

An In-Depth Look at the Tax Consequences of Asset Location

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Article Highlights

- By fine-tuning where an investment is held, investors can improve their overall aftertax portfolio return.
- The tax characteristics and the level of return influence whether an investment is more suitable for a tax-deferred or taxable account.
- A downloadable spreadsheet on AAIL.com compares the aftertax rate of return of holding investments in taxable and tax-deferred accounts.

Asset location refers to where an investment asset is held: in a tax-deferred retirement account (e.g., an IRA) or in a taxable account. By fine-tuning asset location, investors can improve their aftertax return on their overall investment portfolio.

Articles on asset location cannot definitively rank the type of investments to place in a tax-deferred account because such a ranking depends on changeable factors: return parameters that are constantly in flux in the economy; tax rates, which change with the political environment and investors' income level; and investment holding periods, which are specific to the investor. This article summarizes the general information on asset location and gives investors access to a model that can help refine asset location decisions to take their own unique situation into account.

Overview of Asset Location

Investors maintaining the same asset allocation in their taxable and tax-deferred retirement accounts are not receiving maximum benefit from their tax-deferred accounts. Investors should place the investments in the tax-deferred accounts that will provide the greatest benefit. The benefit of placing an investment in a tax-deferred account can be measured by the increase in the annualized aftertax rate of return.



General Guidelines

There are four general factors that indicate an investment is favorable for placement in a tax-deferred retirement account.

1. The investment is qualified to be placed in a tax-deferred retirement account. Not all investments are allowed in tax-deferred accounts. For instance, the tax code prohibits most collectibles from being held in an IRA. Exceptions to this rule allow certain U.S. gold and silver coins issued after 1986 as well as silver, platinum and palladium bullion to be placed in an IRA.
2. The investment's returns are frequently subject to inclusion in taxable income when held in a taxable account. Either the returns are periodic, current income such as interest or dividends, or the investor anticipates a short holding period before the investment is sold and gains are recognized.
3. The investment returns are taxed at the high ordinary income tax rate, not a preferential, lower rate such as the 15% rate on qualified dividends and long-term capital gains applicable to many individuals.
4. The investment has a relatively high rate of return. The more return an investment generates when held in a taxable account, everything else equal, the greater the tax liability.

Specific Advice

1. Original issue discount (OID) bonds, especially zero-coupon bonds, should be held in a tax-deferred account. The tax law requires taxpayers to impute interest on OID bonds and pay income tax on the imputed interest each year,

Tax Deferral: A Large Benefit of Investing in a Tax-Deferred Account

The deferral of tax is a primary advantage of investing in a tax-deferred account. The longer the payment of the tax on an investment is deferred, the higher the aftertax return. The increased return occurs because the investor continues to earn a return on funds that would have been paid in taxes if the same investment had been held in a taxable account. In a taxable account, the tax law generally allows an investor to defer the tax on an asset's appreciation until the asset is sold. For instance, with common stock, any appreciation of the stock is not taxed until the stock is sold. Table 1 shows the impact of a lengthening deferral period on an asset appreciating 10% per year when held in a taxable account at a tax rate of 15%. As the deferral period lengthens, the aftertax return increases, reducing the benefit received by placing the investment in a tax-deferred account.

As the deferral period increases, the aftertax rate of return approaches the pretax rate of return. At the extreme, if an investor holds an appreciating asset to the end of her life, then passes the investment to heirs, the heirs receive a step-up in basis equal to fair market value at the time of death. If the asset was sold immediately after inherited, there would be no income tax. In this situation, investor's aftertax return equals the pretax rate of return.

Table 1. Deferral Period Effect on After-tax Rate of Return in a Taxable Account

Deferral Period in Years	Pretax Rate of Return* (%)	Aftertax Rate of Return* (%)
1	10	8.50
5	10	8.72
10	10	8.94
25	10	9.36
50	10	9.65
Until Death of Owner	10	10.00

**Assumes 10% annual appreciation and a 15% tax rate.*

despite not actually receiving cash for the imputed interest until the bond is sold or matures. On OID bonds, the taxpayer must pay tax on interest not received. This creates a negative deferral of tax, lowering the aftertax rate of return of OID bonds below similar-yielding non-OID bonds.

2. Appreciating "estate" assets with little or no current return, which are planned to be left to heirs, such as collectibles, real estate or land, should not be placed in a tax-deferred account. Income tax on the assets' appreciation can be avoided through the step-up in basis, if transferred at death.

3. Tax-exempt municipal bonds should not be held in a tax-deferred account because the investor ends up paying tax twice. The reduced interest these bonds pay compared to similar-risk taxable bonds is considered an implicit tax. (An implicit tax is the lower return received on a tax-preferred investment because investors bid up the prices due to the reduced tax, lowering the pretax return below similar tax-neutral investments.) The explicit tax is paid when distributions are made from a tax-deferred investment vehicle; the distribution

would be taxed at the ordinary tax rate.

4. Collectibles should generally not be placed in a tax-deferred account. First, many collectibles are prohibited from being held in tax-deferred accounts. Second, collectibles allowed by law to be in a tax-deferred account typically generate no current income and therefore allow for tax-deferral of any appreciation until sold.

The general guidelines and specific advice are helpful, but certain asset location decisions remain unclear. For instance, what happens when an investor is deciding between placing a stock or a bond in the tax-deferred account? The investor expects a higher rate of return on the stock, but the bond has more current income taxed at ordinary tax rates. In this case, the best asset to be placed in the tax-deferred account depends upon the expected return parameters of the stock and bond, the expected holding period of the stock and the personal tax rates applicable to the investor. In order to measure these seemingly ambiguous situations, a model has been developed and is available in the AAII.com Download Library at www.aaia.com/download-library/

[download?DL_ID=742](#).

The Model

The model computes the annualized aftertax rate of return of investments if held in a taxable account and three different types of tax-deferred accounts. The model requires estimates of returns on the investment, the expected holding period, the time until the investment would be liquidated to make retirement distributions and the investor's expected tax rates. To compute the aftertax annualized rates of return, some simplifying assumptions were required. First, each asset is assumed to generate constant annual returns from current income and/or capital appreciation. Such returns are measured as percentage yields, or the return divided by the investment's value. Second, interim cash flows generated by the investment are assumed to be reinvested in a similar asset with the same return and tax parameters. Tax rates are expected to be constant throughout the investment period, but the investor's expected ordinary tax rate applicable for distributions from tax-deferred accounts in retirement is

Table 2. Current Maximum Federal Tax Rates

Type of Income	Maximum Tax Rate* (%)
Ordinary Income	39.6
Interest Income	43.4
Qualified Dividend Rate	23.8
Ordinary Dividend Rate	43.4
Long-Term Capital Gains Rate	23.8
Short-Term Capital Gains Rate	43.4

**Includes 3.8% health care surtax on investment income.*

not assumed to be the same rate. Tax-deferred accounts come in three varieties: deductible/excludible tax-deferred accounts (like the traditional IRA and 401(k) retirement plan), the Roth IRA or 401(k), and the non-deductible IRA. The model calculates annualized aftertax returns for each of the three tax-deferred account varieties.

Effect of Tax Rate Increases

Asset location is even more important now due to the new maximum dividend and long-term capital gains tax rates of 20% and the new 3.8% health care surtax on investment income for those with net investment income and modified adjusted gross income over \$200,000 for single taxpayers and \$250,000 for married couples filing jointly. See Table 2 for the maximum tax rates in 2013.

Table 3. Stock and Bond Annualized Returns Using Maximum 2013 Tax Rates

	Annualized Rate of Return (%)		
	Taxable Account	Tax-Deductible, Tax-Deferred Account	Differential (%)
Bond (4% Coupon)	2.26	4.00	1.74
High-Dividend Stock (4% Dividend Yield, 6% Annual Appreciation)	7.88	10.00	2.12

Example

Assume an investor holds two investments in both a taxable account and a deductible/excludible tax-deferred account, such as a traditional deductible IRA or 401(k) retirement plan. The first asset is a bond paying 4% interest, selling at face value. The second investment is a stock with a projected 4% dividend yield, expected to realize 6% annual appreciation and intended to be held for 10 years. The investor has estimated it will be 30 years until the assets will be distributed from the retirement account.

Table 3 shows the annualized rate of return for the bond and the stock at the maximum tax rates effective this year. Using the new maximum tax rates for 2013, placing the stock in the tax-deferred account results in a 2.12% increased return, which exceeds the bond's 1.74% differential. The stock should be the asset placed in the tax-deferred account because the investor realizes a larger increase in aftertax rate of return on the stock. In this case, the substantially higher expected total return on the stock more than offsets the fact that bond interest

is taxed annually at ordinary tax rates.

Impact of Higher Tax Rates

The new maximum tax bracket and new net investment income surcharge make it important to reassess your asset location decisions. For instance, bonds traditionally have been a better asset than stocks to place in a tax-deferred account because the interest is taxed annually at the ordinary tax rate. However, given the current low yield on bonds, and higher tax rates for some investors on dividends and capital gains, investors may find it preferable to place high-dividend stocks in a tax-deferred account instead of low-yielding bonds.

The benefit of placing an asset in a tax-deferred account increases with the higher tax rates and the investment income surcharge. The 3.8% surcharge on investment income is not applicable to distributions from these retirement accounts. With higher tax rates, even non-deductible IRA contributions become more attractive relative to taxable accounts, especially for those subject to the new surcharge. ▲

Asset Location Dos and Don'ts

- Do maximize 401(k) and IRA investments.
- Do put original issue-discount (OID) bonds in a tax-deferred retirement account.
- Don't put municipal bonds in tax-deferred accounts.
- Don't put "estate assets"—assets with little or no current income, expected to be left to heirs—in a tax-deferred account. Let heirs receive a stepped-up basis by bequeathing the asset to them in your will.

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