Retirement Planning: Tax Diversification

What is Tax Diversification?

The concept behind tax diversification is to manage wealth accumulation in such a way as to create the most tax-efficient cash flow in retirement as possible. This requires understanding the income tax implications of the various ways to save for retirement in order to potentially spread tax exposure among different retirement savings vehicles. At its most basic, tax diversification planning answers the question…**Do I want to pay taxes now or later when I'm retired?** The most widely used sources of retirement income include:

- **Investment Accounts** into which you invest funds on which you've already paid income tax. Investment earnings may be subject to taxation, including taxes on interest, dividends, and realized capital gains. The tax treatment of investments varies based on the type of investment, holding period, and individual circumstances. The capital gains tax rates may be lower than your income tax rates.

- **Tax-deferred qualified retirement accounts** into which you (and/or your employer) make contributions on which no income tax is paid (i.e., pre-tax contributions). Examples include 401(k) plans, governmental plans such as 403(b) plans and IRAs. The funds in these plans grow free of income tax. When you retire, however, and draw funds from these plans to provide a retirement income, distributions from the plans are generally fully subject to income tax as received.

- **After-tax qualified retirement accounts** into which you make contributions on which you've already paid income tax. Examples include Roth 401(k) plans and Roth IRAs. The funds in these plans grow free of income tax. When you retire and draw funds from these plans to provide a retirement income, distributions from the plans are generally received income tax free.

Why is Tax Diversification Important?

Tax bracket planning. Withdrawals can be made from tax-deferred and after-tax retirement accounts in amounts designed to minimize the effective income tax rate paid.

Social Security taxation. It may be possible to minimize or even eliminate the taxation of Social Security benefits by using some combination of withdrawals from tax-deferred and after-tax retirement accounts.

Medicare Part B premiums. Higher-income Medicare beneficiaries pay higher premiums for Medicare Part B. You may be able to alleviate this outcome through carefully planning the sources of your retirement income...tax-free or taxable.

Flexibility. Having retirement assets with different tax characteristics may provide additional flexibility when addressing retirement income needs and potential tax consequences.

Bottom Line on Tax Diversification

No one can predict how tax laws will change down the road when retirement comes knocking. Investors should think sensibly about possible taxation scenarios they might encounter in retirement before making long-term decisions on the types of accounts to invest in presently. For example, think to yourself “what are the chances of being in a higher tax bracket or a lower tax bracket in retirement” and then invest appropriately. If you still don’t have an idea of what your tax bracket may be in retirement, it might be a wise choice to have assets spread across different account types, such as tax-deferred, after-tax and investment accounts.

Whatever the final type of accounts you spread your assets across, individuals who have not had the time or do not have the knowledge necessary to consider tax diversification may consider conferring with a qualified professional and/or a tax advisor. Tax diversification may escape some, but in today’s investment landscape, it is a critical step in helping people further unlock the value of their financial plans.