Tax diversification:

Providing flexibility in retirement

Katherine Tierney, CFA, CFP® • Senior Strategist, Client Needs Research

Changes in tax rules, much like the stock market, can be unpredictable and emotional. However, tax diversification may help counter the ever-changing tax landscape and provide flexibility in your desired retirement.

What you need to know

Investing in accounts with different tax treatments can provide you with flexibility (and potentially higher after-tax income) in retirement.

The order in which you withdraw income from different types of accounts in retirement can have an effect on your taxes.

You may want to consider other ideas that may provide a tax advantage, such as municipal bonds, dividend-paying stocks and tax-loss harvesting in your taxable accounts, based on your specific situation.

Using different types of retirement accounts to achieve tax diversification

Generally, we believe that to achieve tax diversification and balance, you should contribute to both traditional and Roth retirement accounts. But the focus of your contributions may change depending on your life stage and tax situation.

A traditional individual retirement account (IRA)/401(k) tends to be more beneficial if:

- You expect tax rates to be lower in retirement than they are today (or at the time of contribution).
- You are in a high tax bracket today and would prefer the immediate tax savings of a deduction or a pretax contribution.

A Roth IRA/401(k) tends to be more beneficial if:

- You are young, in a low tax bracket or expecting tax rates to be higher in retirement than they are today (or at the time of contribution).
- You can forgo the tax deduction today for the prospect of tax-free retirement income.
- You don't plan to spend these assets and want to pass them on to heirs. A Roth IRA doesn't have a required minimum distribution (RMD) during the owner's lifetime, and distributions may be tax-free income to heirs.
- You expect higher income from taxable sources and would benefit from the Roth's tax-free income to help manage whether you move to a higher tax bracket or how much Social Security benefits are subject to income tax. Roth distributions are not considered income when determining the potential taxation of Social Security benefits or income-related adjustments for Medicare Part B and D premiums.
- You have most of your investments in traditional IRAs/401(k) accounts. If you can forgo the current tax deduction, consider shifting your contributions to Roth accounts. If you have fewer contribution years remaining, converting a portion of retirement assets to a Roth may increase tax diversification and flexibility in retirement (but will also cause a current taxable event).

Source: Edward Jones.

How you allocate your contributions across traditional and Roth accounts will depend on your particular situation and might change over time. Your Edward Jones financial advisor can help design an appropriate retirement strategy for you. In addition to your Edward Jones financial advisor, consider working with a tax professional when evaluating tax benefits of a Roth versus a traditional account and/or making any decisions to convert.

Benefits of tax diversification on retirement income

Placing money in tax-deferred accounts (such as traditional IRAs) can provide you with tax deductions now. Contributing to tax-free accounts (such as Roth IRAs) can provide you with tax-free income in retirement. Each provides benefits that could prove more valuable, depending on future tax rates. But while your situation and the tax code may be anything but constant, one thing is certain: Flexibility is an important benefit of having money in different types of accounts (i.e., tax diversification).

Consider the following hypothetical example:

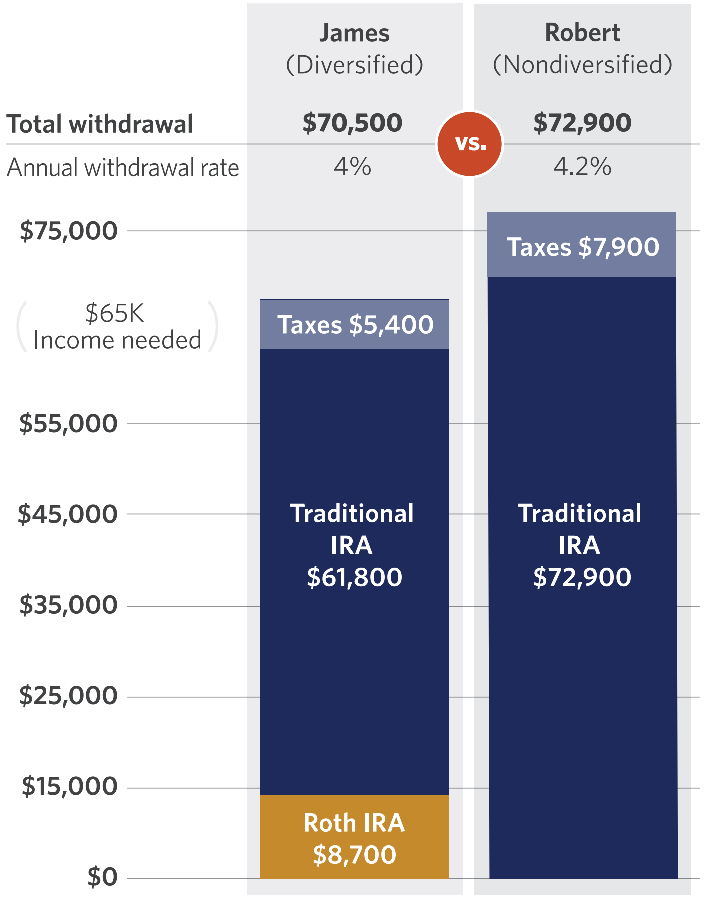
Robert and James are 68 years old and have saved $1.75 million for retirement. Robert has all of his money in a traditional (tax-deferred) IRA. This means all withdrawals will be taxed as ordinary income. James has investments in traditional and Roth IRAs, which means he can withdraw money from his traditional IRA (which will be taxed) and/or make tax-free withdrawals from his Roth.

Let's assume Robert and James need $65,000 in after-tax income to supplement retirement spending each year. As shown in the chart on the right, because Robert's withdrawals from his traditional IRA are taxed as ordinary income, he has to withdraw about $73,000 to cover his taxes due and meet his $65,000 income requirement. As a result, he is pushed into the 22% tax bracket — part of his withdrawal is taxed at 10% and 12%, and the rest is taxed at 22%.

On the other hand, James diversified his accounts. He withdraws from his traditional IRA only up to the maximum income amount for the 12% tax bracket. Then he switches to his Roth IRA for the remaining amount, taking tax-free withdrawals. This prevents him from moving into the 22% tax bracket. Because James was able to withdraw from accounts that have different tax treatments, he received the same $65,000 in income while paying $2,500 less in taxes than Robert. James also withdrew about $70,000 from his accounts versus the $73,000 Robert had to withdraw to achieve the same income. This highlights another benefit of tax diversification: James is able to receive the same amount of after-tax income as Robert but by taking less from his investments.

Since the amount you withdraw from your portfolio helps determine how long it can last in retirement, this strategy may help your savings last longer. Remember, these are just hypothetical examples; any withdrawal strategy should be discussed with your financial advisor and tax professional.

Tax diversification benefits



Source: Edward Jones estimates. Uses individual tax brackets for 2024. Incorporates the standard deduction. This hypothetical example is for illustrative purposes only and does not depict an actual investment. Rounded to the nearest $100.

Your sequence of withdrawals

How much you withdraw from your investments may be the most influential factor in how long your money will last. Since every dollar you spend on taxes is one dollar less you have to spend on your retirement goals, the aim is to increase after-tax income. Tax diversification can help structure withdrawals to potentially reduce taxes and increase the amount of after-tax spendable income.

Generally, we recommend taking withdrawals in the following order:

1. RMDs, if necessary
2. Dividends/interest from taxable accounts
3. Taxable accounts (positions with losses first, if available, then gains)
4. Tax-deferred accounts (traditional IRA)
5. Tax-free accounts (Roth IRA)

This sequence is just a guide. The accounts and investments you might have to use for withdrawals may vary from year to year, depending on tax and investment considerations. For example, it may make sense to vary this sequence or take from multiple account types to help reduce taxes and prevent moving into a different tax bracket, as highlighted in the example on Page 3.

In addition to taxes, consider selling investments in which your portfolio is overweight to help rebalance it. It's important to maintain the proper balance between stocks and bonds within your portfolio.

In sum, where you take withdrawals from should depend on your tax and financial situation. As a result, it's important to discuss your expected income and withdrawals with your financial advisor and tax professional each year.

Tax diversification: An investment perspective

While this report focuses on types of accounts, we also recommend the following about your investments.

Investment considerations:

- Municipal bonds
- Dividend-paying stocks
- Annuities
- Advisory programs that offer tax management features

You may also want to consider other actions, including:

- Tax-loss harvesting
- Portfolio rebalancing and reducing overconcentrated positions
- Increasing contributions to traditional or Roth IRAs and employer-provided retirement plans
- Converting traditional retirement funds to a Roth account
- Using tax-advantaged education savings vehicles, such as 529 Education Savings Plans

Get diversified

Tax diversification can help provide flexibility and sustainability for retirement savings. While tax codes may be complex and ever-changing, the solution doesn't have to be. Talk to your Edward Jones financial advisor about how tax diversification can play a part in your long-term retirement goals.

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Diversification does not guarantee a profit or protect against loss.

