Potential Changes to Your 401(k) - Transcript

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Tom Mullooly: Welcome to the Mullooly Asset Management podcast. This is Episode number 259. Thanks for tuning in. I am your cohost, Tom Mullooly and with me today is my other cohost, Brendan Mullooly.

Brendan M.: Got a lot to discuss, I think, right?

Tom Mullooly: So I think the first thing that we want to jump into is Congress is sticking their fingers into retirement plans again.

Brendan M.: Yeah, they're thinking about some changes to the retirement landscape. I have to put it that way because they ... It's kind of a whole host of different topics that they jump around on, which is often the case. They kind of try to band things together and then put them through. I don't know what the headliner is in this package that they're trying to get approved, but ...

Tom Mullooly: I don't even know the reason why they're doing this. As far as I can see, it's a revenue neutral kind of package. There's nothing that increases tax revenue. It doesn't really decrease it. It defers it a little further down the road, but I don't see any reason why they're even doing this. They're not even tackling the fiduciary role, which is ... I mean we could do a whole another podcast on that.

Brendan M.: Yeah, I think that that would be more important in terms of making an impact let's say, but ...

Tom Mullooly: But what do we know? Right.

Brendan M.: Yeah. There were a handful of things in this proposed bill that we find interesting or have some thoughts on, positive or negative.

Tom Mullooly: I think there's three or four highlights that we want to touch on. What was the first one?

Brendan M.: The first one is that they would like to encourage plans like 401ks in a workplace to offer annuity options within the plan, which this has been brought up before.

Tom Mullooly: Yes.

Brendan M.: I want to say like 100 episodes ago on this very podcast.

Tom Mullooly: Right.

Brendan M.: We recorded, except that we were in our previous office when we talked about this. I remember talking about it with you before.

Tom Mullooly: You have a good memory.

Brendan M.: You had a standing desk. It's now my standing desk.

Tom Mullooly: It's your standing desk now. That's right.

Brendan M.: I remember ... We've talked about this before and so you probably have seen it multiples of the times since I am seeing it for at least a second time now, probably more.

Tom Mullooly: Part of the big issue is when you look at the lump sum. Let me back up even further. When you get your pension statement, if you have a pension, somewhere near the top of the statement is going to say, "You're on track to receive a monthly pension of X dollars per month", right? Sometimes they don't even tell you what the lump sum value is. A 401k statement is totally different. They hardly ever, they do, but they hardly ever tell you what this could translate into in a monthly income.

Brendan M.: Can we take an aside there? Because I think that if you reported that number to people, which is the one that actually matters to almost everybody out there whose using 401k type plans, the amount of monthly income that this is going to generate when you decide to stop working, people would probably behave so much better with their investments. Because that number is going to change so much less than the headline of lump sum number of whatever is in the plan and if we're talking about functionality, that is realistic ... I mean that is what we should care about, is it not? How much income is this going to throw off?

Tom Mullooly: Absolutely right. And so what I think gets people’s attention is the staggering lump sum value of their 401k and they get to a point where they think whatever the number is for you, whether it's 250,000 or a million dollars, whatever that number is, just about everybody gets to a point where they're like, "Oh, my goodness. I can't manage this kind of money. I'm going to need an advisor to do this." And so what their introducing is the opportunity to when you want to, basically annuitize your 401k into a monthly stream of income.

Brendan M.: Which no longer requires management because you're turning over the lump sum to an insurance company who gives you a promise. As long as the insurance company is good, which I think is in most cases fine tying your hat on, you will get your monthly check and you don't have to worry about what should the mix of stocks and bonds look like given that I anticipate taking X out per month in retirement. It kind of simplifies that maybe and turns what is a defined contribution plan back into something that looks more like a defined benefit plan, which we have taken this transformation in full circle now.

Tom Mullooly: Right.

Brendan M.: People used to have pensions. Now, a lot of people have defined contribution plans where they're more responsible for the investments and the contributions over time and this would be a way to bring it back and say you can simplify things again if you want and we'll pay you a check in this amount.

Tom Mullooly: Isn't it possible, or conceivable that people can do this without actually putting the money into an annuity?

Brendan M.: They could.

Tom Mullooly: Why can't you call your 401k provider and say, "Hey, send me 800 dollars a month."

Brendan M.: I think that the problem is you can do that, but then people still have to look at that big lump sum number and they don't know if the mix of investments is right and when the markets gone crazy, they're not thinking about, "Well, you know, I have X percent in bonds and I'm only taking this out per month, so I can afford to ride out this market volatility", and then they sell or do something rash at a time when they shouldn't and that's what you're paying a price for to avoid. You're avoiding that because people can definitely screw that aspect of it up because ...

Tom Mullooly: And they do.

Brendan M.: ... It's not that simple.

Tom Mullooly: And we've seen people who went to cash in 2008 and never went back into the market.

Brendan M.: Right, and so they would've been better off buying the monthly stream of income because now what they've done is permanently lowered the amount of income that they can take from an account because they've been sitting in cash, not earning any kind of a return.

Tom Mullooly: The opportunity to add the annuity feature to a 401k basically eliminates seeing that lump sum and like in my previous example where they're sending out ... The 401k administrators just sending you a check for 800 dollars a month. You're still going to see the value of the account getting jacked around by the stock market, which may cause you to make more changes ...

Brendan M.: Bad decisions.

Tom Mullooly: ...Bad decisions. With the annuity, you're basically giving up the asset and saying, "I'm turning in my 401k. In return, I'm going to get a check for 1,700 dollars a month forever."

Brendan M.: Yeah. So just to put a bow on this aspect of the bill, I think that it falls under the category of what we kind of said at the beginning. I don't think this is necessary because you could work your entire career with 401k and you could do this. You could annuitize your IRA in whatever lump sum, or you could roll the 401k, or a portion of it, which is probably more advisable than going all in on an annuity. But you could do this without it being offered within your plan.

You could shop at two different insurance companies that offer annuities and say, "If I give you X, what will you pay me and over what period of time?"
And just one that fits for you and I think that in a lot of cases doing that with a portion of your money for some people might make sense.

Tom Mullooly: So one of the other highlights in his House package that they ... When are they voting on this? I think it's coming up.

Brendan M.: Yeah.

Tom Mullooly: Oh, no, they already passed it.

Brendan M.: Right. It needs to go ...

Tom Mullooly: Go to the Senate now.

Brendan M.: Yeah, House passed it and it needs to go to the Senate and then the President. So I think next week is when it's going to go ... Oh, no, that's something different, right? Never mind.

Tom Mullooly: So one of the other highlights is basically wrapped up by basically saying, "You're not getting older, you're getting better."

Brendan M.: So they want to change the RMD age.

Tom Mullooly: Okay, so RMD stands for Required Minimum Distribution. If you're anywhere near your late 60s or over 70, you know what we're talking about.

Brendan M.: Yeah, there seems to be a lot of anxiety around what these things are and what they mean. To us, a lot less serious than what they seem like to people who come to our table who seem genuinely worried about them sometimes. Like, "I know I need to start taking money, but I..." People usually don't have any idea of like how much, what the ramifications are going to be. These begin in the year that you turn 70-1/2 now. They want to push that out to age 72, and I guess the reasoning being that life expectancies are longer and they'd like to give people an extra year and a half leash until they have to start taking money from their accounts.

I don't necessarily have like strong feelings about this. It's fine. I just don't think that it does anything really to help anybody.

Tom Mullooly: Well, I guess if you start with your first required minimum distribution at age 70 or 70-1/2, you have a longer life expectancy and so if you start at 72, you have a somewhat shorter life expectancy.

Brendan M.: Yeah, is the table going to be the same? You just have to start taking more when you're 72? Is that how it works?

Tom Mullooly: So, you're actually going to start by taking more ...

Brendan M.: At a higher percentage than you would have?

Tom Mullooly: Right, at 72 because you're starting at a later date and have an implied shorter life expectancy. Honestly, I think they should index Social Security distributions the same way.

Brendan M.: Yeah, I think another thing that somebody brought up, kind of use this point as the jumping off to say something else that I agreed with is that rather than do a change like this where I can't think of a huge use case in terms of who this makes sense for or helps a ton in terms of moving the needle on their retirement being good or bad. You could take something like the IRA where the average person under age 50 can put in 6,000 dollars a year, 7,000 dollars if you're older and just make that amount equal to what you can do in like a 401k.

Tom Mullooly: Yeah.

Brendan M.: Because then it just makes it simpler for people to save for retirement, which is ultimately what ... If you're going to be focusing on Legislature to do something for retirement, I think that we should be thinking of ways to get people to save more for retirement or to enable them to save more for retirement and make it simpler and not necessarily doing something like this where I ... I mean sure it helps if you're 70 and you don't want to take money now, you have an extra year to, but does that like make or break your retirement? Like I don't think you're going to make it or break it based on that.

Tom Mullooly: The fact that we're talking to some clients about donating their required minimum distribution to a charity, yeah, they don't get the deduction, but they don't get the tax bill either tells us that there are some people out there, a portion of the population, that don't need to take this money out, and they would rather do something beneficial, "Well, let's give the money to something that's really going to be positive."

Brendan M.: It's interesting because a lot of people will complain that they have to take their RMDs and then you float the qualified charitable RMD as an option, and that quickly gets shot down too.

Tom Mullooly: "Nah, I'll take it."

Brendan M.: Yeah, it's like I don't need the money, and I don't want to pay the taxes, but I also don't want to donate it to anything.

Tom Mullooly: Right.

Brendan M.: Some people do and that's terrific. If people want to, they can give up to 100,000 dollars a year based on whatever their RMD is to a charity and then there's no tax for anybody

because charities don't pay tax, and you don't have to pay it, which is terrific. But a lot of people don't ... They're in an area where they don't necessarily want to give the money away, but they also want to complain about the taxes, and I think that that's an interesting spot to be.
That's just life, you know.

Tom Mullooly: It's the American way.

Brendan M.: Yeah, that's fine kind of the way it is. Interesting observation from my experience.

Tom Mullooly: I don't really understand why they're talking about this because as I said earlier, it's not a revenue generator for ...

Brendan M.: The RMD thing?

Tom Mullooly: Yeah, I don't ...

Brendan M.: Yeah, so some of these other things that they floated, and these were more on the side of helping to pay for some of these changes, so I guess some of the revenue they would lose from bumping out the RMD age, they would pay for ... This is a point of contention, I guess, for a lot of people is that they're going to change the rules on what we in the industry call a stretch IRA where you can name a beneficiary on your individual retirement account. Let's say, you're 70 and you want to leave it to your grandchild when they're 15.

You can name them as the beneficiary and then whenever you pass away, they inherit your IRA and they have to take RMDs based upon not your life expectancy, but their own, meaning that IRA can last them for decades if they're just taking out the minimum.

Tom Mullooly: A long time.

Brendan M.: I mean, obviously, they're always welcome to take more than the minimum as everybody is, but interesting way for people to pass on assets to the next generation and they're proposing ... They're going to put a schedule on it where you would have to, regardless of your age, you would have to deplete it by the end of like 10 years is what they're talking about. So just to put a cap on that. So that would bring in more tax revenue for the government where they're losing some by bumping out the RMD age to 72.

Like you said, it's like a revenue neutral or apparently. I haven't crunched the numbers, but you've got to give up something to get something and I'm not sure I would want to make that trade off. I think the stretch IRA is a better planning tool than worrying about RMDs.

Tom Mullooly: I think the stretch IRA is one of the greatest things that they've allowed in the last couple of years in the tax code. I think it's a terrific way to continue compounding money for a long period of time.

Brendan M.: How long has that been around for? It's not new, is it?

Tom Mullooly: It's not new, but they enhanced ...

Brendan M.: Was it in 03?

Tom Mullooly: ... What they could do. I actually think it was in 06.

Brendan M.: Okay.

Tom Mullooly: So, it's been around for about 10 years.

Brendan M.: Mm-hmm (affirmative).

Tom Mullooly: But prior to that, it was, "Hey, it can go to a surviving spouse, otherwise, it's getting paid out", and pay the tax and here's your check.

Brendan M.: Right.

Tom Mullooly: That's really it. That was the only option. It's interesting how you said that they're discussing a 10-year cap. I'm going to really sound old when I talk about this, but when I got started in the business in 1983, we used to have clients who would do three year or ten year, they could choose which schedule they want, income averaging. So say you had a period of time where you got bonus money from your job where it was crazy for one year, you could go over a three-year period and do income averaging and spread your ...

Brendan M.: Your income taxes.

Tom Mullooly: ... Tax liability over three years.

Brendan M.: Right.

Tom Mullooly: You could also do it like if you had a startup that went public, or some crazy transaction where you had a lot of income recognized for two or three years, you could do income averaging over 10 years.

Brendan M.: I don't know why they got rid of this, but things that pop into my mind is that if people have a ton of money in one year and then they're supposed to pay a tax bill over a period of 10 years, like what if the money isn't there anymore.

Tom Mullooly: Yeah, it's a problem.

Brendan M.: Like they spend it all.

Tom Mullooly: It's a problem. It's a problem.

Brendan M.: Again, aren't people very prone to do stuff like that?

Tom Mullooly: It happens. It does happen. Ask any baseball player.

Brendan M.: Yeah, like you see these guys going broke who make millions of dollars.

Tom Mullooly: Yeah.

Brendan M.: A ton of money. So I guess that that's why they got rid of that?

Tom Mullooly: All of this got wiped clean, kind of like a scene from Raiders of the Lost Ark, with the TEFRA, with Tax Equity and Fiscal Responsibility Act in 1986.

So all of these cute little things just gone. Good while it lasted. So the stretch IRA is the ... I think that that's probably the part I would like to see eliminated from this tax package because it really is a great benefit to the folks that have the opportunity to use it.

Brendan M.: Yeah, I don't know. That seems like to be where they're making this into something that's revenue neutral, though, so I wonder what else would be put on the chopping block. Like there would have to be something given up to bump up the RMD age. I would imagine they can't just ... I mean they could just do that, but it would add to the deficit. I don't know if anyone cares about that anymore.

Tom Mullooly: Nobody seems to be worried about that, I don't know why. There was one other thing that I saw in there about group 401ks.

Brendan M.: Yeah. This could be on the table to help small businesses where the cost of having a retirement plan is either prohibitive or makes ...

Tom Mullooly: Let me tell you, having a full-blown 401k at a company like we have here, it's not cheap.

Brendan M.: Right.

Tom Mullooly: It's expensive, especially when you have five, six, 10, 12 employees, it's very expensive.

Brendan M.: You get better rates when you scale and have a big company to offer it to. Places that offer 401ks can cut you a better deal and ... So, it's a lot to put on the plates of small businesses, especially the size that you're alluding to, like our company here. This would allow them to band together with other companies that are in their industry or are very close to it and they could come up with maybe a lower cost or a better solution for all of the employees collectively because they could band together to get some of these better group rates, things like that.

Tom Mullooly: So we're members of the Financial Planning Association.

Brendan M.: Right.

Tom Mullooly: FPA, and they offer group disability coverage through that. They reached out to me just last week and they said, "Would you be interested in submitting some information?". They're thinking about a pilot program for group health coverage basically through members of this Financial Planning Association, FPA. It's a National association.

So this would be like an affiliate program and I can see something like a group 401k getting rolled out in the same kind of fashion. I'm a little worried, though.

Brendan M.: Why? And why is that?

Tom Mullooly: If this gets mishandled, if it gets turned over to companies that want to just gum up the works with some high-fee investments in the 401k plan, it's going to be a problem.

Brendan M.: I would hope that since it's a 401k and it'll be subject to ... Well, I don't know, we're assuming a lot. If it's under a ERISA Laws, it can only be so egregious. I mean we've seen some real harsh shows in the 403V space, which isn't regulated by ERISA, you'd hope that it's at least going to be up to ERISA Standards, but that's not to say that we've seen, or that we haven't seen terrible 401k plans, too, that are subject to ERISA and it's just people getting gouged because it's a small company and owners get talked into stuff that they don't understand by largely insurance reps.

Tom Mullooly: A lot of 401ks for small businesses, just so listeners understand, you know, if you work for AT&T or General Electric, you have a plan that is probably ...

Brendan M.: Very low cost and probably well run.

Tom Mullooly: However, if you work for a small employer, and again, it's five or six employees even up to 40 or 50 employees, your plan is usually put together by the business owner's insurance agent or their broker at a broker term.

Brendan M.: Right.

Tom Mullooly: And so you're paying retail prices instead of wholesale process.

Brendan M.: Mm-hmm (affirmative).

Tom Mullooly: It's, I guess, a good analogy.

Brendan M.: Yeah.

Tom Mullooly: It's very expensive.

Brendan M.: And that kind of brings back the other point of maybe ... I don't know if this solution works out, it could be very good if it lowers cost and gives more people access to plans because one of the ways that small businesses handle this sometimes is to just not have a plan. And then so if your company doesn't offer a plan, the silver lining is that you're always eligible regardless of your income, you can contribute to an IRA and it's deductible, but you can only send in 6,000 dollars a year.

Tom Mullooly: That's it.

Brendan M.: So I think if you're not covered by a plan at work, I don't see why you shouldn't be able to send 19,000 dollars like you would into a 401k, but send it into an IRA instead. Again, there would be ripple effects to that, too, that they would have to look at. They would have to find a way to make sure that it isn't just helping the wealthiest people to put more money into an IRA on top of their 401k, because that's not what we're intending here. This is for people who work at a small business that can't afford to have a 401k plan, and that's a lot of people.

I don't know what the exact number is in the county, but I would imagine it's probably only about 50% of people that have access to a 401k plan.

Tom Mullooly: Access, not necessarily participating.

Brendan M.: Right, they might not use it. Laws that you could create to raise that number, the people who have access to and participate in a 401k plan or whatever plan would be offered through their place of employment. I think doing stuff to raise those percentages should be the goal of legislation and not necessarily some of this stuff that we're talking about.

So maybe the group 401k plan is a good idea if it can help.

Tom Mullooly: It raises the bar for everyone.

Brendan M.: Yeah.

Tom Mullooly: It gives everybody the opportunity, or more people like you said.

Brendan M.: Yeah. Not everybody ... Not everybody's going to save, even if they have access to it, but if they don't have access to the plan at all, then they're definitely not going to do it.

Tom Mullooly: Here's my concern with this is that as I mentioned earlier, if these group plans get administered by ... If they let the brokers have it, they're going to wreck it. You know, they gave the 529s, they handed them over to the brokers, they wrecked it. If they hand over these group 401ks to brokers, they're probably going to just line them with fees. That's going to be a problem.

They could use the model of the TSP, the Thrift Savings Plan, for government employees. You want to just talk a little bit about that.

Brendan M.: Their fees within the plan, the TSP Savings Plan, which is for government employees, they make Vanguard fees look high, which is a joke if you don't follow. Vanguard has some of the lowest fees in the industry and these funds that are offered within the TSP are like a fraction of Vanguard costs. They're basically free, very simple options in terms of putting together an allocation.

Tom Mullooly: It's chocolate, vanilla and strawberry essentially.

Brendan M.: Right, which is what people should be doing in their company 401k while they're accumulating. They should set up a sensible allocation and let it be an average in. They shouldn't be hopping around from fund to fund all the time.

It's a really low-cost plan and this is where all the people creating government bills have their own retirement dollars going. So they should give us access to the same plans that they have, but that isn't the way the world works because they also have really great healthcare and we don't have access to that either.

Tom Mullooly: It's all about fairness or the lack of.

Brendan M.: Right.

Tom Mullooly: Yeah.

Brendan M.: But, yeah, that could be another solution.

Tom Mullooly: That's going to wrap up Episode 259. Thanks again for tuning in and we will see you or catch up with you on Episode 260.