



## Tax Location in Today's Uncertain Environment

By Glenn Frank  
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The tumultuous political climate in Washington has heightened anxiety around the country, and the uncertainty left when Congress adjourned without tackling any of the looming tax changes has left taxpayers and investors wondering just what is in store for 2011. Though the crystal ball remains cloudy, and while taxes may rise for no one, everyone, or just the wealthiest Americans, steps taken today can help tax planners and their clients be better prepared – no matter what the politicians do.

With or without a change in policy from Washington, every investor's first step should be to place each asset in its optimal location for tax purposes. There's no need to wait for year-end planning; tax evaluation should be a continuous process, with reallocation as needs and conditions change. Staying abreast of where and how assets are distributed can yield significant savings over the long and short terms. For example:

- Buy-and-hold equities (an S&P 500 index fund, for instance) are almost always best placed in a taxable account. Appreciation on these investments is not taxed until the equity is sold, and then the tax should be at a favorable long-term capital gains rate. If an investor never sells a stock, their heirs may not have to pay taxes on the appreciation, thanks to a "step up in basis" provision in the tax code.

Conversely, if the gain is inside a tax-advantaged account, such as an IRA, the appreciation will eventually be taxed as ordinary income at a higher rate, and there is no "step up in basis" for heirs. Losses in taxable accounts can also be used to offset gains accrued indefinitely into the future, but losses in retirement accounts can never be used to offset taxable gains.

- On the other hand, short-term gains from high-turnover equities are usually best suited for tax-advantaged accounts. In a taxable account, these gains would be taxed at an investor's top marginal rate. Corporate bonds, which have no favorable tax treatment on their yields, also belong in retirement accounts. In an IRA, these yields will not be taxed until the account is drawn down, at which time the owner will presumably have retired and may be in a lower tax bracket than during their years of high income accumulation.
- Investing in a 529 college savings plan as one element of an overall tax strategy can help reduce a parent's tax burden. While children are generally the beneficiar-



ies of these accounts, in high-net-worth families they are well designed for parents – after all, parents of means are often the ones footing the bill for higher education. When assets are strategically located in 529 plans, these vehicles become one of several important tax-smart pillars.

As long as the funds in a 529 account are used for qualified educational expenses, they can be withdrawn free from federal tax and, in many cases, with state tax benefits as well. They therefore make an outstanding location for family fixed income assets. Since they should grow more predictably than equities, concentrating these assets in 529 plans allows parents to know just how much will be available and dedicated for a child's education as their matriculation draws near. The remainder can then be taken from the family's growth or liquid assets held elsewhere.

- Very often after the sale of a business or other windfall, retirement accounts end up being a relatively small portion of a total portfolio. As a result, there may not be adequate room in retirement accounts for an investor to hold all of their targeted tax-inefficient assets. In these circumstances, a low-cost variable annuity can be used to defer taxes for many years; unlike retirement accounts, withdrawals on an annuity do not have to start at age 70.5.

Though the outlook for 2011 remains blurry, it is not a complete mystery. Financial planners can make a few assumptions about likely outcomes and put together several plans, to implement depending on how Congress acts after the midterms. In such a volatile environment, taxpayers could be burned if they wait too long before considering their options.

While, for the most part, every American faces the same tax laws, their financial situations are as varied as their personal lives. General principles and frameworks provide a standardized starting point, but each taxpayer should craft an income and investment strategy that suits his or her individual needs. No one knows what the future will bring, but a penny's worth of planning today could yield a pound's worth of saving in 2011.

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