Gaming the Financial Aid System - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management podcast. This is episode number 268. I'm one of your co-hosts, Tom Mullooly, and with me is one of the top 100 financial advisors in the United States according to Investopedia, Brendan Mullooly. Congratulations.

Brendan Mullooly: Yeah, thank you very much. Obviously wouldn't be able to do that without you and the business here, so thanks for bringing me up right in this company.

Tom Mullooly: Oh, you're welcome. But this one's all you kid. So very good job and keep up the great work.

Brendan Mullooly: Thanks.

Tom Mullooly: We're all really proud of you.

Brendan Mullooly: Thank you.

Tom Mullooly: There were a few articles in the media the last few days that we wanted to touch on here in episode number 268. The first one was from the Wall Street Journal, a loophole in college financial aid in the state of Illinois. It's been discovered there's some wealthy parents that are transferring guardianship of their teen kids so they can qualify for financial aid.

Brendan Mullooly: Yeah. Obviously this leaves a bad taste in a lot of people's mouths because it seemed like, to me at least, the people who are doing these maneuvers are folks who would otherwise not qualify for financial aid, meaning that they're pretty well off financially and that they probably paid somebody like a lawyer, accountant or maybe an investment advisor to check out the laws in depth and figure out this loophole for them so that they could transfer guardianship of their child to get more financial aid. As a friend of ours put it on Twitter, illegal, no, unethical, yeah, gross. Definitely. And that's pretty much how I feel about it.

Tom Mullooly: I know when we were talking before the microphone came on, I had picked up a similar phrase that I've heard my entire career that sometimes bulls win, sometimes bears win, but pigs get slaughtered.

Brendan Mullooly: Yeah. You would hope that doing something like this, not that ... I don't wish ill on anybody, but doing something like this I think definitely puts some negative karma in the bank down the road. It's just, it's not a good look and I don't think it's anything that anybody would be proud of or admit to other people. I don't know. Maybe they would. Maybe it's something people chit chat about at country club dinners or something like that.

Tom Mullooly: Yeah, it's hard to figure out. That's the worst part is that these folks could probably write a check and be okay and it wouldn't even ding their net worth.

Brendan Mullooly: But at the end of the day, whether it's this loophole, and if this is somehow closed, we'll be onto the next one in a few years. I don't think it means that we shouldn't ... We should definitely close loopholes like this when we find out that they're being exploited. I think they're going to exist in perpetuity and it's kind of like find a leak in the dam and put your finger in that one and then another one spouts over here, so you put your finger in that one too. And it's just you're trying to stop these things from happening and people are just always going to find ways to-

Tom Mullooly: It will.

Brendan Mullooly: ... game the system. And especially when they have money and an incentive to do it, they don't have to do the work themselves. I'm sure none of these people figured this out on their own. They probably paid somebody to read through legal documents and find a way for this to work. Do you think that there are any negative repercussions of transferring guardianship of your kid to somebody else? I mean, I'm trying to think. There could be ripple effects to this that sure, it looked good on paper when you needed college aid, but down the road could have big drawbacks. Like can you take it back?

Tom Mullooly: I don't really know. And I guess the question is what if your child is involved in a serious accident, like a car accident? Are they insured? Do they have healthcare coverage if you've transferred guardianship?

Brendan Mullooly: Yeah, right. How does that all work?

Tom Mullooly: It's a hell of a risk.

Brendan Mullooly: Right. So if you do still provide their health insurance, let's say, one, is that even possible because they're not legally your child anymore, but two is that considered a gift to them that you're giving them healthcare coverage and are there tax implications to that? I don't know.

Tom Mullooly: Yeah, is that imputed income?

Brendan Mullooly: Yeah, I have no idea. I mean they're a minor, so probably not, but all questions to ask. And Oh, I mean, just thinking in terms of beneficiaries on an account or inheritance. I know in New Jersey, for example, there are certain relationships between people who have very different rules in terms of tax implications of inheriting money from somebody. Like if you inherit money from a direct descendant, which is a parent or a grandparent, right?

Tom Mullooly: That's right.

Brendan Mullooly: But not if it's a sibling or not if it's not your parent, if it's like an aunt or an uncle or something.

Tom Mullooly: They're not direct descendants, so they have a different tax bracket, especially when it comes to New Jersey state estate taxes.

Brendan Mullooly: Yes.

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Tom Mullooly: Okay. Next article came from Business Insider. This was kind of a goofy one, but the title was, I Watched My Father Jump Through Hoops to Claim his Inheritance and Learned There is a Better Way to Pass Money to Your Kids. And it was written by Anonymous.

Brendan Mullooly: Yeah, it was a freelance journalist who has learned about this process through their own dealings, which is I think how a lot of people learn about inheriting money and what happens when somebody who you are related to or close with passes away. How does that all get tied up? It's not something that people do a lot in their lifetimes, and it's usually something you learn on the go.

So one of the big things in this article that jumped out at me was it seemed like the author had done a pretty good job understanding these different mechanisms and how stuff works. But there was I think a fundamental misunderstanding of the gift tax, which is something that we often end up talking with clients about a lot. And I think it's because it's pretty confusing.

Tom Mullooly: I'll say. We talk with clients about this multiple times because it just doesn't seem to be something that is clear cut enough for folks to understand.

Brendan Mullooly: Yeah, you call it a gift tax. And the tax connotation I think makes you feel like it's any other tax, like I pay my federal income taxes.

Tom Mullooly: Who do I make the check out to?

Brendan Mullooly: Yes, is it going to be withheld from the gift or am I going to owe it in April when I file my 1040? And that is not the kind of thing that the gift tax actually is. It's totally different and it's kind of nebulous. You almost have to think of this pile of money, so to speak, in terms of it's a bank that you get to count your gifts off of for your entire lifetime. Explain that a little better.

Tom Mullooly: Yeah. We'll make this clear again. Yeah. When you are making a gift to someone and it exceeds the current threshold, which is $15,000 per person per year. So if you give a gift that say is $25,000, you're now $10,000 over the limit. You have to file a gift tax return. The first phrase that I use to help diffuse the situation is it's an informational return, because there is no check, no money that's going to be transferred to Uncle Sam in this process. But what's happening is everybody has a lifetime exclusion, a threshold, and that threshold currently is over $11 million. And so over the course of your lifetime, the gifts that you give that are in excess of $15,000 per person per year, that amount in total when you pass away is going to be deducted. Or it's going to reduce your threshold.

So say just round these numbers off. If your threshold were say $11 million, and over the course of your life you gave away, in excess of the 15 grand per year, $1 million in gifts to various people, your estate tax threshold is now $10 million. That's how the gift tax gets applied.

Brendan Mullooly: Right. And then so then the rest of your assets would have to exceed $10 million after your death and transfer the taxes before anybody owes any kind of an estate tax, or on the federal level.

Tom Mullooly: Yeah. Right.

Brendan Mullooly: State's different.

Tom Mullooly: So give tax is something that, as I mentioned previously, we've had this conversation with clients and we've had it multiple times with the same clients. And I'm not saying that anybody doesn't get it. It's a different concept, because as you laid it out earlier, a lot of people think, okay, tax, who do I make the check out to? When's it due? How do I do this? They've never gone through this before. Or maybe they've, you know.

Brendan Mullooly: I think they need some kind of different terminology for what this actually is. Make it a standalone thing because I can't even think of anything else that's similar to this to relate it to.

Tom Mullooly: A conversation I had with an accountant earlier this year, basically she said it doesn't matter now what the gift is for most people. If you've got an estate that's $1 million or $4 million or $6 million, it doesn't matter. Give away whatever you want to give. We'll fill out a gift tax return. It's not going to move the needle for you when it comes to getting your estate wrapped up.

Brendan Mullooly: Good point. These thresholds and laws change over time, can only really operate under the set of rules that we have now. And so this is the world as it exists today. And I think there are a lot of people out there that maybe are stirring up fear where there doesn't need to be some. Because a lot of people will talk about, for example with the federal estate tax threshold being what it is now that that provision is to be sunset come 2024, I want to say, or-

Tom Mullooly: '25 I think.

Brendan Mullooly: '25. So, we only have until then with these laws, but that doesn't necessarily mean we're going to get to 2025 and they're going to drop it back down. They could leave it unchanged. They could bump it up again. Sure, they could reign it back in. I think that would maybe be unpopular. Because I think some of the people who are in Congress who would vote on a law like that, are-

Tom Mullooly: They may be getting close to the threshold.

Brendan Mullooly: They're the ones who may be close to the threshold, not the average everyday American. So if we're expecting those people to self-impose a tax that's going to affect their family's wealth in the future. I'm betting against that, but I'll stand prepared to eat those words if it comes to fruition.

Tom Mullooly: There's a lot of articles that you can find online about estate planning. The most important thing that folks should do when someone close to them passes away is take a deep breath. It may only happen once or twice in your lifetime, but it's stuff that financial planners like us work with on a regular basis. I mean many, many times throughout the course of a year this happens. Clients pass away. Family members of clients pass away. We deal with this stuff, as most financial planners do. There's certain things that you're going to need to do that aren't going to be available, like death certificates, until the event happens.

So there isn't much that you can do in the sense to pre-prepare for this kind of thing. There are some things, but-

Brendan Mullooly: If it's not you, meaning if you're going to be somebody dealing with this. I think that you can be a little proactive in the sense of, I think the best thing that you can do in terms of estate planning for yourself-

Tom Mullooly: For yourself.

Brendan Mullooly: ... is to just be proactive. And you can do a number of things that are not expensive or complicated to just make sure that things go as smoothly as possible for whoever you would be leaving any kind of inheritance to, your spouse, children, grandchildren. Just check your beneficiaries.

Tom Mullooly: Spell it out.

Brendan Mullooly: Have your basic estate planning package done. Have a will. These basic steps can just save people that you care about a lot of headache down the road, and it's not complicated tax maneuvers we're talking about for the majority of people. It's basic things and I think most people would prefer that their loved ones be not stressed out over legal matters after they're gone.

Tom Mullooly: We've had two phone calls in the last month where people were, one of them was literally standing outside of a funeral home calling us. That's not the time to be doing estate planning. There was an article in Forbes, the title was, Fintech Firm Solves Number One Retirement Fear, Outliving Your Money. I'll agree. I think one of the top retirement fears is running out of money.

Brendan Mullooly: Do we have enough? Are we going to be okay? And that is the a core of the financial planning process. Trying to answer those questions. And if it's not as big a concern for somebody, like they're pretty good, they know they're not going to run out of money, but how do we make it last and how do we do this intelligently?

Tom Mullooly: So the solution, so to speak, in this Forbes article, I kind of walked away disappointed. It's like eating a Pop-Tart. Like, "Oh, this is going to be really good." And then you're finished eating it and you're like, "That's it? That's all there was?" It's terrible. They talked about having people buy annuities so that they can't outlive the income. And technically that's true. If you buy a fixed annuity or one of these immediate annuities, you put a lump sum in, you start getting a check every month, you are going to get money that you cannot outlive, because even if you live for 50 more years, you're going to get a check every single month.

Brendan Mullooly: I think I would say the article was a pleasant surprise because while it discussed annuities, it steered clear of the ones that we strongly dislike here, and Ken Fisher agrees with us, all of his commercials. But the annuities that are touted as accumulation vehicles, and so variable annuities-

Tom Mullooly: Variable annuities.

Brendan Mullooly: ... and their many descendants.

Tom Mullooly: And their ugly cousins.

Brendan Mullooly: Indexed annuities, things of that nature. These are not things to focus on when you are in the accumulation phase growing your wealth. But for some people at retirement, this article discussed if you're not in a position where maybe you're going to have a pension in retirement, some people do, some don't. More don't than do. It may be wise to consider taking a portion of your money and using it to buy something like a single premium immediate annuity, which is going to replicate a pension. And depending on how much you put in, you can get a monthly check for X and it's either going to last your lifetime, maybe you do it over a a joint lifetime if you have a spouse.

There are a lot of iterations and I think that that's an important point too, is if you're going to tie up some of your net worth in a product like this where you give up control of the lump sum that you're putting into there and trade it for a monthly income, how long is that going to last and is it going to last your surviving spouse potentially too, which is important.

Tom Mullooly: I think it's a good idea and it's a probably a good solution for folks that are maybe not that good at managing their money, in the sense that instead of being handed a gigantic amount of money all at once, now they're going to get a certain check every single month and they can live within those means. And I think that will be helpful to a certain portion of the population.

Brendan Mullooly: You could use it too as a baseline. You kind of figure out what you stand to collect from something like social security, and if that's not enough to keep the lights on and pay the basic bills at home in retirement, maybe you put in just enough to some kind of product like this to supplement that so that you have a baseline where you're covering all your expenses and then whatever's left in your investment account, you position that as you're comfortable and grow your money and then use it for extra stuff, like travel or gifts or paying for grandchildren's education or whatever it is you want to do.

Tom Mullooly: So here's the the part that I don't understand. And maybe plan administrators should do a better job of this, but if you've got an IRA or if you've got a 401(k) and you start taking distributions from your plan, can't you just tell the plan administrator or the custodian for your IRA, "I want to receive X dollars per month until it runs out or until I run out"? Or, "I want X percent of my investments paid out on a monthly basis"?

Brendan Mullooly: So I guess the big fear is that it could run out. You could do a percentage forever.

Tom Mullooly: Because you'll never get there. I mean that check might be really skinny.

Brendan Mullooly: The check is going to change in value depending on what the investments are doing, but you could take 3% or 4% in perpetuity if you're comfortable with that amount being variable, but not many people are.

Tom Mullooly: That thing's going to get smaller and smaller and smaller over time.

Brendan Mullooly: That's another thing to consider is that in many cases, you're going to look at a fixed annuity type product and it's going to not be something like a social security that will adjust for inflation over time. Almost all cases, unless you're paying up for something extra that adjusts with CPI or something like that, I think you're going to get a dollar amount per month, and that's that kind of thing. So you've got to make sure that you still ... Again, you would want to do this with a piece of your money because at some point if you're getting $1,500 a month from fixed annuity, let's say, that $1,500 a month may have paid the bills in totality when you were 60 years old, but when you're 85 it may not go as far as it used to. In fact, I can virtually guarantee that it won't. And so that's why it's probably important to use that as just a portion of what you're doing and then to still have something that's growing because you're going to need to supplement that over time.

Tom Mullooly: It's the only way to keep up with inflation. So I think the other part, and we discussed this before we flipped on the mic, was with an annuity, yes, if you live way past your normal life expectancy, you win that bet. The insurance company has to continue to pay you for as long as you're alive. But if you take out an annuity and you start to receive these payments and you die prematurely, the insurance company keeps the money.

Brendan Mullooly: I would say in the aggregate, the insurance company wins because these are profitable businesses and so they make bets that they tend to win on average, which means there's a chance you're one of the losers. It means there's a chance you're one of the winners in this scenario.

Tom Mullooly: You'll be you'll be dead either way.

Brendan Mullooly: Yeah. And I think my point there would be that if it's something that allows you to feel comfortable and to sleep at night, having a base level income coming from a product like this, I would concentrate less on winning the bet. I mean, sure, try to live as long as you can. That's great. I hope everybody wins the bet and lives to 110 and we bankrupt these companies getting our annuity checks. That's awesome. But I wouldn't be too worried about losing the bet, aside from the fact that I would want to make sure that if I lose the bet, meaning let's say I buy this thing when I'm 60 and I had created a financial plan expecting that I might live until late 80s, early 90s, I want to make sure still that if I have dependents, a spouse in particular, that they're still going to be okay even if I lose the bet on this annuity product, because that's an important aspect.

Tom Mullooly: There was an article that was written by Christine Benz in Morningstar, and the title was, A Chicken Way to Lighten up on Lofty Positions. You and I both took away some different points on this.

Brendan Mullooly: Yeah, so Christine was talking about turning off dividend reinvest on your investments. And in particular if you have a taxable account, like a brokerage account let's say, where you have a single position maybe that has done really well over time, but now it's grown to be unsustainable or a risky percentage of your account or your net worth and you're thinking of ways that you could maybe trim back on this and not be so concentrated in one stock or position, mutual fund, ETF. And so if you turn off the dividend reinvest on that individual investment, you'll get the dividends that it pays in your money market rather than continuing to grow what you have in that investment. And I thought that was pretty smart.

Tom Mullooly: That is interesting. However, if you're reinvesting dividends over time, you're actually adding to your cost basis. So your taxable gain may not be as big as you once figured it might be.

Brendan Mullooly: Could be. I think that the problem with that is that you still have ... If you are reinvesting the dividends rather than taking them into the money market, you still have to physically go enter the sell order to get some of that money back and you could do it on specific share lots to only peel off what you've accumulated in dividends or maybe capital gain distributions over time. So you could do the same thing. I think as Christine pointed out in there, whether you re-invest or take the dividends in cash, the tax implications in the year that you received those distributions or dividends, it's a moot point. It doesn't matter what you do.

But I think it's tough. When you have a position that's done really well and you've been adding to it, I think this is maybe a good way to discreetly allow yourself to lighten up on something when it would be a lot harder to go in there and sell shares of that thing. Because I don't think people want to do that. And I know that you and Tim a few weeks back talked about people have a lot of aversion in taxable accounts especially to doing something like rebalancing to keep the percentage of stocks and bonds maybe that they own in their investments, in check with what they've set out to do in their financial plan because it's going to have tax implications.

Tom Mullooly: It's a tough spot and we've seen this a lot just in 2019. Client calls up unexpectedly, needs to take some money out because they're doing something. We review what positions they have. The easiest sale is money that might be sitting in a short term bond fund where there's little to no gain.

Brendan Mullooly: And it's good because we hold positions in stuff like this in short term bonds as a part of the portfolio, in part at least because we know that things are going to come up like this and that is where we would prefer to pull the money from initially.

Tom Mullooly: But what happens to the balance that was in the portfolio? The balance that we had has now been shifted to the point where we may be, that account may be 100% stocks now.

Brendan Mullooly: Yeah. Or it's at least a very different look in portfolio than what we started out with and that's not, volatility-wise, what the client signed up for. It's not what they signed up for. It's maybe not what ... They don't need to be experiencing volatility like that, but then to not rebalance that account because it means selling stocks that have a gain, paying some capital gains and then putting money back into bonds to get the account back in alignment. You obviously don't want to be overactive with this. You want to be sensitive to taxes, but to just not do it at all because of a tax bill, I think that eventually you're going to get whacked and when you're feeling the pain the most is going to be the worst time to go in and then rebalance because your account's going to be down.

Tom Mullooly: So let me translate for the listeners. So we have an account that might be 70/30 stocks and 30% bonds, 70/30 account. And over a period of time, client has removed 20% of the 30% and so now it's really a 90/10 account where 90% of the remaining account is in equities and the market goes through a 20% drop.

Brendan Mullooly: We saw it in one calendar quarter last year, December. Most of it in a month. It can happen fast.

Tom Mullooly: It can happen very quickly. Then what?

Brendan Mullooly: Then what happens? Either you get spooked and you feel like you need to do something because that was more than you thought you were capable of handling or what happens then if you continue to have a need to draw from the portfolio, then you're forced into selling your stocks when they're down, whether you're freaked out about the market or not. And so again, it's not something that you want. You don't need to be doing this on a monthly basis and especially not in a taxable account, but you've got to consider these things. And so I think that Christine's point was this is maybe a small thing that you can do to lessen the burden of rebalancing because if you've got this money accumulating in the money market perhaps, it's in your cash allocation, which is part of a bond allocation in many cases, and you can re-deploy it into a bond fund if you need to rebalance and the market's been going up.

Tom Mullooly: Bloomberg noted that the IRS is tracking down 10,000 crypto owners to pay back taxes. I think what's important to remember is that the early adopters to these different cryptocurrencies were people who wanted to stay off the grid. They wanted to be under the radar. There were a lot of people who were involved in activities that they didn't want any tracking on.

Brendan Mullooly: You know, they're people that just valued their privacy or thought it was cool. It's not everybody. Not everybody who has crypto is a criminal. Let's be fair.

Tom Mullooly: No, they're not. They're not. Yeah, they like their privacy or they-

Brendan Mullooly: They feel it's an interesting space.

Tom Mullooly: ... sell weapons, or whatever. And we touched on this briefly in a earlier podcast, but the amount of software and tracking that the IRS has now, their abilities far outstrip our ability to hide.

Brendan Mullooly: The big thing that I took away from this was not necessarily specific to cryptocurrency at all. It was just the way that they're dealing with it is illuminating and worth sharing, that you're probably not getting one by on the IRS and it's almost certainly not worth trying. The way they're dealing with this is that they're sending letters to people and basically the way it was explained in the article at least was that if you're getting a letter, it's too late and they're not going to go easy on you. If you think that you should have paid more in taxes or there was unreported stuff going on and you were in cryptocurrency, you can come forward, throw the flag on yourself and they'll probably be a lot more lenient. Again, a ploy to get people to come forward, but at the same time, I'm not sure I would. Would you be looking to roll the dice on that? I mean it just doesn't seem like it's worth it to me.

Tom Mullooly: We just took over an account where a plan administrator was not making proper distributions. And we brought this to the attention of the client as we were transferring the account in, and we feel it's in their best interest to volunteer this information. And we also had a situation where this happened with a client's IRA several years ago where they did not make ... the previous IRA custodian did not make a required minimum distribution and we felt it was in their best interest to come forward with this rather than wait.

Brendan Mullooly: And it's good too because you're not put on the spot. If you can discover these kind of issues, you have all the time in the world to put together the numbers and to clearly state what occurred and then say, "Hey, it would be great if maybe you waive this penalty that I'm supposed to pay. Here's all the tax money. I'm really sorry. Here's what happened." If you're willing to roll the dice, good for you. Not something I would condone.

Tom Mullooly: That's going to wrap up episode 268. Thanks for tuning in and we will catch you on the next episode.