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Tax-Smart Stashes For Your Assets

By Christopher Farrell

If you want the perfect asset-allocation plan, you'll have to design it in a tax-smart way. That means carefully distributing your stocks, bonds, and other investments between taxable and tax-deferred vehicles such as 401(k)s and individual retirement accounts. ``Investors can increase their returns by locating their assets optimally across taxable and tax-deferred accounts,'' says Clemens Sialm, assistant professor of finance at the **University of Michigan** Stephen M. Ross School of Business.

Asset location is tricky because of the Byzantine tax code. Taxes are deferred on contributions to and earnings from 401(k)s and IRAs, but withdrawals are taxed at ordinary income rates. But in a Roth IRA, the contribution is funded with aftertax dollars and the savings are tax-free. Taxes are owed every year in a taxable account, but Uncle Sam plays favorites. Interest earned on bonds by a high-income saver is taxed at the top federal marginal income tax rate of 35%, yet the levy on most dividends is only 15%.

You can minimize total taxes and maximize returns by putting assets that face the highest taxes into tax-sheltered retirement accounts. Here's an example from James M. Poterba, a Massachusetts Institute of Technology economist: Suppose you put $10,000 into bonds that generate a pretax return of 5% per year, and the interest is reinvested at 5%. After 30 years, the $10,000 is worth $30,800 if you are in the 25% marginal federal tax rate. If the same bonds were in an IRA, and taxed at 25% on withdrawal after the 30 years, it would be worth about 9% more.

With investments taxed at lower rates, such as the 15% maximum tax on long-term capital gains, the IRA could work against you. Had you put $10,000 in stocks, earned 5% a year, sold them in three decades, and paid only capital-gains tax, the investment would be worth nearly $40,000. Had that equity investment been made in a traditional IRA, the proceeds would be taxed at the 25% rate, leaving you with about $6,000 less (assuming tax rates stay the same).

Remember, the location choice comes after the asset allocation decision. And you should make sure you're funding your tax-deferred accounts to the max. But the more you're able to save, the more you will help boost your returns by paying attention to different tax treatments.

Location, Location, Location

BEST FOR TAX-DEFERRED ACCOUNTS

Taxable bonds and bond funds

Real estate investment trusts

Any actively traded mutual, commodity, or hedge funds

Individual equities you expect to hold less than a year

BEST FOR TAXABLE ACCOUNTS

Tax-exempt bonds and bond funds

Individual equities you expect to hold more than a year

Tax-managed mutual funds

Growth stocks with no dividend payout

THESE CAN GO IN EITHER

Broad-based equity index funds

High dividend-paying stocks

Exchange-traded funds

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