Required Minimum Distributions, Selling Bonds, & Old 401(k)'s - Transcript

Tom Mullooly: Welcome to episode 196 of the Mullooly Asset Management podcast. This is Tom Mullooly.

Tim Mullooly: And Tim Mullooly.

Tom Mullooly: In this episode number 196, we're going to cover topics like required minimum distributions from retirement plans. We're going to talk about when you should think about selling a bond. We're going to talk a little bit about home equity lines of credit and recovering an old 401K along with some other topics. Thanks for listening and let's get started.

Tim Mullooly: The first question asks, can I defer a required minimum distribution to next year? The summary goes on to say, "I would like to take out half of my RMD by December 31st of this year. I would like to withdraw the other half in 2018 by April 1st. I turned 70 and a half in June of this year. Is this an okay strategy? The goal of this is to keep my annual income down a little in 2017, I realize that my income will go up more in 2018."

Tom Mullooly: The answer to this question "is this an okay strategy?" is yes, it's an okay strategy. When I first heard the original question, can I defer a required minimum distribution into next year? On the surface the answer is no.

Tim Mullooly: Right. Yeah, in this person's specific situation, the answer is yes but in pretty much any other case the answer would be no.

Tom Mullooly: Right. What Tim's referring to is this person who wrote in with the question turned 70 and half this year. The rule for required minimum distribution says you must begin your first required annual minimum distribution by April 1st of the year after you turn 70 and a half, that's the latest but there's a wrinkle, Tim, right?

Tim Mullooly: That's right. You have to, you can wait that long to take your first required minimum distribution but just know you also have to take that year's minimum distribution as well. If you wait to take your entire first year's distribution then that next year you're going to essentially be taking two RMDs in one year.

Tom Mullooly: Right. You do have the ability to defer in the first year but it's every year after that, that's actually pretty good question.

Tim Mullooly: Right. In this case, the person would be taking, if they wanted to split their first one up, half and half. Be like the first year they're taking half and then next year they're going to have to take one and a half to make up for the rest of that RMD.

Moving on, the second question asks, when should you sell a bond? The summary says, "I'm learning about bonds. Why would someone sell their bond if they're holding a zero coupon bond and it generates 6% return on maturity? I'm currently holding those. I was reading that people sell their bonds when interest rates go down because they can get more than what they paid. When is the most opportune time to sell a bond?"

Tom Mullooly: Well Tim, I'll throw the question back to you, when is the most opportune time to sell a bond? In our opinion.

Tim Mullooly: When it matures.

Tom Mullooly: Right.

Tim Mullooly: That's the whole original premise of owning bonds. You buy them, you hold them to maturity and then you collect your money. Somewhere along the road people decided that they wanted to trade bonds and buy and sell them before they mature, threw people for a curve ball but the original idea was to hold it until maturity.

Tom Mullooly: The idea when we recommend bond allocations to clients is that they're going to sit with these for the duration. That they're going to have this income stream coming into their account and hopefully it will be a stable source of value for them and will turn out to be a good investment. In this particular case, they own a zero coupon bond and it generates a 6% return at maturity. Zero coupon bonds are very different than a traditional bond. Traditional bond pays interest twice a year and you buy it near or close or at face value and then you get the face value of the bond back at maturity. Zero coupon bond totally different. Zero coupon bond, like the name implies, zero coupon, you don't get any coupons. You buy a heavily discounted investment that's going to come due at 100 cents on the dollar at some future time. That's how a zero coupon bond works.

Because it doesn't receive coupon interest every six months and it's deeply discounted in price, what happens is, when interest rates change either up or down, you're going to find the value of the zero coupon bond itself fluctuating wildly like an internet stock the way some of these things can move. When interest rates are moving up, you're going to get an exaggerated move down in the value of your bond. And vice versa. When interest rates are going down, the value of a zero coupon bond is going to move, traditionally, much more than what you would normally see in a bond.

We have a take a giant step back and remind people that the prices that you see on your account statement or online or in the paper or some other place, these are for listed blocks of a million dollars. Institutional size bond bids. They are not the bid that you're going to get if you try and sell your $10,000 bond. You're just not going to get that price.

Tim Mullooly: Right. These bonds, they trade by appointment so you're going to have to call up your broker and ask what the price is for the bond at that exact time.

Tom Mullooly: Right. And if they give you a price, they're usually going to tell you this price is good for an hour. When you get your statement in the mail and rip open your statement, see the value of your bond has gone up or down, realize that that's what happened on the last day of the month when that statement was printed. You may be looking at this two or three weeks later. Not accurate. But interesting question in the sense that a zero coupon bond is going to move, it's a completely different vehicle compared to a traditional bond that has a coupon that pays on a regular basis. People do sell their bonds when interest rates go up and down. If you want to speculate on the moves in interest rates you could buy zero coupon bonds, you could actually buy an exchange traded funds that holds these things and does the same. Interesting question.

Tim Mullooly: The next question goes on to ask, what is the impact of the tax deductible nature of a home equity line of credit?

Tom Mullooly: Okay, we need a little more information.

Tim Mullooly: The question also asks, how would I decide between a higher but tax deductible interest rate of a home equity line of credit versus a lower non-deductible rate of a different loan? What is the tax deduction worth in terms of interest rate?

Tom Mullooly: We have to do a little bit of math. I'm going to use, instead of talking about the loans, I'm going to talk about bonds and show you how to calculate the taxable equivalent yield on a bond and then you can do the same in the opposite direction for a loan. Suppose you're trying to decide between a taxable corporate bond and a tax free municipal bond. Let's just say you're in the 28% tax bracket. We're not going to include state or local taxes for this example. Let's just say you're in the 28% tax bracket. That means you keep 72 cents on the dollar or 72% of the yield is what you actually keep in your pocket after you pay taxes.

If you have a taxable corporate bond that has a yield of 5%, after taxes, if you're in the 28% tax bracket, you keep 72% of that. So what we do is we take 5% times .72 and your effective after tax yield is 3.6%. Now if you're with me so far, the next step is if you can find a tax free investment that's paying 3.6 or better, go with the tax free investment. Assuming all other things are the same. Credit quality's the same, the length, the time to maturity is the same, assuming that all these other things are equal and you're just trying to judge between the two of them, then that's how you do it. The reason why it's hard to answer this particular question is because we don't know this person's tax rate. They have to figure out what their tax rate is and then do the math and figure out which is going to be more beneficial to them.

Home equity lines of credit have a little bit of extra value as the writer mentioned in that you can still write off interest paid on a home equity line or loan. That's, it's worth considering. Good question.

Tim Mullooly: The next question asks, what can I do with a recovered 401K from a previous employer? They go on to say, "I received a letter in the mail that informed me of an old 401K account from a place I worked during college. The letter said that the 401K was automatically rolled over into an IRA. I had tried previously to roll this account over to my new employer's 401K but was told the balanced was not vested and I lost it when I left the company. While I am happy the account was not lost, I am unfortunately maxed out at the $5,500 contribution limit to my Roth IRA for the year. What are the options for this money? Is there a way I can move this money around without being taxed or pay a penalty? Is it possible to have a transfer applied to next year's tax year? I enrolled in my Roth IRA in October of this year and do not have an employer sponsored plan that I'm eligible to transfer the funds to."

Tom Mullooly: There's a lot of questions packed into this. Let's go through this pretty slowly. The letter said that he received from a former employer was that his 401K account was automatically rolled over into an IRA. Sounds unusual, doesn't it? That an employer can take money and without your consent roll it into an IRA.

Tim Mullooly: That puzzled me at first as well.

Tom Mullooly: They can actually do this. What they, since 2006, what plan administrators are entitled to do is, if you have former employees on the payroll who have balances in a retirement account at work, they can, if the plan permits, they can take low balances, that's anything considered $5,000 or less and they can do one of two things. They can basically withhold 40% for income taxes and send you a check, and then you just have to sort it out with your taxes the next year. They'll send you a check for the net difference. Or they can take it out of the plan, roll it into an IRA on your behalf. You can then move that IRA anywhere you want but it gets it out of their plan. That's a cost for 401K plan administrators to keep all of these formers employees on the books each year. There's a lot of administrative work so everyone's trying to cut costs and be on top of things and minimize expenses and that's one way that they're able to do this.

When he left the company, now we're going back in time, he wanted to roll this account over to his new employer's 401K but was told the balance was not vested. That's possible because you're always 100% vested in the money that you put into the plan but the employer match may not vest for six months or a year, sometimes longer. But the employer match portion, he may not have been vested in, especially if he went to do this right away. He actually got some good guidance in the sense that, hey, you're not totally vested in this, and you may want to wait. The problem is he lost track of the paperwork.

Tim Mullooly: Right.

Tom Mullooly: Now this money's out of the plan and is rolled over into an IRA. Then he goes onto say, "Well I'm happy that the account was not lost, I am unfortunately maxed out that 5,500 contribution limit to my Roth for the year."

Tim Mullooly: This is where we think that the person is just confused as to what they can do with that account. While the contribution is 5,500 for a Roth IRA, rolling over money into the account does not count as a contribution. You can roll over a balance of anything greater than 5,500.

Tom Mullooly: A million dollars.

Tim Mullooly: It doesn't matter what the amount is. If it's a rollover, it can be any amount. It can be more than the 5,500 so he doesn't really need to worry about that in this case.

Tom Mullooly: The only thing that would come into play is that this 401K money was rolled over to an IRA so it's all pre-tax and now he's talking about putting money into a Roth IRA so he would have to do a Roth conversion, pay taxes on the money that's coming out of the traditional IRA and roll it into the Roth. Is there a way that I can move this money around without paying tax or pay a penalty? Actually you can leave it. You leave it in the traditional IRA.

Tim Mullooly: I don't see a problem, we don't have any other information about this person, but just on the surface, I don't see a problem just leaving it in the traditional IRA.

Tom Mullooly: And he works now where he doesn't have an employer sponsored plan that I'm eligible to transfer the funds to. He's limited in the sense that he can't move this money into a 401K with a new employer. There's a couple of things that we remind our clients in these kind of situations. If you have money that came out of an old 401K and you intend to roll this money into your new company 401K plan, then you need to set up, either do a direct transfer to the new 401K plan, which isn't an option here, or you need to set up what's called a rollover IRA with a brokerage firm or a bank and set up a rollover IRA. There's a couple of different terms for IRAs. There's traditional IRA, there's rollover IRA and then there's Roth IRA.

Traditional IRA you can put away $5,500 a years, 6,500 if you're over age 50. Rollover IRA, the whole idea behind this is this is a temporary parking place where you're taking money from a retirement plan at work, like a 401K and you're parking it there and you're going to be moving the money in the future into another plan somewhere else. You should not put new contributions into a rollover IRA account. Once you do that, you cannot roll that money over into another plan. Probably not the answers that this person wanted but it gave us the opportunity to remind our listeners of a couple of different things.

Tim, I think we have one more question.

Tim Mullooly: Yep. The last question for today's episode asks, is an inherited mutual fund taxable? The summary says, "My father recently died, I received about $30,000 as the sole beneficiary of his mutual fund. Is this taxable income? I thought that inherited monies were tax exempt but I have heard differing responses."

Tom Mullooly: There's always a lot of confusion when it comes to receiving inherited shares. Mutual fund shares and stock shares, you need to know what's going on with this. Whether you’re inheriting stocks, bonds, mutual funds, ETFs, it's important to know that your cost basis becomes whatever the value was on the date of the passing of the person that you're inheriting from. If your father passed away six months ago then the date of death valuation will be your new cost basis. When you receive these shares, whether again, whether it's a stock, mutual fund, ETF, bond, it's going to be, unless there's a really unusual situation, it's going to have a cost basis that's very close to today's value. You won't have a lot of tax exposure when it comes to this. Mutual funds there's a little bit of a twist and I'll just allow me a quick story which I may have mentioned on a previous podcast.

We had a situation where a client, husband passed away, wife came to me and said, "My husband put $10,000 into a mutual fund in 1969. It's now grown to $109,000. It looks like I've got a $99,000 tax gain on this." In this particular case, we sold it right before the husband died because they needed the money, didn't really want to do that. It would have been better to inherit this with a stepped up cost basis. What the investor, new investor was overlooking was that every year for 40 years, this mutual fund paid capital gains and the capital gains is reported every year and you pay tax on it each year. That capital gain actually gets factored in, it gets added in to your cost basis and after doing the digging and going back through 40 years of capital gain distributions on this particular fund, we found out that her cost basis was about $92,000 so she had a $17,000 taxable gain not $99,000.

Tim Mullooly: Significantly less.

Tom Mullooly: She owed taxes on, again, this was sold before the person passed away, so they owed taxes on $17,000, not on $99,000. Always important to ask and to find this stuff out. We have a little bit of regret when clients come to us and they tell us what they did instead of asking us what to do.

Tim Mullooly: A lot of questions we get are did we do the right thing, and not, help us make a decision so that we can do the right thing.

Tom Mullooly: There's that big sigh that we have at every episode, it seems. Good questions in episode 196, we appreciate you listening and we look forward to talking with you again in episode 197. Thanks for listening.