Diversify to minimize taxes after retirement

By Lynn Asinof

Globe Correspondent / March 6, 2011

Add it all up. Brokerage, retirement, and bank accounts. The equity in your home. An inheritance from your parents. On paper, it might seem like a lot. But when it comes time to cash out, you may find that you are ending up with a lot less.

Taxes can take a big bite out of your nest egg just when you need that money most. That is why a growing number of financial advisers are starting to focus on diversifying portfolios according to the different tax treatment afforded specific types of accounts. The goal: make taxes manageable when it comes time to spend that money.

Driving this approach — known as tax diversification — is uncertainty over future federal tax laws. Sure, Congress last year delayed any significant tax increases by extending Bush-era tax cuts through 2012. But advisers say that doesn't remove the potential for higher rates after 2012, particularly as concerns over federal deficits mount.

“There are so many unknowns,’’ said Dana Levit of Paragon Financial Advisors, a fee-only financial planning firm in Newton.

Given the uncertainty, the critical questions become, “When should you pay tax on the income you are tucking away, and what will your tax rate be at the time you withdraw it?’’ By choosing to pay some tax now and some later, taxpayers can hedge against future tax changes. In other words, said Levit, you don't want to have all your eggs in one basket.

Consider what happens to a retiree with a traditional tax-deferred individual retirement account, a tax-free Roth IRA, and a taxable brokerage account. He needs $50,000 this year to cover living expenses. If he takes the money from his brokerage account, the only tax paid would be on capital gains, since the money invested here has already been taxed as income. Capital gains are typically taxed at lower rates than income.

But if he takes the money out of a traditional IRA — which in most cases are funded with pre-tax dollars — every dollar will probably be taxed as ordinary income, significantly reducing the money that he has available to spend. Yet, if he takes the money out of his Roth, there will be no tax at all since these accounts grow tax-free after being funded with after-tax dollars.

Because he has all three types of accounts, this hypothetical retiree has more control over the tax he ends up paying. The difference can be substantial. This retiree would be hit with an $8,700 tax bill if he withdrew all that money from his traditional IRA. But if he split withdrawals between his Roth and traditional IRA, he could cut his tax bill to just $4,700, according to calculations by investment management firm T. Rowe Price.

That kind of savings can make a huge difference, particularly for retirees who must take minimum distributions from their traditional IRAs once they turn age 70 1/2, says Christine Fahlund, a T. Rowe Price senior financial planner. Moreover, by carefully balancing withdrawals from taxable, tax-deferred, and tax-free accounts, retirees can lower their taxable income, potentially reducing or eliminating taxes on Social Security benefits, she says. A portion of these benefits become taxable once retirees exceed certain income limits.

But tax diversification isn't just for the over-60 crowd. Younger savers can benefit from having different tax pockets from which to draw money. Contributions made to Roth IRAs, for example, can be withdrawn at any time without penalty or tax. Levit says that's why she often suggests her clients park up to half of their emergency fund money in these accounts.

Roth 401(k), now offered by a growing number of employers, says Fahlund. There are income limits on contributing to a Roth IRA. For the tax year 2010, only couples with less than $177,000 of modified adjusted gross income and single filers with less than $120,000 can make Roth contributions.

There are no income limits on Roth 401(k)s.

Those who exceed Roth IRA income limits, or don’t have access to a Roth 401(k), may want to consider converting some of their traditional IRA assets to a Roth.

Such conversions will trigger income taxes. Still, some advisers say it may make sense to start gradually converting to a Roth to take advantage of the extension of the lower Bush tax rates, keeping a careful eye on the amount converted so tax bills don’t skyrocket.

The payoff from tax diversification comes when it’s time to spend hard-earned savings. By having the choice of taxable, tax-deferred, and tax-free accounts, Levit says she can manage clients’ tax brackets, often keeping them at the 15 percent level.

“You have to take the money from the right place at the right time,’’ she says.