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SPECIAL REPORT -- HOW TO RETIRE

What Doesn't Belong in Your 401(k)

Make sure to reserve the limited space there for assets subject to the most tax

You have a Standard & Poor's 500-stock index fund and a corporate bond fund. Does it matter which you put in your tax-deferred retirement account and which goes into your taxable brokerage account? You bet. Where you place your assets can make a significant difference--increasing your retirement wealth by almost 7%, according to Clemens Sialm, an assistant finance professor at the University of Michigan.

You've heard about asset allocation, the process of diversifying to achieve the highest return for your risk tolerance. But it's just as important to think about asset location. The goal is to maximize aftertax returns by reserving the limited space in your tax-deferred accounts for items that generate the largest tax bills.

Asset location, or placement, is a concern for those who save more than the current annual contribution limits of $10,500 on 401(k)s and $2,000 on individual retirement accounts. Generally, those who save less should put everything (except tax-exempt municipal bonds) into tax-deferred accounts. They offer advantages that are hard to beat, such as tax deductions and perhaps an employer match on contributions. Your money also grows more rapidly than it can when you are forced to pay taxes every time you sell a winner or pocket dividends and interest.

FIRST DIBS. While asset location is an inexact science, there are some general rules (table). If you want to trade, do so inside a tax-deferred account to avoid paying capital-gains taxes every time you sell a winner. And never put muni bonds in your 401(k) or IRA, or you will pay income taxes on their tax-free income as you withdraw the money.

Such obvious scenarios aside, the asset-placement plan that's right for you depends on what's in your portfolio, your time horizon, and your estate-tax goals. For investors who meet their fixed-income needs with munis, for example, the decision is easy: Put equities in the 401(k). But if you're not in a high enough tax bracket for munis to make sense, give taxable bonds first dibs on your 401(k).

Generally, bonds benefit more from tax deferral than stocks do. That's because a much higher percentage of their annual earnings--100%, for bonds held to maturity--comes from interest, which is taxed at ordinary income-tax rates. In contrast, income--in the form of dividends--and realized capital gains make up only about 14% of an S&P 500 fund's annual return. By sheltering bond income in tax-deferred accounts, you avoid losing a large chunk of it to the IRS. "The benefit of that over a lifetime is huge," says Chester Spatt, a finance professor at Carnegie Mellon's Graduate School of Industrial Administration.

Indeed, an investor in the highest bracket who plows his $10,500 401(k) contribution into a bond fund today and sells in 20 years will have $4,651 more than he would have by holding the bond fund outside his 401(k). The same investment in an S&P 500 fund, once liquidated, is worth less inside a 401(k) than outside, says Joel Dickson, a tax efficiency expert at the Vanguard Group.

Individual stocks you plan to hold for the long run should get low priority for space in your 401(k) or IRA. After all, they generate little in the way of taxes until you sell. And why pay income-tax rates on your profits--as you would when tapping a tax-deferred account--when you can opt for lower capital-gains tax rates? (The exception is stocks with high dividends, which belong in tax-deferred accounts.) Another downside to placing stocks in an IRA: If you sell a loser, you can't claim the loss on your tax return.

Of course, many investors want an all-equity mutual-fund portfolio. In that case, put actively managed funds--those run by stock-pickers who trade often--into a tax-deferred plan. That way, you shelter the taxable distributions that result from their trades. Candidates for taxable accounts are index funds, which sell stocks only when their benchmarks change, and tax-efficient funds, which aim to minimize tax bills.

The decision of what to put where is less clear-cut when you own a mix of actively managed equity funds and taxable bonds. Here, your time horizon is key. If you have equity funds that invest in growth stocks, put them in your 401(k) or IRA if you plan to hold them at least 15 years, says Sam Beardsley, director of investment tax at T. Rowe Price Associates. As long as your equity fund outpaces your bond fund by an average of five percentage points a year, "the compounding of the higher pre-tax return on the stock fund will result in greater earnings than sheltering the bond fund," he says. Since value funds often produce more taxable distributions than growth funds do, they should perform better in a deferred account over shorter periods.

If your asset placement isn't what it should be, go ahead and restructure. But before selling winners in taxable accounts, harvest losses to reduce your tax bill, says Sue Stevens, financial-planning director at Morningstar. You can always adjust your tax-deferred accounts because gains on sales aren't taxed in them.

Although individual stocks generally belong in taxable accounts, many people own company stock in 401(k)s. If that includes you, you may have an opportunity to move this stock out when you retire or leave the company. Instead of rolling it over into an IRA, put it in a regular brokerage account. Since you bought the stock with pretax dollars, you will owe income taxes on the amount you purchased it for once it moves to a taxable account. But when you sell, you will pay the favorable capital-gains tax rate instead of the income-tax rate you would owe on withdrawals from an IRA, says Christine Fahlund, a senior financial planner at T. Rowe Price.

LONGER VIEW. Asset-location rules can reverse if you throw estate planning into the mix. For example, if you plan to leave your IRA to grandchildren, your time horizon expands to cover their expected lifetimes. As a result, an S&P 500 fund might be a better choice for your 401(k) than even a bond fund. Although the index fund produces smaller taxable distributions, it earns more--10% a year, on average, vs. 7% for the bond fund. With those smaller sums growing at a faster clip, an index fund will eventually come out ahead of a bond fund.

One caveat: Once you put something in a tax-deferred account, your heirs won't get a step up in basis. This tax break, available in a taxable account, erases the capital gains your investment earns during your life---at least as far as the IRS is concerned. The break is generally worth more with stocks than bonds, which earn more of their returns in interest than capital gains. So crunch the numbers to make sure you still come out ahead.

Designing an optimal asset-placement strategy can be daunting. But the payoff is lower taxes--and more money to retire on.

By Anne Tergesen