Interview With IRA Expert Ed Slott

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Certified public accountant Ed Slott, the author of five books, is considered one of America's premier experts on IRAs. Here, he gives advice on Roth conversions and why the retirement game is actually won after you stop working.

Robert Brokamp: I read in *The Wall Street Journal* that you converted your traditional IRA into several Roth IRAs.

Ed Slott: Yeah, that is a little complex for most people, but that is true, and if it is in *The Wall Street Journal*, it must be true.

RB: That was my first question. Is it true or not?

ES: Yeah, I went above and beyond. I don't recommend that. There is a lot of paperwork in what I did.

Remember, I am a tax advisor. I don't sell stocks, bonds, funds, [or] insurance, which is the reason you can always get the truth from me, because I am not selling you anything. But I have a financial advisor. I had to do all the paperwork and it is a mess. I have, actually, six Roth IRAs - each invested in different sectors -- and I can cherry-pick losers. That is one of the big benefits of the Roth conversion -- the ability to undo it.

RB: Right. So you are talking about a recharacterization, correct?

ES: Yeah, so if you have them in separate accounts, you can cherry-pick losers and keep the winners. What I mean by that is, if you don't have them in separate accounts, all the gains and losses are aggregated. That is the way the tax law works. I will give you an overly simplified example to make the point.

Let's say you want to convert $100,000 from your traditional IRA to a Roth, and now you put it in one Roth and you want to make two investments [of] $50,000 each. You want to invest in stock A and stock B. Later on, stock A becomes worthless -- it goes down to zero -- but stock B doubles in value; it is worth $100,000. Well, there is no benefit to recharacterizing because under the tax rules, you have to aggregate it, and when the smoke clears, you still have the same $100,000.

Now if instead, you open two Roth IRAs at $50,000 each, and in Roth IRA 1 you bought stock A and in Roth IRA 2 you bought stock B, and stock A becomes worthless and stock B becomes

$100,000: In that scenario, you can recharacterize only stock A, because it is in a separate Roth, and keep stock B. When the smoke clears, you have the same $100,000 in the Roth, but you only paid tax on $50,000. That is basically why I [broke up my conversion into six Roth IRAs and] put the money in different sectors -- ones that aren't likely to go up or down together.

The paperwork that comes -- all the statements every month -- it is not for me. But you only need to keep them separate until the time to recharacterize expires. You have until October 15 of the year following the year of the conversion. So for a 2010 conversion, you have until Oct. 15, 2011, to change your mind. Once that date passes, then you can consolidate them into one big Roth IRA. You don't need to keep them separate anymore because the option to recharacterize or cherry-pick losers is gone.

RB: When you recharacterize, let's say in October 2011, what value do they use? Is it [as of] Dec. 31, 2010?

ES: No, you recharacterize at the value on that day. Say you converted $100,000 from your traditional IRA to a Roth, and then you see in early October 2011 it is only worth $20,000. Well, now obviously you should recharacterize; it goes back to a traditional IRA. But you will be off the hook on paying tax on $100,000.

RB: One of the rules of thumb regarding Roth conversions is that if you think you will be in a higher tax bracket in retirement, converting makes sense. Was that why you converted?

ES: It was that, as well as a psychological thing. I hate debt. I have no mortgages on any of my homes. The last thing I want in retirement is to owe anybody money. While I am earning, everything is bought and paid for, so when I need money in retirement, whatever I draw out is all mine. If you have an IRA and you don't convert, you have a mortgage on that retirement account. Most people don't look at it that way, but that is what it is. I don't care if you have a million dollars in your IRA; there is a mortgage on that. [As much as] half of that is owed back to the government, just like you owe money on your house to the bank.

This year, everyone with an IRA and a 401(k) should, at a minimum, at least have the Roth conversion conversation. Everyone qualifies now. There are no more income limits, so high-income people qualify; some of them still don't know it. In that conversation, I always say you have to address three questions: When do you think you will need the money? What do you think future tax rates will be? And where are you going to get the money to pay the tax?

It may turn out that a partial conversion is good for you. This is one of the misunderstandings I have seen all around the country. Most people say, "I can't afford a Roth conversion," because they think it is all-or-nothing. That is not the case. You can do partial, smaller conversions. But in my case, I believe I will be at higher tax rates in the future. I don't want to have to worry about them, and I am happy to pay it off now. Also, I will never be forced to take required distributions. My clients that are over 70 ½ [the age at which distributions must be taken from traditional IRAs, but not Roths] hate required distributions. They hate being forced to take money they don't need and pay tax on it. I am relieved of that by taking the hit now. I am 56 now. When I turn 70 ½, I can keep that growing. I never have to take the money out if I don't want to.

RB: What do you say to people who are worried that the government is going to change the rules?

ES: Everybody says that to me. Basically, it is some version of "Can I trust the government?" I am betting my retirement savings that they'll keep the Roth tax-free, for a couple of reasons. No. 1, it would be politically risky to change it. Most of the guys that voted for the Roth are still there.

But the big reason is because our government is broke and the Roth IRA brings in money, and everybody in Congress is a short-term thinker. Remember, the only money that can go into a Roth IRA is already taxed money, and the government is already counting on a windfall from that. If I were the government's accountant, I would say, "But look at the long term. If everybody did it, you would never have any taxes paid." They don't look that way, so I am banking on their shortsightedness. And I think that is a good bet.

RB: Looking at retirement accounts in general, what are the biggest mistakes people make?

ES: Not having a plan for the second half of the game - the exit strategy. The first half of the game is the accumulation phase. But the retirement game is won in the second half, taking the money out. That will determine how much you keep and how much goes to the government. Taxes will be the single biggest factor, and most people don't have a plan, for one big reason: They think someone else took care of it - their accountant, attorney, or financial advisor. They figure, "Well, I am paying these people all this money; I'm sure it's taken care of." If they ask their advisor, the advisor will say, "We got it covered." But they don't. Most advisors have no knowledge in this area. The average financial advisor, I hate to say it, is basically a salesman. They sell you the stocks, bonds, funds; they really don't do the tax planning.

They don't realize how deep this area is, how many nooks and crannies and complex tax rules there are. Even the CPAs, my colleagues -- they might help you with your income taxes, but they don't know what to do when money comes out of a 401(k) or an IRA. Should I do a rollover? Do I know about company stock tax breaks? It is a specialized area. The average CPA is clueless on this. And the estate attorney might know estates and trusts, but when it comes to the tax rules surrounding retirement accounts, they are just not up to it.

Now, there are some advisors, very few, that do know this. In fact, even in my own little way, I tried to do something about it, because for years, when I was doing tax returns for people, I was at the end of the food chain. What do I mean? I am the last one. When you are doing tax returns for a client, you are recording history. You are just writing down things that already happened and you can't change in most cases. I would be sitting with people, and I'd look at their tax return, and I would say, "What did you do?" They'd say, "Oh, I just did a rollover from a 401(k) to an IRA, but it didn't get to an IRA." And I'd have to tell them, "Now it is all taxable. You just lost your retirement account. You worked 20, 30, 40 years and it is gone. How does this happen?" Over and over again, they'd respond, "Well, I thought my financial advisor was taking care of it."

So I felt like the sorry messenger giving bad news all the time, but I realized it was a business opportunity for me. I said this over 20 years ago; it is even worse now. The reason it is worse now is because there are more advisors and more retirement money. And most advisors still don't address this. They are only taught to sell, sorry to say.

That doesn't mean they are bad. That means they don't focus on the second half of the game, the exit strategy and tax planning.

RB: I was a broker for a couple of years, so I know exactly what you are talking about.

ES: I am not saying they are bad guys, but you need a specialist. It is like going to the general practitioner when you need a specialized operation. So I started creating seminars for advisors. I thought, "Wow, advisors should learn this stuff. Wouldn't every advisor want to know this for their clients?" I still teach lots of advisors, but I would have to say, if I put a number on it, less than 1% of advisors take training in this area.

So about five or six years ago, I created a directory of advisors that have taken training. How would I know that? Because I created the program. It is called "Ed Slott's Elite IRA Advisor Group." You can find out about that on my website, IRAhelp.com. Now, it doesn't mean these guys know everything. But they invest their time and money to learn about these strategies. It is advanced training, and it is continuous. We have several workshops a year; they are constantly updated on tax laws. They have access to our IRA technical experts. You can find these advisors on our website.

I am in an office building with a lot of accountants, and I was here last week. A guy grabbed me -- he is one of the partners of the biggest firm -- and he says, "Look, I got this situation. I don't really know anything about it." It involved an inherited IRA. It was already too late to fix it. Here is the guy telling me 10 different ways he doesn't know anything about this stuff. "You know, we don't do that kind of work," he said. And they are a big accounting firm.

RB: Can you tell us some real-life IRA horror stories?

ES: I always say an IRA is like an eggshell; you break it, it's over. You get one chance, and then the tax spills out. It doesn't matter if you worked 30 years and built up $500,000. If it all gets taxed at one shot because you were working with an advisor that didn't know how to complete a rollover properly, it is over.

A case came up today on the tax service. A guy goes into his bank and says, "I have this IRA and I am not getting much interest. I want to switch it to an account that has better interest." So the bank employee puts him in a Christmas Club account, which is not an IRA account.

Now he doesn't find this out, probably, until he goes to his accountant, a guy like me, and the accountant looks at this and says, "What did you do? It is all taxable."

"What do you mean? I switched to another account."

"Yeah, but it is not an IRA." Nobody questioned that if you take from one IRA, you have to go to another IRA -- otherwise it is taxable.

Anyway, he had to go through a long, exhaustive process with the IRS and request what is called a PLR -- private letter ruling -- which costs thousands of dollars and takes six to nine months of time, all because somebody at the bank didn't know an IRA [should] go into another IRA. They gave him relief in that case, but they don't always provide relief. He could have gone through that and lost this case, and then it all would have been taxable -- plus the money he spent for the ruling.

Another case came out similar to this. This came, actually, to our office and we are dealing with it now. [This person] took money out of his IRA, about $500,000; he wanted to do something with it. Right around that time, somebody died in his family and left him money. So he says, "Eh, I don't need that $500,000. I'll put it back in my IRA." Which he did within the 60 days, so he was fine. Then a little while later, in the same year, he does it again. He takes money out of his IRA to buy into some business or whatever it was, and then he decides, "Nah, I don't want to do it." He puts it back. This happened five times throughout the year.

Well, you can only do that once. You are only allowed one IRA rollover per year. What was amazing was, it was with a major mutual fund company. It wasn't until the fourth time they said, "You know what? I don't think you can roll this over again." By the way, he paid tax on $500,000.

Another big mistake is not checking a beneficiary form, not knowing who the beneficiaries are. I just had a case where we saw that it hadn't been changed in 20 years and the beneficiary was dead.

RB: And then it goes to the estate?

ES: In that case, it went to the estate and there was no solution. It all had to come out very quickly after death. The stretch IRA was lost. [To take advantage of the stretch IRA, the beneficiary form must name one or more human beings, not the estate.]

I am sick of seeing these horror stories from the biggest financial institutions that are out there spending all their money telling everybody how smart they are. When you really need them, they don't have the knowledge. The stock market goes up and down; when it goes back up, you get your money back. If you lose it to taxes, you will never get that money back. So you have got one chance to get this right.