Changes to the Kiddie Tax - Transcript

Tom Mullooly: Hello and welcome to the Mullooly Asset Management podcast. I'm your host Tom Mullooly. In this episode, we're going to talk about the Dow and the S&P and futures and how that can hopefully not impact your life. We're going to be talking about Morgan Stanley moving to acquire E-Trade and we'll also spend a little bit of time talking about the Kiddie tax and custodial accounts. I want to spend a little time talking about the market and about futures you'll see mentioned on CNBC and on the radio on your way to work. Sometimes it's a little bit of an adjustment and you need to adjust to the levels that the markets are at. We'll sometimes get calls from clients who are alarmed because they see the market down a couple of 100 points. It's important to remember that now we're recording this in February of 2020. The Dow Jones is trading at 29,000. The S&P 500 is trading at 3,300.

I don't want to sound like an old fart, but I can certainly recall a time in my career where the Dow Jones was trading at 3,300. Now the S&P 500 is trading at 3,300. Without looking it up, the Dow was trading at 3,300 around 1992. That was 27 or 28 years ago. Today it's at 29,000. The S&P 500 is now at 3,300. So when they talk about the futures in the morning or when you hear a market update and the market is down 300 points, remember that that's about 1% on the Dow Jones. It's 1%. A half of 1% in either direction for the Dow Jones would be 150 points up or 150 points down. That's a half of 1%. Likewise, the S&P 500 at the moment around 3,300 to be moving a half of 1% is 16 points, 16 S&P points. 1% is going to be 290 or 300 points. We used to be ecstatic when the Dow Jones would move 250 or 300 points up and we would be depressed when the market was down 250 or 300 points.

That is now a move of 1% and so we have to adjust. The landscape is always changing when it comes to this. The other thing that goes without saying, well, does go without saying because I'm about to say it, is when the market is moving more than 1%, I'm certainly going to be looking for headlines that might be driving that. I'll say this again, we've said this a couple of times on recent podcasts, we never know for certain why the market is going down on a particular morning or a particular day. The ultimate answer is because there are more sellers than buyers, that's why markets go down. But we'll never know the pure reason why. There never is just one reason, but sellers may line up because of some particular news and it's our job to know the news that's going on. Having said that, we're probably not going to act on that headline. We don't want to be managing money with an itchy trigger finger. That's a bad way to manage money.

But our brains, something about human brains, we continually seek, or I should say we perpetually seek a logical explanation for something, some news or some event that really can't be explained. I'll say that again. Our brains perpetually seek logical explanations to back up events that are happening. Markets go higher because there's more demand and people are looking to put their money to work, and so there are more buyers than sellers. Likewise, markets go down at least on a daily basis for the pure reason of there are more sellers than buyers. People don't want to hear that. They want to hear news, they want to hear a story that's related to what's going on. And if they don't get an answer from their advisor, they're probably going to rack their brains until they come up with a logical explanation to back up their idea.

The market's going down because... fill in the blank. We never really know for certain. Adjust your expectations for the markets when you see the Dow Jones up, the futures or the market itself up 100 or 150 points, realize that that's about a half of 1%, 150 points. If the market's down 300, don't panic, it's down 1%. We also have to adjust for the S&P now at 3,300. A half of 1%, 16 S&P points. 1% is going to be about 33 S&P 500 points. Yesterday, Morgan Stanley announced that they're buying E-Trade for $13 billion. I have to say as an advisor, over the last few months, we've been getting solicitations to come talk to E-Trade. We use TD Ameritrade and Schwab. We have not worked with E-Trade, but we've been getting solicitations from E-Trade as I would suspect a lot of investment advisory firms probably have been getting solicitations as well.

As investment advisors, we can work with any broker that we choose. Every year, as part of our books and records, we have to perform due diligence and interview our current broker relationships and other relationships to shop around as a fiduciary and see if there's a better deal for our clients out there somewhere else. We get terrific service from TD Ameritrade and from Schwab. We're very happy with the relationships that we have, but it's on us each year to perform some due diligence and to speak with these other brokers. The problem is, these brokers aren't around as much as they were. I used to tell folks years ago when the firm started that we could work with just picking some names out. We could work with Scottrade, we could work with E-Trade, we could work with TD Waterhouse, we could work with Schwab, we could work with Ameritrade. Here's what's happened in the last 10 or 12 years.

Ameritrade merged with TD Waterhouse. Scott trade was acquired recently by TD Ameritrade. E-Trade has now announced that they're going off and getting married to Morgan Stanley. One by one, all of these players are being taken off the battlefield. What happens? When I left Morgan Stanley in 2002 and started this firm as a registered investment advisor, I was no longer required to work for a brokerage firm. I could basically line up with a discount broker and do our trades through the discount broker. What we provided as a firm, an investment advisory firm, was investment advice for our clients. Really, if you think about it, we could do the trades anywhere. So that's why each year we have to perform some due diligence and shop around and see where we can get the best deal for our clients. So when I left Morgan Stanley, I started moving client assets to TD Waterhouse.

I remember Waterhouse Securities back in the 80s when I got started, they had merged since then with TD Bank. TD stands for Toronto Dominion Bank? Yes, it's Canadian. And so, TD Waterhouse was their brokerage division and they also offered services for investment advisory firms like Mullooly Asset Management. In 2005, they announced that they were merging with Ameritrade. They would rename the firm TD Ameritrade. Now, fast forward, the same firm has picked up Scottrade in the last few years and now there is a potential deal on the table to merge Charles Schwab with TD Ameritrade. Again, we have an obligation to our clients every year to perform some due diligence and shop around and see where the best deal might be. Which brings us back to this headline from yesterday, Morgan Stanley is now buying E-Trade. The headline in the Wall Street Journal this morning is, Morgan Stanley is buying E-Trade betting on smaller customers.

I'm not really sure how that's going to work out. The opening paragraph in the Wall Street Journal, "Morgan Stanley is buying E-Trade Financial in a $13 billion deal that will reshape the storied investment bank and firmly stake its future on managing money for regular people." Congratulations on being regular. I will say that this is probably the exact same headline that came out 20 plus years ago in 1997 when Morgan Stanley announced that they were buying Dean Witter. Dean Witter, I worked there. Dean Witter, a few years earlier, was part of Sears. That big conglomerate was Sears and Coldwell Banker and Allstate Insurance and Dean Witter. It was a little bit of a culture shock merging these two firms together. But that was the same theme 22 years ago, was that the storied investment bank is now going to be staking its future on managing money for regular people. This is an interesting transaction.

What we're going to see is there's going to be a few places where Morgan Stanley, this new firm, will be able to cut some expenses. In the article in the Wall Street Journal which we'll link to in the show notes, they talk about an immediate $400 million a year in cost cutting moves and also the free cash that's available at E-Trade. I want to talk about free cash for a moment because I think this is important. If you put money into a money market at a brokerage firm, you're going to find that the rates you'll earn on that money are very small. As I used to say, you'd need a microscope to see these kind of numbers. What is now happening is there are alternatives where you can put money into a money market that will earn something closer to a 13-week treasury bill. And that's normally what you'll see quoted for money markets.

Something closer, but not exactly. Something closer to the 13-week yield on a treasury bill. At the moment, in late February, 2020, that's about one and a half percent. There was a point last year where some of these online money market accounts were paying over 2%. This provided a great opportunity, but understand that that online money market rate is going to fluctuate and it's going to trail whatever the 13-week T-Bill or money market rate is going to pay. But if you put your money at a brokerage firm, you may find that the money is sitting in the house money market account and it's earning 0.1, 0.2, something like that. It's not a sexy yield. What happens with the spread between what you earn on your money market, 0.1 or 0.2%, and the actual T-Bill rate? Think about it. A brokerage firm can basically put your money into treasury bills, no risk, earn one and a half percent but they're paying their money market clients 0.1 0.2, 0.3%.

That's an instant pick up in spread that they can put in their pocket. So these are the kinds of things that help. They help pay for the deal, but not entirely. There's another little feature of E-Trade that a lot of people may have overlooked until this deal was announced yesterday. E-Trade has done a terrific job in locking up a major portion of employee stock ownership plans. This is a big deal. If you work for a corporation and you're granted stock each year as a bonus or part of your compensation package, at some point you'll have to exercise the options or sell the stock. E-Trade has done a terrific job in locking up that market and some of these smaller clients become bigger clients when they're awarded these stock grants and they later exercise and sell their shares and they become much bigger clients. And so, they have done a terrific job.

Now, E-Trade has kind of changed their stripes over the years. In 1999, 2000 when dot-com stocks were doing really well, you'll probably remember the commercials on TV with the E-Trade baby, that stock, hard to believe, was trading at around $200 a share. However, just a few years later in 2008, 2009, E-Trade was a $5 stock. Part of that was from the dot-com collapse.

The other part of it was E-Trade started getting into doing home equity loans and they had a lot of folks on margin. But this home equity loan business that they got into got really messy. Remember home equity loans, you are usually, as the lender, you are in the second position as a lien holder against a home. And if your home is underwater, there's basically no equity to backstop that loan. So anybody doing home equity loans really was on the verge of extinction at that point.

But E-Trade is done a good job in getting back on their feet and now they're in a position where they're now going to be involved in this merger with Morgan Stanley. So the landscape continues to change. That's one of the lines that we use, I used it just a few minutes ago in this podcast. But we can't get used to things being like they used to, whether we're talking about the markets or we're talking about what's happening in the economy. The landscape will always be changing and so that is part of what goes on with the investing business. There was another article that we'll link to in the show notes regarding the Kiddie tax. Some of you may be familiar with custodial accounts that parents set up for their kids. One of the big wake up calls in the last 10 years or so was, I think some folks forgot that when your child becomes of age, legally that money becomes theirs.

I think a lot of brokerage firms forgot that too because there was a period of time where all brokerage firms suddenly seemed to snap to their senses and find that some clients had continued to maintain custodial accounts for their grown children, children who were now in their 20s, some even in their 30s, where the firm just never went back and updated the paperwork. If you have a custodial account, you need to remember that this money legally becomes property of the child once they become an adult. But getting to the article that we'll link to in the show notes, there were some massive changes to the tax laws in 2017 that President Trump had signed and they became effective in 2018. One of these changes wiped out some benefits that the custodial accounts had offered. In years prior, there was a certain exemption. If you earned $2,000... I'm rounding these numbers. But if you earned $2,000 in a custodial account for your child, the first $2,000 was essentially exempt.

It didn't apply to a child's earned income from being... in the story, they talk about it as some of them being a camp counselor, owning a paper route. I don't think people do that anymore. But it didn't apply to earned income. This is unearned income. $2,000 was essentially exempt. With the tax law change in 2017, all of the income... that exemption went away and all of the income from these custodial accounts now became taxed at trust rates. Trust rates, if you have a trust, you know what I'm talking about. The trust rates are very, very different than what we would pay in terms of income tax. So the trust rate, the top tax bracket for trusts is 37%, and it usually kicks in at a pretty low level, like 13 grand a year. So all of a sudden in 2019, young children started having income tax problems because the money that used to be exempt or part of this was exempt or taxed at a very, very, very, very low rate is now suddenly being taxed at some pretty high numbers.

They specifically referred to families that were receiving military survivor benefits. They talked about the story of a widow of a Navy officer. She had a top tax rate of 12% on her income. Her income was less than $55,000, but her six year old son had a top tax rate of 37% on his survivor benefit. His survivor benefit was $29,000. He continues to get income until he becomes an adult.

Because of the situation, the way it was structured, he is now under the new tax law. He is now subject to a much, much higher tax rate than his parents. What they've done, Congress repealed the Kiddie tax revision late last year in 2019 and they reinstated the prior law for 2020 and beyond. If you wound up paying higher taxes than normal in 2018 and 2019, you can actually go back and file an amended return for 2018. The 2019 returns won't be doing until April of this year. But this affected almost 400,000 tax returns because these were folks that had normally seen a portion of this money becoming exempt and now they were subject to this tax.

It was a real problem. So if you do have custodial accounts for your children, a lot of the problems that creeped up with the change in the new tax law are now going away. That's going to wrap up this current episode of the Mullooly Asset Management podcast. We appreciate you tuning in and we'll catch up again on the next episode.