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Strength Along Your Journey

Are You Practicing Tax Diversification?

JANUARY 2017

Failing to practice tax-diversification is likely exposing you to significant risk. The purpose of this article is to explain why tax diversification is important.

What is Tax Diversification?

Most understand the concept of diversifying investments in order to reduce risk by limiting exposure to any one investment, sector, or asset class. However, few grasp the importance of practicing tax diversification, and are subjecting themselves to unnecessary risk as a result.

From a tax perspective, your assets can generally be grouped into three buckets:

Taxable	Tax-Deferred	Tax-Free
Gain/income is taxed currently.	**Pre-tax dollars used, tax on gain/income is deferred.**	**After-tax dollars used, no tax on gain/income.**
i.e., Mutual funds; stocks held in a brokerage account.	*i.e., 401(k), Traditional IRA, company-sponsored deferred compensation plan.*	*i.e., Roth IRA, municipal bonds, cash value in life insurance contract.*

Tax diversification aims to allocate investment between these buckets, particularly the tax-deferred bucket and the tax-free bucket. Most are over-concentrated in the taxable and tax-deferred bucket.

Why Many Fail to Practice Tax Diversification

For high earners, the lack of diversification is generally because tax-free vehicles, like Roth IRAs, have significant eligibility and contribution limitations. However, there are other ways to fill the tax-free bucket and gain tax diversification as explained in the next article. But first a bit on the importance of tax diversification.

Why Tax Diversification is Important? Tax-Deferral Does Not "Save" Taxes.

There is no tax savings when money is channeled into a tax-deferred vehicle like a 401(k) or an employer-sponsored deferred compensation plan. Rather, tax is just postponed. The government will collect tax dollars eventually, but for a time, it is just granting you use of the money. Not a bad deal in many respects – you get to invest those dollars and hopefully earn compounding returns before you must pay back the tax (and the tax on the gains). But what if tax rates go up or your income rises, placing you in a higher tax bracket?

You are a Debtor of the Government, and the Government is an Unpredictable and Fickle Lender

So, if you have a 401(k) or other deferred tax obligation, you are essentially a debtor of the government. The tax bill that is postponed is like a loan and the government is your lender. With most loans, you know what the interest rate will be, but with your 401(k), you have no idea. Now, technically there is no interest rate so to speak on your 401(k), but in many ways, the tax rate functions like an interest rate, and that is where uncertainty rests.

When it comes time to pay the IRS, the then current tax rate is applied to all withdrawals, not the tax rate at the time of deferral. In some ways, a tax-deferred vehicle is a bet that your tax rates will decrease between now and when you withdraw money, which will likely not begin for 20 or 30 years and will then be spread out over a span of 30 years.

We can speculate, but no one can know where tax rates will be at such time, which accentuates the importance of tax diversification.

Uncertainty = Risk. Where Will Tax Rates Be in 30 Years?

Many believe they will be in a lower tax bracket when they start drawing income from their accounts. There are three main problems with this belief: (1) tax rates are always subject to change, (2) most people do not decrease their lifestyles in retirement, and (3) most people have fewer reductions since they are done buying houses and raising children. In addition, they may have unexpected cash needs, meaning they bump themselves into higher tax brackets by taking withdrawals.

So, where will tax rates be in 20, 30, or 40 years? We obviously cannot know, but consider:

Today's tax rates are low when considered historically.

Our national deficit is almost $20 trillion and growing at an alarming pace.

Our Federal government operates at a significant deficit each year.

Programs like Social Security, Medicare, and Medicaid are projected to overwhelm the national budget in the not too distant future due to changing assumptions and demographics.

The United States has a math problem, and either spending must decrease dramatically and/or revenue must go up dramatically. This accentuates the importance of tax diversification. Since after-tax dollars are used, the appreciation of assets in the tax-free bucket are sheltered from future tax increases. **This is the whole idea of diversification: hedging against the unknown.**

706 2nd Ave, S. Suite 600 | Minneapolis, MN 55402 | www.storycapital.com