



## **Asset Location: 9 Tips for Avoiding Unnecessary Taxes**

*June 3, 2008*

Should actively managed mutual funds be held in tax sheltered accounts? What about limited partnerships? And how should advisors prepare for potential increases in capital gains rates?

Questions such as these can be answered through an analytical approach to deciding where to “house” assets – in taxable or tax sheltered accounts.

Glenn Frank is a Senior Investment Strategist for Wachovia Wealth Management, and was the Founding Director of the Master of Personal Financial Planning program at Bentley College in Waltham MA. He is a member of the program’s advisory board and teaches two portfolio construction courses within the program – Asset Allocation and Investment Vehicles. He is also the patent holder on “*OptiTax*” – a software tool which optimizes the location of investments between taxable and tax deferred accounts.

We spoke with Frank on May 29 to learn how advisors can systematically analyze the tax implications of high-net worth portfolios.

### **Crafting the Process**

“Investment location should be a very tangible step in the overall investment process,” says Frank, adding, “Unfortunately, it is sometimes forgotten or overlooked, given the complexity of ever changing tax laws.”

To improve location decisions, Frank identifies several sequential steps:

- Which asset classes are clients currently using and what embedded capital gains are in these accounts?
- Which asset classes should clients be using after financial planning and risk tolerance has been assessed?
- Which managers are best to capture the targeted asset classes? Are mutual funds or separately managed accounts being employed? Are the managers active or passive?
- After income and estate tax considerations, where should these managers reside (taxable or tax deferred accounts)?
- What are the tax implications of portfolio rebalancing?

Frank says advisors should focus on the investment location issue, which is a “huge value add opportunity with high-net worth clients.” It is more difficult today, unlike years past when many advisors used mostly straightforward stocks and



bonds. “Now with the incredible proliferation of investment vehicles and the related breath of diversification available across global markets, location is much more challenging,” says Frank.

### **Thinking Holistically**

Advisors should begin by thinking holistically. Most clients want to maximize family wealth, so they must get their arms around all their clients’ accounts, including those that are currently taxed as well as those that are sheltered from taxes. Taxable accounts generally include brokerage accounts, trusts and children’s custodial accounts. Sheltered accounts include annuities, the cash value of insurance policies, 529, 401k, and IRA plans.

“I recommend putting everything in a spreadsheet, organized by asset class, which I call the family investment matrix,” says Frank. Often there is an epiphany as clients see their asset allocation in totality for the first time.

On the location issue, the key is understanding taxes thoroughly. How is each client account taxed for both income and eventual estate tax purposes? What is the character and timing of taxation for each investment manager? What is likely to be on 1099s and K1s? This can include ordinary income, short and long term capital gains, qualified and non-qualified dividends, foreign tax credits, etc.

The next step is to go through an ordering process: rank all of the managers used by tax efficiency. For example, large cap US stocks via an index fund or ETF are highly tax efficient (with few capital gains and dividends taxed at just 15%). At the other end of the spectrum are high turnover REIT mutual funds which are very tax inefficient (with short term capital gains and rent yields taxed at the highest marginal rates).

Accordingly, the first investment to hold in a taxable account might be an S&P 500 Index fund. A REIT mutual fund might be the first investment for an IRA.

The real driver of the location decision is where to place equities. The implications of long term compounding on asset classes, such as equities, which should offer higher returns, is dramatic. If equities are tax efficient, then put them in taxable accounts. If they are tax inefficient, then put them in retirement and *then* decide location for fixed income. For example if equities are high turnover (short-term gains) they belong in tax deferred accounts, and bonds belong in taxable accounts (and if the client is in a high enough tax bracket then buy munis).

Within this general process, an element of rigor must be applied when analyzing managers and estimating 1099 and K1 income. Analyzing the tax consequences



of alternative investments today is a complicated area where advisors can further endear themselves to their clients.

### **Specific Steps that Make Tax Sense**

Within this general context, Frank highlighted a number of examples of how the asset location decision enters into play:

- 1. Strategically locating family fixed income in 529 plans** – A common question Frank encounters concerns the assets that belong in 529 plans. The answer often depends on whether the 529 plans are considered part of the family portfolio, or whether they represent a separate pot of money set aside strictly for education. The answer to this question lies in the answer to another question - who will make up the shortfall if the 529 fails to meet the cost of education? If the parents will make up the shortfall, then the 529 plan's performance will impact them and therefore the 529 should be treated as part of the family portfolio. In this case it is a marvelous place to put fixed income given its tax-free status. Family growth assets can be located somewhere else under parental control. An added benefit utilizing fixed income is that it is a predictable amount from a budgeting perspective. Growth assets should then be outside of a 529 plan. Frank says "putting things that are subject to long term capital gains treatment into sheltered accounts is like turning gold into lead."
- 2. Strategically buying low cost annuities to house tax inefficient asset classes when there is no room in retirement accounts** - It is good to put tax inefficient assets into retirement accounts, but the capacity of retirement accounts may be limited. Frank encounters situations where there is no room in retirement accounts and the asset mix includes REITs and/or high yield bonds, or there are 401k plans which do not have these investment options. If the assets were located in taxable accounts too much would be lost to taxes. As an alternative, Frank recommends low cost variable annuities to house these tax inefficient asset classes.
- 3. Certain assets almost always belong in taxable accounts** - Examples include buy-and-hold equities, most index funds, and most ETFs (except for some that are heavily taxed each year). Unlike mutual funds, a separately managed account (SMA) can harvest losses during the year which can work very well in a taxable account. SMAs (such as SSgA's TEMC –tax efficient market capture platform) that track an index with ongoing tax loss harvesting offer the benefits of index funds with added tax savings. Frank considers them a "no brainer" way to capture the performance of the large cap US equity asset class, giving clients S&P 500 returns, while harvesting losses during the year to offset other gains in



the portfolio.

Certain limited partnerships, such as timber and private equity, usually offer long term capital gains and should be in taxable accounts. The same applies to most ETNs which, under current tax law, have tax favored status, although there is debate on this.

Frank notes that the active-passive debate enters into play. Most analysis of active versus passive strategies is on a pretax basis. On a post tax basis, passive usually has a big edge. "If you like active managers," says Frank, "all things being equal, it is better to keep them in tax deferred environments. You can get married to a manager you love, and then the manager leaves and you must pay capital gains taxes for your money to leave." In a retirement account you don't have that issue.

4. **Certain assets almost always belong in accounts not currently taxed**  
- These include high yield bonds, REITs, and high turnover managers. Hedge funds can be very tax inefficient and, as Frank notes it can be very vexing waiting for K1s that don't come until October. "When permissible it is better to hold them in a retirement account," he says.
5. **There are mathematical benefits to paying capital gains taxes on concentrated positions, in order to reduce portfolio volatility -**  
With concentrated positions, Frank's experience is that advisors want diversification, but getting clients to write a big check to IRS is tough. Advisors can't promise a higher return on a diversified portfolio, but can promise reduced volatility. Frank believes that reducing volatility by paying taxes today often makes a lot of financial sense. The size and frequency of potential losses is far greater with single stocks than a diversified portfolio. Loss years are compounding killers. Additionally, clients gain the psychological benefit of being able to sleep at night.
6. **The estate tax side is important to consider –** Estate issues are very specific to clients and individual circumstances, so general guidelines are perilous. Advisors must look to the ultimate disposition of the account. If taxable accounts are likely to pass to the next generation (and step-up in basis laws are in effect) then if buy and hold equities are held in these accounts, appreciation will never incur a capital gains tax.



7. **The philanthropic side is important to consider** -for charitable gifting purposes, housing buy-and-hold equities in taxable accounts allows for a full deduction while avoiding tax on unrealized gains. If high turnover assets are housed in taxable accounts, taxes are continually paid – accordingly, there won't be much capital gains tax avoided when they are gifted.
8. **Age matters** - The younger you are, the more sense it makes to house the highest expected return investments in tax deferred accounts. Decades of growth with zero tax interference can create a tremendous accumulation even after taxes are paid at the end.
9. **Proactively pay capital gains taxes later this year if it looks like rates are going up** - Frank says there is clearly pressure to increase taxes, and capital gains rates will likely be hiked up. Ordering rules for housing assets will need to be revised. If advisors believe an increase in the capital gains rate is an eventuality, then it is a matter of timing one's tactical investment decisions. Advisors should look at harvesting capital gains this year, and pay the potentially lower "Republican rate" while it lasts. Frank warns that this may not be an easy sell. "It may be a function of how the assets are invested," he says, adding, "if the gains are in a taxable mutual fund with expected ongoing capital gains distributions, the decision to harvest gains is much clearer. But if gains reside in buy-and-hold equities that won't come out for a long time, then you should probably not incur the taxes now." Tax law changes could be passed as early as 2009 so these decisions may need to be made soon. .

Frank warns that none of these rules work universally and "rules of thumb" can be dangerous when it comes to tax planning. "Much of the commentary on asset location in the past has been too simplistic, and has failed to incorporate the diversity of assets typically held in high-net worth portfolios," he says. "My goal is to sensitize advisors to these issues and to offer a logical framework for analyzing this critical step in the investment process"

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