Consider This Program

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On This Show:

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Show Notes:

Topics Include:

- Roth Conversions
- Stock Swapping & Upgrades
- Capital Loss
- Short-selling & Loans

Roth Conversions

A Roth conversion is when I take money out of an IRA or a 401k account that's already tax-deferred (I have not paid any taxes on the money that went in or on the growth), and I'm going to take some of that money right now and convert it from an IRA to a Roth IRA or a Roth 401k so that I never have to pay taxes on that money or the growth on that money ever again. Is it a good time to do a conversion when the market's down?

If you believe the market is down? Remember one thing you always have to start with in a marketplace is where did it come from? Was the market too high before it fell? Just because something fell 50% doesn't mean it shouldn't have fallen 50%. You have to be determined. You have to feel that the market is truly low, not artificially low or artificially high. If that's the case, then yes, it would be a good time to do the conversion. Remember on a Roth conversion, they're always right for the beneficiary. They're not always right for the person who does it.

Are the taxes based on the value of the IRA at the time of the conversion? In the old days we used to be able to reconvert and we can't do that anymore. The taxation is based on the amount you converted the day you did the conversion.

Do you think that taxes are at the lowest? We'll see. I will tell you historically, our tax rates right now are as low as they have gone. In my personal position and situation, I will tell you, I believe my tax rate will go up over time as opposed to decline over time. You have to make that call for you. We have the baby boomers retiring. We know what our deficit is and we just added a little over $4 trillion in a federal stimulus package to get through the Coronavirus.

You are reporting more income on your taxes that year, but is it best to pay those fees or that extra tax with non IRA money?

You have to. I've yet to be able to do a mathematical workup where it made sense to pull money out of an IRA and use part of the money that you pulled out of the IRA to pay the taxes on the IRA to do the Roth conversion. If you do not have the available cash, then you shouldn't do the conversion. This year (because of the economic uncertainties in the interruption), for people who have a lower income amount (or people who have variable income because of the Coronavirus), this may be an ideal time to look at doing those kinds of shifts for the conversions. You can borrow up to a hundred thousand dollars. You've got three years to pay it back.

Is there a time when a conversion is not a good idea? If you believe your tax rate is going to fall in the future it would make no sense to do a conversion. Remember when you go to retire, you need 100% of your standard of living. If there is a way you're going to retire at a lower standard of living or at a standard of living that has a lower tax rate attached to it, the Roth conversion may not make a lot of sense for you.

If you've got a lot of health issues where you may have a big healthcare cost issue in one year (where you actually can go back and itemize), then it may be something you want to consider. Ideally you want a third, a third, a third. My wife and I's objective is to have a third of our money that is tax deferred, a third of our money that is after tax, and a third of our money that is in Roth money.

A contribution is the amount of money that you put on based on earned income. This year you have to qualify, meaning your income has to be low enough and yet have enough money to be able to qualify. You can put in money for you and your spouse if you're married, filing jointly. That's a contribution. Conversions have no income limitation so you can be any age and you can have zero earned income and still do a conversion as long as you can afford the taxes.

Stock Swapping & Upgrades

What triggers a stock upgrade? You're trading in anything to get something better. That's an upgrade. What happens in a period of economic uncertainty? That's the thing that stock markets hate. When you have economic disruption or uncertainty, you have price dislocation and prices fall for different reasons. Stocks go down in value or up in value for one of three reasons. First, you have people who are making what we call purposeful trades.

I have no desire to own a rental home that I am going to try to flip. Purposeful trading for me is driving by that place that is for sale. For you, it's buying that place. It's for sale right now. That's purposeful trading. When things get rocky, you have painful trading. Then we've got problem trading, which is where we are on the Shark Tank and somebody is needing capital. And you've got panic trading. That's what happened about two or three weeks ago in the market. When you had a period of capitulation where people flat out panic: they didn't care what they own, they didn't care what the company did, they didn't care about the earnings. They just said: get me out.

Does The Financial Enhancement Group have a process to try to find stocks like before they upgrade? That's not part of our game. We try to get on base score runs, win games. We have certain processes for the companies that we own. The way we assess values is a threefold thing. My job is to be responsible for what we call the narrative. I look at the big picture of the demographics. Adam's job, as our Chief Investment Strategist, is to figure out what things are truly worth from a book value standpoint and what's a fair price to pay for them. Andrew Thrasher's job, our Charter Market Technician, is to look at it and say, based on what that stock is doing relative to all the others, how is it performing? We put the three together and that's what builds the basis of our portfolio.

Capital Loss

What is a capital loss when you don't make money? It's not an IRA. Once money goes into the black box of an IRA or a 401k, it doesn't matter what it went into. We're talking about a retail account. It's money after tax. There are people who will have this adage that you didn't lose money until you sold. We are not people who will tell you that that is the case. Every dollar that you have, you get a vote. You get a revote today, is there a better place for it to be used? The idea of having money in stock and selling out of stock and going to cash is one thing. The idea of selling a stock today and buying another stock, that's a whole other story. That's more of what we do: repositioning that capital for a greater opportunity with less risk.

We've got $100 we've already paid taxes on. I always talk about my $100 coffee cup (which I don't have, I'm just pretending). It costs $100. I paid for it after tax. The terminology that we use is this: that is my cost basis. There's three reasons to trade. There's purposeful trading, problematic trading, and panic trading. I purposely paid $100 to this coffee cup for some unknown reason. Now, all of a sudden something has happened in my life. One of my kids is having a problem because of the virus and they've been dislocated from work and they need money. All of a sudden Angie comes up and says, “I really like that coffee cup, but it's not worth near what you thought it was. I'm going to give you $60 for the coffee cup.” I would tell her no. She's going to come back the next week when things are even worse and say, “I'll give you $50 for the coffee cup.” I take her $50 grudgingly. Now I have a recognized loss. If you offered me $50 or $60 for the coffee cup and I didn't sell it, I didn't lose any money in theory. I'm not telling you if you didn't sell, you didn't lose. That's not an entirely accurate statement. You should not just hold your eyes shut and hold on to things just because you own them. I now have a $50 capital loss. In a stock portfolio, I'm able to look every day to see what people are willing to pay me for my stocks.

And I don't want to get stuck in a situation where I can't sell stocks because the taxation and capital gain is too great. That's what we saw happen to people in 2018, 2007 and 2000. You want to build up capital losses when you can. On top of that, I can book $3,000 worth of capital losses a year even against gains. If I have $100,000 capital gain this year and I have $120,000 capital loss because of stuff that I intentionally sold and didn't go to cash, this is not panic selling. This is purposeful trading where I reallocated the money to other positions that were similar or what I thought was an upgrade.

Right now I've got that $120,000 worth of losses. I've got $100,000 worth of long term capital gains. The losses go against the gains, so I have no taxation there at all and I can use another $3,000. Let's say your tax rate is 20% and a $3,000 loss. That means I'm going to put $600 into your billfold this year, cash money that you can take home, use for Christmas, use for vacation, because we were proactively harvesting losses.

Are you allowed to buy an asset and sell it solely for tax purposes, then just go out and replace it? The rule is if I sell something that's a long term capital gain or a short gain, that gain is recognized immediately. If I sell something at a loss, I have to wait 30 days to buy back that identical asset. If you don’t wait, that’s called a readjusted basis. If I bought another equal or identical asset, there is no rule.

Short-selling & Loans

There are different strategies you can do to be able to use the value of assets that you already own. You want to give yourself the opportunity to be able to be liquid when you need to be. Liquid means converting to assets that are spendable today. There is a difference between an equity line of credit and a home equity loan. With a home equity loan, you get a fixed term with a fixed rate. You set it up for 15, seven, or three years and pay it off. You can not borrow any more against it. A line of credit is not on a fixed rate. It's somehow tied to the prime rate, usually prime plus two and they will come out and evaluate your home and then normally appraise your home minus what you already own. Generally they're going to give you anywhere between 70, maybe 80% of the value of your home.

So JP Morgan announced that you now have to have 20% down to buy a home. I'm going to find it shocking if they stick with that. We are in changing times. Keep in mind, there's loans. That means you're using the equity value inside of your home, typically your residence or your primary residence, I should say, a fixed payment. You're going to pay it back over a given period of time, just like you would a first mortgage on a home. The second is a line of credit where you can, put and take. You can put money in, you can take money out. It used to be scary to take a line of credit knowing it was tied to the prime because you didn't know for sure what the interest rates were going to do.

With interest rates down and the housing market still up, is it a good time to take a home equity loan as a fiduciary? If I was a securities broker, I would tell you that to do that is absolutely immoral and unethical. As a fiduciary, my job is to treat your money as it was my money and we were in the same situation. Looking at April 13th with the S&P 500 rallying 20%, the answer is I would not be taking money out of my house today to go buy into this market. I still think what you saw March 9th and 10th is going to wind up being a good buying opportunity. I would've pulled money out of my house then, though I would have never told somebody else to do that.

People use what's called margin on their stocks. Rarely do you see stocks dip or homes depreciate in value as quickly as stocks can. One of the things that we think is going on in the marketplace right now is what's called a short squeeze. You see my $100 cup and you think it's only worth $50. You sell it at $100 knowing that you're going to have to pay interest and you're not going to collect dividends along the way. That's the way margin works. You believe you can buy my coffee cup back at $50 and you just pocketed the $50 difference? That's selling short. In this recent rally, short squeezes affect people who had sold stock short. You've sold stock short and all of a sudden the stock price has started to go back up. Now you have to buy it.

What if the rates take a turn? What's the quickest you've ever seen rates go up? They fall much quicker than they rise typically and that's exactly what we saw happen here. It's what we saw happen in December of 2018. The interest rate itself went down on an elevator. Watching the fastest rise however, is a different story and it, and it takes a little bit of time. They're more on an escalator. Are open-ended lines of credit still deductible? Only if they're used toward your home. You have to prove that they are able to be used for that.

Disclaimer: Joseph Clark is a Certified Financial Planner™ and the Managing Partner of Financial Enhancement Group, LLC an SEC Registered Investment Advisor. He is the host of "Consider This" found on WIBC Saturday mornings from 6-7a.m. as well as three other Indiana-based radio stations. Joe has served as an Adjunct Assistant Professor at Purdue University where he taught the capstone course for a degree in Financial Counseling and Planning.

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