

Episode 249: Why Your Tax Bracket Doesn't Tell the Whole Story

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Tax planning, Roth conversion, RMDs, Social Security, Mortgage payoff, Tax diversification, Capital gains, Tax brackets, Effective rate, Retirement income, Taxable accounts, Asset allocation, Tax mapping, Medicare surcharges, Sequence risk

SPEAKERS

Alex Murguia, 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. One of this week's questions comes from a couple with two very different feelings about their mortgage. Alex expects they've appointed Wade as the tiebreaker. Dear Abby, but with amortization schedules, plus Roth conversions and a whole lot of tax talk.

Alex Murguia 01:00

Hey everyone, I'm Alex, and I'm here with Wade, and together we are

Wade Pfau 01:07

the Retire with Style team. And welcome to the Retire with Style podcast.

Alex Murguia 01:11

There you go. I know, right? Didn't sound right because we're not the Retire with Style. We're skipped your first

Wade Pfau 01:16

line. Yeah, yeah,

Alex Murguia 01:18

yeah. Very good, very good pickup on the grammar there, Wade. How you been, man?

Wade Pfau 01:24

Doing good, doing good. Yeah, we're back together recording again. We we do these sometimes in batches, and this is a new batch. Actually, the episode recording right now. It'll be just one day delay before it's live. The world. Yeah,

Alex Murguia 01:35

yeah, yeah, yeah. We'll be like tomorrow. So since it's Monday, we're recording today. Tomorrow's Tuesday when we release. Anything happen this weekend as we gather for the fall season, the commencing of the fall season. Apple picking pumpkin anything. We finally got

Wade Pfau 01:50

some rain and it cooled down in Texas, but there we're still far away from true fall weather with apple picking and things. But yeah, we are getting ready for the tax planning challenge. It's going to be coming up that first week in November, and we do finally have a registration page ready for that. So if you check in the show notes for today's episode, you can get registered for our tax planning challenge. It's going to be starting November 2. It's a three-day challenge. It's kind of like our past retirement income challenges, except instead of giving you access to the funded ratio for the week, you'll have access to our tax map calculator that will help you make those decisions regarding is there an opportunity to do a Roth conversion to maybe harvest some capital gains, and I'll I'll walk everyone through that process. So it's going to be November 2 to November 4, 12 p.m. Eastern time to 2 p.m. Eastern time each of those days, it's going to be a great opportunity to do your tax planning before the end of the calendar year and look for those Roth conversion or capital gains harvesting opportunities.

Alex Murguia 02:50

100% Now, two things: you dismissed me very quickly when I asked you about the apple picking, and you went right into the tax mapping. So I like I like today that you're all business, all business, all business

Wade Pfau 03:03

all the time.

Alex Murguia 03:04

Yeah, nice, nicely done. No, no, no. The tax mapping is great. One of the things we were curious is we didn't know what to call this when we were thinking about it. It can can you just talk about a little bit about what we're going to cover in this challenge? In addition to because tax mapping, what is that? But also, a lot of this involves certain financial planning tactics. You know that you use a tax mapping for not just year-end planning, but there was a Roth conversion element to it that's actually quite substantial. And we get questions all the time about that.

Wade Pfau 03:35

Yeah. So the tax planning challenge-it's using our tax map calculator, a tool we created for the Retirement Researcher Academy that we're opening up to make public for the week of the challenge, giving you an opportunity to put in your information to look for those opportunities, and well, even so, if you sign up and register, you're going to get an email. I've created a series of three background videos to help get everyone up to speed, now maybe many of our listeners don't need this, but there's three videos you can watch to help you get up to speed before the challenge. If you register for the webinar, it's on just the basics of how federal income taxes work in the U.S. and then one about tax diversification and the general properties of your taxable brokerage accounts, your tax deferred retirement accounts, and your tax exempt or Roth retirement accounts, and then a third video that just explains in more detail how required minimum distributions are calculated. So you come into the challenge with all that kind of information in your head, and then we'll walk through the process of looking at how your

your 1040 tax form is constructed, understanding it's not just about filling tax brackets. It's about the effective marginal tax rate that considers the impact not just of income on federal income taxes, but understanding the impact of income on how your Social Security is taxed, how Medicare surcharges may apply, the IRMA, the income-related monthly adjustment. Amounts, how your long-term capital gains and qualified dividends stack on top of ordinary income, and the tax problems that that can create, including the net investment income tax as well. How there are below-the-line deductions that you may be eligible for even without itemizing. A good example is that new age 65 plus bonus deduction. How those phase out with income, and then also if you use the Affordable Care Act for health insurance, how those subsidies phase out and drop to zero at a certain threshold. So we'll go into detail about how all that works, and then we'll work through a bunch of case studies. You'll have access to the tax map calculator. You can look at your own information. It's going to be a big group, so we won't look at any individual in the challenge publicly. You'll do that part behind the scenes on your own, but we'll go through a bunch of case studies so you can better understand and interpret what you're seeing with the tax map calculator to look for those opportunities to voluntarily generate income and pay taxes because you deem that to be useful from a long-term perspective to get the most after-tax spending and and legacy from your asset base, whether that's by doing a Roth conversion or by harvesting long-term capital gains. Hint: when you can do that at a 0% tax rate, might be worthwhile to do. Just we're going to really work through that process. That's what the tax planning challenge is all about.

Alex Murguia 06:24

That's great, Wade. That's good stuff. And again, why we're doing it at this time of year because it's around this time of year where you do tax planning for the upcoming tax season. And when you can actually, you have enough time that you do the planning. The planning signals something. There's still enough time, usually, for you to actually act upon it before the year end. So it's a great time from a you know window perspective to begin to look at this.

Wade Pfau 06:52

Yeah, by December 31, you'd need to do any of this Roth conversion or capital gains harvesting to get it counted on the the current tax here.

Alex Murguia 07:01

Okay, that's great, Wade. And so, in that vein, we have some Q and A's from the last YouTube live that actually center around taxes. So let me hit the let me serve them up and watch you hit it out of the park, Wade. What do you think?

Wade Pfau 07:16

Yeah, right. In honor of that registration page now being available, we thought this would be a tax themed episode. Many questions have come in, and so I've been sorting them to try to create themes for episodes. So this is going to be a tax centric episode.

Alex Murguia 07:31

All right. Like to say, death and taxes. Hey, death and taxes

Wade Pfau 07:37

inevitable. The

Alex Murguia 07:38

good news: you're going to die. All right. Which Roth conversion strategy is generally better for a 60-year-old? 15-year full conversion, ages 60 to 75, convert all assets into a Roth in equal amounts over 15 years within the 12% tax bracket. 10-year target conversion ages 65 to 75, 0% effective tax rate after standard deduction ages 60 to 65. Wait until 65, then convert enough over 10 years within the 12 percent bracket, so that the remaining pre-tax balances won't trigger RMDs above the 12 percent bracket starting at age 75.

Wade Pfau 08:23

Okay, so two strategies were proposed, and the the biggest difference between them, if it was hard to catch that all when listening, one strategy was aiming for so 60-year-old, do I want to gradually spread out Roth conversions over the next 15 years, or the the second strategy was: Do I want to not do anything for the next five years and enjoy a 0% tax rate, just kind of messing with my standard deduction, but then do a more targeted Roth conversion between ages 65 and 75? Now to answer that, I don't know that there's elements of this may not be. There's more to think about, but generally speaking, if you have Roth conversion opportunities, I think it's better to get started sooner rather than later. So the first general point would be, you don't necessarily want to be using not going above your 0% tax bracket, i.e. your below the line deductions for the next five years, if you have opportunities where Roth conversions may help, you probably should get started more directly right away. That being said, though, the the strategy that spread things out over 15 years had had you Roth converting your entire tax deferred account. That may not always be a great idea, but it really depends. And with a lot of the questions today, we don't have enough information to give definitive answers. Do you have other income sources? Because what you don't want to do is Roth convert money that ultimately would you'd have a small enough IRA balance, and you don't have other income so that RMDs would still be inside of your below. Line standard either if you're itemizing or just your standard deduction, that's a 0% tax rate. And if you're not able to fill a 0% tax rate with RMDs, you needlessly Roth converted if you were paying taxes in the 12% rate, for example, when you could have just waited and paid taxes at a 0% rate. So you don't necessarily want to Roth convert the entire account? The general goal is Roth convert enough so that at least your RMDs are going to fill a standard deduction. Now, in this case, if there is other income so that your standard deduction's already filled, well, then it might make sense to go ahead and aim for Roth converting the the entire amount. But that's I can't can't say one way or the other, and then also this this question the the 15 year conversion said like spread the Roth conversions equally, so that for the next 15 years you're somewhere inside of the 12% bracket. First of all, it's not it's not just filling up the 12% bracket. That's what the tax planning challenge is really going to emphasize. You don't just fill tax brackets. Maybe you can target a 12% effective marginal tax rate, but there can be things that happen in the 12% tax bracket that would cause you to pause and stop. Such as if you start pushing your long-term capital gains from the 0% to 15% bracket, suddenly you're in the 12% bracket, but it's really a 27% effective marginal tax rate. Or later on with Social Security, if you can avoid the Social Security tax torpedo, it you might stop before you fill the 12% bracket. But otherwise, if there's no constraint, you should go ahead and be filling that 12% bracket at that time, because then that might get you later on. Instead of spreading this out equally over the next 15 years, maybe in 10 years you finished your Roth conversions, and now you actually can have money going into the the 0% standard deduction again, or at least your other. I guess in this scenario where you want to Roth convert the entire amount, your other taxable income sources do fill the standard deduction, but you're putting less tax pressure on them by that time.

Wade Pfau 12:08

So, all that being said, I lean more towards getting started sooner rather than later, taking advantage of those opportunities, getting it done potentially sooner rather than later, but just being careful about whether you want to Roth convert the full amount of the account or not depends on if you have other taxable income sources as well, and also with the tax map calculator, it's going to show you like how much you can convert each year to get right up to the threshold of where you want to stop, and generally, it's better to be thinking in those terms than thinking, "Well, I'm going to go partly into the 12% bracket and then stop. Now, you might as well go ahead and go all the way to the end of wherever that that stopping point is. You might as well go all the way to that stopping point each year, get the process done quicker because then it can open up more opportunities to pay taxes at a lower rate later on, more quickly later on.

Alex Murguia 13:07

Yeah, it makes sense.

Wade Pfau 13:09

Okay, is there any nuance around that? Because I'm

Alex Murguia 13:15

surprised myself. I was able to follow the line, no problem. All right, next next question, part one. So there's obviously a two parter. Part one. I'm a 60 year old, just retired, 3 million in traditional IRA. Based on plan spending, we would firmly we would be firmly in the 22 to 24 percent tax bracket. I have a million dollars in just inherited in a just inherited taxable account, so 0% gain. Part two, during the income valley years before RMDs, should I draw from the taxable to limit myself to the 12% bracket? That seems like the best tax play by far.

Wade Pfau 14:01

Okay, now yeah, this is going to be a question where there's not enough information to be fully clear about like a definitive answer again, because I'm a little confused about some details when it says based on the planned spending, we'd be firmly in the 22 to 24 percent bracket. Is that because you have other income sources outside of the IRA, or

Alex Murguia 14:24

I assume that he meant because of his expenses that he anticipates

Wade Pfau 14:29

that if they're taken entirely from the yeah yeah he's going to

Alex Murguia 14:31

need to withdraw a certain amount that's going to push him into that. Let's just go with that assumption.

Wade Pfau 14:36

Yeah, so it's if I only use the IRA, it'd be pushing me into the 22 to 24% Kind of how

Alex Murguia 14:43

I read

Wade Pfau 14:44

it. Okay, and then just inherited a 1 million in a taxable account, and then with a step up in basis, that means right, you're you get to refresh any subsequent gains or any income generated by the account would be taxable, but you're getting to start over into. Terms of there's no embedded capital gains, so you can spend from that at a relatively low tax rate. Okay, so then during my income valley years before RMDs, should I draw from the taxable to limit myself to the 12% bracket? And then again, we're we're missing some there's some implied things going on. I think what he's saying, and this is what I would handle it.

Alex Murguia 15:24

Wade, why don't you set your assumptions of how you're going to answer this question? Because I think it's a valuable question. You set your guardrails, and there will be enough people listening that those will that will apply to them, and they'll get value out of it. Yeah. So I particular gentleman that wrote the question. If we got some assumptions off, so be it. Right back.

Wade Pfau 15:44

Yes. So my interpretation of the question is: Instead of drawing entirely from the IRA, which would ultimately push me into either, I guess, the high end of the 22 or even the 24% bracket, should I only draw from the IRA until I fill out the 12% bracket, and then take the rest of my spending from that inherited taxable account, which is probably not going to have much taxable income as a part of that because there's not going to be embedded capital gains.

Alex Murguia 16:11

Exactly.

Wade Pfau 16:12

Yeah. Well, we don't have all the information, but yeah, I think thinking in those terms sounds reasonable because it's about blending. The other option here is you only spend in the early years from the taxable account, but then it sounds like you're not going to really have much taxable income at all. You may not even be filling the standard deduction again, which is always the the bad idea of wasting standard deduction. So if you just spent down the taxable account first and saved the the IRA until later, you might be paying at a 0% rate now, and then getting pushed into the 22 to 24% rate later. Yes, so comparing that to the suggestion here, take from the IRA now to fill the 12% bracket, draw for the rest from the taxable account, sounds like a pretty good blending strategy for that. That's going to give you some spend down of the IRA as well, so that then maybe, well, I guess later on, at some point, probably Social Security is going to kick in too. But but later on, maybe it will help you to probably you're still going to be in the 22% bracket, but at least staying out of the the 24% bracket, and maybe you're going to have better control over hitting those Irma surcharges by gradually spending down that IRA as well. You could be thinking as well about Roth conversion opportunities that might help you ultimately stay closer to that 12% bracket, at least in a lot more years than otherwise. But but yeah, at least this kind of blending between the taxable and tax deferred account, based on the information we have, sounds like a reasonable way to be thinking about things.

Alex Murguia 17:48

Yeah, I agree. Yeah, these two questions are actually quite nice in the vein of how people should be thinking about it. You know, not the first part. I know you said the first part about just thinking about bracket management. It's not just that. There's there's more to it. Think about the big picture, the effective rate, but it's kind of a good rhythm, right? In terms of how they're thinking about it. That's great. Yeah. Okay.

Briana Corbin 18:14

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 retirementresearchers.com/8tips. Again, get your copy of Retirement researchers eight tips to becoming a retirement income investor by going to retirementresearcher.com/eighttips. That's the number eight tips.

Alex Murguia 18:52

Third question: I'm looking for resources for constructing key information needed for tax maps. I don't know in what sense they're using that phrase. Tax map is EMR tax map the appropriate keywords to use when searching?

Wade Pfau 19:09

Yeah, so I actually search for the term EMR tax map to to see what shows up. And yeah, so for more information, generally speaking, there's really only two people out there using that term: myself and Joel Sasser, who who I learned the whole strategy from. So when you search up the EMR tax maps, you're you're going to see articles mainly because most of what I've written is just in my book. So if you want my version of things, it's Chapter 10 of the Retirement Planning Guidebook. Make sure to get the third edition, and then when you do the search for EMR tax maps, actually Joe and I wrote a few articles together that you can find through Advisor Perspectives. But it seemed like the big thing showing up in the online search was a white paper he wrote about EMR tax maps for Nationwide, and that downloading that white paper that's a great resource either by Joe L. Sasser, or by myself would be the two main resources for more information. But again, if you want to go into this in great depth and have access to our tax map calculator, join us for the tax planning challenge starting november 2. It'll be a great opportunity to to do that deep dive and get that information that you're looking for as well.

Alex Murguia 20:22

Okay, Wade, business idea, business idea. Whenever anyone search EMR text map, send them to Amazon. Your book, baby. Yeah,

Wade Pfau 20:36

yeah. Because I

Alex Murguia 20:37

opportunity right there.

Wade Pfau 20:39

Other than things I've written with Joe, I haven't really written much that would show up on the internet. Is right? It's really I I put that all into my book. So so chapter 10 of the Retirement Planning Guidebook is my take on the tax maps.

Alex Murguia 20:52

There you go. All right, all right. The next question is kind of long, so I'm gonna actually prep it while you're answering the next one because this is it's a paragraph, so I don't want to mess that mess mess that up. So let me go to the the next one while I cover five later. But here's this one: How should a retired a retiree couple 64 and 62 think about paying off 385,000 a \$385,000.15-year mortgage at 6% Once pops, I think you're. I think you're. You're going to be the mediator in an argument here, Wade. I think they got an argument and they said, "Let's see what Wade says. You know, and that'll determine it. All right, that's that's the vibe I'm getting so far. But all right, let's start from the top. How should a retiree couple ages 64 and 62 think about paying off a \$385,000 15 year mortgage at 6%? What spouse would love to pay it off? Not necessarily in one stroke, but maybe more lump sums over two to three tax years. The other is indifferent and wants to follow the most efficient tax path if it is materially better. Current approach is a compromise: biweekly payments that will shorten the payoff date modestly. Period. Other factors: they're delaying Social Security, which should be 80 to 85,000, not including colas. PAAs are 4030 and 2050 a month.

Wade Pfau 22:30

Yes, that's a social. I think this is an

Alex Murguia 22:32

advisor that's writing this in now. All of a sudden, and and is kind of throwing you like a use case that he's having trouble with. He or she's having trouble with. That's the vibe I'm getting now. It's it's sort of switched. Assets include one tax deferred at 1.8 million and tax free at 700,000, but no tax and no taxable account. Could use solo 401k loans up to 100,000 any combo of tax deferred and Roth, but presumably Roth. Tax deferred marginal rate would be 22 or 24%

Wade Pfau 23:07

Okay, yeah. So, do they want to accelerate the the payment of their mortgage? This whole thing about taking a loan from their 401k to do that, I guess you'd want to be looking at the interest rate on that. But is that going to be much better than the the rate on the the mortgage? Now, in terms of the the tax efficiency, and as you mentioned,

Alex Murguia 23:30

you're paying back the four 1k loan with after tax, not not you know, in addition to the rate.

Wade Pfau 23:38

Oh yeah, right. You'd have to come up with the

Alex Murguia 23:42

yeah. I don't. You'd be using your

Wade Pfau 23:44

tax-free account to.

Alex Murguia 23:45

That's why I just that that one seems like a no-fly zone to me. But I'll let you. Yeah,

Wade Pfau 23:51

unless it has like a super low interest rate, that probably is not really a direction we're gonna pursue in our answer. Psychologically, yeah, it can be nice to to pay off the mortgage. Maybe the the way to be thinking about this too. So, oh, what I was saying about like the the tax efficiency, mortgage interest is deductible, but these days a standard deduction is so large. There, unless you're itemizing, and that we don't know if this couple is itemizing, if you're not itemizing, there's no tax benefit of having a mortgage. You're not getting to itemize the interest on the mortgage. That's not reducing the after-tax rate of interest on the loan, unless you can itemize it. So that's probably not a consideration. But maybe what you can be thinking about here is the whole conversation around like should you do a Roth conversion? I wouldn't necessarily want to be taking from the Roth to repay the mortgage, but instead of Roth converting, maybe it's like if our tax map calculator says you have the capacity to Roth convert \$40,000 this year, maybe the idea. Is instead of Roth converting it, you use it to to pay off mortgage more quickly and get that loan balance down at a more accelerated rate. I'm assuming you have discretion about exactly how much you want to pay off each month. That's probably the way I'd start thinking about it if you're looking for like a more tax efficient approach. Beyond that, you are kind of-I'm assuming there's not a lot of other income sources, and you're waiting for Social Security. It's going to be another six to eight years before all the Social Security's money is coming in. So you are somewhat vulnerable to the sequence of returns risk right now, where you've got 2.5 million dollars that you can spend down in a more accelerated manner before Social Security begins. I don't know what your spending goals are right now, but if we're saying that the tax-deferred marginal tax rate would be in the 22 or 24 percent brackets, that might suggest you have somewhat high spending goals, unless we're talking about a big mortgage payoff is a part of that. So that being said, you do want to be careful about the sequence of returns risk. And if you are going to prepay the mortgage, you are vulnerable, more vulnerable to sequence of returns risk. So another factor might be the whole kind of the glide path strategies or the buffer asset strategies of, hey, if markets are doing well over the next few years, that might encourage you to follow that method of prepaying the mortgage more quickly with money that you might otherwise Roth convert. If there's a market downturn coming up, then you might put a pause on those accelerated mortgage prepayments. That could be a way to think about things as well, but well, I hope that's just providing some guidance then about how to to think about this question because it is it's a complicated one and it's partly just personal preference. 6% is kind of high from in terms of well, if I just leave my money invested, I'm going to definitely earn a higher than 6% rate of return. If you had like one of those two and a half percent mortgages, that might be a stronger case to just keep the mortgage. Not necessarily for a retired couple. That's what your asset allocation is as well. But yeah, if you really would feel more comfortable paying that mortgage more quickly, I think you can make a strong case that it's worthwhile to look for those opportunities. And I outlined an approach to take with that. Instead of Roth converting money, you prepay the mortgage, and maybe you put a pause on it if there's a market downturn. Yeah.

Alex Murguia 27:39

Okay. Makes a lot of sense. All right, the other question, and I read it again just to see how we can digest this for someone listening to it. And I think conceptually, there's a lot of good points here to to discuss. So I ask that the people listen to this conceptually because I I think this is

you know something everyone asks, which is balance of assets and tax deferred accounts versus taxable accounts is it a good idea or not? You know, when I'm in that like delaying bridge era of my life, and so here goes. I would love to hear about strategies around taxable accounts. I'm 43 and have approximately \$2 million in investable assets, with a million held in taxable brokerage account and 775k in a MIGA multi-year guaranteed annuity that will expire at the end of the year, and for those of you think of a MIGA as a CD ladder, the rest are in traditional and Roth IRAs rather than retirement accounts. My husband earns approximately 75,000 a year as a contractor and plans to work until age the age of 55 through 60. Our house and cars are paid off. We spend approximately 100 to 110,000 per year, and I am no longer working. My CPA recommends we buy real estate, but when I run the numbers, it seems like a great deal of work with little payoff in our area. Seems like a random thing to throw in there. How should I think about the fact that most of my assets are taxable rather than in tax deferred accounts? Is this actually an advantage for early retirement because of the flexibility and access to the money before 59 and a half, or should I prioritize going back to work to move more money into my retirement accounts going forward?

Wade Pfau 29:30

Okay, and actually, this individual asked a question twice, and the details were different each time. So I use this version of it because it has more. The original version just said there was 2 million in taxable brokerage accounts. Okay, and now version added some nuance. So we've got a million.

Alex Murguia 29:48

What was throwing me off was the CPA. I don't know. I I guess hey, what do I do with the money? And the CPA said buy real estate, or maybe they needed losses for taxes to offset things. I I'm just like, where did that come from?

Wade Pfau 30:00

Well, or it could be the so they already have a shortfall where they're having to spend from their assets because the husband earns 75,000 and they're spending 100 to 110,000. Maybe the CPA's idea was fill that income gap with real estate income, but that's dude. Why?

Alex Murguia 30:17

Why are you why are you throwing shade at the husband like that? Well. Maybe he's doing other things that add value to the family. We don't. You're just dollars and cents, aren't you? You quickly saw he's only making 75. They're spending 110. What the hell is going on here? Come on, wait. Yeah, they're spending their

Wade Pfau 30:38

nesting. But I I don't know if that's real estate was supposed to fill that gap or not would be my only

Alex Murguia 30:47

yeah

Wade Pfau 30:48

yeah yeah and we can't say a lot about real estate specifically because I personally don't have any temperament to own my own real estate I could never be a landlord so I can't suggest one

way or the other but yeah I don't know how real estate in and of itself is going to give you a shot at higher returns than investments, although it is creating a bit of a pause that you have 40% of your assets in a MIGA when you're in your early 40s. That's a pretty heavy fixed income allocation. Yeah, it has nothing to do with the

Alex Murguia 31:22

fact that it's in a MIGA. It's more the stock to bond allocation. It's kind of what you're talking about.

Wade Pfau 31:26

Yeah, yeah. So the MIGA might be fine for a bonds, but already we're talking about 40% of your assets of your investments are in a MIGA. I don't know. Is it the taxable brokerage account 100% stocks, or does it also have a mix of stocks and bonds?

Alex Murguia 31:39

Well, but wait, you say that? But 40s, she's not working, so there's no capital. the the The husband's making 75 grand, so there's no there's not a lot of human capital right now to draw from. So you can make the case: yes, they're young, but they're technically retired. You know, so they should be somewhat conservative, and I know, no, no aspersions to the husband for saying you're basically retired, but you know what I mean, right? Like, there's it's it's a little different than the traditional 40 year old that's hustling it, still you know driving for that brass ring and is making enough money that they're investing that they can set it and forget it. This is almost like a fire thing.

Wade Pfau 32:23

Yeah, and I would suggest running this to a like a financial planning software, like our funded ratio at the academy or or something, because I'm concerned about like what the the funded ratio of this plan is. I haven't run any numbers, but already they're distributing from their assets in their early 40s, I don't know how much they're going to have by the time they're in their late 50s to 850. Where they get

Alex Murguia 32:49

3 million, which is shortfall right now? No, that's the other question.

Wade Pfau 32:52

They have 2 million. They don't have 3 million. 2 million,

Alex Murguia 32:56

and they're okay. They have 2 million, and they're spending. No, but I'm looking at the husband's making 75k, right? They're spending 100 and let's just say 110. So that's \$35,000 that they need to pull from the portfolio. \$35,000 for from a \$3 million portfolio. What do you think? 2

Wade Pfau 33:15

million, not 3 million. Oh, \$2 million. Yeah, they have a. It's like a 2% withdrawal rate. So right now it's not yeah extreme or anything, but then they're going to still be early retirees by 55 to 60.

Alex Murguia 33:28

Yeah, yeah, yeah. I got you.

Wade Pfau 33:29

And that now, so I don't know what their assets are going to be worth at that point. That's where need to run this through some software because 100 to \$110,000 does seem somewhat aggressive for what the withdrawal rate could be at that point.

Alex Murguia 33:45

Well, let's let's take the question, and then because we can talk about the details of this case, and you know, it's there's value in terms of people listening to how you think about it and what questions to ask. That's more important than the answers have you know majority of that, but the conceptually, the question here is, you know, how much do I sandbag in my taxable accounts versus tax deferred accounts? Yeah, does that give me more optionality? Reduce optionality? Is it worth the risk? And the reason I brought in at the beginning the bridging question is because this kind of thing usually comes up around then. I I missed I mistook. This person's 40, so this is not a, you know, they're not in the situation where they think about bridging anything.

Wade Pfau 34:29

So yeah, the original version of this question made it sound like they didn't have any retirement accounts yet, but this version of the question maybe they have like \$200,000 in retirement accounts, because yeah, having some tax diversification is good. And I was also going to say, make sure you have a Roth IRA open because you need one to be open for at least five years before you can ever make a qualified distribution. Now, about that, the flexibility of a taxable brokerage account, yeah, there can be issues before age 59 and a half. You, I don't think you're you're going to be hitting that threshold of concern, and you can take your your contributions to a Roth IRA out at any point. Just you can't take out the growth without potentially facing penalties. So I don't think, yeah, there could be flexible flexibility with a taxable brokerage account. The problem with the taxable brokerage accounts is ongoing taxation. If any interest, if you have bonds in those accounts, and any dividends, whether they're qualified or ordinary, and any kind of, if you're having to sell shares to get capital gains, that's all taxable on an ongoing basis each year. So that's why generally, when people have the opportunity, they want to fill their tax their retirement plan space first to get those tax advantages, and then the taxable account becomes where you put the leftover funds after you've taken full advantage of your retirement accounts. So now, whether the question asked, like, should should I return to work so that I can put more money into retirement accounts going forward? Whether I don't think you would uniquely need to return to work for that purpose because you still have the capacity. Because the the husband's working, he has the the capacity to still put funds into an account, and you can make a contribution to a spouse's Roth IRA as long as one person in the couple is working. So that whether or not to return to work would be more run this to a financial plan and see what yeah is a budget budget status is. But beyond that, I don't think you have to work uniquely to put more money into retirement accounts. But but yeah, there could be opportunities and advantages. I

Alex Murguia 36:41

would say she does because I would think the way it's worded is 110. They're already at their max. They

Wade Pfau 36:47

yeah, they're having able to

Alex Murguia 36:48

maintain their 110 \$1,000 spending if they contribute and there's no money tree, so it has to come from somewhere.

Wade Pfau 36:56

They don't have new savings, but they'll be eligible because they're already distributing. But they are eligible to make contributions to retirement accounts because the husband's working, and they could just sell from their taxable account to put that money over time into their retirement accounts. Yeah, and you you might think about doing that. You don't necessarily have to do it too aggressively at this point, so you do have some retirement accounts already. It sounds like you do already have a Roth IRA. That would be for each spouse needing one to qualify for the the five year window on their own accounts. And yeah, that's about all all we can really say on this particular question.

Alex Murguia 37:42

All right, welcome you to join us

Wade Pfau 37:44

for our tax planning challenge. And

Alex Murguia 37:47

yeah, exactly. This is where we would break it down and actually run it and see if

Wade Pfau 37:52

for their case too. I'm sure next year we're going to do another one of our traditional retirement income challenges with the funded ratio. Oh

Alex Murguia 37:58

yeah, the beginning. Yeah, that might be an

Wade Pfau 37:59

even more important one for for this case. Fair enough. All right.

Alex Murguia 38:06

Then

Wade Pfau 38:07

we'll end it with: Are there transcripts for your podcasts? Yes, there are. If you go to the website retirewithstyle.com, mainly it's a website that lists the podcast episodes, and then when you click on an episode and scroll down, there's a lot of information about the episode. And near the bottom, you got to keep scrolling. There'll be a link. Download a PDF of the the podcast transcript, and that would be the way to find those.

Alex Murguia 38:36

All right, Wade. Anything else?

Wade Pfau 38:38

No, just hope everyone will join us for that tax planning challenge starting november 2. You can register with the in the show notes. the The link to do that registration is available at this point.

Alex Murguia 38:49

All right, everyone, take it easy for this week's episode of Retire with Style, and we'll catch you next week.

Wade Pfau 38:55

Thanks, everyone.

Alex Murguia 38:56

Bye now.

Briana Corbin 38:58

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 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.