Tax Diversification in Retirement Planning

Gregory C. Freeman

Abstract

Much has changed in the past five years from predictions that the baby boom generation will begin retiring in mass in 2010 to questions of whether this generation will have enough resources to fund its retirement years. We have seen poor stock market performance since 2000 placing enormous pressure on retirement savings, projected higher medical and long-term health care costs, a Social Security system that seems tenuous, and longer life expectancies. This presents serious challenges for retirement and for tax planners and their clients trying to accumulate a retirement nest egg and protect those assets from threats of greater taxation and possible inflation. In addition, planners are increasingly being asked to reliably predict or create viable assumptions about what the federal tax system will be like in 10, 20 or even 50 years. The emerging importance of tax planning was recently reported in a study by Lincoln Financial Group. Its October, 2009 survey of retirees with annual household incomes greater than $100,000 (ages 62 to 75) revealed that taxes made up more than 31 percent of overall spending in retirement.[1]

To accommodate these changes and demands, a paradigm shift is needed among retirement and tax planners from the traditional strategy of making the most of tax-deductible savings today, with the assumption of lower applicable tax rates during future retirement years, to strategically planning for future tax treatment of investment accounts and retirement income. This approach accepts the premise that how investment accounts and retirement income will be taxed in the future is no longer predictable, and advocates trying to maximize the diversification of investment portfolios based on creating multiple sources of income, each taxed in a different way.[2] As a result, clients may be better positioned for a more financially secure retirement by leveraging current tax laws to help improve retirement income, while protecting investments and income from being overtaxed. Of course, clients with low retirement objectives (maybe under $60,000 retirement spending per year), or clients who do not have significant savings or the ability to save, may be unlikely to benefit from this type of planning, but circumstances can change (inheritance, sale of business, settlement of a lawsuit, etc.). For this reason, I would not underestimate the impact taxes could have on all of us in the future.