It's All About (Asset) Location

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Objectives

- Define what ***Asset Location*** is
- Explain why ***Asset Location*** matters
- Provide some practical guidelines for ***Asset Location***
- Have you leave here today understanding the following slide

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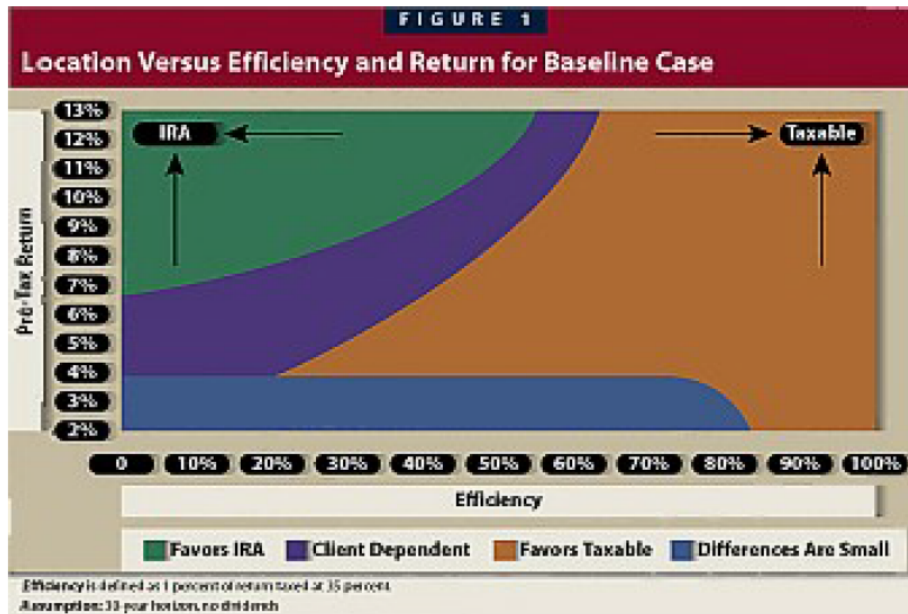

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Asset Location Defined

How investors distribute investments across:

- Taxable, Tax-deferred & Tax-free Investment accounts
- Trust accounts
- Partnerships
- Charitable entities
- Insurance/Annuities

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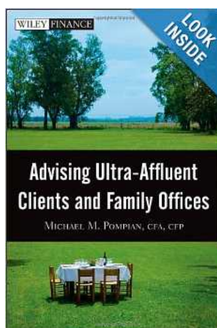
Why Should You Care?

"The most brilliantly conceived investment portfolio and estate plan can be seriously undermined by the failure to locate assets in the right locations."

-Michael Pompian,
Partner at Mercer Hammond Investment Consulting



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Why Should You Really Care?

Research has shown effective asset location decisions can add 0.2-0.5% of "free" additional annual return.[1]

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How Much Can This Really Add?

Additional return from Asset Location can add from 6 to 15% to the terminal value over a 30 year period.

Additional Annual return	(Years)					
	5	10	15	20	25	30
0.20%	1%	2%	3%	4%	5%	6%
0.35%	2%	3%	5%	7%	9%	10%
0.50%	2%	5%	7%	10%	12%	15%

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Asset Location Choices

In the Estate

Tax-Deferred

Taxable

Tax-Free

Out of the Estate

Tax-Deferred

Taxable

Tax-Free

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Make-Believe Portfolio[2]

Client Assets:

Taxable Account $500,000

Traditional IRA $500,000

Simplified Assumptions:		
	Expected Return	Taxed At
Stocks – 50% Allocation	10%	15% (Long-Term Capital Gain)
Bonds – 50% Allocation	5%	25% (Ordinary Income)
Investments are held for 30 years. No investment turnover or rebalancing.		

Should bonds be held in the taxable account, or the IRA account?

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Bonds in the Taxable Account

- **Bonds (taxable)**
  - 5% gross return, less 25% ordinary income tax **(each year)** = 5% x .25 = 1.25%
  - **3.75% after tax return** (5% -1.25%)
  - **$1,508,736** at the end of 30 years ($500,000 x 1.0375^30)
- **Stocks (tax-deferred)**
  - 10% gross return for 30 years = $500,000 x 1.10^30 = $8,724,701
  - Less 25% tax due on all withdrawals **(after 30 years)** = $8,724,701 x (1-.025) = **$6,543,526**
- **Total = $8,052,262**

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Bonds in IRA Account

- **Bond (tax-deferred)**
  - 5% gross return for 30 years = $500,000 x 1.05^30 = $2,160,971
  - Less 25% tax due on all withdrawals = $2,160,971 x (1-.25) = **$1,620,728**
- **Stock (taxable)**
  - 10% gross return for 30 years = $500,000 x 1.10^30 = $8,724,701
  - Less **15% (LTCG)** tax due on the **gain** at the **end** of 30 years = ($8,724,701-$500,000) x (1-.015) = **7,490,996**
- **Total = $9,111,724**

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Example 1 (continued)

	Bonds in Taxable	Bonds in IRA
Bonds	$1,508,736	$1,620,728
Stocks	$6,543,526	$7,490,996
Total	**$8,052,262**	**$9,111,724**

- **Bonds** defer annual ordinary income taxation until withdrawal
- **Stocks** enjoy preferential LTCG tax rates and taxes owed **when** gain is realized

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Real World Portfolio #1

A $2 Million portfolio with several "locations"

Account	Amount	Constraint
Joint Taxable	$100,000	N/A
Traditional IRAs	200,000	N/A
Roth IRA	100,000	N/A
Employer Tax Deferred 403b &457b	400,000	Mutual Funds Only
Canadian Retirement Accounts	1,200,000	U.S. ETF's

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Real World Portfolio #2

A $10 Million portfolio

Account	Amount
Joint Taxable	$9,700,000
Traditional IRAs	100,000
Roth IRA	13,000
Employer Tax-Deferred 401k	187,000

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Another Factor - Expected Return

- If the expected return of the asset class is low, there is simply not much benefit to tax-deferral
- The higher the expected return, the greater the benefit from tax-deferral

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Differences in Ending Values (Ordinary Income Asset)

Sherice invests $100,000 in taxable bonds for 30 years.
Should she locate these bonds in a **Taxable** or **Tax-Deferred** account?

Investment Amount	$	100,000
Term in Years		30
Ordinary Income Tax Rate		25%

Expected Return	Tax-Deferred Account	Taxable Account	Difference
2%	$160,852	$156,308	$4,544
4%	268,255	242,726	25,529
6%	455,762	374,532	81,230
8%	779,699	574,349	205,350
10%	1,333,705	875,496	458,210

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Differences in Ending Values (Capital Gain Asset)

Wendell invests $100,000 in a U.S Broad Market Index fund.
Should he locate the fund in a **Taxable** or **Tax-Deferred** account?

Investment Amount	$	100,000
Term in Years		30
Ordinary Income Tax Rate		25%
Long Term Capital Gain Rate		15%

Expected Return	Tax-Deferred Account	Taxable Account	Difference
2%	$160,852	$168,966	$8,114
4%	268,255	375,663	$107,408
8%	779,699	955,326	$175,626
10%	1,333,705	1,583,199	$249,494
12%	2,271,994	2,646,593	$374,599

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But What Happens When

- Capital gain rates max out at the 23.8% federal bracket?
- Net Investment Income tax rates max out at the 43.4% top bracket?
- Taxpayer is subject to state income tax?
- Municipal bonds enter the mix?
- Investor's accounts are much more lopsided as either nearly all taxable or tax-deferred?

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Least Tax Efficient
Place in Tax-Free or Tax-Deferred

Most Tax Efficient
Place in Taxable[3]

Very Inefficient
- High-yield (taxable) bonds
- Real estate/REIT
- Any high-turnover active stock fund
- Small-cap active fund

Moderately Inefficient
- Small-cap or value index (without ETF class)
- Large-cap active fund
- Bonds
- Value ETF or index fund with ETF class

Efficient
- Small-cap or mid/cap growth/blend ETF. or index fund with ETF class
- Small-cap international ETF, or index fund with ETF class
- Emerging markets index

Very Efficient
- Tax-managed small-cap
- Large-cap growth/blend index or total U.S. market index
- Large-cap international index
- Tax-managed large-cap
- Tax-managed international

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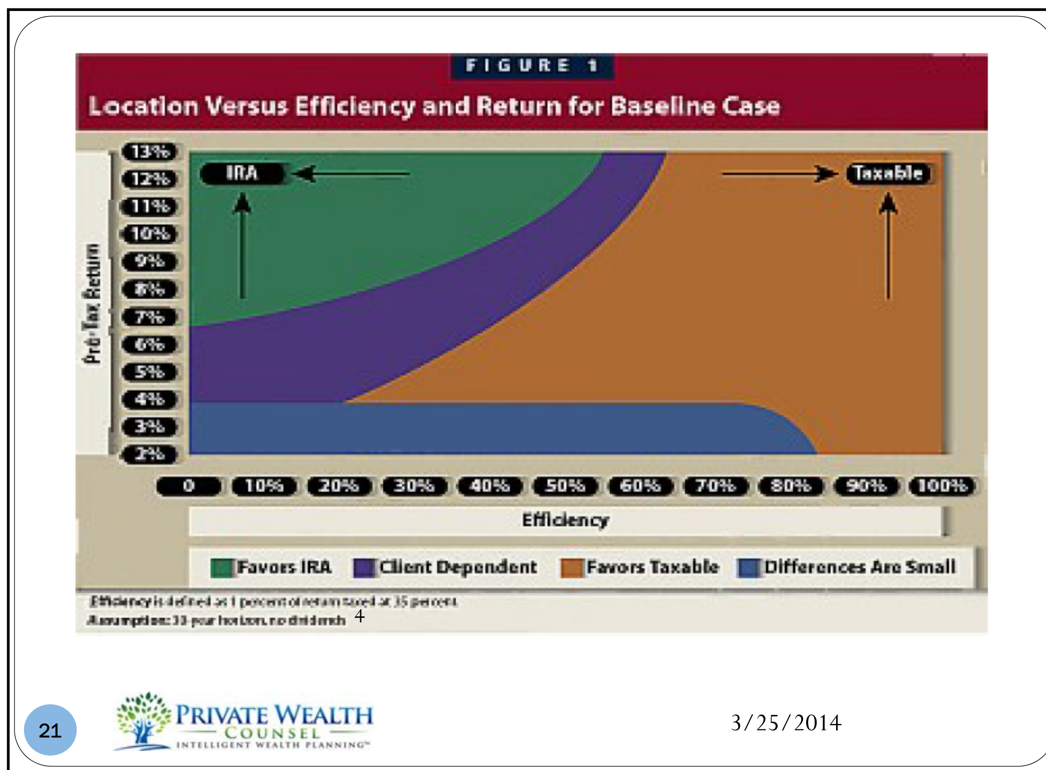

A Practical Approach

1. Fill up the Roth IRA with assets class(es) with the highest expected return (and the more tax inefficient the better).
2. Fill up tax deferred accounts with most tax inefficient assets first with some minimum level of return.
3. Allocate those assets with high expected returns and high tax efficiency to taxable accounts.
4. Locate higher growth assets to longer-term accounts.
5. Generate taxable income for generations in lower brackets.
6. Use low basis securities to fund charitable Donor Advised Funds/ foundations/direct gifts.

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Location Choices to Avoid Long-Term Capital Gains:

- Appreciated assets held more than one year
  - **Get a step up at death**
    - Recall Sam Donaldson's presentation at last month's Estate Planning Symposium – substitute low basis securities from grantor trust to grantor when death is imminent
  - **Donate to charity** - let charity sell and realize the gain
    - Give direct to charity or Donor Advised Fund or Foundation
    - Look to "Harvest Capital Gains" from a taxable portfolio, then merely repurchase the same holding and enjoy a "step-up in basis" [5]

(An article on this topic is included in the handout.)

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Location Choices to Defer Long Term Capital Gains:

- Use appreciated assets held more than one year to fund
  - Charitable Remainder Trust
  - Charitable Gift Annuity
- Defer capital gains from asset sale until payments are received by donor/beneficiary

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Other Location Considerations

- Long Time Horizons Favor Unrealized Gains
  - Asset Protection/Generation-Skipping/Dynasty Trusts
- Charitable Lead & Grantor Retained Annuity Trust
  - Locate high expected growth assets in an attempt to have appreciation in excess of prevailing 7520 rate outside of estate
- Consider a Self-Directed IRA or "Romney IRA"
  - Hold potentially highly appreciable investments in private equity, partnerships, real estate, etc.

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Increasing the Tax-Free Bucket
Idea # 1 –Fund Roth IRAs Early

- Anyone under age 70½ with earned income (or a spouse with earned income) can fund a ROTH IRA
- What is the youngest age one can have a ROTH IRA?

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"Baby Holly"– played by Elanor Anne Wenrich

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Can Baby Holly Fund a Roth IRA?

Let's make the following assumptions:

1. She is not married, nor head of household for tax filing purposes.
2. She will make more than $121,000 in 2014.
3. She is therefore precluded from ***directly*** funding a ROTH IRA.

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Can Baby Holly Fund a Roth IRA?

Assumptions continued:

4. Baby Holly's parents use a cutting edge, Miami-based investment advisor who recommends she fund an after-tax ***<u>Traditional</u>*** IRA at the beginning of each year.

5. As a matter of course, said advisor routinely runs Roth IRA conversion analyses for all of his clients at least once a year.

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Should Baby Holly Convert?

- After-tax IRA funded on 1/5/14 with $5,500.00
- Roth IRA analysis is run on 3/5/14
- Funds had not yet been invested, and as a result of earning 1.00% in a money market account for 60 days, the account balance is now approximately $5,509.04
- Analysis concludes that the conversion will cost Holly: $9.04 x 39.6% or $3.58 (plus applicable state income tax)
- Advisor recommends Baby Holly do a Roth Conversion

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TIPRA to the Rescue!

The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), repealed the income limits on Roth ***conversions***, starting in 2010. This provision allows high wage earner Baby Holly the ability to do a Roth conversion.

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Beware IRC Section 408(d)

From the Journal of Accountancy – April 2013 **"Making a "backdoor" Roth IRA contribution**

- "**Sec. 408(d)(1) ordinarily requires a pro rata allocation between taxable and nontaxable amounts** (using the Sec. 72 annuity rules) when reporting distributions received from an individual retirement plan (an individual retirement account or annuity (IRA)). The practical effect is that a taxpayer must recover any nontaxable amount (basis) ratably as distributions are received, by tracking basis on Form 8606, *Nondeductible IRAs*. The tax liability on such a distribution can sometimes lead a taxpayer to improperly conclude his or her best option is to recover the nontaxable portion ratably as distributions are received, without considering a Roth conversion."
- "Taxpayers looking for tax benefits and flexibility should consider Sec. 408(d)(3)(A)(ii), which provides an important but sometimes **overlooked exception to the pro rata rule. It applies to certain distributions rolled over to an eligible retirement plan** (that is not an IRA). For this exception to apply, "the maximum amount which may be paid into such plan may not exceed the portion of the amount received which is includible in gross income (determined without regard to this paragraph)." [6]

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Increasing the Tax-Free Bucket
Idea # 2 - The Romney IRA (but better)

- Work at a firm that maximizes contributions to a Simplified Employee Pension (SEP-IRA) ($52,000 for 2014)
- Convert contribution to a Roth IRA
  - "A SEP-IRA account is a traditional IRA and follows the same investment, distribution, and **rollover rules** as traditional IRAs."[7]
- Purchase shares in early-stage private equity firms

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Increasing the Tax-Free Bucket
Idea # 3 – Outside of the Estate

- Fund Roth IRAs of kids, grandkids, and other beneficiaries
- Own life insurance outside of the estate

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Mr. Sachs provides fee only, fiduciary representation to clients, their families, and businesses as part of a long-term consultative approach to help them achieve their investment, financial planning, and charitable goals. He is a Principal with Miami based Private Wealth Counsel and was most recently a Principal of nationally recognized Wealth Management firm.

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