The Importance of Asset Location in Retirement Planning

141 Sully's Trail
Pittsford, N.Y. 14534
Office: 585-248-5700
Toll Free: 877-416-5700
Fax: 585-248-5703
www.ParksCapital.com
www.youtube.com/c/ParksCapital

–Amy E. Buttell

When it comes to the distribution of retirement assets, where those assets are located in the portfolio can have a direct bearing on how much income you receive.

Asset allocation is conventional wisdom for most investors; asset location, not so much. But an ill-conceived asset location strategy can cost you in both the accumulation and distribution phases, says William Reichenstein, Ph.D., CFA, and professor of investment management at Baylor University in Waco, Texas.

With an asset location strategy, the goal is to maximize the tax advantages of specific accounts, using the tax code to your benefit.

"There's nothing illegal or immoral about using the tax code to your advantage when devising an asset allocation and asset location strategy for your clients," says Reichenstein, who is the author of *In the Presence of Taxes: Applications of After-Tax Asset Valuations*.

While there's an overall asset location strategy that makes sense — holding assets that throw off income taxed as ordinary income in a tax-deferred account, such as a retirement account, and holding assets that primarily produce capital gains in taxable accounts — that strategy needs to be fine-tuned for each individual.

Risk and reward in asset location

Reichenstein views the most effective asset location strategy as one that takes into account both the potential reward and risk of different asset classes, realizing that the government has a share of both in terms of present and future tax payments.

For taxable accounts. The government has a potential share in any investment gains as well as in any investment losses. If an investment loses money and is cashed out, the government gets less in taxes than it otherwise would. If the investment is in bonds or some other type of asset that is taxed at ordinary income rates, the government gets more in taxes than it would if the funds were invested in stocks or other assets that generate capital gains or that are sheltered in retirement accounts. That's because capital gains are taxed at a lower rate than ordinary income.

For traditional retirement accounts, traditional IRAs, 401(k)s, 403(b)s, and self-employment accounts such as SEPs and solo 401(k)s, the government has a share in future distributions and gains because of taxes due to be paid during the distribution phase. Losses within such accounts can't be deducted, unlike losses in taxable accounts. Distributions, whether taken from investment principal or gains, are taxed as ordinary income, regardless of the type of asset.

For Roth retirement accounts, including Roth IRAs, 401(k)s, and 403(b)s, the government has no future

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share in the revenue from the account, since the account is funded on an after-tax basis. As with traditional retirement accounts, losses can't be deducted, but neither principal nor capital gains are taxed upon distribution.

Managing the trade-off

It's not always possible to locate assets in the most effective manner and adhere to the most appropriate asset allocation. In that case, analyzing the specific assets that need to be allocated within a portfolio and figuring out alternatives is the best option.

For example, actively traded stocks should be in retirement accounts so they won't be taxed at high short-term capital gains rates. On the other hand, if stocks will be bought and held for a long period of time, they can be placed in a taxable account; unrealized gains won't be taxed at all, and realized gains will be taxed at lower capital gains tax rates.

Cash is one asset that seems to make sense in a retirement account because of the interest income it generates. But in most cases, you need cash for an emergency fund, so in order to have immediate access to it, you should leave in a taxable account, Reichenstein says.

Most bonds and bond funds as well as REITs and REIT funds all belong in tax-deferred retirement accounts because they are taxable at ordinary income tax rates. Tax-exempt municipal bonds are appropriate for taxable accounts.

Roth vs. traditional accounts

Generally, it's to your advantage to contribute to a traditional retirement plan over a Roth if you expect to be in a lower tax bracket during retirement. But since there's no way to know what tax rates will do in the future, it's a guessing game.

There is one other factor that many fail to take into consideration. "If you're talking about a Roth 401(k) or 403(b), that $22,000 contribution in after-tax dollars is effectively a lot larger than an equivalent contribution to a traditional 401(k) or 403(b) in pretax dollars. If the decision isn't clear cut, I'd go with the Roth 401(k) or 403(b) for that reason."

Other issues to take into consideration when considering a Roth include the fact that distributions aren't required from Roth accounts, which can make them a better estate-planning vehicle, and the fact that they don't generate taxable income in retirement. If you have a variety of assets to choose from when taking distributions—including traditional retirement accounts, Roth retirement accounts, and taxable accounts—it's easier to mix and match distributions from these accounts to come up with the best strategy.

A final word

Although it's important to have a general awareness of tax issues when contemplating retirement, there is no substitute for consulting your tax advisor for advice specific to your individual situation.

Amy E. Buttell is a freelance journalist who writes for Horsesmouth, providing insight into critical issues facing financial professionals and their clients.

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