BUILDING BLOCKS FOR RETIREMENT

Diversification

Diversification — The Tax Angle

Many investors may be aware of the importance of diversification. However, some investors take diversification one step further. In addition to investing in different asset classes (e.g., stocks, bonds, cash, commodities, real estate), these investors choose to hold investments in different types of accounts to obtain the benefits of *tax diversification*.

The basic premise: Spreading money among accounts that are treated differently for tax purposes provides investors with the flexibility to better manage their taxes and potentially enhance their after-tax returns.

Tax-Deferred Accounts

Traditional individual retirement accounts (IRAs), 401(k) plans, and other employer-sponsored retirement plans allow investors to defer income taxes on investment earnings. And pretax or tax-deductible contributions to these accounts provide current tax savings. When investors eventually withdraw their money, however, they must pay taxes on the previously tax-deferred amounts they receive -- at the ordinary income tax rates in effect in the year of withdrawal. And they cannot benefit from the potentially more favorable tax rates on long-term capital gains and qualifying stock dividends.

Roth Accounts

Roth IRAs and Roth accounts in employer plans also offer tax-deferred earnings. However, investors can avoid taxes on Roth investment earnings *permanently* (under current law, that is) by not taking withdrawals until a five-year period has elapsed and they've reached age 59½.

Tax free is better than tax deferred, but Roth accounts have a downside: They cannot accept pretax or tax-deductible contributions. So investors receive no immediate tax benefit. Converting a traditional IRA or tax-deferred plan account to a Roth account triggers income taxes on all previously untaxed conversion amounts.

Taxable Accounts

Investing in taxable accounts generally means paying taxes on any earnings each year. An upside: Under current law, the federal tax rates on net long-term capital gains and qualifying stock dividends are lower than the rates that apply to ordinary income. Investors may be able to manage their tax exposure by:

- Holding appreciated stock instead of selling it. This strategy defers taxes on the gains. Of course, by holding their stocks, investors risk price declines.
- Investing in mutual funds that attempt to keep investors' taxes to a minimum by controlling portfolio turnover and timing the realization of gains and losses.
- Owning municipal bonds or municipal bond funds that pay tax-exempt interest. (Caution: Interest on certain municipal bonds is potentially subject to alternative minimum tax.)

Using tax-deferred, Roth, and taxable accounts strategically can help investors navigate what might be a changing tax landscape in the years ahead.

PENTEGRA

701 Westchester Ave, Suite 320E, White Plains, New York, 10604