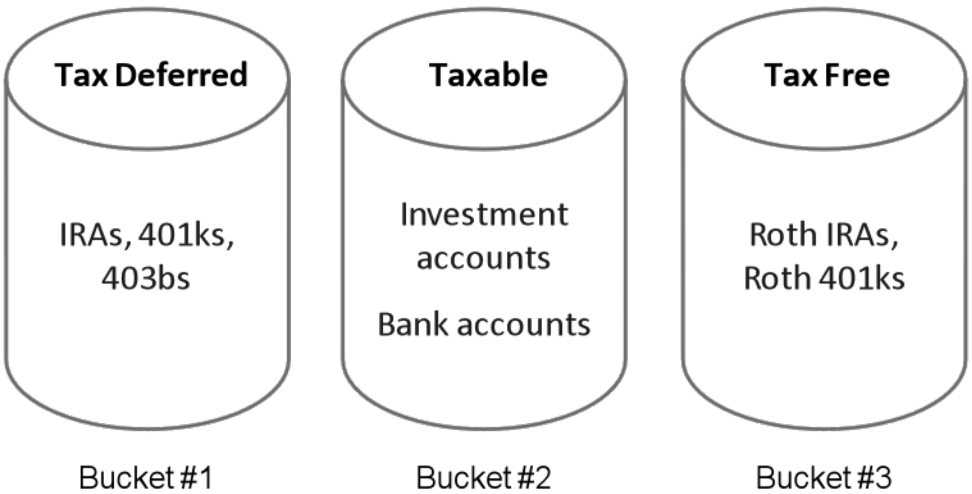
# Three Tax Buckets

The key with tax planning is to be proactive. The purpose of having three different tax buckets is to minimize taxes now or in the future, and to provide flexibility when taking withdrawals. This strategy is also called tax diversification. Figure 8.1 shows a diagram of the three tax buckets.




## Bucket #1

This bucket is for tax-deferred assets, such as retirement plans (traditional IRAs, 401(k)s, or 403(b)s). Typically, the money you invest in a traditional retirement plan is deducted from your income in the year of the contribution. Taxes are not due until the money is withdrawn, and whatever amount is withdrawn is considered to be taxable income for that tax year. IRAs have been available since 1974, and these accounts have become the most common way to save for retirement.

Saving and investing only in bucket #1 was a wise strategy in the past if folks expected their tax rate to decline during retirement. Bucket #1 takes advantage of the tax deferral benefits of traditional retirement plans, so the tax rate during retirement is critical to this strategy working well. For many years, folks were encouraged to invest in a tax-deferred account (such as a 401[k] or a traditional IRA) rather than in a taxable account.

It is common for investors nearing retirement to have a large traditional IRA, but very little money in a taxable account. This could be termed "IRA rich, but cash poor." Unfortunately, many people no longer expect their tax rate to decline significantly during retirement, which is why having multiple tax buckets has become important.

## Bucket #2

This bucket is for taxable accounts. Many people do not realize that saving and investing in a taxable account is always wise. The gains on this money are not tax deferred, but investors with taxable accounts have benefitted for many years from the 15 percent preferential tax rate on capital gains and qualified dividends. This was raised to 20 percent effective January 1, 2013, but only for couples with very high income. Most folks will still pay the 15 percent tax rate for capital gains and qualified dividends. Even if you must pay 20 percent, it is still a preferential tax rate when compared to the high marginal income tax brackets.

Bank accounts are taxable accounts, but I always encourage folks to have a taxable investment account as well. I recommend building an emergency fund (in a taxable investment account or bank account) that will cover up to six months of living expenses. Once this fund is established, any extra money (such as savings at the beginning of each month, a tax refund, or a bonus), should be deposited into your taxable investment account.

## Bucket #3

This bucket contains tax-free accounts, such as a Roth IRA, Roth 401(k), or Roth 403(b). This is the newest bucket because Roth IRAs only became available to investors in 1998. (Roth 401[k]s and Roth 403[b]s became available in the past five years.) Money invested in these types of accounts is not deducted from income in the year of the contribution, so there are no tax benefits on the front end. However, the tremendous benefit of a Roth IRA is that the contributions and the gains will not be taxed going forward. For this reason, a Roth IRA trumps a traditional IRA in my view.

For several years after Roth IRAs were introduced, folks were concerned that the tax-free provision of the Roth would be eliminated and gains on Roth IRAs would become taxable in the future. This concern seems to have been put to rest during the past 15 years. More information about the benefits of Roth IRAs is provided later in Chapter Eleven.