Income Tax Diversification

If you're saving and investing for retirement, you're familiar with the concept of investment diversification. The idea is to invest in different types of assets to balance your overall investment risk and return. This same principle can be applied to income taxes. It makes sense to have financial assets that offer different types of income tax advantages when you save for retirement (Contribution), while you grow your savings (Accumulation) and when you need them for income (Distribution).

The following diagram outlines the income tax advantages that are available during each of these stages:

Contribution

- After-Tax
- Pre-Tax

Accumulation

- Taxable
- Tax-Deferred

Distribution

- Taxable
- Tax-Free
- Tax-Advantaged

Choosing options that offer tax advantages during different stages may help you to accumulate more for retirement and reduce your income tax liability during retirement.

The following table provides an overview of some different types of retirement plans and products and the income tax advantages they offer. Some are subject to a 10% penalty for distributions prior to age 59½, and may also have annual Required Minimum Distributions (RMD) starting at age 72 (age 70½ for those who reached age 70½ by the end of 2019). Failure to take full RMD will result in a penalty tax equal to 50% of the short-fall. Additional information is provided in the comments column.

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Consider Your Options

Plan or Product Type	Pre-Tax Contributions	Tax-Deferred Accumulation	Tax-Advantaged Distributions	Pre-59½ Penalty	RMD	Additional Comments
Pension & Profit Sharing Plans	✓	✓		✗	✗	Employer contributions and funding are limited. These plans generally offer guaranteed retirement benefits and may allow rollovers to an IRA at retirement. Account value may pass tax deferred to the account beneficiary at death, subject to RMD requirements.
401(k), 403(b) Plans & IRAs	✓	✓		✗	✗	Pre-tax participant contributions are limited. Employer contributions and account earnings are tax deferred. Withdrawals are taxed as ordinary income. Account value may pass tax deferred to the account beneficiary at death, subject to RMD requirements.
Roth IRAs & Roth 401(k)s		✓	✓	✗		Contributions are limited. Both account earnings and withdrawals are income tax free if the owner is 59½ and has had the account for five or more years. Account value may pass to the account beneficiary at death, subject to RMD requirements.
Annuities		✓	✓	✗		No statutory limit on deposits – product limits may apply. Earnings accumulate tax deferred. Withdrawals are taxed gain-first. However, payments from an income annuity will have an exclusion ratio – a portion of each payment is considered a tax-free return of cost basis.
Cash Value Life Insurance* (Non-MEC)		✓	✓			Premiums limited by coverage amount purchased, which is subject to underwriting limits. Life insurance death proceeds are generally income tax free. Policy cash values accumulate tax deferred and may be accessed on a tax-advantaged basis.[1]
Municipal Bonds			✓			No limit on how much you can invest. Interest earnings are federal income tax free and may be reinvested during accumulation. State and local taxes may apply. Capital gains taxes may be due if bonds are sold.

* The decision to purchase life insurance should be based on long-term financial goals and the need for a death benefit. Life insurance is not an appropriate vehicle for short-term savings or short-term investment strategies. While the policy allows for loans, you should know that there may be little to no cash value available for loans in the policy's early years.

[1] Distributions under the policy (including cash dividends and partial/full surrenders) are not subject to taxation up to the amount paid into the policy (cost basis). If the policy is a Modified Endowment Contract, policy loans and/or distributions are taxable to the extent of gain and are subject to a 10% tax penalty if the policyowner is under age 59½.

Access to cash values through borrowing or partial surrenders will reduce the policy's cash value and death benefit, increase the chance the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured.

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