

# UTILIZING ROTH ACCOUNTS FOR TAX DIVERSIFICATION

Tax diversification is a critical but often overlooked component of personal financial planning. While investors commonly diversify across asset classes, tax diversification focuses on spreading assets across accounts with different tax treatments to manage future tax risk. Accounts such as Roth IRA's and Roth 401(k)'s play a central role in this strategy by offering tax-free treatment of growth and withdrawals. Their unique features offer protection against future tax increases and valuable flexibility for retirement and estate planning.

Tax diversification generally involves three types of accounts: taxable accounts, tax-deferred or pre-tax accounts (such as traditional IRA's and 401(k)'s), and tax-free accounts (such as Roth IRA's and Roth 401(k)'s). Each account type is taxed differently, and holding assets in all three allows retirees to control when and how income is recognized. Roth accounts are unique because contributions are made with after-tax dollars, but ongoing growth and qualified withdrawals are tax-free.

One of the primary benefits of Roth accounts is protection against uncertainty in future tax rates. Contributions to traditional pre-tax retirement accounts are most beneficial when tax rates in retirement are lower than during one's working years. While this is true for some retirees, it is not guaranteed. Future tax law changes, rising government spending, or unexpectedly high retirement income (oftentimes from large required minimum distributions) can result in higher-than-anticipated tax rates. Roth accounts mitigate this risk by locking in today's tax rate and eliminating future taxation on withdrawals.

The advantages of Roth accounts become more pronounced over long investment horizons. Because earnings grow tax-free, Roth accounts allow compounding to occur without erosion from annual taxes or future withdrawal taxes. This can make Roth accounts especially attractive for younger investors and for holding higher-growth long-term assets such as equities.

Roth accounts also provide flexibility during retirement. Withdrawals from traditional pre-tax retirement accounts are taxed as ordinary income and can push retirees into higher marginal tax brackets at inopportune times. Higher income can increase Medicare premiums and cause a greater portion of Social Security benefits to be taxed. Other tax benefits such as the new additional senior deduction or Affordable Care Act healthcare subsidies for early retirees can be lost when income is too high. In contrast, qualified Roth withdrawals do not count as taxable income. Having adequate Roth balances can allow retirees to strategically blend withdrawals from different account types to meet spending needs while managing tax exposure.

Roth accounts also differ significantly from traditional pre-tax retirement accounts for required minimum distributions (RMD's). Roth IRA's are not subject to RMD's during the original owner's lifetime, allowing assets to continue growing tax-free. This is especially valuable for retirees who do not need to draw down all their assets and for those focused on legacy goals.

Roth conversions further enhance the role of Roth accounts in long-term plans. A Roth conversion

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involves transferring assets from a traditional retirement account into a Roth account and paying income tax on the converted amount in the year of conversion. While this creates a short-term tax cost, conversions can be particularly effective in low-income years. Common examples include early retirement years (before Social Security, RMD's and/or pensions begin), periods of temporary unemployment, or years with large deductions.

By intentionally converting only enough each year to remain within a lower tax bracket, individuals can gradually shift assets into tax-free accounts at favorable tax rates. Over time, this strategy can reduce future RMD's, lower lifetime tax liability, and improve retirement income flexibility. Roth conversions are most effective when paired with careful tax planning and long-term perspective. Conversions can be even more powerful during periods of temporary market corrections, as more shares can be moved from a pre-tax to a tax-free environment when share prices are low.

Another important consideration is how tax situations change for married couples when one spouse passes away. While married couples filing jointly benefit from wider tax brackets and higher income thresholds, these benefits are lost when a surviving spouse starts filing as a single taxpayer. This shift results in significantly higher marginal tax rates on the same level of income. At the same time, income sources such as Social Security, pensions, and RMDs may decrease only modestly, or not at all when one spouse passes away.

This phenomenon, sometimes referred to as the “widow’s penalty,” can create substantial tax challenges. Roth accounts can help mitigate this risk by providing a source of tax-free income for the surviving spouse. Roth conversions completed during joint-filing years—when tax brackets are more favorable—can serve as a form of insurance against adverse tax outcomes later in life.

Roth accounts are also advantageous for estate planning. Beneficiaries generally receive and distribute Roth assets income-tax free, which can be valuable for heirs in higher tax brackets. Although distribution rules for inherited accounts have become more restrictive (i.e. requiring full distribution within 10 years), the tax-free nature of Roth withdrawals remains a powerful benefit. Most beneficiaries who inherit Roth assets are allowed to keep 100% of the balance growing tax-free until the end of the 10th year following the original owner’s death.

In conclusion, Roth accounts are a cornerstone of effective tax diversification. Their tax-free growth, flexible withdrawal rules, absence of lifetime RMD's and strategic value in Roth conversions make them an essential tool in many financial plans. When combined with an understanding of changing tax dynamics such as those faced by surviving spouses, Roth accounts provide flexibility and resilience in an uncertain tax landscape. Incorporating Roth assets alongside taxable and tax-deferred accounts can allow investors to better manage taxes over a lifetime, not just in a single year.

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