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Asset Location for Tax-Optimization

We've all heard it said that when it comes to real estate, the most important factors are location, location, and location. Location also matters when it comes to investing, and sometimes where you hold your assets can be just as important as what assets you hold. Even the most impressive returns can be substantially diminished by a hefty tax bill. Asset location is a tax-minimization strategy that takes advantage of how different types of investments are taxed and utilizes different types of investment accounts to minimize your ultimate tax burden.

Most investment accounts will fall into one of three categories. First, there are taxable accounts. These are traditional brokerage accounts that hold securities where dividends and interest are taxed in the year they occur, and capital gains are realized when selling investments that have gone up in value. There are also tax-deferred accounts like traditional IRAs and 401(k)s, where investments are made with pre-tax dollars and the eventual withdrawals are taxed as regular income. Finally, there are tax-exempt accounts like Roth IRAs and Roth 401(k)s, where investments are made with after-tax dollars and later withdrawals are tax-free, assuming that all the rules are followed.

Asset Type	Tax Treatment of Returns	Most Suitable Account Type
Tax-free municipal bonds & mutual	Exempt	Taxable
Stocks held for more than 1 year	Long-term capital gains rate	Taxable
Equity index funds	Long-term capital gains rate	Taxable
Tax-managed mutual funds	Long-term capital gains rate	Taxable
Real estate investment trusts	Generally, 20% tax exempt, 80% taxed	Tax-deferred or tax-exempt
High turnover mutual funds that incur	Taxed at ordinary income rate	Tax-deferred or tax-exempt
Fully taxable bonds and bond funds	Taxed at ordinary income rate	Tax-deferred or tax-exempt

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Conventional wisdom has long held that bonds should be held in tax-deferred or tax-free accounts and stocks should be held in taxable accounts. The logic follows that the interest earned on bonds generates a great deal of taxable income that should be minimized. However, the reality is much more complex, and investors need to consider a variety of factors, such as their current and anticipated future income tax bracket, their time horizon, their investments' anticipated returns, and their personal risk tolerance.

Research has shown that in many cases it would be smarter to hold stocks in tax-deferred or tax-exempt accounts and bonds in taxable accounts, especially if the investments will be held for a long period of time. Because when you hold an investment for long enough, the high returns of stocks over time could generate a larger capital gains tax burden than the income of bonds over time. At the same time, however, it may be more beneficial to hold volatile stocks in a taxable account so that you can take advantage of possible losses to lower your tax burden. The advent of mutual funds has even further complicated matters, and it is important that investors pay attention to how actively managed a fund is and how many "taxable events" the fund accrues. Stellar returns can be greatly diminished if the fund regularly realizes short-term capital gains.

Ultimately there is no one size fits all rule for asset location, so it is important to meet with an advisor who can help ensure that your long-term investment strategy aligns with your financial goals and can be supported by a coordinated, strategic asset location plan that will help minimize your tax burden.