All About Asset Location: How to Make the Most of Your Accounts

This is a guest post from Robert Brokamp of The Motley Fool. *Robert is a Certified Financial Planner and the adviser for The Motley Fool's Rule Your Retirement service. He also has a newly reinvigorated blog, and you can have your day interrupted once or twice by his Twittering. Robert contributes one new article to Get Rich Slowly every month.*

Want to have more money and pay less in taxes? It's easy! Just call this number and send in your three easy payments of — no, wait. Actually, all you have to do is learn a little about asset location. No, not asset allocation — asset *location*: deciding which assets should go in which accounts. A recent surge of Roth assets, thanks to the increasing availability of the Roth 401(k) and the wave of conversions that occurred last year, makes this a particularly timely topic.

Wait! Don't leave! Though a little tedious, this is an important subject.

To understand asset location, you need to remember that **most investors have accounts that receive different tax treatment**, such as the following:

- *A traditional tax-deferred account, like a traditional IRA or traditional 401(k)*: Contributions may be tax-deductible, and the investment growth and income isn't taxed until money is withdrawn. Those withdrawals will be taxed as ordinary income — the highest tax rate most Americans pay. It ranges from 10% to 35%.
- *A Roth IRA or Roth 401(k)*: Contributions aren't tax-deductible, but withdrawals are tax-free (as long as you follow the rules).
- *A taxable, non-retirement account*: The taxation of an account that isn't an IRA or employer-sponsored retirement account (*e.g.*, a 401(k)) varies. Interest from bonds and CDs as well as short-term capital gains are taxed as ordinary income, but qualified stock dividends and long-term capital gains are taxed at lower rates, currently between 0% and 15%.

Studies have shown that **making the right choices about which investments belong in which accounts can increase an investor's after-tax wealth by 15% to 20%** over a lifetime. So what are those "right choices"? They can be summed up by five basic rules.

Rule #1: Keep Taxable Bonds and Certificates of Deposit in Tax-Deferred Accounts
If you hold these investments outside of a traditional IRA or 401(k), the interest is fully taxable at ordinary income rates. You essentially hand over a good portion of the return each year to Uncle Sam and Sister State, leaving less to grow through the years.

Tip: Confused about bonds? To refresh your memory, read about the basics of bonds and how bonds work.

Rule #2: Consider Keeping Bonds With Tax Advantages in Taxable Accounts
Some bonds have their own built-in tax advantages. Treasuries are exempt from state and local

taxes, and municipal bonds can be exempt from all taxes — federal, state, and local. If you place muni bonds in a traditional IRA, however, you lose the tax advantages.

Unless you live in a state with high taxes, it likely still makes sense for you to hold your Treasuries in your tax-deferred account, especially if you're years away from retirement. However, it rarely makes sense to buy municipal bonds in your tax-advantaged retirement accounts. The only exception is if you're buying bonds that are trading below par value (the price at which they were originally issued) and you expect the price to rise, leading to a capital gain. While the interest from government-issued bonds might have tax benefits, a capital gain — for example, the $100 profit you made if you bought the bond at $850 and sold it later for $950 — is fully taxable if held outside of an IRA or 401(k).

Hold off the tax man by putting the right investments in the right accounts.

Rule #3: In Taxable Accounts, Favor Stocks With Little to No Dividends and Those You'll Hold for Many Years

Let's say two investors put $50,000 in the exact same stock and hold it for a decade. The stock doesn't pay a dividend and earns an average of 8% annually. Investor A holds the stock in his traditional IRA, and Investor B holds it in her taxable brokerage account. A decade later, here's the value of each account and the taxes each investor has paid through the years (at this point, they haven't sold the stock yet):

- Investor A holds the stock in a traditional IRA. The pre-tax value of the account is $107,946 and Investor A has paid no taxes on the gain — yet.
- Investor B holds the stock in a taxable brokerage account. The pre-tax value of the account is $107,946, and Investor B has paid no taxes on the gain — yet.

Surprise! The values of the investments and the taxes paid (*i.e.*, none) are exactly the same, even though Investor B held the stock in a "taxable" account. That's because when you buy and hold stocks, especially ones that pay little to no dividends, you have *built-in* tax deferral.

But what happens when these investors sell their stocks to spend the proceeds in retirement? Assuming they're both in the 25% tax bracket, Investor A will have to pay a 25% tax rate on everything he withdraws from the IRA, whereas Investor B will pay just a 15% long-term capital gains rate — and only on the profit. If they each liquidated the investment and withdrew the cash from the accounts:

- Investor A would pay $26,987 in taxes and have $80,960 remaining.
- Investor B would pay $8,692 in taxes and have $99,254 remaining.

As if more after-tax wealth weren't enough, there are other benefits to holding equities in your taxable account:

- If shares drop below what you paid for them, you can harvest the losses by selling the shares and using the capital loss to reduce taxes. Of course, you can do that with any type of investment, but stocks present more opportunities since they're more volatile.
- If you hold dividend-paying foreign stocks in your taxable account, you can claim the foreign tax credit for any taxes assessed by the country in which your stock is headquartered. However, you can't claim the credit if you hold the stock in an IRA or 401(k).
- Investments in a taxable account receive a stepped-up cost basis upon the owner's death. Say a person buys stock for $10,000, and its value grows to $50,000. When he dies, this person bequeaths the stock to his daughter. Her new cost basis will be $50,000; she will not owe taxes on the $40,000 of capital appreciation.
- A less fatal way to escape paying capital gains taxes is by donating appreciated stock held in a taxable account to a qualified charity. Bonus: The donation can also be deducted on your tax return.

While all these benefits sound good, the tax efficiency of holding equities in a taxable account relies on your buying and holding for years and keeping dividends to a minimum. What do you do for high-yielding stocks or those you trade more frequently? Read on!

Choosing the right accounts lets you keep more of your money.

Rule #4: For Your Roth, Choose High-Growth, Tax-Inefficient Investments
When it comes to deciding what to put in this tax-free account, keep two principles in mind:

- Generally speaking, the **assets in your Roth should be the last you withdraw in retirement**. Studies indicate it's best to first tap your taxable accounts, then your traditional tax-deferred accounts, and your Roth last.
- Which account do you hope will be the biggest when you retire? The one with the best tax advantages, of course. That's the Roth, since withdrawals are tax-free.

Given those two principles, the ideal investments for your Roth are those that have the greatest return potential, especially if they're tax-inefficient. Historically, small-cap value stocks have posted the highest returns, and because of their generally higher turnover and higher dividends, the mutual funds that invest in that sector are among the most tax-inefficient — so these would be good candidates for a Roth. You could also use the account for any other active-trading strategies or real estate investment trusts, which pay a high yield but have dividends that aren't eligible for the lower qualified-dividend tax rate.

Also note that Roth assets are the best kind for your heirs to inherit, since they'll also enjoy tax-free growth. If leaving a legacy is important to you, then the Roth has an investment time horizon that extends beyond your lifetime; thus, it can theoretically hold riskier assets.

Rule #5: Retirement Changes Asset Location a Bit
Once you retire, if you plan to invest in high-yield stocks for the income, it makes sense to hold them outside of a tax-deferred account to take advantage of the lower tax rate on qualified

dividends. It’s less important where you hold the bonds that produce interest you plan on spending, since that interest will be taxed as ordinary income no matter what (muni bonds excepted).

When you’re ready to retire, you may want to mix things up a bit.

Remember: It’s Not What You Make, It’s What You Keep

Smart asset location also means you’ll pay fewer taxes. The higher your taxable income, the less likely you are to qualify for certain tax breaks. Also, once you begin receiving Social Security, the more you earn, the more likely your benefits will be taxed, and the more likely you’ll pay higher Medicare premiums.

So while paying attention to your asset location won’t double your portfolio overnight, it will pay off for decades to come — perhaps even after you’ve headed off to the *Antiques Roadshow* beyond the pearly gates.

Asset Location at a Glance

Here’s a quick summary of which investments to keep in which accounts:

- **Roth accounts:** Small-cap stocks; REITs; active-trading stock strategies; high-turnover and/or high-yielding funds, especially if they have above-average growth potential.
- **Traditional tax-deferred accounts:** Corporate bonds; Treasuries (especially TIPS); high-yielding and slower-growth stocks; diversified commodities funds; investments listed in the Roth category above if your Roth accounts aren’t very big or you don’t have a Roth.
- **Taxable, non-tax-advantaged accounts:** Low- or non-yielding stocks you plan to hold for several years (decades, even); low-turnover stock funds (e.g., many index funds and ETFs as well as “tax-managed” funds); municipal bonds; U.S. government savings bonds or I-bonds; maybe Treasuries if escaping state income taxes is important to you.

Note: This article uses current federal tax rates, which will continue through 2012. Tax law will certainly be different a few years from now, but I think it’s a good bet that some current principles — such as long-term capital gains rates will be lower than ordinary income rates, and that municipal bonds will have tax advantages — will continue.