10 Questions

WITH NOTEWORTHY PEOPLE

Ed Slott on Roth IRAs, Automatic IRAs, and Retirement Planning

by Amy E. Buttell

Who: Ed Slott, CPA

What: Founder of Ed Slott and Company LLC, author of several books including *Stay Rich for Life! Growing and Protecting Your Money.*

What's on his mind: I think the IRS should get rid of all the 10 percent penalties for taking money early out of a retirement account. For the government, it's a deterrent for taking your money out early so some people don't blow their whole retirement.… But, in this economy, a lot of people are desperate.

I understand people have to pay a tax on the money … But, just when they need it most, they get hit over the head with another hammer, a 10 percent penalty just for being in bad financial straits.

PODCAST

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In the late 1980s, Ed Slott was a CPA practicing on Long Island, New York. Like most CPAs, he dealt with a lot of tax issues and frequently was left trying to pick up the pieces when clients—or their financial advisers—made financial mistakes with large tax consequences. The most painful mistakes, he remembers, were those involving retirement accounts.

"People came into my office in March, and I'm sitting there saying, 'What did you do?' It was always something that happened last year, something that I couldn't correct like a rollover gone wrong," he says. "The problem was, I was at the end of the food chain. When you're doing taxes, you're recording history. So people work 30 or 40 years to build up a $400,000 401(k) or IRA and the plan was to take a little out each year or pass it on to loved ones. Well, now it's all taxed in one year because the adviser, who moved it, didn't check that it didn't go into an IRA," he adds. "There would be horrible mistakes like that, where I was the messenger. I would constantly hear these horror stories, and either my clients would be getting bad advice or no advice at all. I realized there was a giant void of information and advice around helping people take money out of retirement accounts."

Slott eagerly jumped on this new business niche and started giving seminars. It took a few years to build up the niche and his expertise. "It's like learning a new language, even if you're familiar with taxes like I was," he recalls. "I could see this was going to be big. Every time retirement money is in motion, you have a potential problem. You have a potential fatal error, which means it all gets taxed before its time, which undoes even the best investment planning."

The make-up of the seminars Slott was doing started to change. At first, it was mostly consumers. But then other advisers got interested in what he was doing. "I was doing so many seminars, I guess I started attracting financial advisers," he says. "But, I guess they kept seeing my ad in the paper and thought I was making a killing, which I wasn't at that time."

"So, I think they originally came there figuring, hey, if this guy is onto something, we could do it," he adds. "Then, they realized they didn't have the knowledge to do it." When they realized he wasn't in competition with them, they suggested that he give seminars for financial advisers. Those were so popular that he hardly had time for his own accounting practice, so he started to charge for the seminars.

"I started charging and people started paying and all of a sudden I was in a new

business, which I never intended to have," he says. "This was just a by-product. What it turned into, in a big way, is a consulting and speaking and training business."

Slott had an idea of what he was onto then in terms of how big the business of helping advisers and consumers with retirement and tax planning around distributions could be. "See, back in the 1980s, I knew," he says. "I mean, not that I was a big prognosticator, I just said, 'Well, all these people are 50 in 1980. I'll bet you in 20 years, they'll be 70 and they'll need help.' That was my big prediction, that anyone alive in 1988 would be 70 in 2008 and it worked out.

"I realized that people are in transition, money's in motion, and that's still the case today more than ever before," he adds. "In fact, with the economic downturn, rollovers, layoffs, there's so much money in motion and that's when the big mistakes are made, when people are not checking things. So, you know, this is still as big a niche as it ever was, especially now, with 80 million baby boomers all in the same boat—the opportunity is incredible."

For financial advisers, the bottom line is this, Slott says, "If you really want to attract the retirement market, you have to address the tax planning issues involved. It's the number one, biggest factor that will separate people from their money. So, it doesn't make a difference how much money you make them, it's how much they keep that counts and everybody knows it. And, if you can help them keep more, you'll have more, they'll have more, you'll have more business, more referrals, and better business because you'll be looked at as a planner, not just somebody who picks funds."

1 *Why are distribution planning and tax planning in retirement such important issues for advisers and their clients? What, if anything, are advisers not paying attention to in this area?*

The typical financial adviser gets into the business and thinks, "My job is to make people money." But when taxes are reaching the level that we're seeing now, and going to see, taxes become the single biggest factor that will determine how much of their money, their gains, they will actually keep. Most advisers are not trained on how to handle distributions; they're trained on taking money in and investing that money, and even if they do well for their clients, say they make them 10, 20, even 30 percent a year, if the client loses more than half of it on the way out, what have they done? They've built a savings account for the government.

So, you need that specialized knowledge in what I call the second half of the game, the distribution planning, not just the first half, which is accumulation. Of course, you need accumulation to have something to protect. But once you have reached that point, or you're picking up a client that already has money, job one has to be to protect it from taxes because that's going to be a bigger hit than any investment.

The rules in this area are very complex because these monies are tax-deferred. They're loaded with taxes, so the government wants to make sure they get their cut. You have to work your way through this labyrinth of rules. But some of the rules can be used to your advantage and that's where advisers can really do well for their clients.

2 *You've said this area of retirement planning is a huge opportunity for advisers. How?*

Because, if you really know your stuff, you can make sure your clients end up with more money than they ever had and more of it tax-free. Probably the best analogy is a medical doctor. Everybody understands that the general practitioner is a generalist. He's not a cardiologist. He's not a neurologist. He's not a brain surgeon. It doesn't mean he's a bad guy, he just doesn't have specialized knowledge in those areas. It's the same thing here. The average adviser may not be a bad guy, but he or she just doesn't have the knowledge in this area. People don't know what they

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don't know, and that's most of them. But the worst part is, to not want to know. That's dangerous. You can't just keep making people money and thinking that's good enough if there's a tax bill associated with it.

3 *What kind of proactive financial planning moves should advisers be making right now for their clients?*

You really have to look through a client's balance sheet, that's the key to this, and see what kinds of money they have. Basically all clients have four kinds of money: cash, which is already taxed; capital gain property, that's property that if you sold it would produce capital gain rates, on which the long-term rates are lower than ordinary rates; tax-deferred 401(k)s and IRAs; and then the tax-free category, like Roth IRAs and life insurance. The goal, really, is to get the first three categories into the last one, to start moving everything to tax-free territory. You need to have some kind of plan to have consistent movement there. Because, if you don't do it, the funds end up being a sitting duck for higher taxes.

So, it may take some moves now. That may mean selling some stocks and paying a low capital gain rate at 15 percent; you'll never see that rate again after this year. These are the conversations clients want to have right now, not about what stocks to invest in. It's hard to stand out as an investment adviser just doing investments because everybody does that.

4 *In regard to Roth conversions, how can a conversion affect a client's taxable income and potentially affect Social Security benefits and Medicare premiums?*

With a Roth conversion, you're going to have a spike in income, one or two years if you take the two-year deal for 2010. So, for the years that a Roth conversion hits, yes your income will be increased and it could trigger the tax on Social Security and raise your Medicare Part B premiums. If that makes you angry, like a lot of clients are already saying they're angry about that, well, then, you're still better off converting. Because, if you don't convert, that means you're leaving it in a traditional IRA, which means you're going to be subject, very soon, to required minimum distributions. They may be smaller amounts, but that's going to raise your income every year anyway. So, it's better to be angry for one or two years than to be angry the rest of your life.

5 *Do you think the government will eventually tax Roth IRAs?*

I call this the big Roth IRA question and I get it in every seminar I've ever done with consumers. I tell every adviser at my seminars, "You better know the answer to this question because you're going to get asked when you go out and do seminars to consumers and prospects, somebody's going to ask you this."

Then, I proceed to tell them, here's the answer: there is no answer. But, here's what I say.

I start with my Yogi Berra quote. He says, "I never make predictions, especially about the future." So, that's what I say. Nobody knows what the future will bring. But, I'm betting that they're not going to tax Roths in the future for a couple of reasons.

First of all, it would be politically risky. I think it would be political suicide for somebody who voted for it that they were seen as reneging on their tax-free promise and that would never be popular. The other reason, I think the big elephant in the room, the big reason they won't touch it is because our government is broke and Roth IRAs bring in money up front.

Taxes are going to go up later anyway. I think it's more likely that taxes will increase, then they will repeal the Roth IRA.

6 *You've written about the effect that healthcare reform is going to have on retirement planning. What are the issues involved?*

There are actual taxes that could affect people's investments. Advisers should be looking at that. In 2013, these big taxes hit, specifically a 3.8 percent surtax on investment income. They call it a Medicare tax. Now, it's essential that advisers act on this, not in 2013 when it hits. You've got to be proactive. Once it's here, it's harder to avoid. Right now, the planning is urgent and critical because after 2010, all the planning in the world is going to cost more because rates are going up.

So, the 3 percent tax on that investment income affects high-income people, which means income for a couple of $250,000 or more, or singles $200,000. So, this is a tax on investment income, things like interest, dividends, capital gains, annuities, royalty income, things like that. But, it's interesting what's not in that list. Distributions from IRAs and retirement plans are exempt, but they can push your income up to a point where it hits over the $250,000 and makes your other investment income subject to the tax, where normally it wouldn't have. I'll give you a simple example.

In 2013, you have a client that has only $100,000 in income, that's very simple. He's not subject to that tax because his income doesn't exceed $200,000 dollars. But, if that same year, he converts $500,000 dollars to a Roth IRA, well, now, his income is $600,000, and he's way over. So, now, the $100,000 becomes taxable at the 3.8 percent tax. Now, the 3.8 percent doesn't sound like a lot until you find out it's not 3.8 percent, its 3.8 percent in addition to the regular income tax.

In 2013, the top federal rate is scheduled to be 39.6 percent. Add the 3.8 percent tax, you're at 43.4 percent, and that doesn't include state taxes. In some states, like mine, New York, we'll push that over 50 percent on investment income. That, I think, is the tipping point where clients are going to say, "Why didn't you tell me about this?" They're going to say that in 2013. That's why you have to address this now.

7 *What issues have you noticed that financial advisers have in dealing with their own retirement planning?*

There are a lot. A lot of advisers are not prepared and many of them are making the same mistakes with their own IRAs that they are making with the clients' accounts. As a matter of fact, I just got a question from two different advisers who screwed up their own retirement accounts.

In one case, it was an adviser whose father died and left him a several hundred thousand [dollar] inherited IRA. He didn't know what to do. He was smart enough to call me, but not smart enough to call me before he made a fatal error. He said, "I went to your classes. I know it has to be set up as a properly titled inherited IRA. I went to the bank. I gave them the titling. The lady at the bank looked at me like I had four heads because the people at the banks don't know this either. She said, 'Why don't I just give you the check and you can make it out the way you want?'" So, she gave him the check and it was taxable. I said, "Why did you take that check?" I said, "Remember in my class, I said the minute it comes out it's taxable. You're a non-spouse beneficiary, which means you can't do a rollover.

"You can't put it in an inherited IRA now. Now, the whole $300,000 is taxable. You could have stretched that out over 40 years." He says, "I knew it, but she didn't know, and I took the check," and this was a guy that knew it. So, imagine, this is his own inherited IRA he blew.

8 *The Obama administration has proposed the creation of automatic IRAs, so that employees of small businesses that don't have retirement plans can save for retirement. Do you think that's a good idea?*

I don't think it's a great idea because it will just be another thing small business has to deal with. There'll be all kinds of rules and regulations. You know, they're going to say they'll make it simple. That's what they said when they created the Simple IRA and it's the most complicated of all the IRAs. You know, nobody needs that.

You can't baby people any more—either they're going to save or not. I realize if they're forced to save it's better and they'll be more likely to save. But, you can't fully put that on the employer. What if you employ somebody and they don't work out, or you have seasonal employees; how are you supposed to deal with it? What if the investments don't work out? Is that going to be your fault?

If it's going to happen, it's good that the default is the Roth because with a Roth IRA, contributions to a Roth IRA can always be withdrawn tax and penalty free at any time for any reason. That's not true with a traditional IRA.

9 *If you were in charge and you could make one change to the tax code in the area of retirement vehicles, what would that be?*

I'd get rid of all the half years. That is the most confusing item for retired people. When did I turn 70-and-a-half? Why is it 70-and-a-half and not 70? And it's the same thing with 59-and-a-half. The real root of this is from insurance regulations that go by how old a person is for insurance purposes. It's really confusing.

Another thing that really confuses people is the required beginning date. For the first year, it's April 1 of the year following the year you turn 70-and-a-half. So, for the first year, you have a choice of when to take it, the year you're 70-and-a-half or the year after, up until April 1. It confuses a lot of older people and advisers. If they got rid of the April 1 and just said, every year, once you turn 70-and-a-half and make it 70 instead of 70-and-a-half, the government for that half year will get a lot more money out of it.

Make it 70; everybody knows when they turn 70. I suggest to advisers, by the way, as a tip for building relations with clients, have a 70-and-a-half party. You know, it's something nobody has and you can imagine people saying, "A 70-and-a-half party?" "Yeah, it's my adviser. He's really into those IRAs." That's what you want people saying.

10 *You've built a very successful business and aren't shy about marketing your expertise both to advisers and consumers. What could advisers learn from you about building up an area of expertise and successfully marketing that knowledge?*

The key is to get remembered, and that's applying that education when you're visible. That's what gets you remembered. When clients and prospects leave my consumer program saying, "Wow, I never got this information from my current adviser." And they should be. That's the most common thing I hear at my consumer seminars.

If you really consider yourself a financial planner, part of planning is helping people keep what you've helped them earn. That's how I stood out. I still get people today who call and say the favorite thing I like to hear. They say, "You know, I have a CPA, but he's just a regular CPA. I need a specialist." That is just music to my ears because then I know I've accomplished what I set out to. That's how almost every client comes in. They've already had an accountant, but he was just a regular accountant.

People pay more for expertise. They pay a lot more. But it doesn't matter because it's nothing compared to the dollars [they save], and especially, when people realize that they get the answers pretty much right away. Not that we know everything, but we have so much background and foundation in it.

Clients are willing to pay for this knowledge because they realize, they pay a few thousand dollars, or $10–$20,000 dollars—doesn't matter if I'm saving them millions. And it carries over to their beneficiaries who then become clients. So, it's really a great business-building formula, if you're serious about it.

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