
Where Should You Hold Equities?

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One common investment mistake some investors make has to do with the asset location decision – dividing assets between taxable and tax-advantaged accounts.

The conventional investment wisdom is to locate equities (those expected to have higher returns) in tax-advantaged accounts, and bonds in taxable accounts. Thus, many investors hold their equities in tax-advantaged accounts – such as IRAs, profit sharing plans, 401(k)s and annuities –

and then hold municipal bonds or other fixed-income investments in taxable accounts. However, the current tax structure should encourage investors to consider reversing this strategy.

There are five reasons one might prefer holding equities in taxable accounts.

- First, holding equities in tax-deferred accounts converts what could otherwise be long-term capital gains into ordinary income, subjecting the gains to the potentially higher income tax rates.
 - Second, in most cases, withdrawals from tax-deferred accounts prior to age 59½ are subject to a 10% early withdrawal penalty. In addition, required minimum distributions must begin no later than April 1 of the year after which you turn age 70½. Investors have the ability to time gains within their taxable accounts to take them in low-tax years (years when their marginal tax rate might be lower) and to potentially take losses in high-tax years.
 - Third, holding equities in taxable accounts creates the potential for step-up in basis upon death, thus avoiding all income taxes.
 - Fourth, holding equities in taxable accounts allows investors to donate appreciated shares to charities, avoiding taxes altogether.
 - Fifth, holding international equities in taxable accounts allows an investor to take advantage of the foreign tax credit (FTC). The FTC has no value in tax-advantaged accounts.
- Keep in mind that the location decision is a preference. Investors typically should choose first to fund tax-advantaged accounts.

Thus, if you do not have sufficient room in your taxable account to accommodate all of your equity holdings, you might still want to hold them in a tax-advantaged account.

Another bit of conventional wisdom that is typically wrong, is that investors who do not have enough room for their equities in tax-advantaged accounts should own them inside of variable accounts (VAs). For all the reasons investors should prefer to hold equities in taxable accounts versus tax-advantaged ones, they should also prefer to hold them in taxable accounts and not VAs.

Holding equities in a VA causes the loss of the potential for a step-up in basis for the estate of the investor, the inability to harvest losses, the inability to donate appreciated shares to charity and the loss of the foreign tax credit. In addition, should the buyer need liquidity prior to age 59½, unless the distribution takes the form of a life annuity, an additional 10% penalty would apply.

Besides all that, there is another reason to avoid VAs: their high costs. The only equity asset class that is likely to make sense for holding in a VA is REITs (real estate investment trusts) – because their dividends do not qualify for preferential tax treatment.

Summarizing, the tax advantages and the availability of tax-efficient funds such as index funds, ETFs and tax-managed funds should typically lead investors to prefer to hold equities in taxable accounts. Additional discussion with your tax consultant is warranted. We can help you construct a portfolio with your equities and bonds in the proper place, allowing you to focus on medicine and your family, not the stock market.



Bill Bender is a principal of Mason Road Wealth Advisors representing the well-respected Dimension Funds. SLMMS has a special partnership with MRWA, which offers SLMMS members a discounted advisory fee and access to these highly sought funds with a lower minimum investment than commonly offered. For more information, call Bill Bender or Lori Plescia, Director of Retirement Plan Services at (314) 576-1350.

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