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Asset location

A new lever in strategic retirement saving to reduce taxable income

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Introduction

Asset location is a financial strategy used to incorporate tax management into financial plans. Not all assets and investment vehicles are created equal when it comes to taxes.

Certain assets can provide high yields and investment returns but come at the cost of an increased tax burden, while others may provide better taxable benefit but lack the return or the investment profile to meet desired financial objectives.

Asset location was created to allow investors to diversify portfolios through a combination of investment strategies and maximize tax efficiency, giving access to the proper assets for the desired investment objectives without the drag of higher taxes and investment limitations.

To gain a better understanding of the importance of asset location, the following topics are discussed:

1 **Asset location:** strategic theory
2 **Asset location:** in practice
3 **Asset location:** strategies and tools
4 **Asset location:** conclusion

Asset location

Tax-smart retirement saving

We all acknowledge the power of asset allocation, of diversifying investments across a variety of asset classes to manage market volatility and protect against risk.

Yet even with the most vigilant allocation and rebalancing of portfolios, whether it be 80/20, 60/40 or 50/50 stocks/bonds, investors may still fall short of generating the income needed in retirement. Often overlooked are smart tax strategies that can help reduce the potential shortfall.

Asset location. The taxable status of the assets that generate income in retirement is equally important. If, like the average American, 90% of retirement assets are held in tax-deferred 401(k), 403(b) or 457 and IRA accounts, a retiree's income will be 100% taxable — possibly at a higher tax rate than a preretiree saver would pay today.

Here are examples demonstrating how asset location, the taxable status of assets, can impact the amount of income for retirees:

The following hypothetical examples assumes a retiree with $1.5 million in retirement assets at age 65 continues to grow assets at a 5% rate of return. All examples assume the retiree takes annual income for 25 years, such that the account is zero at the end. The tax assumptions are:

- For the tax-deferred account, all income is 100% taxable at a 30% assumed tax rate.
- The taxable example uses a brokerage account with 50% of the income being taxed at the capital gains rate of 15% (assumes cost basis is 50%, which is non-taxable).
- The tax-free account uses a Roth IRA in which all income received is tax-free.

Based on these assumptions, a retiree may have a difference of $30,000 in after-tax annual income in retirement between tax-deferred and tax-free accounts. The difference would be greater using higher tax rates and less with lower tax rates.

While the best retirement plans informed by asset location hold a mix of all three categories, needs will vary by individual.

Tax-deferred

100% in 401(k), 403(b) or 457 and IRA funds at 65, lasting 25 years is approximately:

$71,000/yr.
after tax

Taxable

100% in a brokerage account at 50% basis, lasting 25 years is approximately:

$91,000/yr.
after tax

Tax-free

100% in a tax-free Roth, lasting 25 years is approximately:

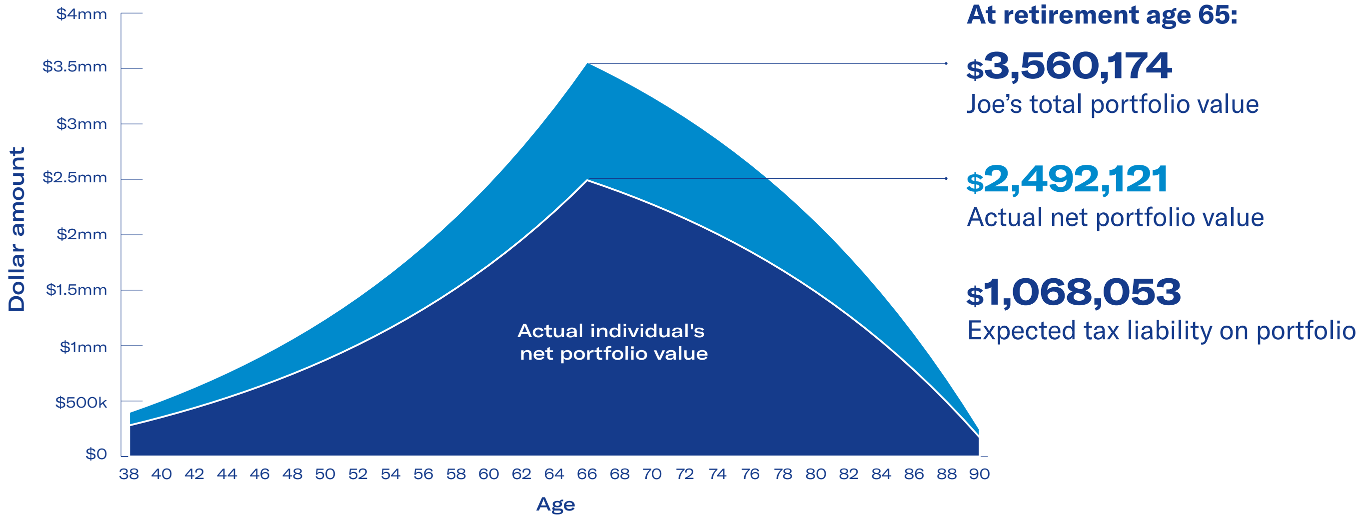
$101,000/yr.
after tax

In a perfect world, we would fund our tax-free accounts and there would be no limit to the amount of growth and distribution we could access through this vehicle. But, there are limitations on the benefits of each account. The asset location strategy recognizes that there is an optimal mix to funding all three categories and positioning certain assets within each. Selecting a balance between 401(k), 403(b), 457, IRAs, HSAs, 529 Plans, Roth 401(k)s or Roth IRAs, brokerage, cash value life insurance, and other vehicles is the key to unlocking the tax benefits of asset location.

How much difference can asset location make?

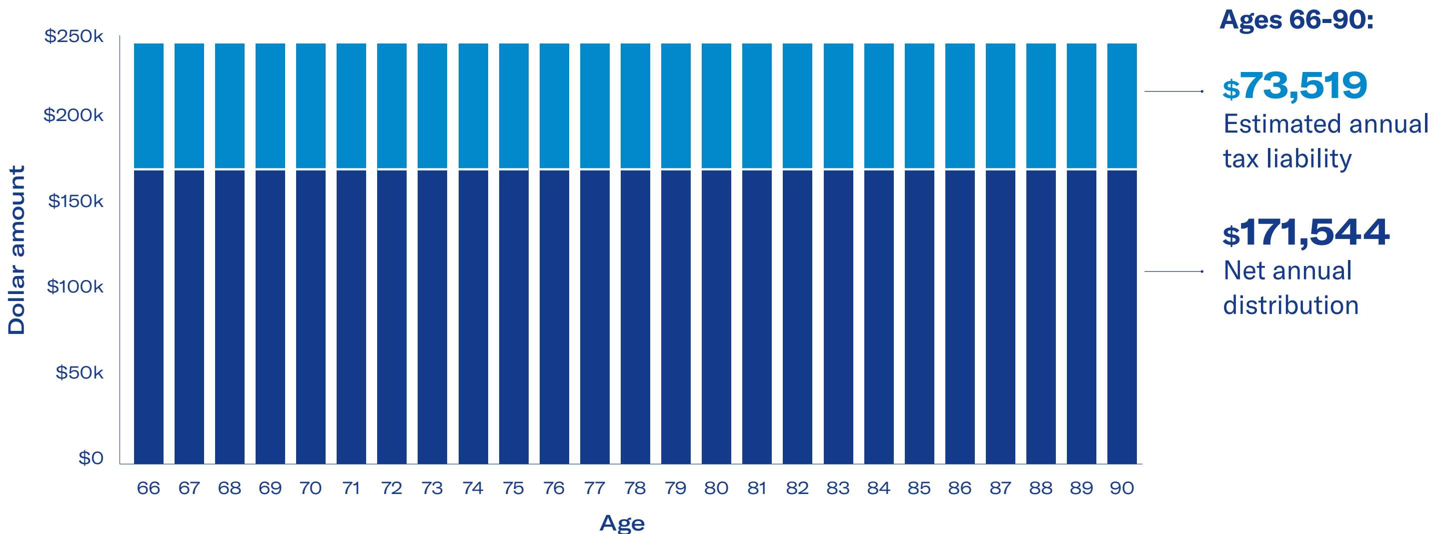
To illustrate the very real impact of asset location on what retirees get to keep and spend of their retirement savings, consider this example of how the tax position of the savings sources being tapped for retirement income can vary retirement income and lifestyle:

What you earn isn't always what you keep



Joe, a 37-year-old engineer, contributes $22,500 per year pretax to his 401(k) and gets a $7,500 company match each year until he retires at age 65. Both pre- and post-retirement, his portfolio grows at 6%.

If we assume Joe's tax liability at any point in time is 30% (both on portfolio value and distributions), his gross annual income will be $245,063 until his 401(k) is depleted at age 90. However, after taxes, **Joe will only get to keep $171,544 of that in his pocket, and $73,519 will go to taxes.**



Asset location solutions

Building an asset location strategy that safeguards retirement portfolios against tax exposure requires an understanding of the account types within which to accumulate savings and their tax treatment upon distribution.

Tax-deferred income

401(k)s, 403(b)s, 457s, and other qualified plans, traditional IRAs, Social Security, annuities

Pretax dollars — fully taxable as ordinary income at distribution

Taxable income

Brokerage accounts, savings, money market, all 1099 income

Savings are taxed as they are accumulated in after-tax dollars

Tax-free distributions

Roth IRAs and Roth 401(k)s, municipal bonds, cash value life insurance, variable universal life

Distributions are tax-free in retirement

Each account type, tax-deferred, taxable and tax-free, has its strengths and drawbacks. Asset location is designed to enhance the benefits of each account and reduce the costs by smartly positioning assets in each group. By targeting certain assets within each account and balancing funding, you may significantly reduce your tax burden and greatly increase portfolio returns.

Taxable vs. tax-deferred calculator

For more specific insight into the tax status of savings and investments, Equitable has provided a calculator handy for illustrating impacts:

equitable.com/tax-strategies/tax-calculators/compare-taxable

Conclusion

Many financial professionals agree that the largest drags on portfolio performance in the long term are behavioral risks, fees associated with investing and taxes. Asset location seeks to reduce one of those biggest drags — taxes — without diminishing a preferred investment strategy, risk profile or certain objectives. By simply reviewing assets and their proper account location, you can significantly reduce tax burdens, which results in increased portfolio returns.

To learn more, or if you have questions, visit equitable.com/tax-smart.

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