

Episode 248: Are You Doing Roth Conversions the Wrong Way?

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Roth conversion, Tax planning, Retirement income, Effective rate, IRMA thresholds, HSA receipts, Social Security, Survivor benefits, Annuity ladder, Buffered ETFs, RMD management, Legacy planning, Tax brackets, Marginal tax, Asset allocation

SPEAKERS

Briana Corbin, Alex Murguia, 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. Pay taxes on the money, then taxes on the taxes, and then taxes on those taxes. Alex asked Wade when it stops. Wade's answer: Never. It's an infinite loop. That and more Roth conversion math in episode 248.

Alex Murguia 01:00

All right, so here's one little lighthearted one here. I hope we can see the benefits of joining your site and using your tax calculator. Does it show how to take withdrawals to minimize taxes? And here, this gentleman's referring, or this lady is actually referring to our retirementresearcher.com membership site, where we have lots of tools like the RESA, the funded ratio, tons of workshops, courses, etc. And on that we have the tax map calculator, which we will be doing a challenge in the coming months. So keep an eye out for that. The same way we do the retirement income challenge, we'll be doing a tax planning challenge for the upcoming year. Yeah. Wait. You want to answer this question now specifically?

Wade Pfau 01:44

Yeah. Yeah. Just we haven't set up the registration page yet, but just keep watching because it'll be coming the first week of November. We're planning to do a retirement income challenge with the tax map calculator, and just like in the past, you've had access for a week to our funded ratio tool. You'll have access to our tax map calculator, so you can check it out for yourself, and then specifically with the question, does it show how to take withdrawals to minimize taxes? That's not the the exact reason we created it, but yeah, you could use it that way. It's it's going to develop a map that shows you the effective marginal tax rate you'd pay on each dollar of ordinary income you distribute, and each dollar of preferential income you distribute, which is the long-term capital gains or qualified dividends. And so, the way you'd use it to answer this question is to show how to take withdrawals to minimize taxes. It's like, okay, I still need money to meet my expenses. Let's look at where I am right now with my income sources, what do I?

Where do I want to withdraw from to cover the rest of my expenses? Do I want to withdraw from my taxable account, from my IRA, or from my Roth? It would let me see. Here's the tax implications, including all the the tax impacts, the Social Security taxes, the Irma surcharges from Medicare, the preferential income stacking, the phase out of deductions-I feel like I'm forgetting something. But all the the Affordable Care Act subsidies, all those different aspects of the tax code, would it would I be taxed too highly by taking it from my IRA? Would I rather take it from the taxable account, or if both are going to get impacted in a pretty significant manner. Would I rather take it from my Roth? And so, in that regard, it would help you figure out where to draw from. Well, I guess always taking from your Roth would be the way to minimize taxes, assuming it was a qualified distribution. But to to be more smart about lifetime taxes, should I figuring where to take it from? If that's a reasonable, effective marginal tax rate to pay on those funds, I might take it from a taxable source. If I'm already at too high of effective marginal tax rates, I might want to take it from a source with less taxes, and that's how you could use the tool to help quote unto help minimize your your lifetime tax bill. Because again, always Roth would minimize taxes for the current year.

Alex Murguia 04:08

Good. All right. In considering large Roth conversions early in retirement, how do I figure out how much to leave in the tax deferred account to take full advantage of the married filing jointly standard deduction and the 10 and the 10% Fed bracket.

Wade Pfau 04:28

That's a good question. So you can. This is going to be very hard to like because every year your investments are going to grow or shrink depending on market returns, so you can't really plan this out exactly over your lifetime, but you can get a sense of like the current tax year, what that would look like. What other income sources do you have outside of the IRA? And then, if if you think about well, what's the RMD rate at age 73 or so? 25, whatever year your RMD start, applying that rate to the current balance of your your IRA would tell you what that RMD would have been this year, and then you can see you can figure out well, usually like roughly an IRA of about \$500,000 would be at roughly. I mean, we have to do this roughly because every year is different. But, but roughly, that would get you to where your RMD would fill your standard deduction, and then to also fill the 10% bracket on top of that, you just look at well, how much income could you have? Divide that by the RMD rate, and that would tell you how big the IRA can be to fill that level of income, and that would give you a sense of what it looked like this year. And if you're talking about well, planning ahead for the 10 years from now, it's hard to know how your investments will do over the next 10 years. But that would be how I could how you'd roughly start thinking about. You don't necessarily want to do Roth conversions to limit your IRA down to zero, because if you don't have any other income sources, you're then going to be wasting your your standard deduction subsequently. So this can be a useful tool in practice to to help calibrate how much do I want to have left in my IRA. And yeah, you can go through the math to find this more precisely, but roughly speaking, somewhere in the ballpark of \$500,000 is going to get you to levels where your RMDs would fill your standard deduction, and that's the the classic standard deduction. The right now we have through 2028 the age 65 plus bonus deductions. I'm not talking about those, but those are currently legislated to phase out after 2028, anyway.

Alex Murguia 06:47

Okay. So here we go. The next one. I was wondering if it is a good or bad idea to use shoeboxed HSA receipts to pay Roth conversion taxes, or just pay them from pre-tax account if you have no other way to pay them.

Wade Pfau 07:06

Uh huh. Yeah, I've been actually thinking about this recently. Right. So we're talking about the HSA. You've had the HSA, and then you have qualified expenses, but you don't want to take them the current year because you'd rather have your HSA growing tax deferred and tax exempt, so you save those receipts, and then you can apply them in a future year to get the money out. So yeah, you. I haven't done any research specifically about this, but it is something that kind of came across as worth considering. Yeah, one way you could use those that HSA is wait till the year where you do a big Roth conversion, have a big tax bill, but then you're not forced to pay the taxes out of your taxable brokerage account or your IRA. You instead take advantage of those receipts that you've been saving to take those funds out of your HSA that year and use those funds to pay the tax bill, I think there's potential for that to be a pretty reasonable way to think about things. Is one potential way to be more strategic about how to get the most value out of your HSA.

Alex Murguia 08:15

Okay, go to a previous question here, and folks, keep on writing them in. We'll we'll get to everything. If you have a question, we see we've got about 60 people on. If you have a question, just throw it in there. We'll we'll get to them. We'll make sure we get to them. And we're doing pretty well, I think, here as we're going down this list. So I know that whatever we don't get to, we'll just dedicate future podcast episodes to.

Wade Pfau 08:39

Yeah, we'll we'll.

Alex Murguia 08:40

So feel free to type them in. They're they're actually great for us to hear what's happening on the you know on the front lines, if you will.

Wade Pfau 08:47

And on the podcast, we've had a lot of Q and A sessions. But right, we'll just any questions we're not able to get to in this live session now, we'll record a Q and A episode for the podcast and make sure we get through all the questions that have been asked.

Alex Murguia 09:01

So here's one. Towards the end of each year, I have been filling in the most. I've been filling in most of the gap between my taxable income and the first Irma threshold with a Roth conversion. The 2026 threshold for filing single is 109,000. My question is this: What is the risk of using the 2027 Irma threshold that will be announced in early November to determine my 2026 taxable income? Since my 2026 taxable income doesn't impact Irma until 2028, is it safe to assume that the 2028 brackets won't be reduced below those of the 2027 threshold.

Wade Pfau 09:45

Yeah, that's like an assumption we make with the Irma planning. Is traditionally the Irma brackets increase here by the same inflation rates that increase all the other tax brackets as

well, except for the very top Irma. Bracket at the 500,000 or 750,000, but like the first Irma, first, second, third, and fourth Irma brackets, all increase by inflation each year. So this year it's \$109,000 based on your income from two years prior. In November, we'll we'll learn the 2027 numbers are probably going to be in the ballpark of 112,000 for a single person, and then November of 2027, we'll learn the 2028 amounts. They're probably going to be in the ballpark of 112,000 in 2028. But we don't won't know for sure until the numbers are released. So the the question is just stating like if I want to get as close as possible to those 2028 thresholds that will apply two years from now. What do I do? And so, the most of the discussion around Irma is you just assume the current year brackets will apply in two years. But no, I think you know if you're comfortable with the assumption Irma brackets won't decrease. This is the problem. Congress could always pass a law to change the Irma brackets and throw everything out the window, but historically Irma brackets don't decrease. I don't think we're going to have deflation in the next two years. It's probably safe to assume that the 2028 bracket is going to be larger, at least the same or larger than the 2026 bracket. Likewise, it's probably safe to assume that the 2028 bracket will be at least as big as the 2027 bracket, and so therefore, if you want to tweak a little more Roth conversion out of when you get those 2027 numbers in November, I think that's perfectly acceptable to do.

Alex Murguia 11:42

Let me do here. Go to the live one. Evaluating large Roth conversions by bracket filling over time versus large upfront conversions, one to three years. How do you best evaluate it? And they're using a brokerage account cash to pay taxes.

Wade Pfau 12:05

Okay, so the question is basically: Do I just gradually do Roth conversions over a longer period of time, or do do I just get it over with in the next? What's the

Alex Murguia 12:14

concept of bracket filling weight? So just to make sure, but bracket filling

Wade Pfau 12:18

is the whole: do I want to fill the 12% bracket or the 22% bracket, and it's already come up today. That's not the right way to think about it. Please don't just fill tax brackets. You want to pay attention to the effective marginal tax rate on each dollar of income, and the effective marginal tax rates you pay can be quite different from the tax brackets. The tax brackets are just the beginning. Then you have the Social Security tax torpedo, the Medicare surcharges, the preferential income stacking, the phase out of below the line deductions, the Affordable Care Act subsidies, and I feel I always feel like I'm missing something. Well, the net investment income tax. I think those are the main ones. You want to see how all those things interact, so it's not just filling tax brackets, but then you do this gradually over time, or do you front load it? The answer to that really just depends on what's the best effective marginal tax rate for you to be managing, and the idea of getting it all done quickly was a concept that Larry Kalakov wrote some answers about with his Maxify software, but then when I ran the same cases he was talking about through my own tax map calculator code that I wrote, I was getting pretty similar results as him. Which is, it's just doing it quickly means you could have you could target a higher effective marginal tax rate, which gives you a lot more capacity to move a lot of money to the Roth more quickly, I think a lot of folks, though, who maybe have even one to two to even potentially \$3 million of investment assets, might be able to get away with just managing a 12%

effective marginal tax rate, which would potentially then allow for doing it more gradually over time. But there's not there's not going to just be a simple answer of should I do it quickly in the next few years or should I spread it out over a longer period of time, because the answer to that is just simply what's the best effective marginal tax rate for you to use a a higher rate which would have you do it quickly or a lower rate which would have you spread it out over time and there's not going to be a simple answer. It's every case is different. You really need to look at this on a case by case basis. Now, when you say that, what's your best marginal tax rate? And I'm trying to put myself in the in the situation of the listener who just you just heard the response. the The response I got generally was, "Hey, look, you don't know because you have to figure out what your effective marginal tax rate is. What happens if someone says, "Well, well, what what does that mean conceptually? Why does it matter? You know, because I I think the concept is one extra dollar of income is taxed at blah blah blah. I I think that's the key, and I I think explaining why.

Alex Murguia 15:00

That matters helps them realize what what kind of break even maybe the wrong word but what is it that you're looking at?

Wade Pfau 15:07

Yeah, you're trying to to spread out pain kind of consistently at the lowest possible tax rates over your lifetime, and so if you don't if you don't have like when we start talking about higher higher than 12% targets, you need more investment funds for that to be worthwhile. Because if you say just have a million dollars in your IRA and maybe have a couple \$100,000 of other assets, if you target at a higher tax effective marginal tax rate higher than 12% if you may like 22, 24% you might end up Roth converting your entire IRA, and if you don't have a lot of other income sources, that's where you get into the problem of you might be wasting future standard deductions if you don't even have enough taxable income to fill your standard deduction. So the answer is usually not to get your IRA balance all the way down to zero. Some RMDs can be helpful because you can pay taxes at a low rate on those if you just don't have a lot of investment funds at that point. So that's where you wouldn't want to overdo it. You wouldn't want to empty out your IRA too quickly because you end up paying at a higher tax rate now and then wasting the ability to pay at a potentially even 0% tax rate in the future, so that's where then if you have like up to \$3 million, maybe managing 12% will work out better for you because it won't get everything converted out of the IRA, and then when RMDs begin, you might your RMDs might still be in the 12% bracket, and so still working out. Maybe at that point, you're managing. I don't want to exceed that first Irma surcharge. That can be a practical constraint in those scenarios. Or if you really don't have that much funds, this may be putting you into the Social Security tax torpedo. Or you might manage up to where your long-term capital gains would be getting, or your qualified dividends would be getting pushed into the 15% bracket, so it's hard to speak generally about what you're going to want to target. But the idea is, I think 12% can work in a lot of cases, and that's not filling the 12% bracket. It's managing a 12% effective marginal tax rate to just make sure you don't overdo it with your Roth conversions and set yourself up to not having money to convert, or not not to not having money to even fill your standard deduction later in life. If

Briana Corbin 17:32

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Alex Murguia 17:56

All right, wait. There's a question that just came in, and I think it was the first question we answered, and I get the sense that maybe this person didn't pick up on it, and so I want to make sure they get this question answered because I think it came in even a couple times in the in the pre-show, and so unless it's the same folks having different folks having the same issues, my ex husband just died. We were married for 26 years, divorced.

Wade Pfau 18:24

Yeah, that's exactly what we've answered.

Alex Murguia 18:27

All right, he remarried about 20 years ago. I remarried in 2012 at the age of 61. Can I collect his social security? I just want this person just to be like, you know, okay, here you go.

Wade Pfau 18:39

Yeah, and this one, since you remarried after the age of 60, you would not have been eligible to get an ex-spouse spousal benefit. But now that your ex-spouse has passed away, you are eligible to pop off to get that benefit if that's larger than you'd otherwise be getting. And you just need to take proof of that marriage lasting at least 10 years to the Social Security, make an appointment with the Social Security Administration office. You have to do those survivor benefits in person. And yes, yes, because you remarried after age 60, you're eligible to get a survivor benefit from your ex-spouse. Okay. Here's another question regarding building a bridge to social security and having assets that can be used if needed to help manage S O R

Alex Murguia 19:30

R. What are your thoughts? Sorry, sorry. Yeah, sequence to help manage sequence of returns risk. What are your thoughts on using a ladder of three-year MIGA annuities? And MIGA is multi-year guaranteed annuity. Think of them as like CD ladders from bank, from insurance companies instead of banks. I like the aspect of being able to do a 1035 exchange at the end of the three-year term if I do not need the money. Excuse me. Which pushes the taxable earned interest down the road. Can I help minimize income for Roth conversions during these lower income years prior to Social Security and pension?

Wade Pfau 20:14

Yeah, so I'm assuming this person's 67 and they're thinking about delaying Social Security to 70. So they're thinking about a three-year social security delay bridge, but then the the tweak on this question is really they're thinking about having like a buffer asset bridge. So

Alex Murguia 20:31

yeah,

Wade Pfau 20:31

would it make sense to have a three-year MIGA ladder that I just won't distribute from if my portfolio is doing fine, but it's kind of there as a buffer asset? I could spend those funds if my portfolio is in trouble, and then if my portfolio is doing fine, I can just defer the interest on that,

have less taxable income, and that opens up more capacity to do Roth conversions. Yeah, I think that sounds fine. I don't have any critique, or think you're thinking about it the right way.

Alex Murguia 21:02

Yep. Let me just give me one second. Just okay. Since I'm already here, is it? You see what I'm saying? You you have it on the same thing. I don't know how to read that one.

Wade Pfau 21:24

Well, there's I think maybe the next question on the list is the same Heckam versus Helox. I don't know if it got reaked, but yeah, we can skip that. We've covered it already.

Alex Murguia 21:34

All right. What is the role that buffered ETFs play in different retirement phases? Can they serve as an alternative to some annuities?

Wade Pfau 21:45

Yeah. So buffered ETFs are those structured returns that have a corollary or parallel with fixed index annuities or registered index-linked annuities. They take away some of the downside risk through using financial derivatives, but then to pay for that, you don't get the full upside market exposure at the same time, and and so when you compare those two annuities, the big difference is with the annuity you can add lifetime income provisions. Either you can annuitize it, which is rare, or you have a guaranteed lifetime withdrawal benefit, which can support guaranteed lifetime income, but you could also just treat those as part of the asset allocation. I've done research around the idea that like a fixed index annuity can play a pretty powerful role as a bond fixed income alternative in a portfolio, because you don't have the interest rate risk of if interest rates go up, you don't have capital losses. You're getting some return between 0% and the cap rate. It's tax deferred. It could be pretty competitive against other bond options. So in that regard, the buffered ETF could play a similar role. And yeah, it could serve as an alternative to either a fixed index annuity or a registered index linked annuity, with the caveat of you're not really thinking about those annuities for lifetime income. You're only thinking about their role in providing a structured return to the portfolio. So, so yes, they could potentially play an alternative, provide an alternative option in that asset allocation mix, that structured return where you're cutting off downside risk in exchange for not getting full upside market potential can have a positive impact on the efficient frontier asset allocation getting the highest risk adjusted returns from your portfolio.

Alex Murguia 23:36

Okay, and how are you feeling so far away? Doing the homes good,

Wade Pfau 23:42

yeah,

Alex Murguia 23:43

right. So here we go. If there are insufficient brokerage assets to cover taxes on Roth conversions, should we pay for the taxes out of pre-tax when there is significant risk of widow of widow penalty, large age differences.

Wade Pfau 24:04

Yeah. So the question is, like, I'm doing a Roth conversion. The general suggestion is you pay for the taxes by selling more shares from your brokerage account. What happens if you run out of the brokerage account? I've heard there like some people say you should never pay the tax bill from the IRA, but I find in all the testing I've done, it's not a problem. You can just pay the, assuming you're at least 59 and a half, so that there's no 10% penalty. I don't see any issue with if the Roth conversion is the right thing to do. It's okay to also pay the tax bill out of the the IRA, but you you do have to. It's a little bit harder mathematically because if you're trying to precisely hit a target for taxable income, you can't forget about the fact that you have to pay the the tax bill. Other than if it's at the end of the year and you have till January 15 for your estimated taxes. You could pay the tax bill in the following calendar year to keep it off of this year's, not having to take that additional distribution. My point is, if you have to take an additional distribution from the IRA to pay the tax bill, that's more taxable income that you have to account for when you're deciding how much to Roth convert. But given that caveat, if you're paying attention to that, I don't have any issue with paying tax bills from the IRA itself.

Alex Murguia 25:27

Okay, and Wade, this is side question. So, if you know you have to take income to pay the taxes from the pre-tax money, right? Then you're going to need a little more income to pay the taxes, and then a little more income to pay the taxes on those taxes.

Wade Pfau 25:44

Yeah, it's a yeah,

Alex Murguia 25:46

and then a little more income to pay the taxes. When does it stop, Wade? Huh?

Wade Pfau 25:51

It's an infinite loop, and there's a yeah, yeah. So how

Alex Murguia 25:54

would you recommend? No one asks, but it's it comes up. You know, how do you recommend someone like account for that infinite loop of income,

Wade Pfau 26:02

that's the biggest problem around programming this because there's a simple formula. If you have a fixed tax rate, like constant tax rate, you can figure this out: one divided by one, or the amount divided by one minus the tax rate. But with these with these tax maps, they're all over the place. The tax rates are always changing, and you get the Irma spikes and everything else. So it is. This is like the hardest part of trying. It's probably why there's not a lot of do-it-yourself tax map calculators out there because the programming. I wonder if there's a logarithm that just says, "Okay, this is good enough. Well, if you could estimate, but then if you're trying to manage Irma brackets, you don't want to be \$1 too high, or you're having a Irma surcharge. So that's where you can't really-you got to be precise. But that's the hard part of programming this stuff.

Alex Murguia 26:53

All right, all right. Oh, I didn't just answer that one. Okay, the next one. Have you ever explored annuities as a strategy to reduce RMDs? Annuities immediately remove a portion of tax-

deferred assets, and the Securities Act 2.0 allows annuitized income to count towards fulfilling RMDs.

Wade Pfau 27:17

Yeah, it's still a work in progress, but Michael Fink and I just finished writing a draft on a paper where we're calling it like the RMD shield, the where you use an annuity inside of a IRA effectively to use the guaranteed payments from the annuity to help offset RMDs on the other non-annuity assets in the IRA, and then that puts less distrib. If we're looking at a case where, you know, some higher net worth people they don't want to spend their IRA money, they have to take out RMDs, but that's really all they want to do. They don't want to take out anything more than that, and so the the RMD shield idea is, if you put part of that IRA into an annuity. The payout rate on the annuity is always going to be higher than the RMDs do on the annuity, so it reduces RMDs on the non-annuity assets, and that indeed, by using a lower distribution rate on the non-annuity assets, it allows the balance on that IRA to ultimately be higher so that you leave a bigger legacy at the end. Plus, because the account's growing over time, the RMDs actually get bigger because the account's growing. But so you have more RMD income coming out of the account, and you leave a bigger legacy at the end. And and that's all managed through using these rules around annuities, where their payment the the annuity has an RMD, but it's going to be less than the guaranteed income it provides, and the difference can then be used to offset RMDs on other assets inside that account, and it works from from our work in that area. How far away is this from being published? It's hard to say. Never know these things.

Alex Murguia 29:07

Oh, you just peer reviewed or a white paper?

Wade Pfau 29:09

White paper.

Alex Murguia 29:11

Oh, okay. But

Wade Pfau 29:11

even the white papers, it could be anywhere from a month to two years to never. It's hard to see.

Alex Murguia 29:17

Well, you seem deflated, Wade. It doesn't even seem like I think I hit a nerve or something. All right, all right. We'll have to get a podcast episode then on it specifically and scratch the the white paper. But all right, that takes us through the 90. We have some. We have a handful of questions here that we'll definitely get to in a future podcast episode. But thank you everyone for jumping in. Really appreciate the time, you know, during the day to talk about all things retirement income planning. We look forward to hearing more from you. If you have any questions whatsoever, just feel free to type them in the comments throughout. Still, we'll we'll keep an eye out for them, collect them. And we'll get them back out to you shortly. Anything else, Wade?

Wade Pfau 30:04

No, yeah, yeah. We got through a lot of the questions, but indeed, there's probably at least maybe just one more episode is all it's going to take to get through the rest, unless more questions get added. We'll we'll check back and make sure we got everything covered. But yeah, thanks everyone. Great questions today gave us a lot to talk about, and we'll we'll continue and make sure that if your questions weren't answered in today's session, we'll get them answered in a podcast episode coming soon.

Alex Murguia 30:31

All right, everyone, take care.

Briana Corbin 30:35

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