

## ***Asset Location: A Step Beyond Asset Allocation***

Many financial advisors preach the importance of asset allocation – the mix of investments between cash, bonds and stocks, as well as sub-allocations within the major asset classes. But few advisors take the implementation of the asset allocation to the next level the way RCG does.

That's because we use what's called *asset location*, and it involves holding certain asset classes in taxable accounts and others in tax-deferred accounts whenever this is possible. Why bother? Because some asset classes are very income-tax friendly while others are not. While our use of passive investment vehicles already results in portfolios being efficient from an income-tax perspective (especially compared to actively managed individual securities or actively managed mutual funds), we want to improve upon that tax efficiency by using asset location engineering.

### **The Basics of Income Taxation of Investments**

Let's start with the basics of income taxation of investments.

- Interest income from bank accounts, CDs, money market accounts and taxable bonds is subject to tax at the taxpayer's marginal income tax rate.
- Interest income from tax-exempt municipal bonds is not subject to regular income tax, but certain bonds are subject to the Alternative Minimum Tax (AMT). Also, interest from all tax-exempt bonds enters into the calculation of how much of your Social Security benefits are subject to tax, as well as the calculation of other "stealth" taxes.
- "Qualified" dividends from stocks are taxed at the long-term capital gain rate, which is currently 15%. However, this special treatment of qualified dividends expires at the end of 2010, resulting in all dividends being taxed at the taxpayer's marginal income tax rate.
- Realized gains on investments held more than one year are taxed at 15%. (This rate expires at the end of 2010 and will change to 20%.)
- Realized gains on investments held less than one year are taxed at the taxpayer's marginal income tax rate.
- Mutual funds are pass-through entities, meaning that whatever tax consequences occur at the fund level are passed through to the fund's shareholders.

### **Holding Patterns**

Whether we use taxable or tax-exempt bonds for a client is a function of their marginal income tax bracket as well as the type of account(s) we are managing for them. The ideal situation is to manage both a taxable account and a tax-deferred account.

When it comes to deciding which stock mutual funds to hold in which account, we prefer to hold the low-turnover and low dividend rate mutual funds in taxable accounts and keep the higher-turnover and higher dividend paying mutual funds in tax-deferred accounts. Specifically, we opt to hold the Vanguard Total Stock Market Index Fund (and its foreign counterpart, Vanguard Developed Markets) in taxable accounts, because these index funds have extremely low turnover (percentage of holdings that are sold in a given year), and the funds have comparatively low dividend rates because a higher percentage tends to be growth stocks, and growth stocks have lower dividend payouts than value stocks.

The corollary is that we favor holding small-cap and value stock funds in tax-deferred accounts, because those asset classes tend to have higher dividend rates and turnover (but still much less than actively managed funds). When we move away from large-cap growth funds, we use structured funds that are passive, but not index funds. These funds stay true to their prospectus-driven mandates, so that small

cap fund managers will retain the purity of the exposure to the asset class by selling a stock when it is no longer “small.” If a stock was purchased when it was small and sold when it was large, that means that there was a gain. Likewise, the manager of a value fund will sell a stock if it moves to the pre-defined category of a growth stock. This disciplined selling produces turnover higher than index funds, so we hold those asset classes in tax-deferred accounts to blunt the income tax impact.

## **Foreign Tax Credit**

Foreign tax credit is another consideration. When dividends are paid to U.S. taxpayers by foreign companies, the entity’s country of domicile requires that income taxes be withheld from the dividend payment. The U.S. taxpayer can then claim the foreign taxes withheld as a tax credit against his or her U.S. income tax liability. For this reason, it is better to hold foreign funds in taxable accounts so this credit is available. Any foreign taxes withheld on dividends from holdings in tax-deferred accounts are wasted.

## **Back to the Drawing Board, Once Again**

Advisors also need to take into account whether to hold bonds and stocks in taxable or tax-deferred accounts. The answer depends on two factors: the current income tax law pertaining to investments and the client’s age. Prior to the Bush tax cuts in 2001, our general rule was to hold bonds in taxable accounts (these being tax-exempt bonds for high tax bracket clients) and hold stocks in tax-deferred accounts. The reason behind this strategy was to put the assets with the highest expected return (stocks) in an account where income tax deferral would provide the greatest benefit.

The 2001 tax cuts sent us back to the drawing board. With qualified dividends and long-term capital gains taxed at only 15%, the ideal asset location strategy reversed: hold the stocks in taxable accounts to take advantage of those low rates. Otherwise, the dividends and appreciation would be taxed at the client’s marginal rate when he or she took distributions from that tax-deferred account. Even though tax-deferral is very valuable, the significant rate differential reversed our prior strategy.

With the scheduled repeal of the Bush tax cuts in 2011, we may be back to square one again. Rest assured that we are sharpening our pencils and formulating our analysis to determine the asset location strategy that maximizes the tax-efficiency of our already efficient portfolios.

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and investment management firm in Florida.*



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