Retirement Researcher

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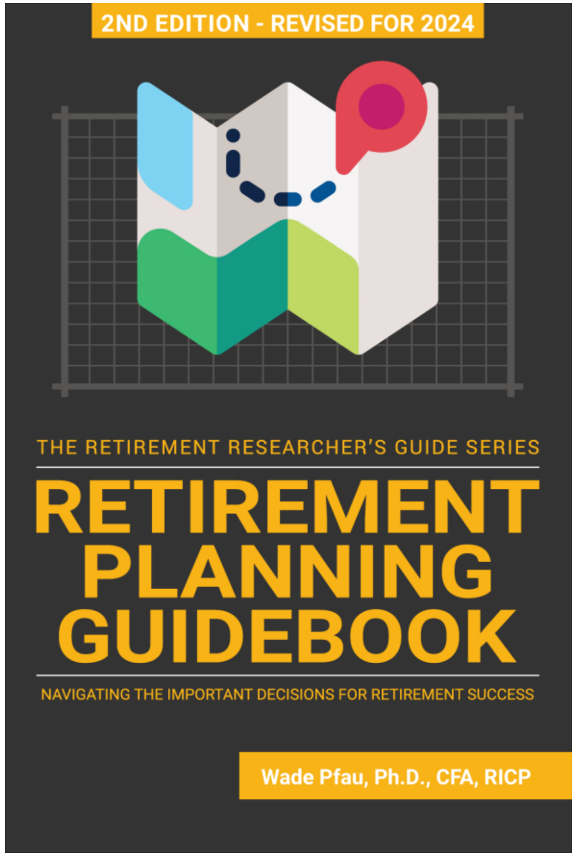

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Creating Tax-Efficiency for Retirement Income

Presented by:

Wade Pfau, Ph.D., CFA, RICP

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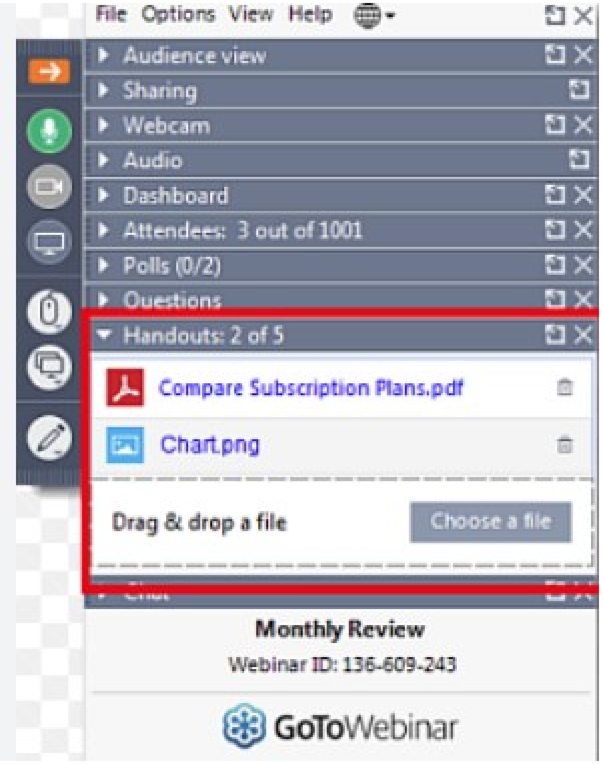

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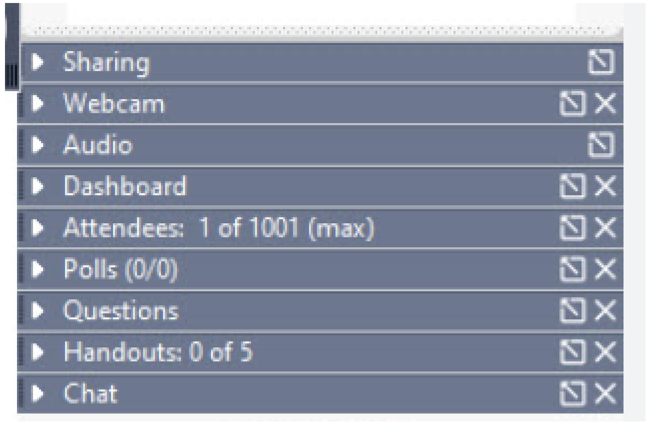

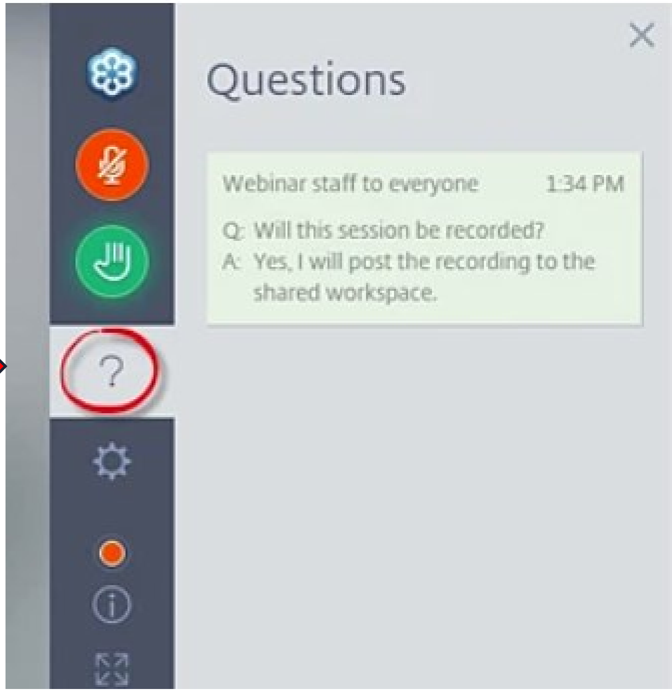

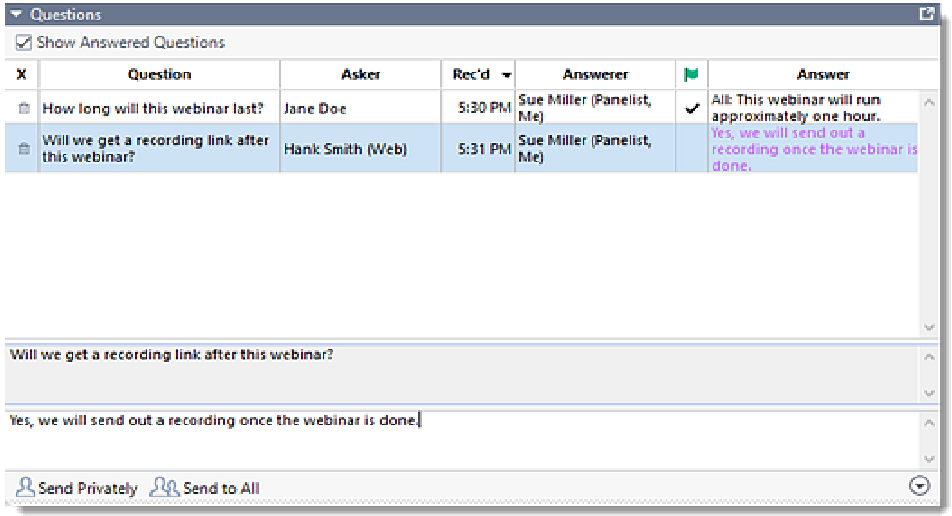

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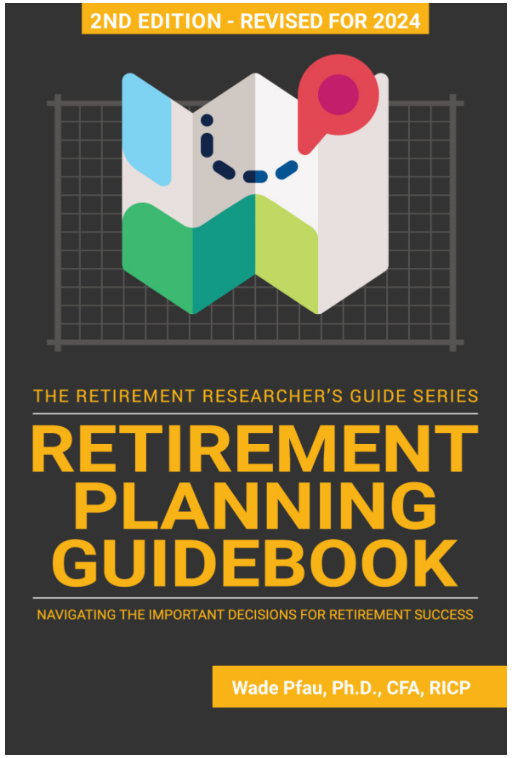
1. Retirement Income Style
2. Retirement Risks
3. Goals & Preparedness
4. Investment & Annuity Strategies
5. Social Security
6. Health Care & Medicare
7. Long-Term Care
8. Retirement Housing
9. Tax Planning
10. Legacy & Incapacity Planning
11. Non-Financial Aspects
12. Implement & Monitor



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What We're Going to Cover

- The Logic of Tax Efficiency
- Tax Diversification
- Tax-Efficient Retirement Distribution Strategies
- Pitfalls to Monitor When Generating More Taxable Income
- A Case Study for Effective Marginal Rate Tax Management

The Logic of Tax-Efficiency

Tax-efficiency can have a significant impact on portfolio **longevity**

Why?

- Maneuvering the Progressive Tax System
- Pay taxes at low rates, avoid taxes at high rates
- Tax code is filled with non-linearities and traps
- Marginal tax rates (additional tax paid on last dollar of income) can be higher than income tax rates
- There are many different types of tax treatment in the tax code that need to be coordinated

Non-linearities in the tax code

- Many tax rules connect to AGI, not taxable income
- Itemized deductions only count when higher than standard deduction
- Preferential income sources (long-term capital gains and qualified dividends) stack on top of other income and have different tax rates
- A dollar of income can trigger tax on Social Security benefits
- A dollar of income can trigger higher Medicare premiums
- A dollar of income can trigger loss of Affordable Care Act health insurance subsidies
- The 3.8% net investment income tax
- Required minimum distributions can push into a higher tax bracket

Income for Tax Purposes

Total Income
\- Above the line deductions
Adjusted Gross Income

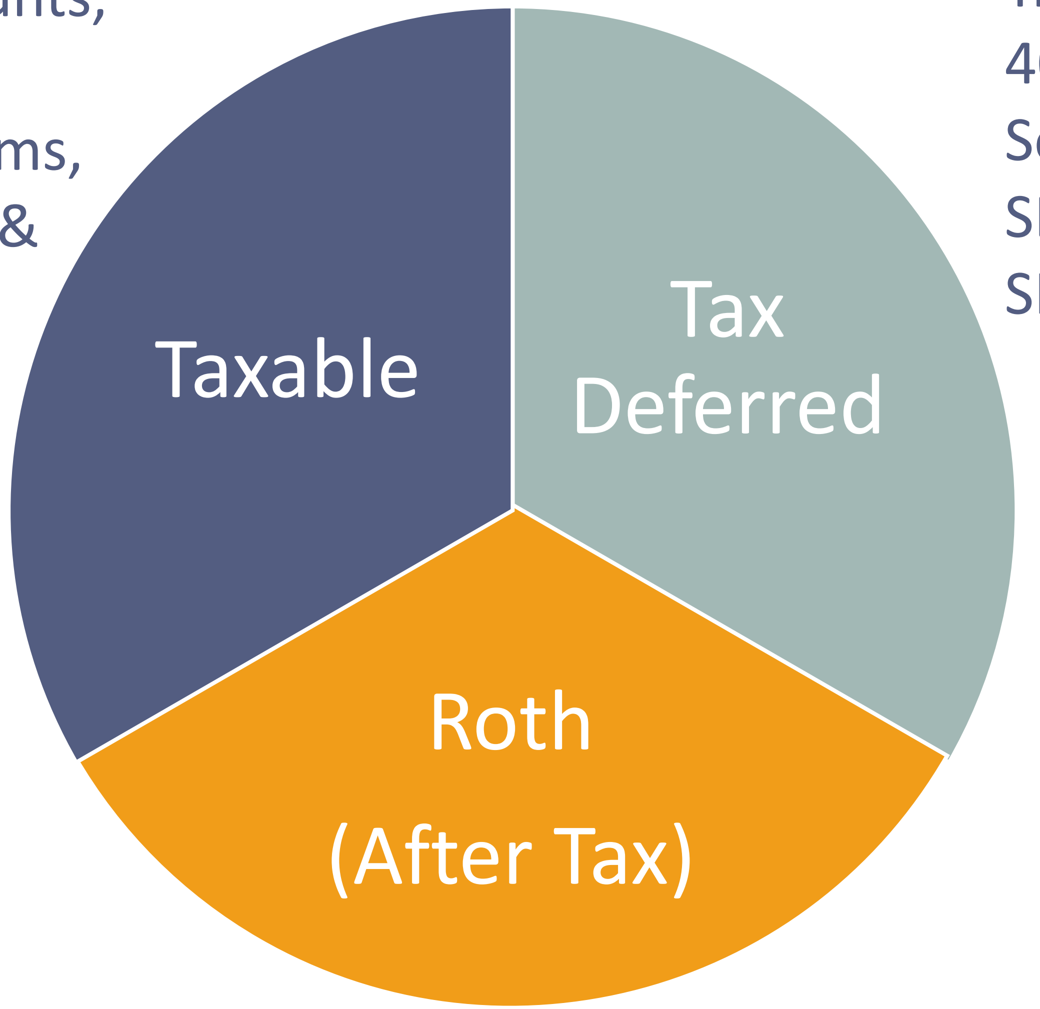
Adjusted Gross Income
\- Deductions
Taxable Income

Tax Diversification

Where to Save

Tax Diversification

Savings Accounts,
CDs,
Brokerage Firms,
Mutual Fund &
ETF Families



Traditional IRA,
401(k),
Solo 401(k),
SEP IRA,
SIMPLE IRA

Tax-Efficient Retirement Distribution Strategies

Conventional Wisdom Withdrawal-Order Sequencing:

- Taxable
- Tax-Deferred
- Tax Exempt

Effective Marginal Rate (EMR) Management – A Better Approach

- Aim to pay taxes at the lowest possible rates
- Fill up lower tax brackets with taxable income, then draw from elsewhere to stay out of higher brackets or painful nonlinearities
- Avoid being pushed into higher tax brackets later through RMDs
- Short-term sacrifice can create long-term benefits
- Biggest impacts (2024):
  - 12% to 22%: $47,150 singles, $94,300 joint filers
  - 0% to 15% for preferential income: $47,025 singles, $94,050 joint filers

3 Techniques to Generate Taxable Income

1) Spend less from taxable accounts and more from tax-deferred accounts to cover the spending goal in a way that increases taxable income toward the desired level.

2) Cover the spending goal from taxable accounts, but then increase taxable income by doing Roth conversions with assets from the tax-deferred account.

3) Generate taxable long-term capital gains by selling and then immediately re-purchasing assets in taxable accounts, especially when still in the 0% tax bracket for preferential income sources.

Increases Taxable Income	Income with Preferable Tax Rates	Spending Sources -- Not Taxable Income
Wages and earnings	Qualified dividends	Cost-basis of taxable investments (i.e. principal)
Qualified retirement plan distributions (IRAs)	Long-term Capital Gains	Roth IRA distributions
Short-term capital gains		Portion of nonqualified annuities
Interest		Portion of Social Security benefits
Dividends (nonqualified)		Health savings accounts (qualified)
Portion of nonqualified annuities		Reverse Mortgage proceeds
Portion of Social Security benefits		Cash value of life insurance (cost basis or loan proceeds)
Pensions		
Rental or other passive income		

For illustration purposes only

Roth Conversions

- IRA Distribution (Above RMDs) to Roth IRA
- Ideally, taxes paid from elsewhere
- Window of opportunity in 60s if already retired
- Might do in large-deduction years to offset deduction
- Can also move more shares during downturns

Reasons to Frontload Taxes

- Public policy unknowns and risk of tax increases
- Tax implications after death of a spouse: taxes can increase as one becomes a single filer again
- SECURE Act: 10-year window for adult beneficiaries may push to higher tax brackets for inherited IRAs
- Prepare in advance to reduce RMD impacts

“Retirement Tax Cliff”

RMDs **unexpectedly** push you into a **higher** tax bracket

Retirement Tax Cliff: Taxable Income Generated by RMDs

IRA Balance	RMD @ 73	RMD @ 75	RMD @ 80	RMD @ 90
IRS Life Expectancy	**26.5**	**24.6**	**20.2**	**12.2**
$100,000	$3,774	$4,065	$4,950	$8,197
$500,000	$18,868	$20,325	$24,752	$40,984
$1,000,000	$37,736	$40,650	$49,505	$81,967
$2,000,000	$75,472	$81,301	$99,010	$163,934
$3,000,000	$113,208	$121,951	$148,515	$245,902

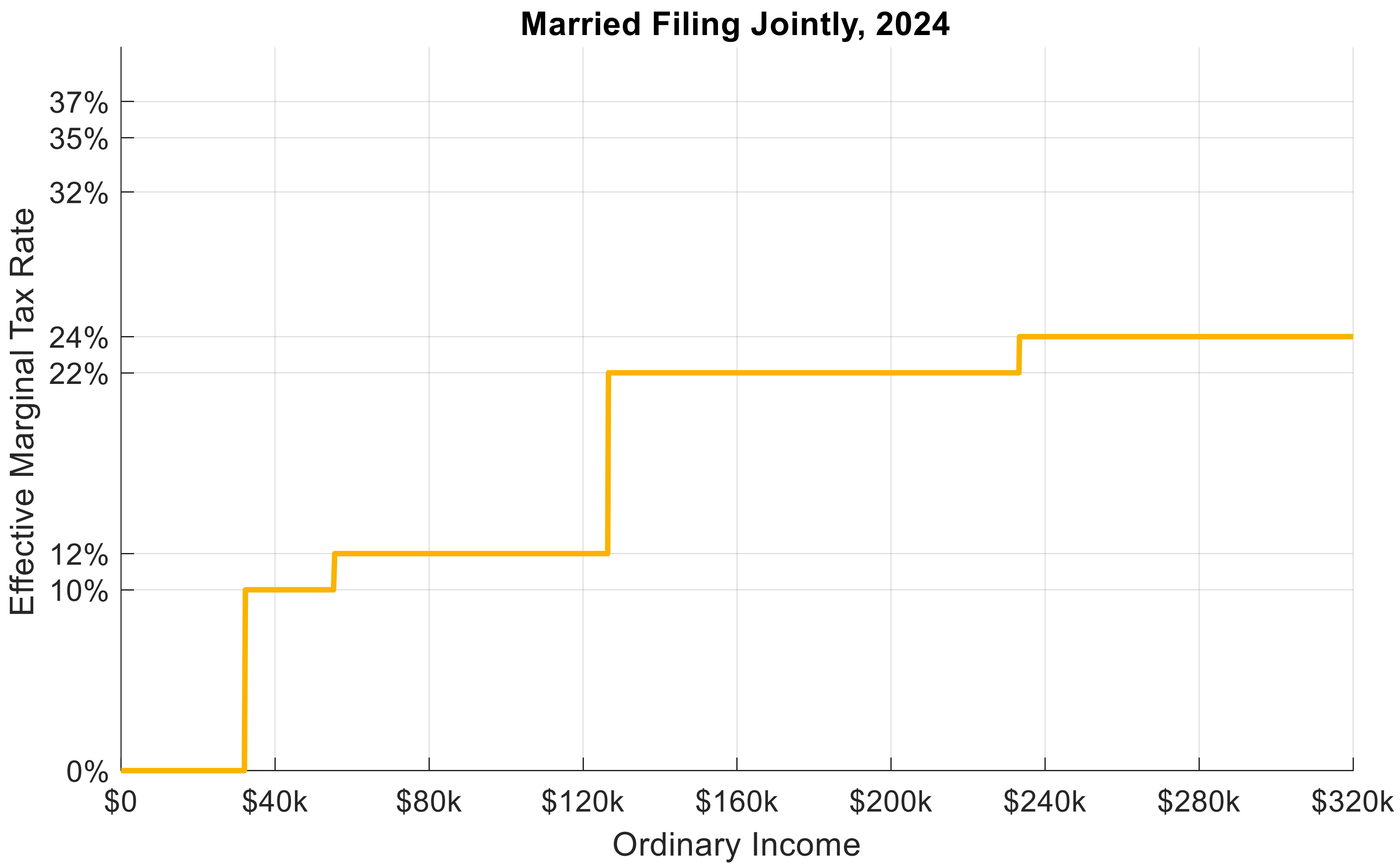
For illustration purposes only. RMDs calculated from data provided by the IRS IRA Required Minimum Distribution Worksheet: https://www.irs.gov/pub/irs-tege/uniform_rmd_wksht.pdf

Comparing 2018 Taxes Before and After Tax Cuts and Jobs Act for 2026 Return

Single Individuals	TCJA	Pre-TCJA	Difference
$0	10%	10%	0%
$9,250	12%	15%	3%
$38,700	22%	25%	3%
$82,500	24%	25%	1%
$93,700	24%	28%	4%
$165,000	32%	28%	-4%
$195,450	32%	33%	1%
$200,000	35%	33%	-2%
$424,950	35%	35%	0%
$426,700	35%	39.6%	4.6%
$500,000	37%	39.6%	2.6%

Pitfalls to Monitor When Generating More Taxable Income

Federal Income Tax Brackets



Important Issues

Increasing taxable income can also generate more taxes besides income tax rates

- ❑ Pushing Preferential Income into Higher Tax Brackets including Net Investment Income Tax
- ❑ Social Security Tax Torpedo
- ❑ Increased Medicare Part B and Part D Premiums

- ❑ Affordable Care Act Subsidies for Health Insurance

Federal tax rates – 2024 taxable income
Qualified dividends & long-term capital gains

Tax Rate for Taxable Income Over:		
Tax Rate	**Single Individuals**	**Married Filing Jointly**
0%	$0	$0
15%	$47,025	$94,050
20%	$518,900	$583,750
Additional Net Investment Income Tax		
3.8%	MAGI above $200,000	MAGI above $250,000

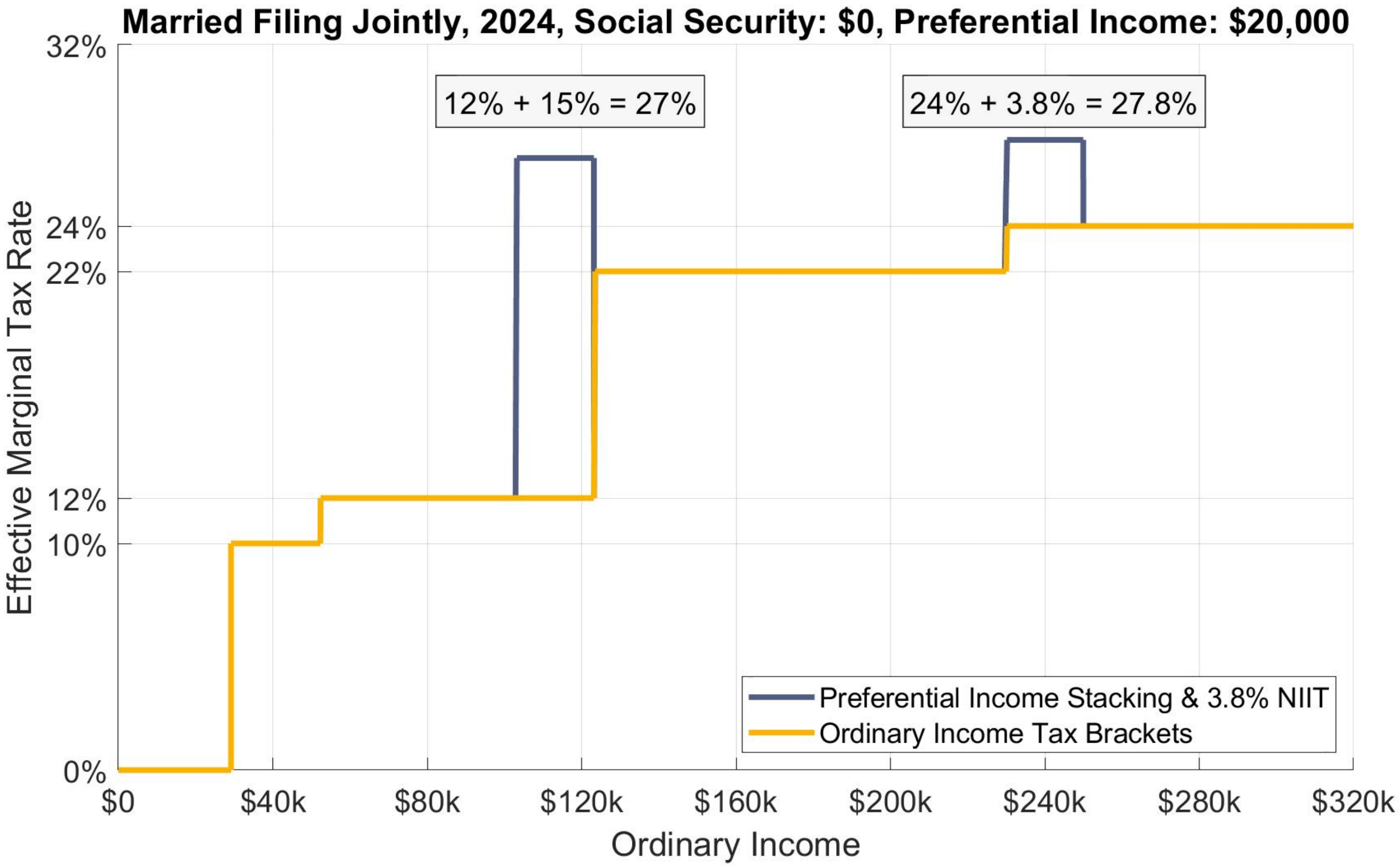
Pushing Preferential Income into Higher Tax Brackets

- Preferential income (LTCG & qualified dividends) stacks on top of other taxable income

- Example – Single Filer Taxable income=$49,025 ($45,025 regular, $4,000 LTCG)

- $45,025: 12% bracket; $4,000: $2k at 0%, $2k at 15%
- Add $1: $45,026 ordinary (<u>12%</u> on $1) + $1,999 at 0% and $2,001 at 15% (<u>15%</u> on $1) = **<u>27%</u>** marginal rate

Preferential Income Stacking & Net Investment Income Tax



Social Security Tax Torpedo

- Up to 85% of Social Security benefits are taxable
- Tax schedule was set in 1994 (not inflation adjusted)
- Determining benefit taxation and marginal tax rates is quite complex
- Proactive planning helps to avoid the full tax torpedo, which is a key aspect of tax-efficiency in retirement
- **Key point**: This tax planning provides another reason for delayed Social Security claiming

Modified Adjusted Gross Income
=
Adjusted Gross Income less taxable Social Security benefits

Provisional Income

=

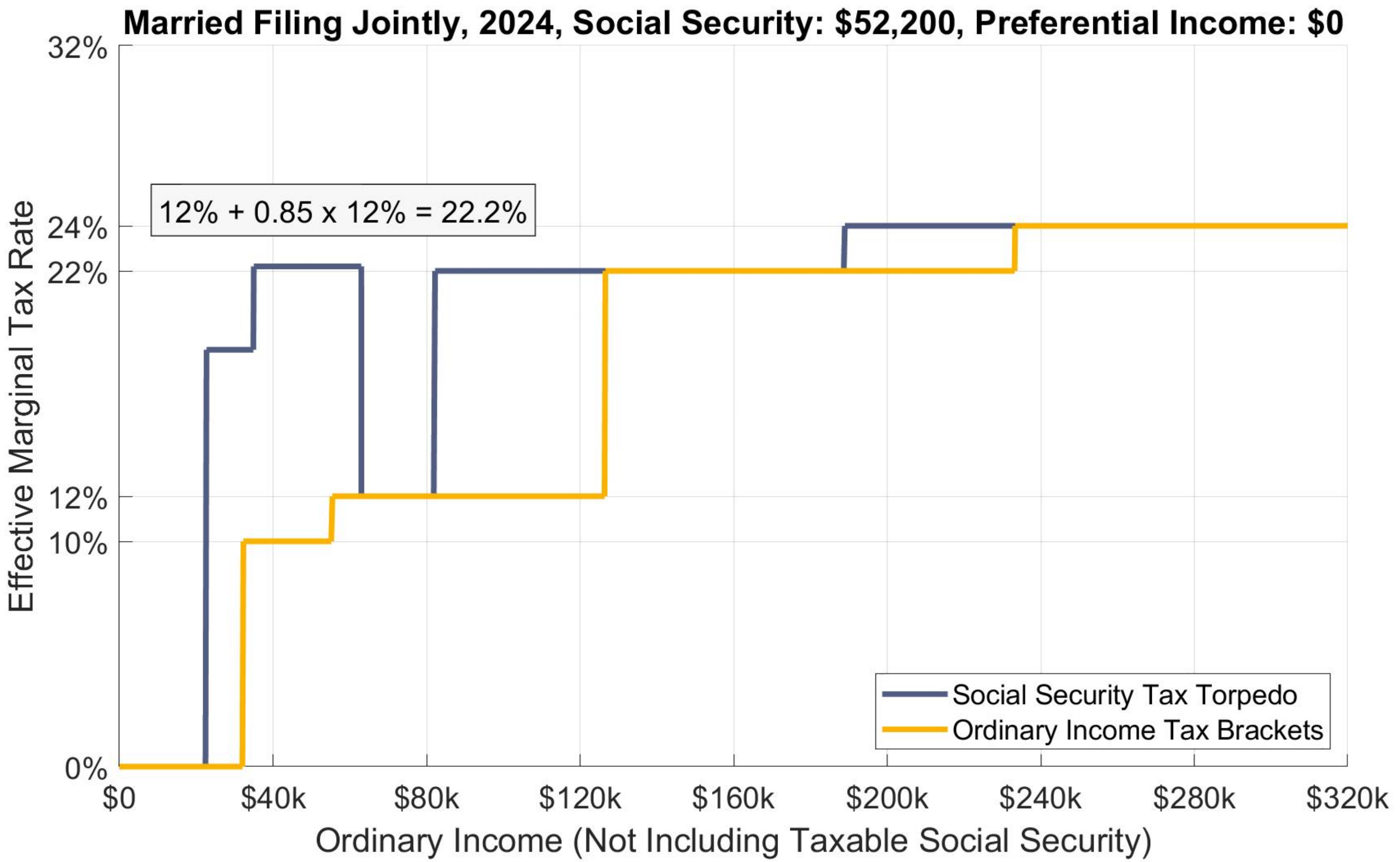
MAGI + ½ Benefits + tax-exempt interest

Social Security Benefits Taxation

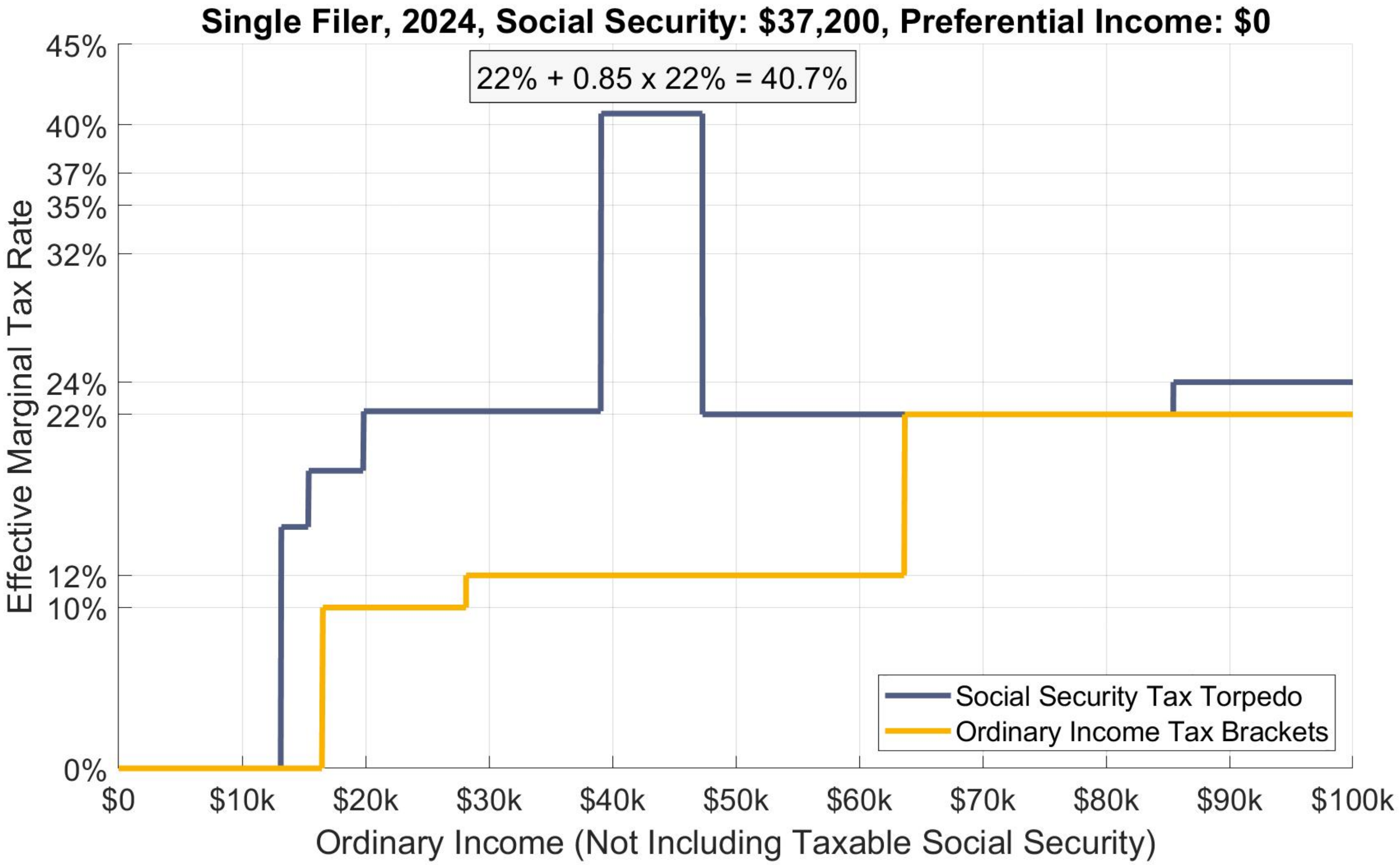
Provisional Income		Taxable Benefits
Single Filers	Married Filing Jointly	
Under $25,000	Under $32,000	0%
$25,000 - $34,000	$32,000 - $44,000	up to 50%
Over $34,000	Over $44,000	up to 85%

Provisional Income = MAGI + 1/2 Benefit + tax-exempt interest

Social Security Tax Torpedo



Social Security Tax Torpedo – Single/Widow's Penalty



40.7% marginal tax rate

(22% tax rate + 22% rate x 85% x $1 of Social Security)

Medicare IRMAA Premium Increases

- Medicare premiums experience jumps at various income thresholds
- Medicare MAGI = AGI + tax-exempt interest (from 2 years prior)
- For life changing events (like retiring), file SSA-44 to request a smaller premium

2024 Medicare Premiums (Based on Taxable Income in 2022)

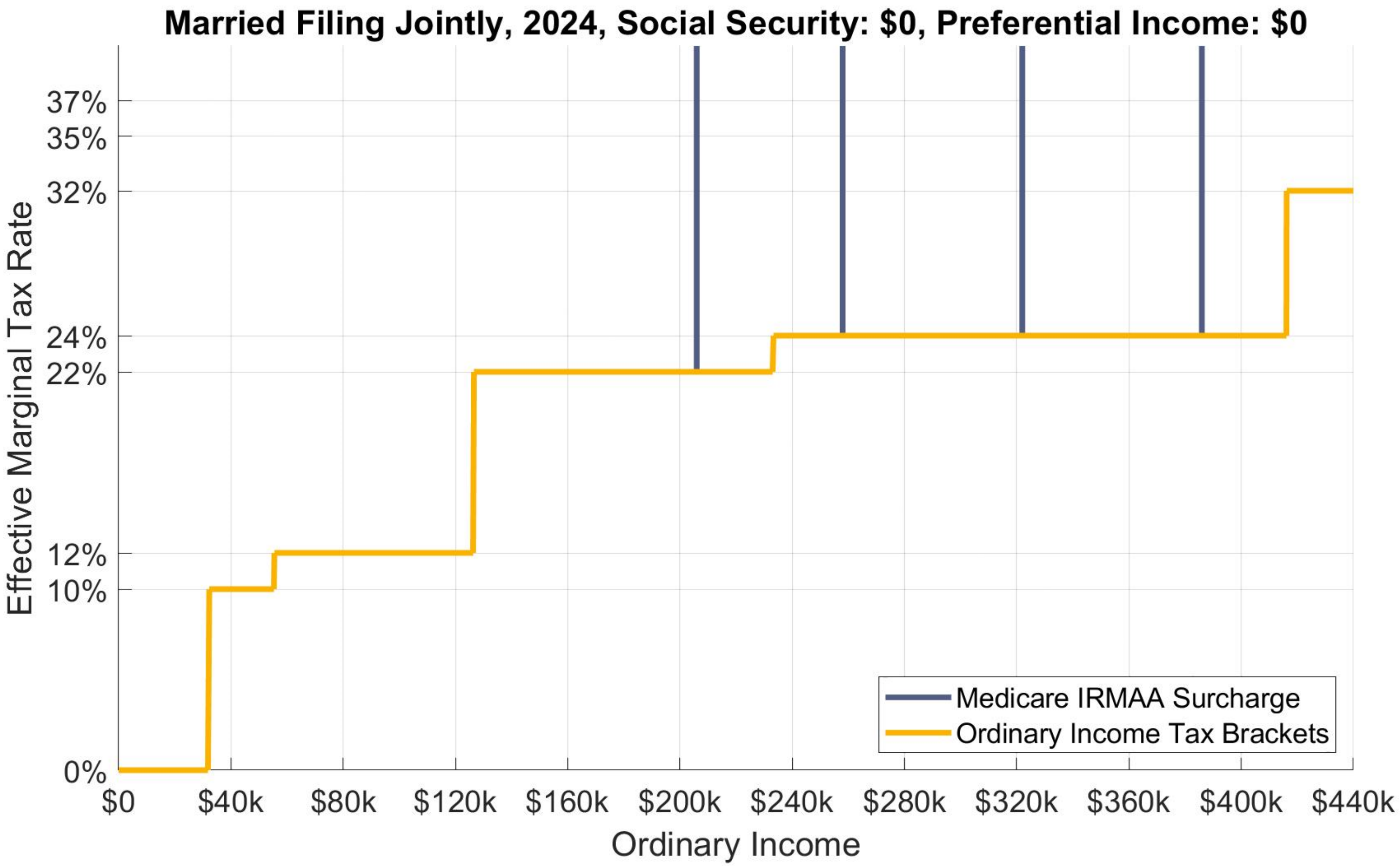
Single Filers Modified Adjusted Gross Income	Married Filing Jointly Modified Adjusted Gross Income	Part B Monthly Premium per recipient	Part D Monthly Premium per recipient	Combined Annual Amount per Individual
$103,000 or less	$206,000 or less	$174.70	$34.70 (base premium)	$2,512.80
$103,001 - $129,000	$206,001 - $258,000	$244.60	base + $12.90	$3,506.40
$129,001 - $161,000	$258,001 - $322,000	$349.40	base + $33.30	$5,008.80
$161,001 - $193,000	$322,001 - $386,000	$454.20	base + $53.80	$6,512.40
$193,001 - $500,000	$386,001 - $750,000	$559.00	base + $74.20	$8,014.80
Over $500,000	Over $750,000	$594.00	base + $81.00	$8,516.40

Note: The modified adjusted gross income thresholds apply to income for 2022 when determining Medicare premiums in 2024. The average base plan premium ("base") for Part D prescription drug coverage is $34.70 per month in 2024, but it can vary between insurers and policies.

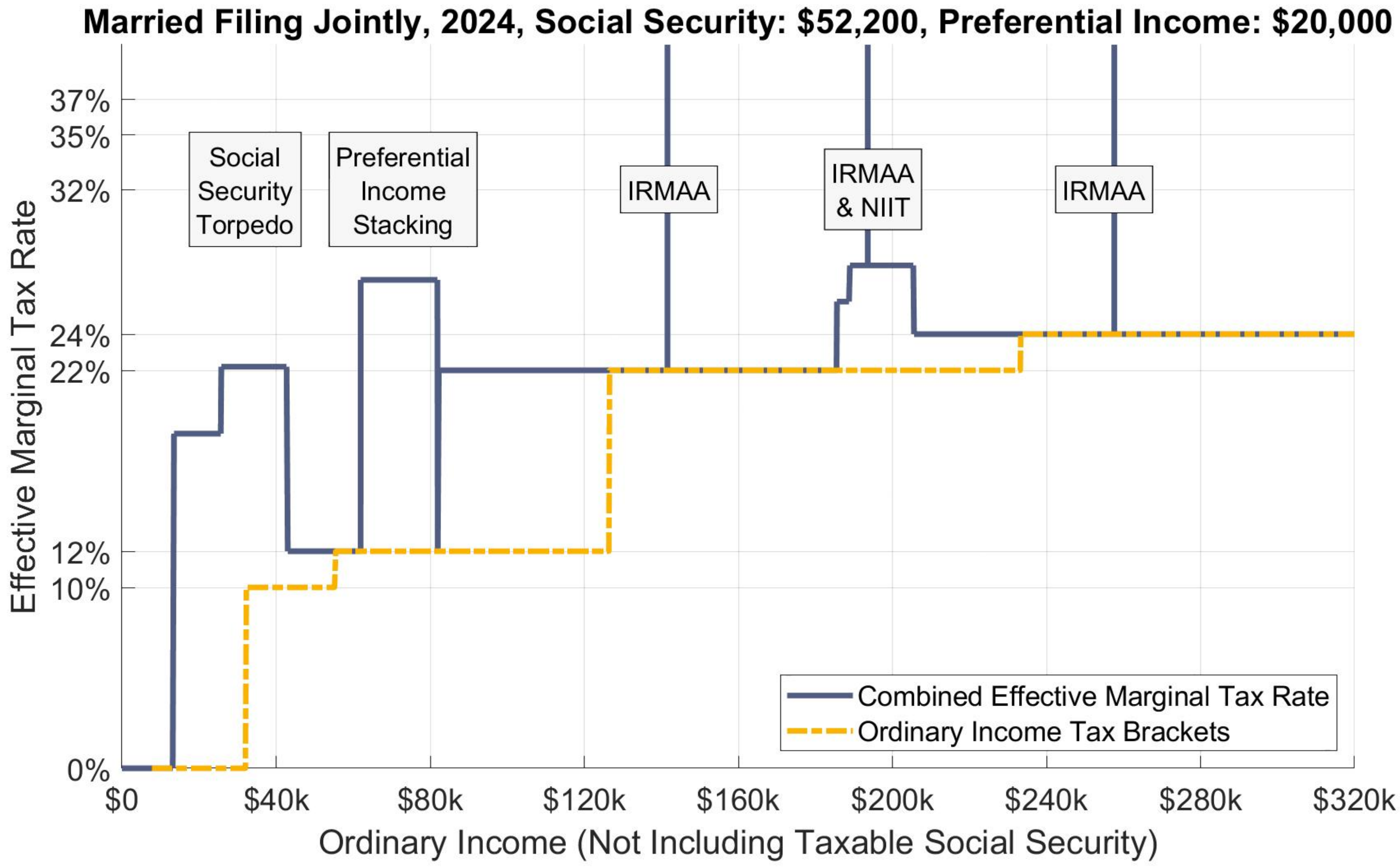
A single person with a MAGI of $103,000 would experience annual premiums of $2,513.

With one more dollar of income ($103,001), the annual premium jumps by $994 dollars, representing an 99,400% marginal tax rate!

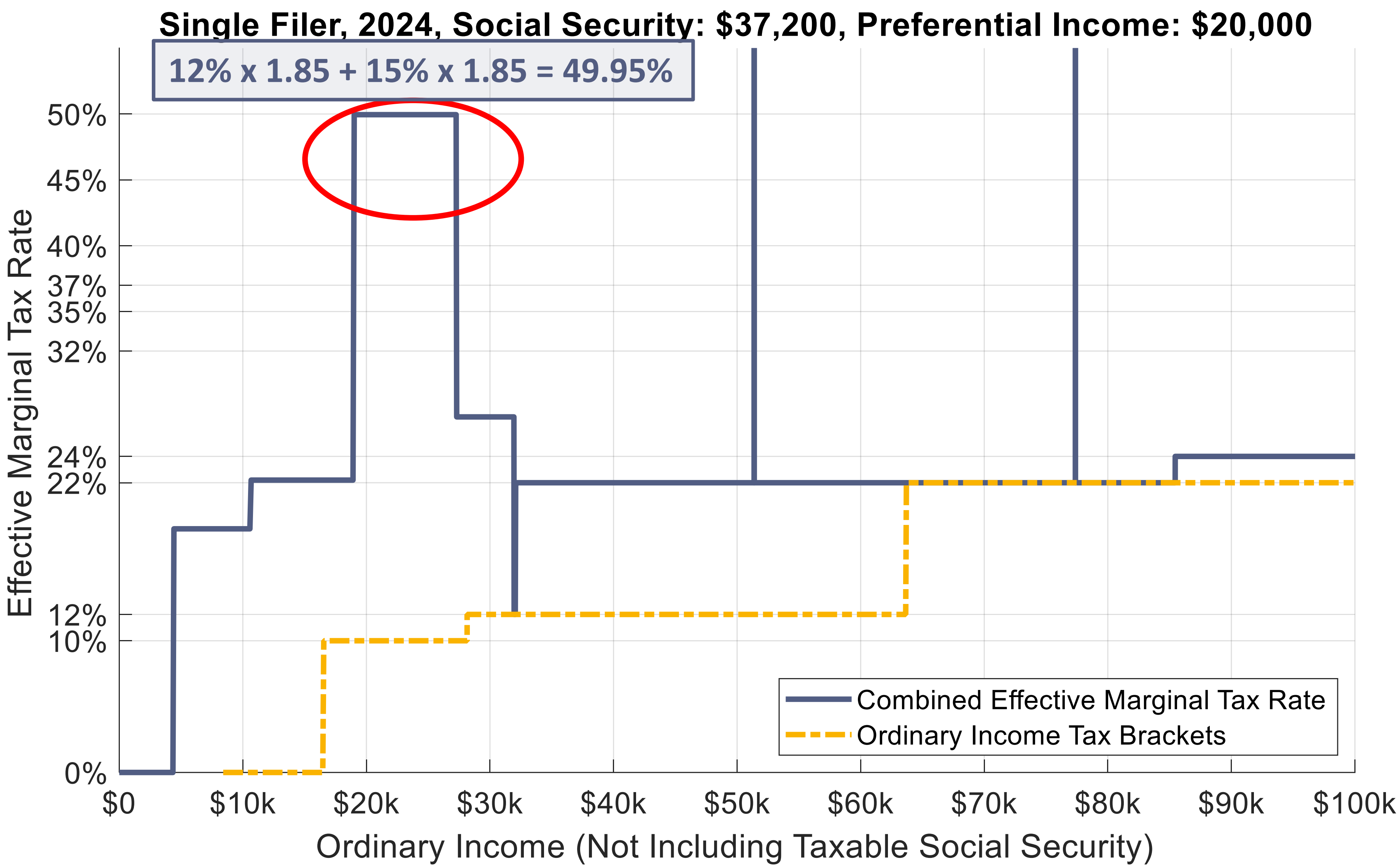
Medicare – IRMAA Premium Increases



Combined Tax Map



Combined Tax Map – Single/Widow's Penalty



49.95% marginal tax rate

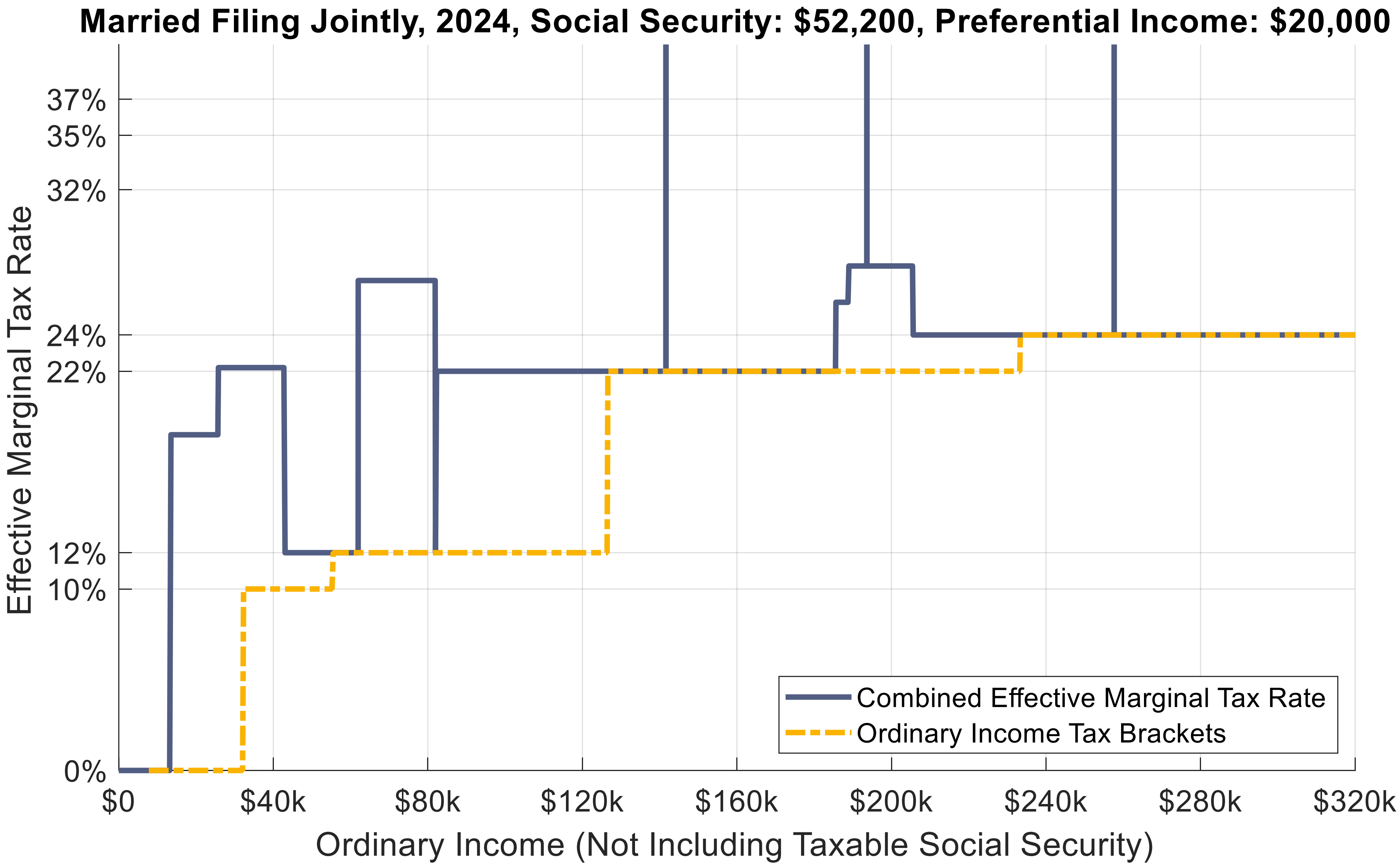
(12% tax rate x $1

+ 12% rate x 85% x $1 of Social Security

+ 15% preferential rate x $1.85 ordinary income)

Managing
Effective Marginal Tax Rates
for Improved After-Tax Outcomes

Using Tax Maps to Make Planning Decisions



What is the retirement distribution strategy that would create the least ordinary income?

Can I justify increasing taxable income by reducing Roth distributions and increasing IRA distributions?

Should I continue with Roth conversions once spending goals are met?

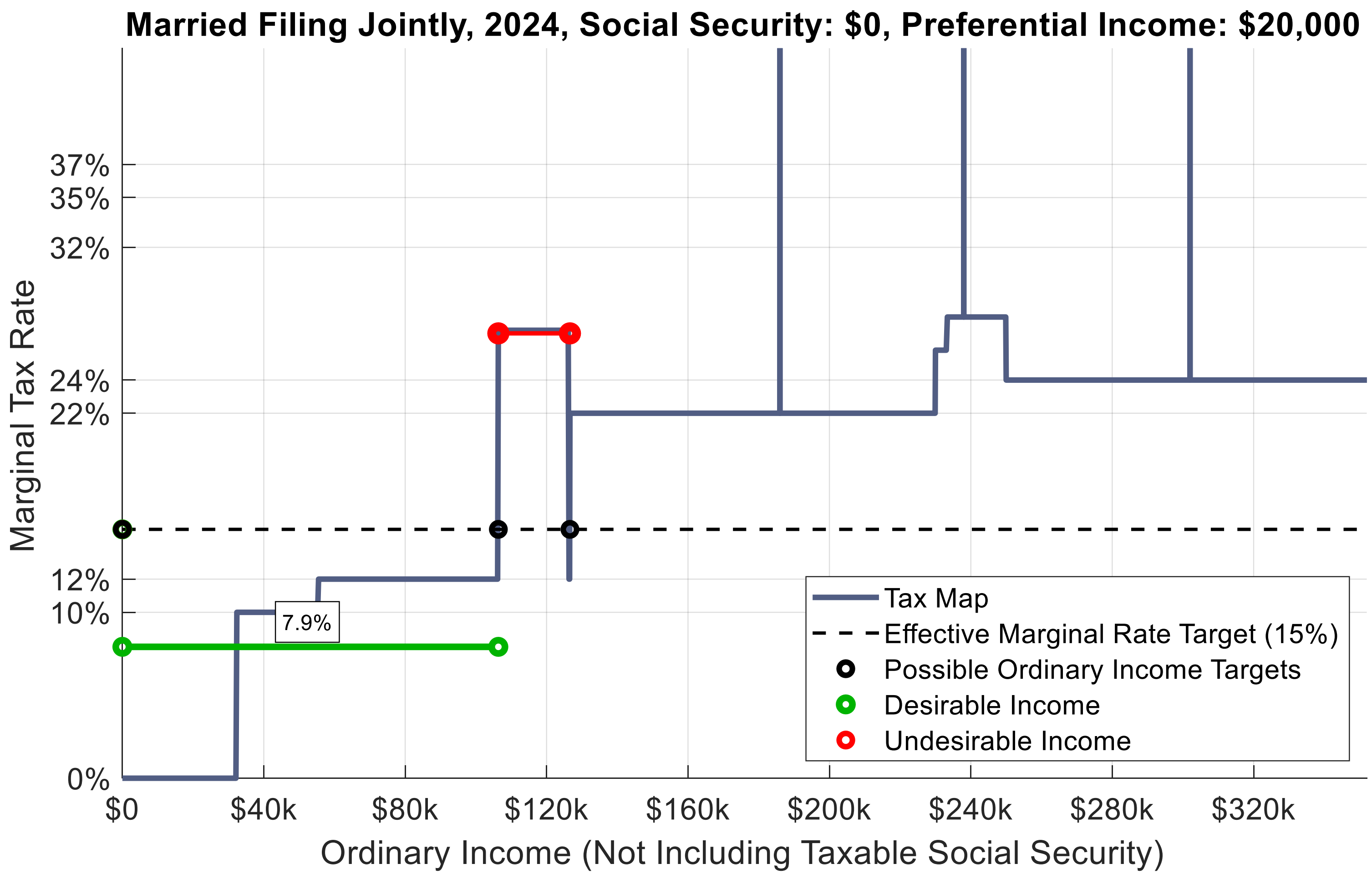
Constraints on Decision Making

- Availability of taxable, tax-deferred, and tax-exempt assets

- Tax Map Starting Point: How much taxable income must I generate?
  - RMDs
  - Social Security benefits
  - Interest and dividends from taxable assets
  - Other taxable income sources

- Spending goals: How much (pre-tax) would I like to spend?

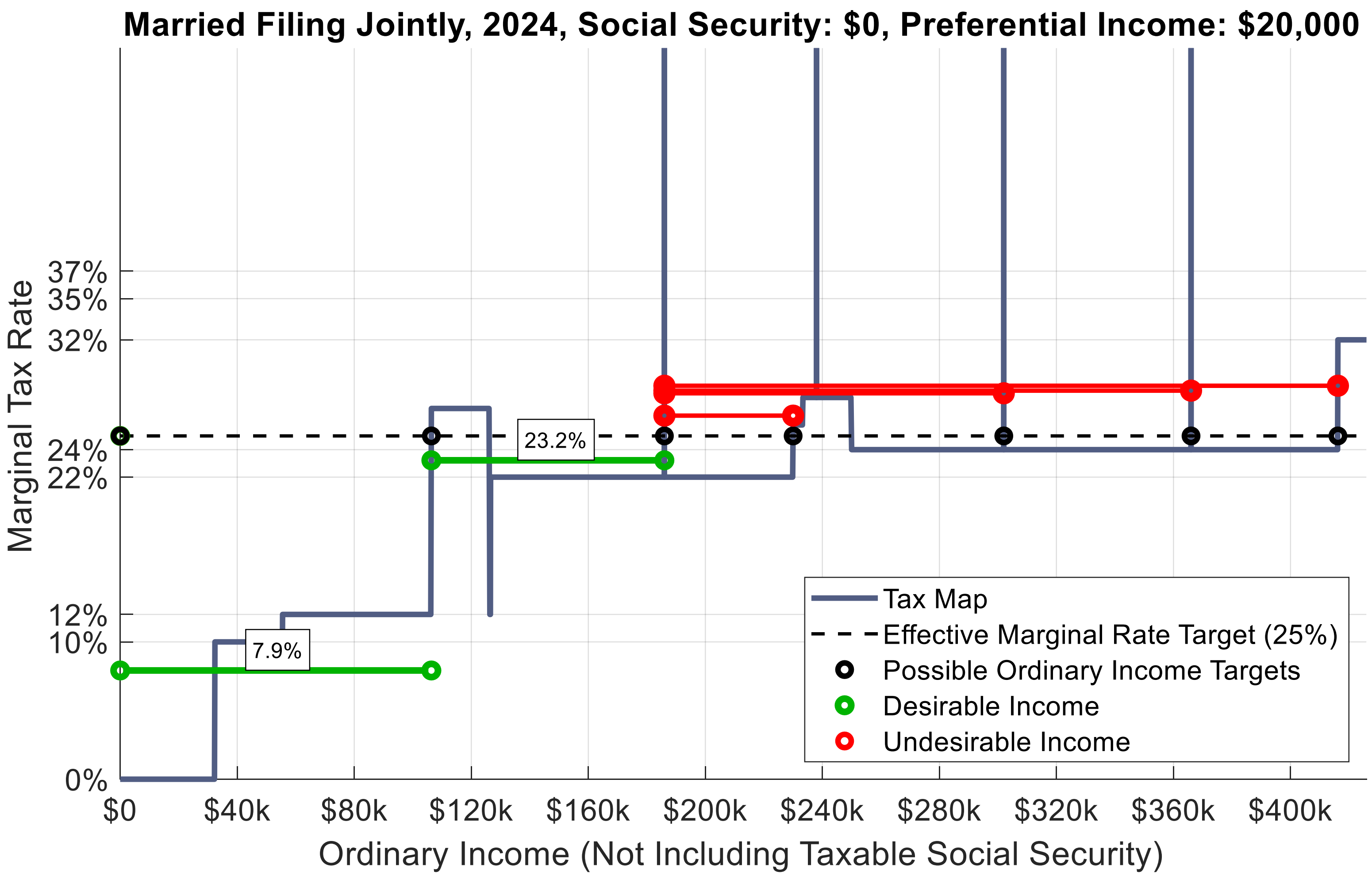
Tax Planning Before Social Security Begins
Targeting 15% Effective Marginal Rate



Constraint:

Preferential Income Stacking

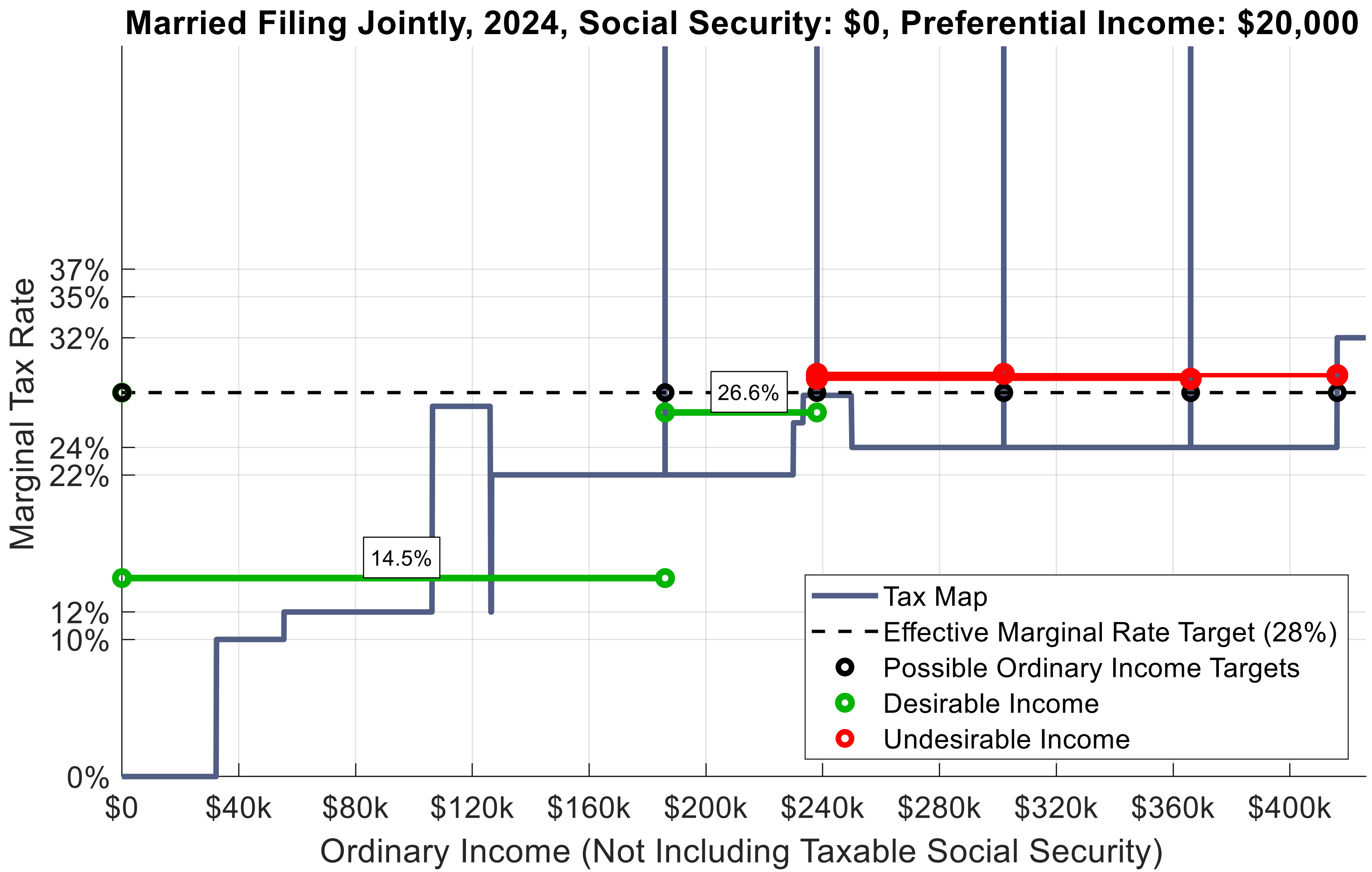
Tax Planning Before Social Security Begins
Targeting 25% Effective Marginal Rate



Constraint:

1st IRMAA Threshold

Tax Planning Before Social Security Begins
Targeting 28% Effective Marginal Rate



Constraint:

2nd IRMAA Threshold

Example for 62-Year Old Couple in 2024

Couple with $2.3 million			
Retirement Assets	Asset Value		
Taxable Account	$800,000	($600,000 cost basis)	
IRA	$1,300,000		
Roth IRA	$200,000		
Social Security (High Earner)	$2,500	Primary Insurance Amount (Monthly)	
Social Security (Low Earner)	$0	Eligible for Spousal benefit	
Retirement Liabilities	Annual Expense	Age Range	Inflation-Adjusted?
Retirement Budget	$120,864	62-84	Yes
	$95,245	85-95	Yes
Taxes	To be determined		

Tax-Efficient Retirement Income for 62-Year Old Couple

Tax Planning Strategy	Legacy Value at 95 (in 2024 Dollars) Social Security at 62	Legacy Value at 95 (in 2024 Dollars) Social Security at 70
Conventional Wisdom	-$15,908	$154,189
10% EMR Target	$16,889	$224,397
15% EMR Target	$36,076	$279,570
25% EMR Target	-$74,709	$183,227

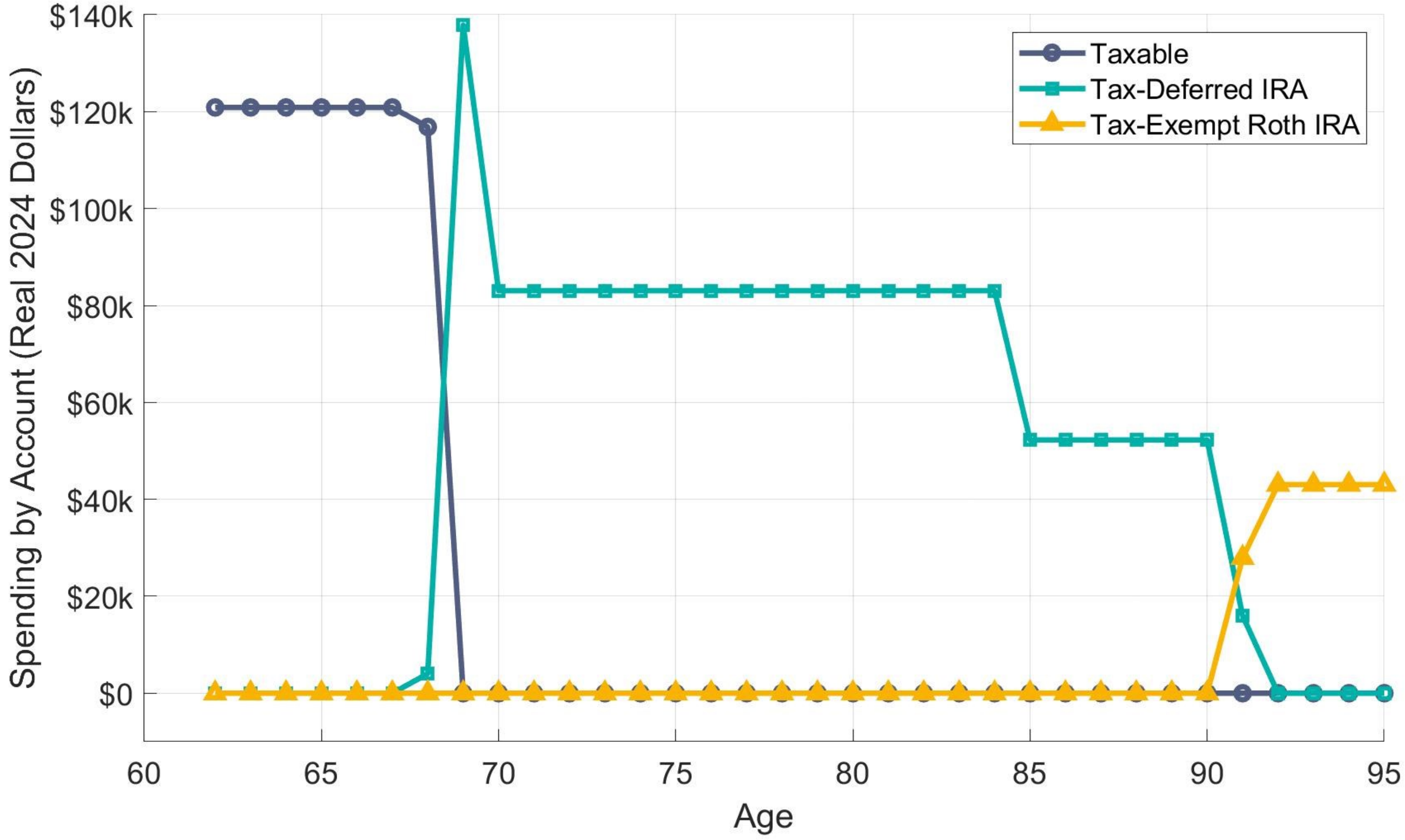
Hypothetical example for illustration purposes only.

Tax-Efficient Retirement Income for 62-Year Old Couple, Claiming Social Security at Age 70
Gross Investment Return: 4.29%

Tax Planning Strategy	Legacy Value at 95 (in 2024 Dollars)	Net Investment Return	Tax Alpha
Conventional Wisdom	$154,189	3.48%	--
15% EMR Target	$279,570	3.77%	0.29%

Hypothetical example for illustration purposes only.

Real Spending by Account, Conventional Wisdom Spending Strategy



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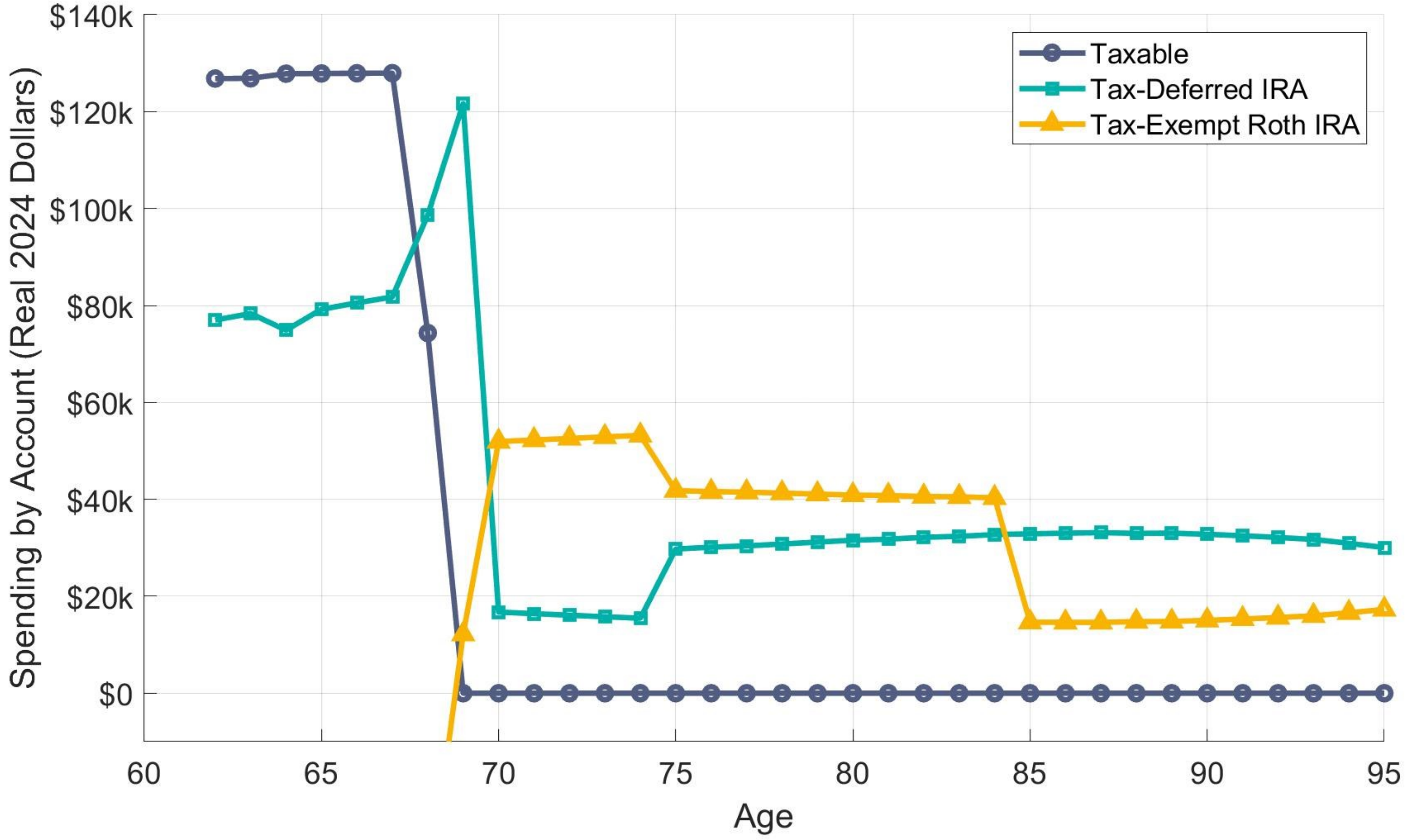
Real Spending by Account, 15% Effective Marginal Rate Target



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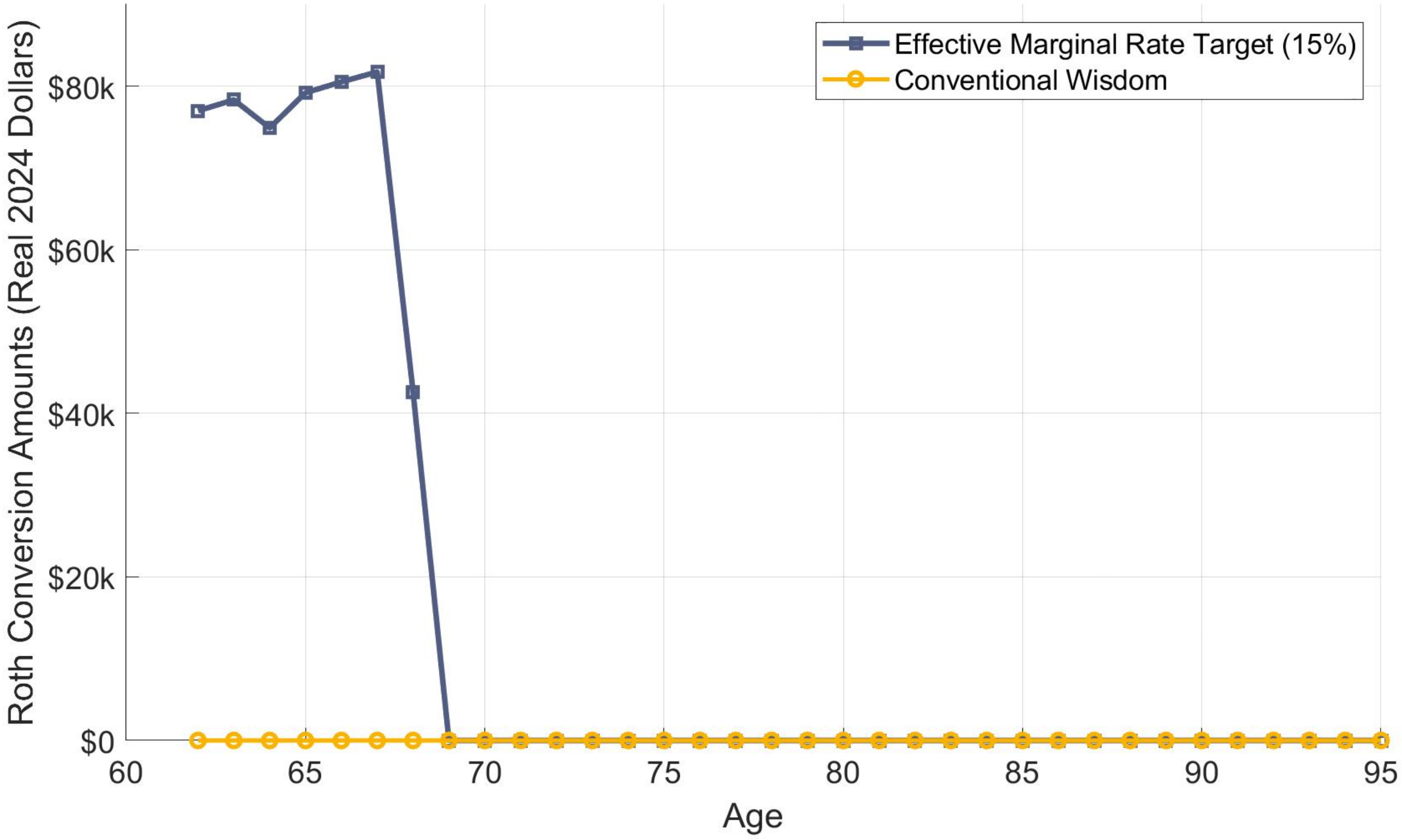
Comparing Roth Conversion Amounts by Age



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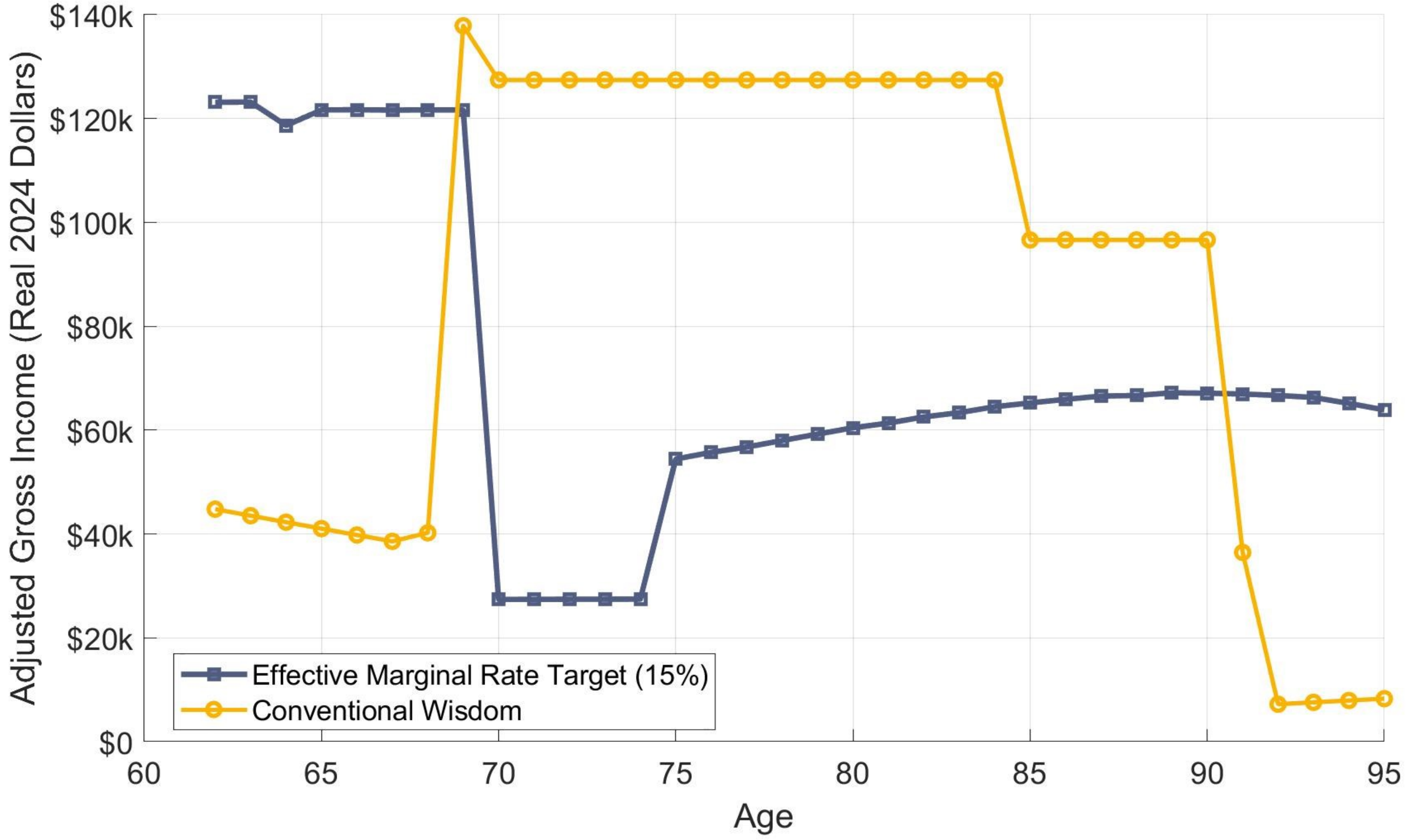
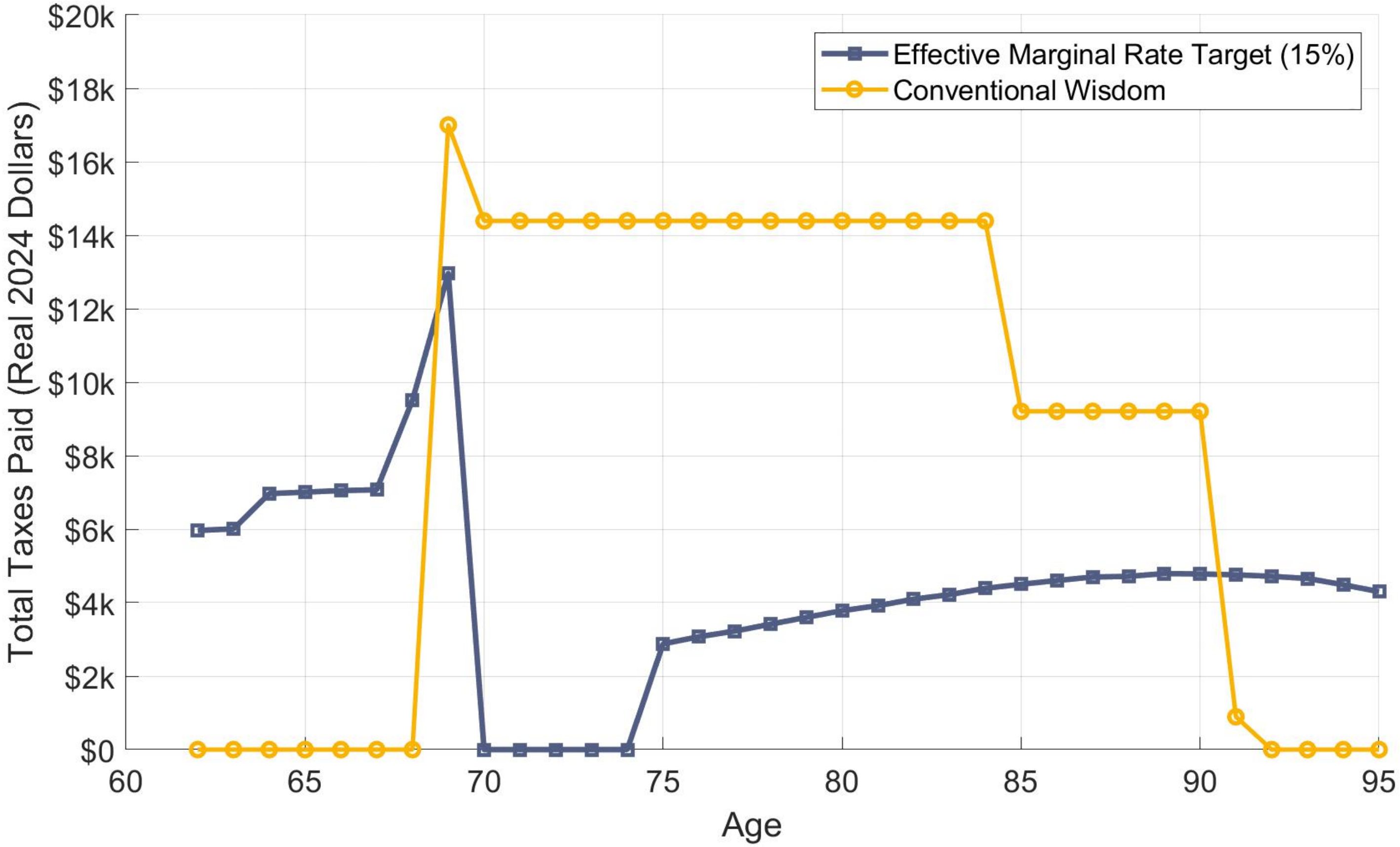
Comparing Adjusted Gross Income by Age



Hypothetical example for illustration purposes only.

Comparing Total Federal Income Taxes Paid by Age



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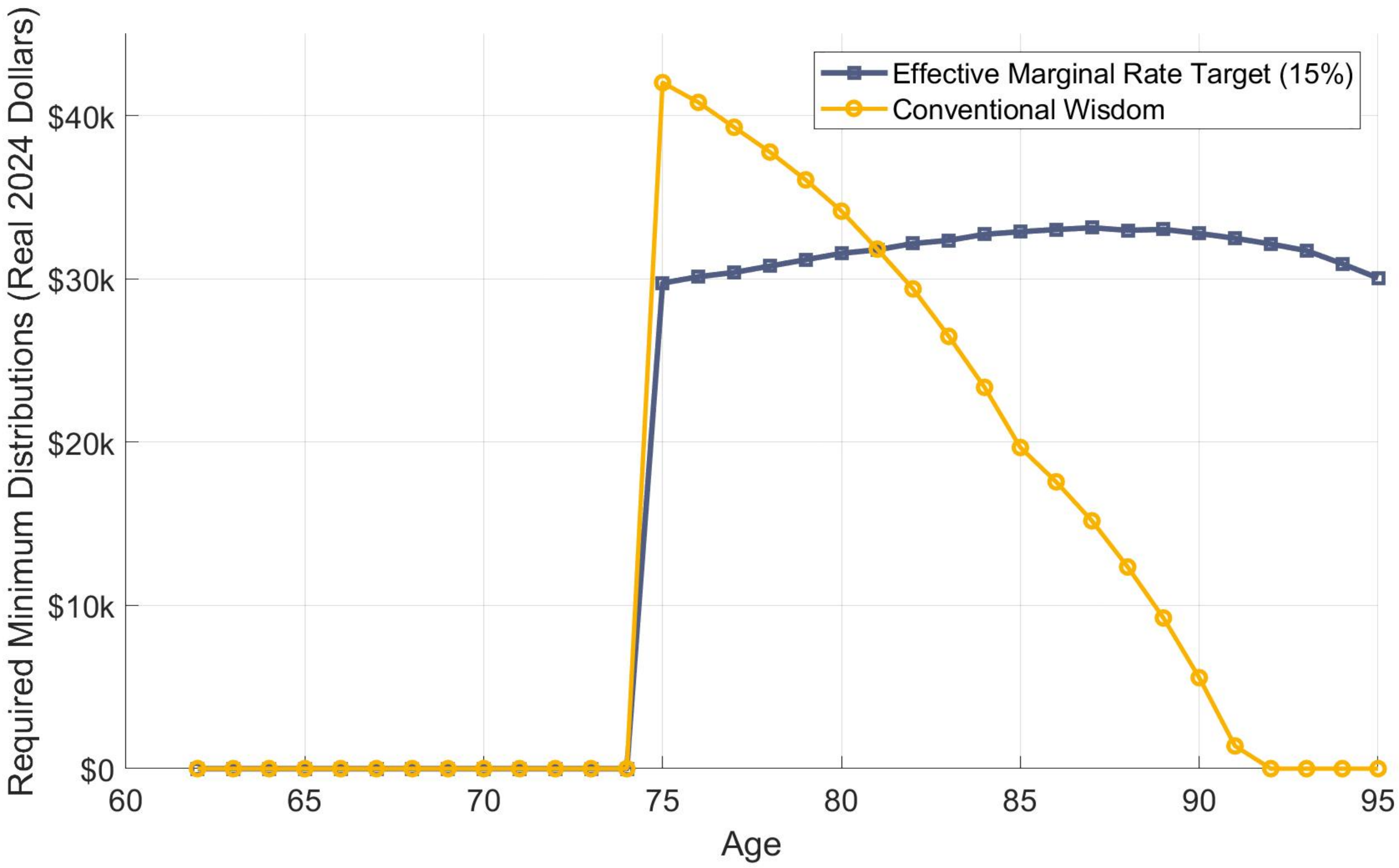
Comparing RMD Amounts by Age



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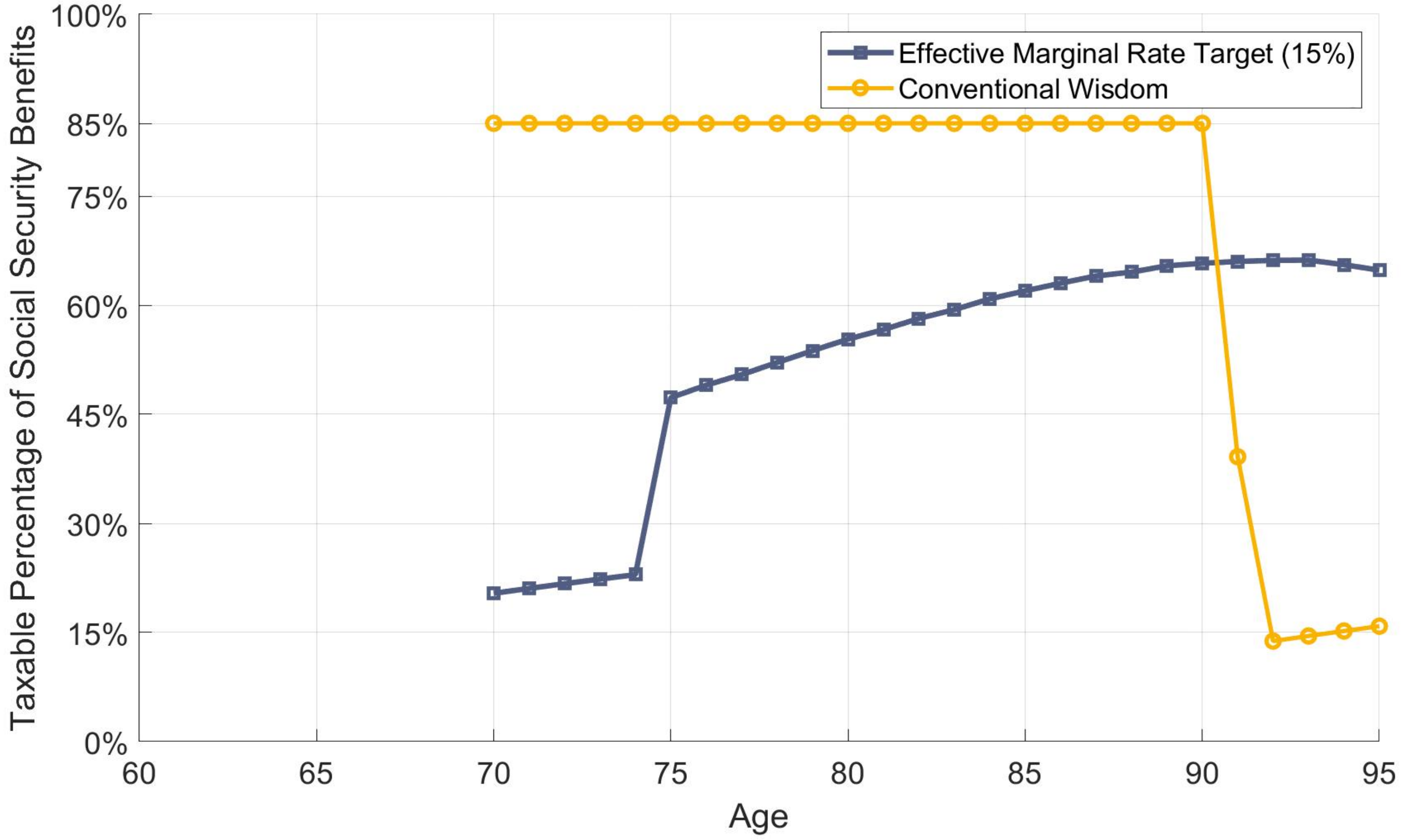
Comparing the Taxable Portion of Social Security Benefits by Age



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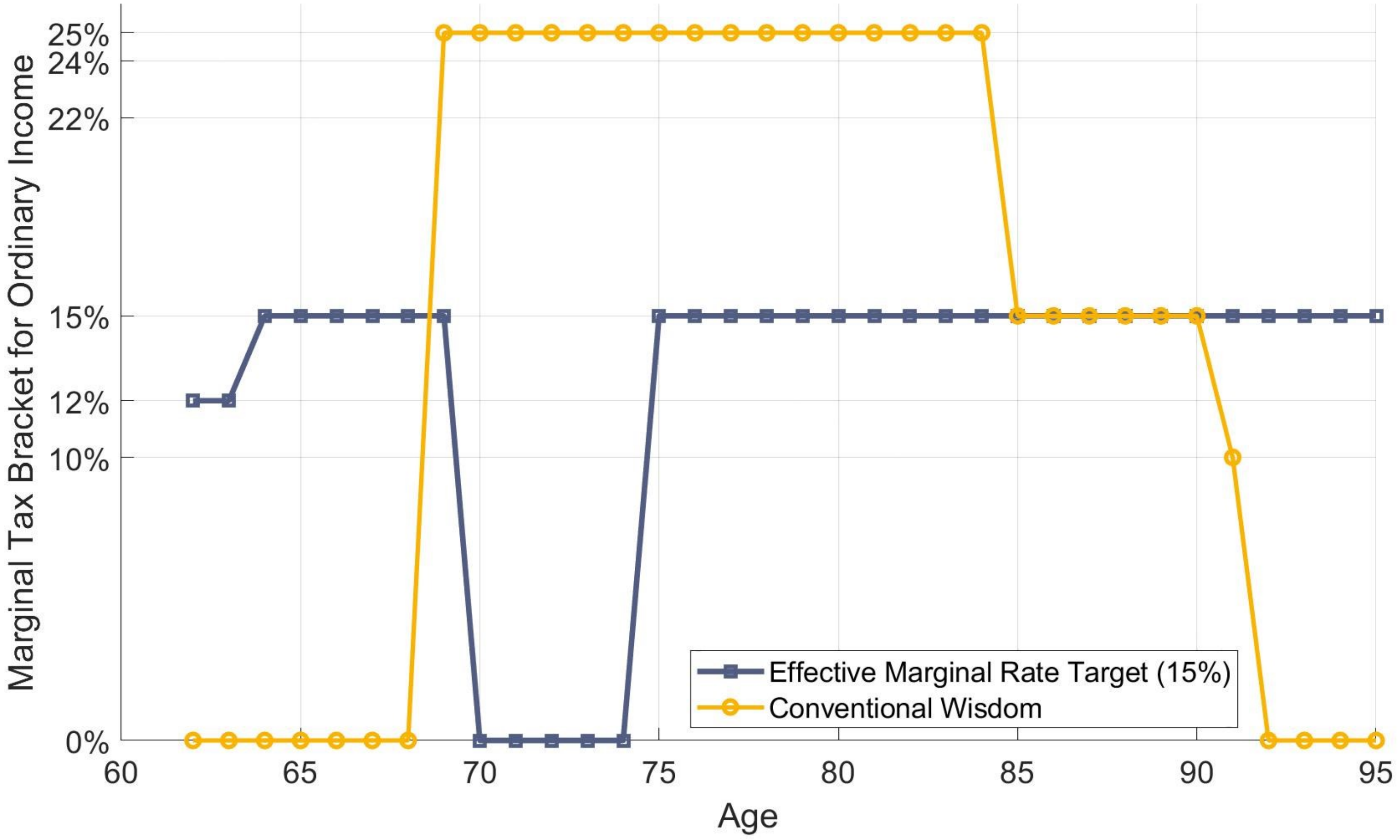
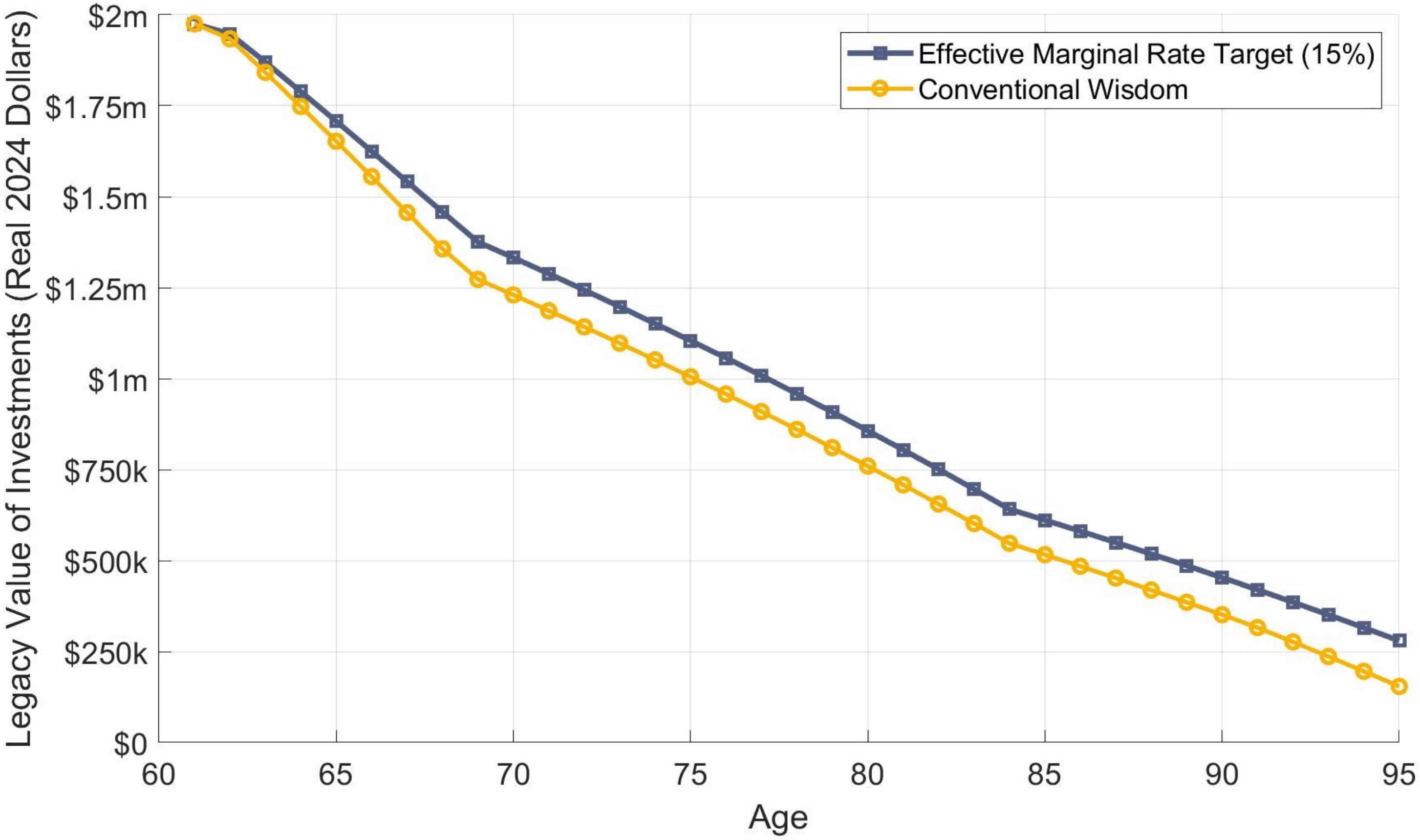
Comparing the Marginal Tax Bracket on Ordinary Income by Age



Hypothetical example for illustration purposes only.

Comparing the Legacy Value of Investment Assets by Age



After-tax Legacy Value of Investment Assets: 100% of taxable account, 75% of IRA, 100% of Roth IRA

Hypothetical example for illustration purposes only.

Conclusion – Key Ideas

- Important: progressive tax code & various pitfalls that raise effective marginal tax rates
- Tax diversification
- Manage tax rates & strategic Roth conversions

THANK YOU!
ANY QUESTIONS?

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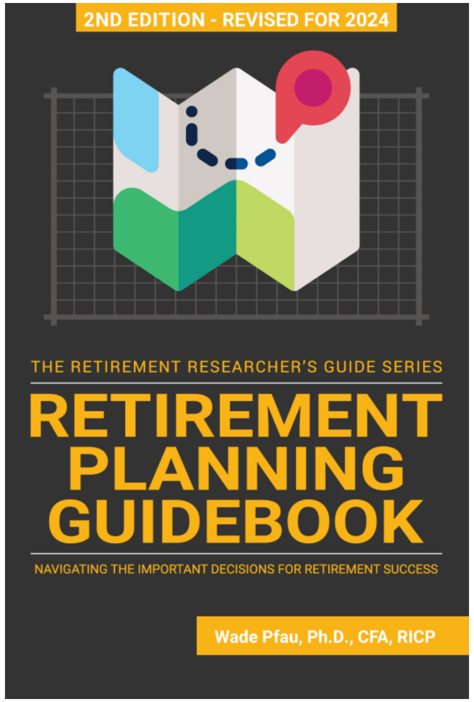

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