KEEN ON
RETIREMENT

Are You Missing Out If You Don't Have a Roth IRA?

Welcome to Keen on Retirement
With Bill Keen and Steve Sanduski

Steve Sanduski: Hey everybody. Welcome back to "Keen on Retirement". I'm your co-host, Steve Sanduski, and with me as always, Bill Keen and Matt Wilson. Gentlemen, how are you today?

Bill Keen: We're doing good this spring, Steve. How are you up there in Wisconsin?

Steve Sanduski: Doing well. Doing well. In fact, it was actually snowing here a little bit this morning before we started talking. The sun has come out now, so the snow has stopped, but yeah, here we are in April and we're still getting snow.

Bill Keen: Now, was that the lake effect snow that I saw when I visited you and Linda up there, or was this just traditional type?

Steve Sanduski: You know, that's a good question, because I have to look outside here and see which direction the wind's blowing, whether it's blowing off of the lake or not. There was certainly no accumulation, but yeah, I saw some snow coming down.

Bill Keen: Yeah, well we don't feel sorry for you. On Easter Sunday here in Kansas City, we had several inches of snow come through. So yeah, interesting weather here.

Steve Sanduski: All right. Well hey, I think a couple things we want to do here today. First is I think you guys have a story that you want to start off with, and then we are going to celebrate a 20th anniversary, and we're going to tease our listeners just a little bit with what that 20th anniversary is that we're celebrating.

Bill Keen: Yes, we'll hold out on them. We had an incident come up in the firm recently that we wanted to bring to the show today. One of the things about the financial services industry that we see is a very high client retention rate, like something up around 90% of the clients end up staying with their advisor over very long periods of time.

What we've found is, that's true even if the clients are receiving poor service, poor performance, no communication. What we believe the reason is behind this is that it's just daunting. All the paperwork that goes into moving, and going out and sharing all your information with a new financial planning team and firm can just be overwhelming.

So instead of voting with their feet and leaving and finding a new advisor, most folks end up just staying. I think that's tragic. You know, here at Keen Wealth, we run the risk by me bringing this up, we always tell clients if you're not happy with our service and with what we're doing, you can vote with your feet. It's one signature, and there's no cost to exit and go somewhere else. And I think that's really what's an important part about this fiduciary relationship that we have with clients is, there's no contracts holding them to us. There's no big fees to get away. Nothing like that, so we have to continue to earn the right to service our clients and to maintain that privilege over their lifetime.

The issue that came up recently was we met with a couple who had been referred in to us. They had moved into Kansas City from out of town, and they'd had a prior relationship at one of the big bank brokerage firms. I always hesitate to name names, so I guess I won't name names of the firm, but it was one that you would definitely recognize, we put them through our process, the holistic model that we go through at the firm, and then we took a look at their investments.

We noticed in their investments that they were paying a fee to this firm on nearly $2 million portfolio, but we noticed there had been no transactions, no trades, no movement in their accounts, although they were paying an ongoing fee to this firm. Once we determined that there was a fit for them here at our firm, and they determined that we were a fit for them, they decided to move their accounts here to Keen Wealth.

Being respectful of their old relationship, they called and they told their old advisory team that hey, we are moving our accounts to a local firm up in Kansas City where we live now, and we just wanted to let you know. And the response was shocking. It almost set me back. The response was, "Oh well hey, that's okay with us, because we've only been focusing on accounts that are 5 million and up for the past few years." Can you imagine that, Steve? I said, "What?"

Steve Sanduski: Yeah, that's horrible.

Bill Keen: So these clients had been paying a fee to a firm for what they thought was somebody watching over their accounts in their best interest. This is maybe too technical for our podcast today, but they were actually in a program that was charging them ... correct me if I'm wrong, Matt ... just a fee in lieu of trades. Is that right, a fee in lieu of transactions?

Matt Wilson: Yeah.

Bill Keen: So it was not a fiduciary engagement. The client in that case legally, actually, had the responsibility to call in and tell the advisors what they wanted to do, but the client thought that these people were watching their investments and that the fee was covering advice, fiduciary advice, when in fact there had been nothing done in these accounts for two years. And then gosh, I mean come on, when they called to let them know they're moving their accounts, they let them know they haven't been working on anything less than 5 million for a number of years now. I say why don't you tell them that years ago, before you charged them all these fees the last few years to do nothing?

Steve Sanduski: Yeah, it's just terrible, and I know that would never happen at Keen Wealth, and fortunately-

Bill Keen: Well, it better not. Well, I could assure that, that's right.

Steve Sanduski: Fortunately, those folks found you guys, and they got referred to you, and I think that's just a perfect example of the great work that you guys are doing at Keen Wealth, is that you have clients that refer people like that to you to get much better fiduciary service. It's sad that we still have to hear those kinds of stories out there.

All right, so what is this 20th anniversary we're going to be talking about here today?

Matt Wilson: Yeah, this is one of my favorite topics, and 2018 ... is the 20th anniversary of the Roth IRA.

Bill Keen: Wow, that's exciting.

Matt Wilson: It is exciting.

Bill Keen: Well, it is exciting, because it's a great tool, but I thought it was going to be we were going to have some sort of fanfare here. Steve, you haven't had any of your sound effects lately. I mean literally, the last year or so we could have used a drum roll or something there.

Matt Wilson: A drum roll, yeah.

Steve Sanduski: Well, I'll tell you what. You guys keep talking, and I am going to pull up my app, and when you least expect it right here, you're going to hear a sound. So I'm going to go dark for a minute while you guys talk.

Matt Wilson: Now, we also have another anniversary this year. 2018 is the 40th anniversary of the traditional IRA. A couple of things to celebrate, tax-deferred earnings and tax-free earnings.

Bill Keen: Well, I think that a number of years ago, decades ago as we sit here today, that our leaders started to realize that we were going to be more responsible for our own retirements than having those pensions just take care of everything, weren't they?

Matt Wilson: That's right, yeah. The onus is on us to save for retirement. We love talking about that, because there's a lot of planning that goes around IRAs. The planning is intense, and it can get complicated and a lot of number-crunching, but the reason it's so important is because one of the biggest expenses that someone has in retirement is taxes, and so it's all about how can we diversify our tax situation? And that's how we can use Roth IRAs. I've seen some estimates lately: $9 trillion in IRA assets, so it's definitely caught on over the last 40 years, with the advent of the traditional IRA and then over the last 20 years with the Roth IRA. And the Roth IRA is getting more and more popular with ... Another study I saw, with individuals that are contributing to IRAs that are under the age of 50, 90% of those contributions are going into Roth IRAs.

Bill Keen: That's good news.

Matt Wilson: It is.

Bill Keen: That means some of this financial literacy that we're talking about, and other commentators, is working.

Matt Wilson: That's right. I mean, people are saving, and they're thinking about where to save those assets. And I think it's helpful always to just explain the differences too. We've got traditional IRAs, if you've been making contributions to traditional IRAs over the years, or if you've been making contributions to your employer-sponsored retirement plan and then you roll that over to a traditional IRA. That's where most folks have their funds. Those contributions are done, typically, on a pre-tax basis. You put in money, you get the tax deduction in the year you make that contribution. You get the advantage of this tax-deferred growth, and then at a certain point when you withdraw money, you pay the income tax at that time.

Bill Keen: Right.

Matt Wilson: The Roth IRA, the difference with the Roth, is you don't get the tax deduction for the contribution, so you put in what we call after-tax money into the Roth IRA, and then it grows tax-free. So no deferred taxes, because you paid the tax upfront, and then there's also no required distribution on those amounts either. So you can leave money in the Roth IRA for the rest of your life. You don't have to take the money out.

Bill Keen: No required minimum distributions at 70-1/2.

Matt Wilson: That's right.

Bill Keen: That does not exist. So Steve, if I was to ask you, would you rather have money at a regular IRA, a traditional IRA, a Roth IRA, or would you rather have assets that are outside of any IRA in an after-tax account, which one would you choose?

Steve Sanduski: Yes. All of the above?

Bill Keen: I think we stumped him, Matt. You know, he is a certified financial planner. I expected him not to be stumped by this.

Matt Wilson: Well you know, I think he's thinking of the tax diversification of ... there's advantages to all three.

Bill Keen: Well, he's also thinking about having more assets. But okay, let's just say you had one amount, which one would you rather have under Matt's simple definition?

Steve Sanduski: Well, all I can say is ...

Recording: Happy birthday.

Bill Keen: So I guess that means the Roth IRA, Matt. We finally got that answer out.

Steve Sanduski: The Roth IRA.

Bill Keen: Of course. Of course. Tax-free forever. So that's a very powerful tool. Now, a lot of folks talk about well, are they going to change that at some point? Am I going to have made all these post-tax contributions and then simply to have the government reverse that ruling and tax me on that at some point? We did a blog post last year on that, why we think that will not happen. In fact, Congress now, if you look at some of the information they've been putting out, they're actually favoring the Roth going forward.

Matt Wilson: That's why we talk about diversification, having buckets of money in traditional IRAs, in Roth IRAs, and in after-tax money, because it gives you those different choices in terms of when you take money out, but then also does maybe alleviate some of that risk, because they might change the rules on one of those types of accounts.

Bill Keen: That's right.

Steve Sanduski: Well, guys, can you give me an example of a typical person that you work with, maybe someone in their early 60s who's retiring, can you give an example of the circumstances where it would be a good planning strategy for that person to do a conversion from a traditional IRA to a Roth IRA? What are some of those circumstances where it would be appropriate from a planning standpoint?

Bill Keen: Steve, you just hit on one of the two ways to get money into a Roth IRA. There's two ways. One is to make contributions each year, if you qualify to do so. A Roth contribution is the $5,500 if you're under 50, or $6,500 if you're over 50, and in either case you have to have earned income in that year to be able to make those contributions. Now, those are Roth contributions. One other note about that: you can make those contributions at any age, so if you were 90 years old and you still had earned income, you could continue to make those Roth contributions. In the traditional IRA, you cannot make contributions past the year you turn 70-1/2. Just as a side note there, a little more flexibility.

The other way, and to your point, Steve, to get money into Roth IRAs is to do a conversion, and a conversion is simply taking any amount from a traditional IRA and telling the IRS that you'd like to turn it into a Roth IRA. Well, why do they allow you to do that unlimited? Well, because it triggers the tax now on the entire amount that you converted, so you and the government are both making a bet on what tax rates look like in the future and who wins on that. Now, I would say the government likes it, because the government's not thinking that far ahead. They're trying to make it through this year, much less 20 years from now, so they like it when taxes get paid sooner than later.

When a conversion happens, you have to be concerned about the increase in your income for that year, as I mentioned, and that will impact ... or it can ... deductions, credits, exemptions, phase-outs of deductions, the taxation of your Social Security benefits, and also Medicare Part B and Part D premiums. So those are kind of side effects. You make one decision, and it has this cascading effect.

We had clients come in recently that have retired early in the year this year. So their earned income will not be a whole lot this year, they have large deferred comp payments that will be paid to them next year in '19. They will have then five years after that before required minimum distributions kick in from their IRAs, which were pretty substantial, multiple seven-figure IRAs.

In this particular case, this client should do a Roth conversion this year, in 2018, nothing in 2019, because of the deferred comp payment that's coming out, and then the next four to five years, until age 70-1/2, there is another window there for that client to do some probably pretty aggressive Roth conversions up until age 70-1/2, to really get some money out of those traditional IRAs that are subject to the required minimum distributions and over into that tax-free environment. That sounds kind of complicated, because it's one year yes, one year no, next year yes, and it's a calculation that has to get done every year, doesn't it, Matt?

Matt Wilson: It is, it's an ongoing discussion that we have on an annual basis, and it's because there are different ramifications. As Bill mentioned, there's no conversion that is one size fits all. Everybody's situation is going to be different because of the impact of the conversion on those other items that Bill mentioned. For us, we

look at primarily what are the tax consequences? So if an individual or a married couple, if they're in the two lowest brackets ... so that's the 10% bracket and the 12% federal bracket, those are the two lowest ... if they are in those brackets, that for us is an easy calculation and an easy recommendation to say we really need to look hard at this Roth conversion.

Bill Keen: Do we think taxes are going up in the future, that we're going to enjoy these low tax rates for an extended period? I believe the taxes are going up in the future. I mean, you just have to look at the deficits that we are carrying and the debt that we're carrying. Steve, I hate to tell you this, sir, but I do think the tax rates are going to go back up again in the next five to 10 years.

Matt Wilson: Now, one caveat to that is people have been saying that for the last 10 years.

Bill Keen: Okay, prove me wrong. I hope I'm wrong.

Matt Wilson: Prior to this year's tax ... We just don't know ... When we are in very low brackets, it's hard to see them getting much lower than that, especially in those lower two, because the way the tax system works is as your income increases, the percentage tax you pay is higher on additional income. So low income, we are in low brackets, and it's probably not going to get much lower than that. But there are impacts of this conversion if you're on Social Security, how much tax you pay on your Social Security. If you have after-tax investments, how much tax you pay on dividends. And then if you have capital gains in after-tax investments, how much tax you pay on those. So a conversion might trigger additional taxes that you weren't aware of, and that's why it's an ongoing calculation each year.

Bill Keen: That's right.

Matt Wilson: But even now, this is one thing with the new Tax Cuts and Jobs Act of 2017, with these lower brackets, that we are looking at making conversions even now into the third bracket and possibly even higher, just because the effective tax, which is the total tax you pay over all of your income, is still significantly lower than it was in previous years, and so we're having those conversations about well, if we push it up, yes, the percentage tax we pay on that additional income does increase, but here's what we're paying. And then if we project out what RMDs look like, this is if we don't do this, your RMDs could be this, if we do do this, here's what your RMDs could look like. And so just having that conversation is, we feel, very prudent.

Bill Keen: I thought I would mention briefly, there are income limits for Roth IRA contributions, so now I'm talking back again about putting in the 5,500 or the 6,500, and if your income exceeds 120,000 as a single person or 189,000 as a married filing jointly, they start to phase out your ability to do those contributions. So there is a methodology called the back door Roth IRA, which simply says you can still make an after-tax contribution, an after-tax

contribution, to a traditional IRA, regardless of your income, but then the IRS allows you to then convert that to a Roth. In the past there had been concerns about the legality of the back door Roth conversion, because I mean, just the concept of calling it a back door anything sounds like it could be shady, if you will. The strategy almost seems too good to be true, or did, but these transactions have consistently had those rumors, but the Tax Cuts and Job Act appears to put those fears to rest, because they confirmed that the back door Roth is an allowable strategy, and there's several references to it included in Congress's Conference Committee Report that accompanied that new law. So that's something to be aware of.

One last factor on that, if you have any other IRAs outstanding, they will take them and total those IRAs and look at how much of the IRAs were after-tax, how much were pretax, and then the conversion, even if you just converted the 5,500 that I just mentioned that was all after-tax, they'll pro rata look at it with all your other IRAs, and so you may get a surprise, in that the majority of it, if you had other IRAs existing at all different places, spread around or even at the same firm you will have a pro rata tax treatment of that conversion. That's something to be aware of, and something we just came across in the firm here recently, didn't we, Matt?

Matt Wilson: We did. Yeah, we had an individual that we met with, and they had explained to us that they had made a Roth conversion last year, and they had thought they had been operating using this back door Roth. They wanted to do it again in 2018, and we said, "Well, wait a minute. When we look at your assets, you have existing traditional IRAs, so even though, yes, you converted a non-deductible IRA, the IRS looks at all of your existing traditional IRAs, and they're going to send you a tax bill for a piece of that conversion, because they're going to assume ... they call it an aggregation rule, so they just assume that percentage that was tax-free, let's say it's 10% ..."

Bill Keen: I call it pro rata.

Matt Wilson: Yes. "... if that percentage, your after-tax contribution was 10% of all of your traditional IRAs, well then your conversion is only 10% tax-free, 90% taxable." Now, they have the ability to reverse it, so we caught this, and we explained this to them, and they're working with their CPA and their existing custodian to get this reversed.

Bill Keen: The 2017 one, they did prior?

Matt Wilson: That's right.

Bill Keen: Yes, because the new tax law says you cannot re-characterize these Roth conversions anymore, in 2018 and beyond, but that one they still could.

Matt Wilson: '17, you're still under the old rules for this little bit longer, but '18, yes, if you do this now going forward and you're not aware of these rules, there's no going back and fixing it, you're just paying the tax. Now, there's no penalty on these conversions. There's federal and state tax, income tax, but there's no 10% penalty too. So that applies if you have a traditional IRA and you take a distribution prior to age 59-1/2, there's tax plus a 10% penalty. And so we get this question a lot too, for individuals that are younger, hey, if I convert money, I'm going to have to pay that penalty, and Roth conversions do not have the penalty applied to them. One extra piece to this is their CPA wasn't aware that they made a Roth conversion last year ...

Bill Keen: I didn't know that part of it.

Matt Wilson: ... so it wasn't even being reported on the tax return, which typically the way the IRS works, it's about a three-year lag-

Bill Keen: They would get an audit.

Matt Wilson: ... and there would have been, "Hey, you forgot to report this. Here's the tax, and here's now your penalty the IRS is assessing, plus interest."

Bill Keen: Right. Well, I'm glad ... You know, we had Ray on last episode, Ray Arellano here at the firm, one of our planners, head of the Financial Planning Division, and he caught that when he was looking through this client's situation, so kudos to him for helping them avoid some problems down the road.

Steve Sanduski: Hey, that raises a question. Maybe you addressed this already, but when you were just talking about this 10% penalty, I was thinking what happens if you have someone who is, let's just say they're 45 years old, and they decide to convert a traditional IRA to a Roth IRA, and they pay the tax, so now they've got their money in a Roth IRA. We know that with a Roth IRA you can take the money out tax-free. Now, can you not take that money out until you're 59-1/2? Or can you take that money out at any age once it's in the Roth?

Matt Wilson: Yeah, great question, Steve. You have access to your contributions tax-free whenever you want. We look at IRAs as retirement savings vehicles, so that's not something that we recommend unless someone is just in dire straits to take their contributions out, but you have access to your contributions tax-free, no matter your age.

Now, conversions and earnings, there are different rules around when you can take those funds out. Earnings have to be in there for at least five years and over 59-1/2 to be tax-free. So when you have any earnings on the investments, those stay in there up until 59-1/2 or five years. You have to meet both those rules to be qualified distribution. The conversion also has a five-year rule on the holding in terms of how long you have to hold that conversion before you can take that money out without the penalty. Now, there'd be no tax on the

conversion, because you've already paid the income tax, but there would be the 10$ penalty if you took the converted dollar amount out prior to age 59-1/2.

Bill Keen: Now, if I want to complicate this a little bit more, Steve-

Steve Sanduski: I'm sorry I opened up this can of worms.

Bill Keen: No, I mean these are interesting. But let me tell you one more thing about converting to a Roth prior to age 59-1/2. If you use the money from your IRA to pay the taxes on the conversion, and you're not 59-1/2, the portion that you used to pay the taxes is taxed, and it's also penalized at 10%.

Matt Wilson: So in other words-

Bill Keen: So you want to make sure you pay the taxes out of outside capital if you're doing a Roth conversion pre-59-1/2. And essentially, really it's better if any time-

Matt Wilson: In any case.

Bill Keen: ... you're doing a Roth conversion to use outside funds, because you're trying to maximize what you're getting into the Roth IRA.

Steve Sanduski: Well, guys, I know we've covered a lot of ground here in the Roth IRA, and it sounds like there's some real interesting planning opportunities, but you have to be very, very careful, and you gave that great example of someone who tried to do it on their own, they thought they did the back door IRA, but when they came to you, you guys looked at it and realized that there was a problem. So this is not necessarily something that you want to do it yourself, because there are some significant rules here that really need to have a professional to understand. So thanks for sharing that great example.

So guys, I think we should probably wrap up here. We've got a lot to digest in today's episode. So any final thoughts from you?

Bill Keen: I want to sneak one last one thing in. This comes up a lot in the firm. We deal with people that are rolling out money at retirement from 401(k)'s and from ESOP plans that have been in existence for a long time, a lot of 40-year veterans of companies, and some of those plans have after-tax money in them. And the clients don't realize that. The IRS allows us to get aware of how much of that money was truly after-tax contributions inside of those plans, and instead of rolling that, commingling those with the pretax funds and essentially being double taxed on them at some point when they spend that money or withdraw that money, they can roll the after-tax money that's inside of a 401(k) or an ESOP over into a Roth at the time of retirement. It's a very powerful tool to be aware of.

Finally, I want to encourage folks to talk to their kids and their grandkids, and encourage them to fund Roth IRA accounts if they can. A minor can make a Roth IRA contribution if they have earned income, even from something such as a summer job. But getting those tax-free accounts started early, time is your friend on these things, and I've shared this before on the podcast, each of my kids have Roth IRAs. And it doesn't take a whole lot of money early on in life to plant the seed, plant the tax-free seed, and get something substantial building for those kids and grandkids.

Steve, with that, thank you for allowing us to go technical today on our show. We do take it very seriously, and we appreciate our listeners' attention and willingness to kind of go down some of these avenues and think these things through.

Steve Sanduski: Yeah, well I think it just shows the level of detail that you folks do here at Keen Wealth, and just paying attention to that detail, because this is serious stuff, and one mistake here can cost people a lot of money. And so I think it's just important that you're able to share some of that detail and how you guys look at this stuff. So appreciate that. So, yeah. Another great episode, great value here, guys. I appreciate it, and we'll look forward to talking to you on the next episode of "Keen on Retirement".

Bill Keen: All right. Thank you, Steve.

Matt Wilson: Thanks, Steve.

Keen Wealth Advisors is a Registered Investment Adviser. Nothing within this commentary constitutes investment advice, performance data or any recommendation that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person. Any mention of a particular security and related performance data is not a recommendation to buy or sell that security. Keen Wealth Advisors manages its clients' accounts using a variety of investment techniques and strategies, which are not necessarily discussed here. Investments in securities involve the risk of loss. Past performance is no guarantee of future results.