Minimizing Taxes With Asset Allocation

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Article Highlights

- Using the tax law to strategically place an investment in either a taxable or a tax-advantaged account will ultimately produce the highest portfolio aftertax return.
- Tax-inefficient investments, particularly those whose return is mostly income, are best suited for tax-advantaged accounts; high-return tax-efficient investments are better for taxable accounts.
- How interest is taxed, whether or not dividends are qualified, the tax-exempt status of income and earnings, state and local taxes and portfolio turnover are all factors to consider when deciding what account to place an investment in.

Asset location is a tax-minimization strategy of placing investments in accounts that ultimately will produce the highest aftertax return for the investor's entire portfolio.

As a starting point, the following general principles should be kept in mind:

- Investors should first establish an emergency fund. An emergency fund is an account where funds have been set aside to be used in the event of job loss, a debilitating illness or some other major unexpected expense. A common recommendation by financial planners is that an emergency fund contain enough money to cover at least three to six months of living expenses. An emergency fund is held in a taxable account and funds are usually invested in low-yielding, highly liquid, principal-protected investments such as bank certificates of deposit (CDs) or government securities.
- Once an emergency fund is created, financial planners commonly recommend that investors first make full use of tax-advantaged accounts. Investors who have already contributed the maximum to tax-advantaged accounts or have good reasons to prefer taxable accounts need to consider the tax efficiency of their investments. An investment is considered tax efficient if it has less tax consequences than other similar investments.

Investors who can benefit the most from asset location strategies are those who follow a balanced investment strategy and have investments in both taxable and tax-advantaged accounts. For example, assume an investor maintains a portfolio that is 70% invested in equities and 30% in fixed-income securities. From a tax perspective, it is not in the investor's best interest to maintain a 70/30 allocation in every account. Instead, the investor should maintain an overall allocation of 70/30, but keep high tax liability investments in tax-advantaged accounts and low tax liability investments in taxable accounts. This strategy reduces total taxes on the portfolio and provides greater long-term aftertax returns.

Factors Affecting Asset Location

The following factors should be considered when deciding the type of account a specific investment should be held in.

Taxation of Interest

Although there are some exceptions, most interest income is taxable as ordinary income. As of August 2017, the seven income tax brackets that ordinary income can be taxed at are: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%.

Taxation of Capital Gains

A capital gain is realized when an investment is sold or exchanged at a price higher than its cost basis.

Short-term capital gains are taxed as ordinary income and are defined as investments held for a year or less before being sold.

Long-term capital gains occur on the disposition of assets held for more than one year and are taxed at rates lower than the investor's ordinary income tax rate. The current long-term capital gains tax rates are 0% for investors in the 10% and 15% tax brackets, 15% for investors in the 25%, 28%, 33% and 35% tax brackets and 20% for investors in the 39.6% tax bracket.

The Affordable Care Act levies an additional 3.8% surtax on capital gains for married couples with net investment income and modified adjusted gross incomes above $250,000 and single filers with net investment income and modified adjusted gross incomes above $200,000.

Taxation of Dividends

Qualified dividends are paid out of earnings by corporations and receive the same preferential tax treatment as long-term capital gains. Not all dividends are qualified, however. Rather, to be considered qualified, a dividend must have been paid by a U.S. corporation or a qualified foreign corporation and the stock must be owned for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date.

Distributions of capital, dividends paid on deposits and dividends from tax-exempt organizations are not qualified and do not receive the same preferential tax treatment.

The aforementioned 3.8% surtax applies to dividends as well for taxpayers above the $250,000/$200,000 thresholds.

Tax Deferral

Tax deferral refers to instances where a taxpayer can delay paying taxes to some future date. Examples of tax-deferred retirement savings accounts include 401(k), 457 and 403(b) plans. These are employer-sponsored investment plans that allow participating employees to contribute a percentage of their pretax salary into one or more investment accounts and benefit from tax-free growth. A regular or traditional IRA is tax-deferred. An annuity and the cash surrender value of a whole life insurance policy operate as tax-deferred accounts as well.

Owners of U.S. savings bonds can wait to pay taxes until they cash in the bond, when the bond matures or when they relinquish the bond to another owner. Alternatively, they may pay the taxes yearly as interest accrues. Most investors choose to defer the taxes until they redeem the bond.

Interest income becomes taxable when it is paid, though there are some ways to defer interest income to a future tax year. For example, some banks and credit unions will pay interest at the maturity of a CD, typically on maturities under one year. Thus, it is possible to purchase a CD in the current tax year, but pay taxes on the income in the following tax year.

Master limited partnerships (MLPs) have an embedded tax deferral within their structure because they can use depreciation to offset distributed cash flows. Because of this, the taxable income they distribute to unitholders tends to be lower than their actual cash distribution. The portion of cash distributions that are not immediately taxed must be subtracted from the original purchase price to compute the investor's tax basis. When an MLP is sold at a gain, some of the gain will be taxed at the lower capital gains rate, but the portion of the gain that results from deductions such as depreciation, which reduces the investor's tax basis, will be taxed as ordinary income. [See "Making Sense of Master Limited Partnership Tax Rules" by Mary Lyman in the November 2012 *AAII Journal* for more about the tax treatment of MLPs.]

Tax-Exempt Status

Tax exempt refers to income earnings or transactions that are free from taxation. Examples of tax-exempt retirement accounts include the Roth 401(k), Roth 403(b) and Roth IRA accounts. They are funded with aftertax dollars, but provide future benefits because withdrawals taken following a five-year period after the contributions to the account have been made and generally after the account owner is at least age 59½ are not subject to taxes.

Investors should consider whether it is better to take advantage of tax deferral or tax exemption in their tax-advantaged retirement accounts. If an investor's tax rate will be lower in retirement, it is better to postpone paying taxes until retirement and make use of the tax-deferred retirement accounts. If an investor's tax rate will be higher during retirement, it is better to choose after-tax Roth IRA contributions and avoid paying taxes at a later date. Because no one can be certain about their tax rate during retirement, many financial planners recommend tax diversification by holding both pretax and aftertax savings in retirement accounts.

State and Local Taxes

Some securities are exempt from federal and/or state taxes. Under current tax law, the interest income you receive from investing in municipal bonds is free from federal income taxes. In most states, interest income received from securities issued by municipalities within the state is also exempt from state and local taxes. In addition, interest income from bonds issued by U.S. territories and possessions is exempt from federal, state and local income taxes in all 50 states.

One of the best ways to determine the tax-exempt advantage of a municipal security is to compare it to an otherwise similar taxable investment. For example, assume two securities are identical except for their tax status. The municipal bond yields 3%, while the taxable bond yields 4%. The investor's marginal tax rate is 28%. The taxable bond's yield can be made comparable to the municipal bond's yield by multiplying it by one minus the investor's marginal tax rate: $4\% \times (1 - 0.28) = 2.88\%$. In this case, the investor would prefer the municipal bond because of its higher aftertax return.

Interest income from Treasury bills, notes and bonds is subject to federal income tax, but is exempt from all state and local income taxes. Interest from U.S. savings bonds is taxed at the federal level, but not the state or local level.

However, investors who use the money for higher education purposes may also be exempt from federal income taxes.

The 529 college savings plan is also a tax-exempt account where contributions are made with aftertax dollars, but portfolio earnings are not taxed as long as the funds are used for educational purposes. Health savings accounts allow for both deductible contributions and tax-free withdrawals for qualified medical expenses. However, it is often more difficult to apply asset location strategies to these sorts of accounts because funds are frequently earmarked for shorter-term goals.

Portfolio Turnover

Portfolio turnover is a measure of the frequency of change to an investment portfolio. It is often expressed as a percentage and is measured by taking the value of securities sold in the last 12 months and dividing this dollar amount by the portfolio's total value.

When a fund sells some of its holdings, realized capital gains are ultimately passed through to its shareholders, triggering a tax liability for shares held in taxable accounts. Although some actively managed funds have the objective to minimize taxes, the typical case is that active management results in a greater tax liability due to a higher portfolio turnover.

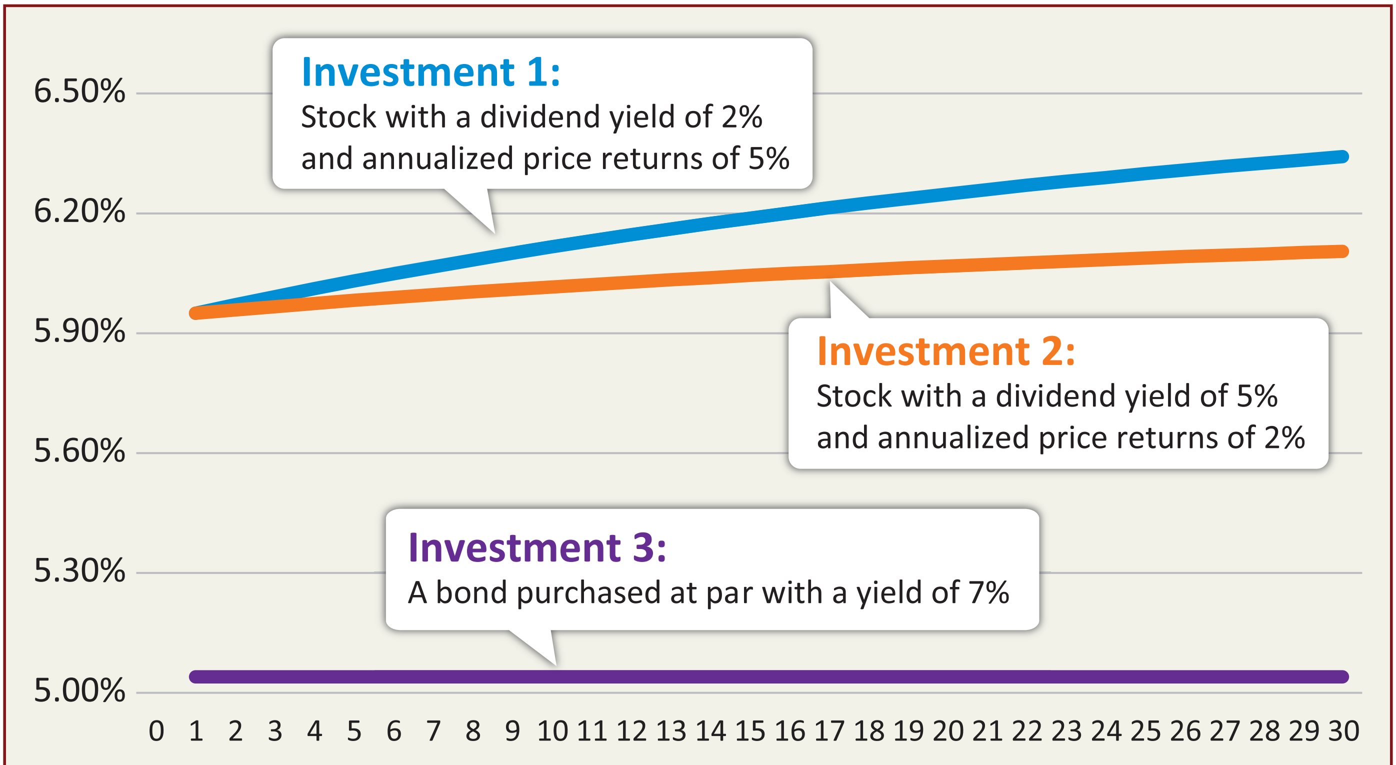
Comparison of Aftertax Returns in a Taxable Account

Figure 1 shows the aftertax returns for three hypothetical investments with holding periods of one through 30 years. The results assume a taxable investor with an ordinary income tax rate of 28% and a qualified dividend and capital gains tax rate of 15%. The three investments with pretax rate of return of 7% are: a common stock with a dividend yield of 2% and price appreciation of 5%; a common stock with a dividend yield of 5% and price appreciation of 2%; and a bond with a current yield of 7% (for comparison purposes). Figure 1 assumes dividends received on the two stocks are qualified and immediately and fully reinvested. Figure 1 also assumes the bond is priced at par (face value) over the entirety of its holding period, so its rate of price appreciation is 0%.

Several important points can be gleaned from the results. First, the aftertax return for the bond is a consistent 5.04%. [The aftertax return is calculated as 7% × (1 – 0.28) = 5.04%.] The bond's coupon payments are considered ordinary income and would be taxed at a rate of 28%. The bond's aftertax return is always lower than the aftertax return on the two stocks due to the preferential tax treatment given to equities.

The aftertax return for the two stocks increases with the length of the holding period, as is shown in Figure 1. It also shows that the aftertax return is higher for the stock with the lower yield

Figure 1. Aftertax Returns for Capital Gains, Dividends and Interest Income



The chart compares the aftertax returns of three hypothetical investments owned by an investor in the 28% ordinary income tax bracket. Dividends are assumed to be qualified, paid at the beginning of each year and reinvested on an aftertax basis for the purpose of this comparison. The stock with the lowest dividend yield has the highest aftertax return because it has the least amount of income subject to annual taxes.

Table 1. Tax Efficiency Ratings of Various Asset Classes

Tax Efficiency	Asset Class	Taxable Accounts	Tax-Advantaged Accounts
Highly Efficient	• Bank CDs, low-yielding money market securities	Most appropriate	Inappropriate
	• Municipal bonds and municipal bond funds	Most appropriate	Inappropriate
	• U.S. savings bonds	Most appropriate	Inappropriate
	• Master limited partnerships (MLPs)	Most appropriate	Inappropriate
	• Tax-managed equity funds	Most appropriate	Inappropriate
Moderately Efficient	• Stocks with low/moderate dividend yields (held for long term)	Appropriate	Appropriate
	• Equity index funds	Appropriate	Appropriate
Moderately Inefficient	• U.S. Treasury bonds and bond funds	Appropriate	Appropriate
	• Investment-grade taxable bonds (held for the long term)	Appropriate	Appropriate
	• Passively managed investment-grade bond funds	Appropriate	Appropriate
Highly Inefficient	• Actively managed stocks and equity funds	Less appropriate	More appropriate
	• Real estate investment trusts (REITs)	Less appropriate	More appropriate
	• Actively managed bonds and bond funds	Less appropriate	More appropriate
	• High-yield bonds and bond funds	Less appropriate	More appropriate
	• Preferred stocks and preferred stock funds	Less appropriate	More appropriate
	• High-yield stocks (held for the long term)	Less appropriate	More appropriate

and higher rate of price appreciation for holding periods longer than one year. Both of these results reflect the tax benefits associated with deferring capital gains. For investors who have both tax-advantaged and taxable accounts, Figure 1 shows there is a strong preference for holding income-oriented investments in tax-advantaged accounts and holding growth-oriented investments in taxable accounts.

Where to Locate Various Types of Investments

Table 1 presents general tax-efficiency ratings for different asset classes. However, tax law is very complicated and there is a wide variation in investor tax status. Investors should understand that the table only provides a general guide; consider contacting a tax professional before making any asset location decisions.

Effective asset location is primarily a function of three elements: (1) an investment's tax efficiency; (2) the investment's expected pretax return; and (3) the proportion of pretax return that is expected to be generated as income. Tax-inefficient, high-return investments are best-suited for tax-advantaged accounts, particularly if most of the return will be generated as income. Investments that are high-return and tax-efficient are better candidates for taxable accounts, particularly if most of the return will be generated as capital gains. For low-return investments, the asset location default is to taxable accounts because of the limited tax liability.

Creating an Asset Location Worksheet

Table 2 is an asset location worksheet for a hypothetical married couple who has $1 million of financial assets. Looking at the combined portfolio, they've allocated 65% of their portfolio to equities, 26% to bonds, 8% to a real estate investment trust (REIT) and 1% to cash and CDs. However, the couple has considered the tax implications of asset location, and this is reflected by how they've allocated their investments between taxable and tax-advantaged accounts.

Table 2. An Asset Location Worksheet

Account	Tax Efficiency	Combined Portfolio ($)	Combined Portfolio (%)	Taxable Accounts ($)	Tax-Advantaged Accounts ($)
Cash and CDs	Highly efficient	10,000	1	10,000	—
Municipal Bond Fund	Highly efficient	20,000	2	20,000	—
Investment-Grade Bond Fund	Moderately inefficient	200,000	20	—	200,000
High-Yield Bond Fund	Highly inefficient	40,000	4	—	40,000
REIT	Highly inefficient	80,000	8	—	80,000
Stocks	Moderately efficient	170,000	17	170,000	—
U.S. Equity Index Fund	Moderately efficient	320,000	32	—	320,000
International Equity Index Fund	Moderately efficient	160,000	16	—	160,000
Total		**1,000,000**	**100**	**200,000**	**800,000**

The portfolio weights in the tax-advantaged accounts are 30% bonds, 10% REIT and 60% equities. The investment-grade bond fund, the high-yield bond fund and the REIT have been placed in the tax-advantaged accounts due to their tax inefficiency. Although the U.S. and international equity funds are considered to be moderately efficient investments from a tax perspective, they have been included in the tax-advantaged portfolio. This was done due to the superior historical performance of equities and the couple making full use of the available tax benefits with their retirement accounts.

The portfolio weights in the taxable accounts are 5% cash, 10% municipal bonds (via a fund) and 85% stocks. The couple has taken advantage of the tax-exempt status of municipal bonds by including them in a taxable account. The large commitment the couple has made to equities can be relatively tax-efficient if they reduce portfolio turnover by being long-term investors.

Summary

Tax-efficient investment is an issue facing investors who have both taxable and tax-advantaged accounts. Due to the complexity of tax regulations and the wide range of individual investment scenarios, it is often best to consult with a tax expert before making asset location decisions. The suggestions in this article may not apply to everyone and its purpose was to simply serve as general guidance.

Investors should first create an emergency fund and then consider taking full advantage of tax-advantaged accounts. These include both tax-deferred accounts such as 401(k) and 403(b) retirement plans and their tax-exempt Roth counterparts. Once an investor takes full advantage of tax-advantaged accounts, they can then begin to consider the tax efficiency of their investments.

Investments that are the most tax-inefficient are typically those that have high expected returns where most of that return will be in the form of income. Investments with the greatest potential tax liability are those that should receive priority consideration for tax-advantaged accounts. Investors should also be aware of the tax benefits associated with certain securities. Municipal bonds, U.S. government securities and MLPs all have tax benefits that make them more appropriate for taxable accounts. ➤

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