Money Matters: Benefits of tax diversification

By Rick Gross

Taxes are an often-overlooked aspect of retirement planning. While many Americans are saving diligently and focused on accumulating the biggest nest egg possible, many investors may not be fully considering the impact that taxes will have on their monthly income in retirement. This is an important dynamic to understand and will prevent any unnecessary surprises when you enter your hard-earned retirement.

Know your retirement plans

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IRAs, 401(k)s, or other workplace plans are great ways to save and invest for retirement. Your contributions are generally made with pre-tax dollars, and you don’t pay taxes until you withdraw money. If you have access to a workplace retirement plan or an IRA, take the time to evaluate how your savings may be taxed in retirement. It’s important to factor this into your retirement income planning.

One way to potentially minimize the impact of taxes in retirement is to accumulate savings in an account that gives you access to tax-free withdrawals. To achieve this, many people choose a Roth IRA. Strategic planning and dedicated saving in a Roth IRA during your pre-retirement years may give you more options to manage your retirement income stream in a tax-efficient manner.

In general, a Roth IRA may make sense for investors who anticipate being in a higher income tax bracket later in life (examples include marriage, progressing in your career or annual raises), or who prioritize having tax-free retirement assets. Direct contributions to Roth IRAs are only available to those who meet specified income limits (check with your financial advisor or tax professional for details). You invest after-tax dollars into a Roth IRA, but if certain requirements are met, all withdrawals can qualify for tax-free treatment. This is a unique advantage that few other vehicles offer. Your employer's plan may also offer a Roth option, which is a way to save even more money that benefits from this distinctive tax treatment.

You can also convert dollars from a traditional IRA or workplace plan into a Roth IRA. This allows you to put a larger sum into the tax-free category for retirement. A Roth conversion can also create a sizable tax liability in the year the conversion is made, so you need to determine if this strategy is suitable for you. If you want to use this strategy, you'll need to have enough money available outside of the IRA to pay the taxes incurred. Always consult with your tax professional before moving forward with this strategy.

Tax-smart retirement spending

Generally, it's a best practice to allow money with more favorable tax treatment to stay invested for as long as possible to extend those tax benefits. The advantage of owning a tax-diversified mix of assets once you reach retirement is that it helps you manage your tax burden on a year-to-year basis, per your personal circumstances. In any given year, your strategy may include:

- Withdrawals from a workplace retirement plan or IRA funded with pre-tax contributions that are fully taxable

· Distributions from a traditional IRA where a portion is taxable

· The sale of taxable investments where tax may or may not be due

· Withdrawals from a Roth IRA that are not subject to tax and don’t add to your taxable income

Managing income levels effectively in a particular year can help limit the amount of taxes due in that year. Depending on your income level, a portion of Social Security benefits may be subject to federal income tax.

Tax decisions should be one consideration in your retirement income strategy. Putting yourself in position to have options as you draw income requires planning in advance. Investing with tax diversification in mind may help you access income with different types of tax treatments in retirement. As you craft your strategy, be sure to discuss the potential tax treatment of your investments with your tax advisor.

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