North American Management

Financial Planning Note

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Will Asset Location Lower Your Taxes?

As we busy ourselves preparing our tax returns this time of year, the question of how to lower taxes arises time and again. With the increase in the top marginal tax rate, coupled with Medicare's 3.8% surtax, one idea gaining more attention is the importance of "asset location" in reducing taxable income.

Smart asset location simply means you are putting investments that are not tax efficient in accounts that are tax-free or tax-deferred and tax-efficient investments in taxable accounts. For example, corporate bonds and taxable bond funds produce interest income, which is taxed at ordinary income tax rates. If you are in the highest marginal tax bracket of 39.6%, this interest income is taxed at that same rate. Holding these bonds in a tax-deferred account instead of a taxable account will eliminate this extra taxable income.

However, holding individual U.S. stocks in a taxable account can be tax-efficient. Any dividends paid are likely to be qualified dividends, taxed at lower rates than ordinary income. If the stock grows and is eventually sold for a capital gain, that gain is also taxed at the lower capital gains tax rate. While the dividends and capital gains might not be taxed immediately in a tax-deferred account, that income will eventually be taxed at ordinary rates when it comes out as part of a required minimum distribution.

Before you rebalance your portfolio, there are a few steps you should consider first:

Quantify your annual cash flow needs. How much are you going to need to take out of your portfolio each year for living expenses? How much charitable gifting would you like to bestow if possible? Is annual family gifting part of your estate plan? The amounts desired and the ability to give stock rather than cash can influence asset location.

Design a withdrawal strategy to minimize taxes. The general rule of thumb is to spend down your taxable assets first, take only the minimum required distribution from your IRAs and leave your tax-free assets to your heirs. It is important to note that low basis stock in a taxable account or large RMDs can alter the tax-efficiency of this plan. In some cases, supplementing taxable income with Roth IRA distributions may be the best way to keep taxes low.

Determine the appropriate asset allocation of your entire portfolio. Look across accounts and across managers to figure out your overall allocation. Does it reflect the amount of risk you are willing to take for the investment return you need to accomplish your goals? The appropriate mix of investment assets (for example, 70% equities, 30% fixed income) has more to do with the success of your plan over the long term than picking individual investments.

Keeping that overall asset allocation in mind, you should be ready to maximize asset location. In the chart below, I have suggested a few types of assets that are typically best suited for each type of account.

Type of Account	**Tax-Efficient Investments**	**Tax Impact**	**Potential Concerns**
Taxable	US & International Stocks, Muni Bonds, ETFs	Qualified dividends & capital gains at lower tax rates; muni bond interest is federal and sometimes, state tax free	Low basis stock can generate large cap gains; foreign dividends can generate additional tax reporting
Tax-Deferred (IRA)	Corporate Bonds, REITs, Mutual Funds	Ordinary income tax is deferred until age 70 ½.	Any dividends or capital gains are taxed as ordinary income when taken out as RMD
Tax-Free (Roth)	Alternatives, Small Cap, Emerging Markets	Gains on higher risk/return investments will never be taxed	Ability to harvest tax losses on volatile investments is lost

Many factors need to be considered when evaluating changes in asset location. In this low interest rate environment, the long term impact of bond interest between taxable and tax-deferred accounts is muted. The ability to gift up to $100,000 of your RMD to charity without tax consequences can favor the placement of individual stocks in an IRA. Finally, when you have the ability to place assets in a favored tax location, within an appropriately allocated portfolio, there are clearly tax-reduction benefits available.

If you have any questions, please contact me or your Relationship Manager.

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