

# Money Matters

The Independent Press  
October 5, 2011

## Skloff Financial Group Addresses Advantages of Tax Diversification By Aaron Skloff AIF, CFA, MBA

**Q: While we are familiar with asset allocation and portfolio diversification, we are not familiar with tax diversification? What is tax diversification and what advantages it may provide?**

### **The Problem – Understanding Tax Diversification**

Many investors understand the advantages of asset allocation – owning a balanced portfolio optimizes risk and return, and the advantages of portfolio diversification – owning numerous investments also optimizes risk and return. But, many investors are less familiar with tax diversification and the advantages it may provide. Like poor asset allocation and poor portfolio diversification, poor tax diversification can be detrimental to your wealth.

### **The Solution - Tax Diversification**

Investments can reside in three types of accounts: taxable, tax free and tax deferred. Investments in taxable accounts generate tax obligations in the immediate tax year. Investments in tax free accounts do not generate tax obligations. Investments in tax deferred accounts generate tax obligations in future tax years.

**Basics of Tax Diversification.** The basic premise of tax diversification is maintaining exposure to taxable, tax free and tax deferred accounts. Since the U.S. and various states Treasury departments refuse to publish future tax rates investors cannot plan with certainty what their future obligations may be, so they must diversify their tax risk. As recently as 1980, the top federal marginal income tax rate (TFMITR) was 70%. In all likelihood the government will be forced to battle the federal deficit by raising the TFMITR from its current 35% level.

Investments in taxable accounts that generate short-term capital gains are taxed at your income tax rate (top tax bracket is 35%), while those that generate long-term capital gains are generally taxed at a 15% rate. Investments in taxable accounts that generate dividends are generally taxed at a 15% rate, while those that generate interest are taxed at your income tax rate. Investments in tax free accounts do not generate taxes. Investments in tax deferred accounts could reduce your taxable income today and subject your investments to lower tax rates in the future (e.g.: during retirement).

**Taxable Account Example.** If you were paid \$1,000 of salary and subsequently paid \$350 in income taxes, you can invest \$650 into a taxable account. If your investment earned a 6% interest rate each year for 12 years you would be left with \$1,029 after taxes (based on a 35% tax rate).

**Tax Free Account Example.** If you were paid \$1,000 of salary and subsequently paid \$350 in income taxes, you can invest \$650 into a tax free account (e.g.: Roth IRA, Roth 401(k), Roth 403(b), Roth 457(b) or 529). If your investment earned a 6% interest rate each year for 12 years you would be left with \$1,308 after taxes (based on a 35% tax rate). Your account would be worth 27% more than the same investment in the taxable account – all attributable to the benefits of tax free investing.

**Tax Deferred Account Example.** If you were paid \$1,000 of salary you can invest \$1,000 into a tax deferred account (e.g.: 401(k), 403(b), 457(b), SEP IRA, Traditional IRA). If your investment earned a 6% interest rate each year for 12 years you would be left with \$1,509 after taxes (based on a 35% tax rate today and a 25% tax rate upon withdrawal). Your account would be worth 47% more than the same investment in the taxable account – all attributable to the benefits of tax deferred investing and a lower tax rate upon withdrawal. Under most circumstances, you must begin taking Required Minimum Distributions (RMDs) from tax deferred accounts after you turn 70 ½ years old. **Importantly, there are estate and financial planning strategies to avoid RMDs and the taxes on those withdrawals.**

**Action Steps.** Tax Diversify. Diversify your investment accounts with the three types of accounts discussed above. Work closely with your Financial Advisor to design accounts to optimize return, risk and taxes. Also, work closely with your Financial Advisor to optimize taxes upon withdrawal.

Aaron Skloff, Accredited Investment Fiduciary (AIF), Chartered Financial Analyst (CFA), Master of Business Administration (MBA) is CEO of Skloff Financial Group, a Registered Investment Advisory firm based in Berkeley Heights. He can be contacted at [www.skloff.com](http://www.skloff.com) or 908-464-3060.