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free and tax-deferred accounts.

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By Stefan Greenberg, CFP, CFS, CLTC, Kiplinger Consumer News Service (TNS)

For many Americans, 401(k) and other tax-deferred retirement plans represent the lion's share of their investable assets. After all, why wouldn't you want to contribute as much as possible to a plan that enables you to:

- Make contributions on a pre-tax basis
- Achieve tax-deferred growth for as long as your assets remain in the plan

- Withdraw assets at retirement when you may find yourself in a lower tax backet

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tax-deferred account with after-tax dollars and a requirement that you pay taxes every year on income and/or capital gains.

What you may not realize, however, is that you have other choices.

Diversification goes beyond asset classes and investment categories

Just as you allocate assets to a combination of stocks, bonds, cash and other investments, you may want to think about allocating assets among:

- **Taxable accounts** that offer a wide range of investment choices, including stocks, bonds, mutual funds and real estate. They also require you to invest with after-tax dollars and pay taxes every year on any income you earn or capital gains you realize.
- **Tax-free accounts** like Roth IRAs that provide you with the ability to invest with after-tax dollars but pay no income or capital gains tax on any withdrawals you make. Other tax-free vehicles include whole, universal or variable life insurance. In addition, municipal bonds offer income that is free from not only federal income tax but state income tax, if they are issued in the state where you reside.
- **Tax-deferred accounts** like the 401(k) we've already described. Again, these accounts offer tax-deferred growth but require you to pay tax on any withdrawals you make. What's more, withdrawals are taxed as ordinary income.

Tax diversification in action

Using the previous example, imagine that you are retired and that your tax bracket is now 25%. You withdraw $250,000 from your 401(k) or other tax-deferred account and incur tax liability of $62,500, leaving you with $187,500.

Now imagine you did this instead:

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gain at only 15%, leaving you with $63,750. Add in the $50,000 withdrawal you made from your Roth IRA or other source of tax-free income, and you'd end up with $207,500.

That's $20,000 more than you would have been able to keep if you had withdrawn $250,000 from only your 401(k) or other tax-deferred account.

It's not what you make …

… It's what you keep. Tax diversification can make the difference between having choices in retirement or being forced to compromise your lifestyle.

But how can you implement a tax diversification strategy, especially if most of your assets are either in a taxable or tax-deferred account?

- **Be tax-aware.** Understand what tax bracket you're in and how short- and long-term capital gains are taxed.
- **Determine whether your employer offers a Roth 401(k)** that allows you to make contributions with after-tax dollars and make tax-free withdrawals at retirement.
- **Consider converting** any traditional IRAs to Roth IRAs and whether incurring tax liability now is worth the prospect of being able to make tax-free withdrawals at retirement
- **Consider sources of tax-free income** you might not have thought about. These might include whole life or other insurance policies that offer cash value, municipal bonds and even 529 plans and/or health savings accounts.
- Finally, **seek professional guidance** before you make decisions you might regret later. Tax diversification can be complex and requires a thorough understanding of tax codes and your overall financial situation.

ABOUT THE AUTHOR:

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