could still have more income at lower, relatively lower tax rates. Maybe cover your health expenses through the IRA distribution and save your HSA for the future.

**Alex Murguia** 30:32
No, wait-is that why I see you with like new new glasses every week? More receipts? That'd be the

**Wade Pfau** 30:41
dog wag the tail of the or the

**Alex Murguia** 30:43
tax tail wag fashionista. No, that's what it was.

**Wade Pfau** 30:50
Yeah, save all those receipts, and otherwise, there's no specific rule other than maybe as a compromise. Start getting more serious about using your HSA to cover medical expenses. Maybe Medicare could be the trigger for. Okay, now it's time to start using that HSA, and that can give you a balance of getting deferred all these years, but still not having a huge HSA balance at the end of your life.

**Alex Murguia** 31:18
Okay, and we'll do one more question and call it a wrap for for this episode. Part of my IRA is in a deferred annuity with a lifetime income rider, and another part of my IRA is invested directly in stocks and bonds. Period. I don't intend to turn on the income stream from the annuity until I am 75. I am currently 70 and will start RMDs in three years. If I don't have adequate resources for the RMDs in my regular IRA, I will have to turn. Will I have to turn on the annuity income? Income. This will reduce my monthly income from the annuity for the rest of my life,

**Wade Pfau** 32:03
and so yeah, you have to pay when RMDs begin. You pay them on your investment balances in the IRA as well as the the contract value in that deferred annuity. And if using IRS rules, it's

determined that the benefit, the living benefit is 20% worth more than 20% greater than the contract value. You may have to pay RMDs on that living benefit's actuarial present value as well.

**Alex Murguia** 32:34
Walk walk me by what you mean by contracted value because I think that you know when people think about their balance in an you know an investment account, you have a balance. You see your statement, etc. I think that's something that people should understand as you're laying down the foundation for this question. What does the contract value mean?

**Wade Pfau** 32:50
Yeah, so we're talking about deferred annuities in this question. So not COs, not income annuities. You did not exchange a lump sum for a guaranteed income. Instead, you've put a premium into an account that you can manage. Whether it's a traditional variable annuity where you choose investment sub accounts, or whether it's a fixed index annuity or registered index linked annuity, it has the the contract value is just the the value of the assets. It's just like an investment balance, but inside of the annuity. That's what I mean by contract value, and you'd have to pay RMDs on that when you get to RMD age. So indeed, this the question is: I have a living benefit, but I don't want to turn it on until later. If the RMDs due are greater than this. Most of the account must be in the annuity. I must not have a lot of investments outside of the annuity. So, if the RMD due is greater than the amount of investments I have in the account, will I have to liquidate part of the annuity to cover the RMDs? And the answer is yes. You would have to do that. Now, you may not have to turn on the guaranteed income. You may be able to take a non-lifetime withdrawal, and many of these deferred annuities will have rules around. Often you can take up to 10% of either the initial premium or the remaining contract value as a free surrender. So there's no surrender charge on that, and also it doesn't force you to turn on the lifetime income, but it would lower the the contract value. It's a distribution, and so then there would be a further rule about how the guaranteed lifetime income would be proportionately reduced to account for this non lifetime distribution. So you may not be forced to turn on the lifetime income, but you will be forced to accept a lower guaranteed lifetime income if you have to take a withdrawal from the annuity balance, whether or not it's a part of the guaranteed lifetime withdrawals. So yes, strictly speaking, this is a legitimate concern that yes, you may have to liquidate part of that. To cover the RMDs, however, I would point out, you know, Moshe Maleski has done this research about how generally, when you have living benefits, you want to start the income sooner rather than later, because you're just spending your own money when the contract value remains. The annuity company is only on the hook to pay you when you fully spent down the contract value to zero, and so the way you get the most economic value out of the annuity is spending as much as you're allowed to get that contract value down to zero as soon as possible. So the strategy of waiting until you're 75 to turn on the the living benefit may not necessarily be the the best strategy for you. Often there's roll-up rates and things to try to encourage people to delay and defer. But Moshelevsky Malevsky did that study where he really demonstrated in most circumstances, take income as soon as possible is the answer for how to work with your.

**Alex Murguia** 35:55
So just to make sure people understand that concept is is you know when you have this annuity, you're paying for the insurance of if the underlying investments go sideways. You know, if the underlying investments go sideways, then you can annuitize. Then the whole thing becomes

annuitized, so you get the guaranteed income. And you're kind of saying, you're kind of almost like saying something that people may think, wait, wait a second. You know what I mean. You're saying the hell with the actual investments to some extent. Tap into the the income as soon as you can.

**Wade Pfau** 36:31
Right. Yeah. Yeah. This is part of the whole thing about like people worry about annuities have a higher fee drag and things, but if you're using them efficiently, the whole idea is to spend it down to zero as soon as you can, because then the insurance company is paying you with their money instead of you spending your own money. If you're paying for this living benefit, but you don't turn it on, or you you defer turning it on till 70-five, you may be getting to the point where you're never actually going to be able to spend on the contract value.

**Alex Murguia** 37:02
What about the argument in a in a in an annuity that's pegged to some index or or whatnot? And they said, "Well, don't you want the index to go up? Because if it goes up year after year after year after year after year, that's that's a greater value.

**Wade Pfau** 37:16
Oh, sure. Yeah, if markets do great and the contract value never runs out. Sure, that's good. It's just most of the time the payout rates on annuities are pretty aggressive in terms of if you're taking the full allowed amount, it's really hard for the markets to go high enough to avoid depleting that account balance by the time you get to your kind of late '80s or early '90s.

**Alex Murguia** 37:44
That's right. I just want people to think through this. Yeah, like with

**Wade Pfau** 37:47
a, especially if the annuity has step ups. If the contract value goes up, you get more and more income out of it, so it doesn't necessarily delay the date that the account would run out of money because you're aggressively increasing the amount you're allowed to spend, along with the growth of the account, and eventually that'll catch up, and the account will get spent down. The

**Alex Murguia** 38:07
other thing with this question that I don't want people to get hung up on is the term deferred annuity, and you you started throwing out a fixed indexed annuity and the like. The

**Wade Pfau** 38:17
kind of deferred, yeah, yeah, yeah. The deferred annuities means now we go back to those annuity episodes. Yeah, or deferring, and that's not to be

**Alex Murguia** 38:25
confused with deferred immediate annuity. Yeah, right.

**Wade Pfau** 38:28
Right, deferred has two meanings for annuities, but in the context of this question, a deferred annuity with a lifetime income writer, what deferred means is you're deferring the decision to

annuitize the contract, so it's not. It means we're not talking about income annuities, single premium immediate annuities, or deferred income annuities, which uses the deferred word in the other way. We're not talking about those. We're we're talking about any annuities where you've not annuitized the contract. Could be a fixed index annuity, a multi-year guaranteed annuity, a registered index-linked annuity, traditional variable annuity,

**Alex Murguia** 39:05
and the final piece is, what does annuitize the contract mean?

**Wade Pfau** 39:10
Annuitize is where you formally sign the contract to convert the value in the annuity into a guaranteed income stream, whether over your lifetime or for a fixed period, but it convert and it create it removes the liquidity and it yeah

**Alex Murguia** 39:25
and it's very possible to own one of these and never annuitize.

**Wade Pfau** 39:29
Well, yeah, and what the living benefit does, it's kind of like a technically when your contract value gets to zero, you're annuitizing. Although there's nothing left in the account anyway, so that's where you can kind of say it never annuitizes, but but yeah, the living benefit guarantees that you can continue to spend a fixed amount every year, even if in the process of doing that you've spent down the entire contract value within the annuity. So the insurance company is on the hook to keep paying you. In situations where you lived long enough, and/or just market returns are bad enough that you've outlived the underlying contract value of your annuity, and there it is. And yes, and you do have to pay RMDs on that. And if you don't have any other funds to pay the RMDs, well, so I was I'm working on something with Michael Finka. the The RMD due on a deferred annuity with living benefit can really never be higher than what the the benefit of the annuity is, even if the payout rate's really bad. Actually, this said this wrong to you before the show, even if with a really low withdrawal rate, that's going to reduce the fair market value of the annuity at the same time. So you can never really have a situation where the RMD from an annuity is greater than the the payout rate your the the income you're receiving from the annuity once you've turned on the living benefit. I guess the issue here is you wanted to defer turning on the living benefit. If you don't have any other assets to cover the RMD, you would just have to liquidate from the annuity to cover that RMD.

**Alex Murguia** 41:12
There it is again. All right, Wade. Thank you for that. We'll continue our series on the Q and A's that we had from our Retire with Style YouTube live session, and we'll see you folks next week. Thank you for listening in.

**Wade Pfau** 41:29
All right, thanks everyone.

**Briana Corbin** 41:31
Wade and Alex are both principals of McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's Virginia, the opinions expressed in this program are for general informational and educational purposes only, and are

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