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Fundamental Portfolio Management Series

Save Money by Carefully Deciding How Your Investments Should be Separated into Your Taxable and Tax-Qualified Accounts

We believe that investors who pay attention to this area of portfolio management will save themselves money. How much depends upon a number of factors, but for some investors it could be 0.30 - 0.50% of your portfolio's value every year. If you have a portfolio of \$100,000, that comes to \$300 to \$500 in the first year. This may not sound like much money, but if you save it every year and your overall portfolio grows, the savings could be substantial. While we cannot predict the future, we believe that committing an hour or so of your time to understand these concepts is definitely worthwhile. First, you can determine if there are good opportunities to start saving money now. Secondly and just as importantly, you can start to incorporate these best practices into all your buying and selling decisions. If you do that, hopefully you will reap the potential long-term benefits of this strategy with relatively little effort each year.

The strategy hinges on the fact that most investors hold investments in two types of accounts: one that is taxed "normally" and another which has special tax advantages such as 401(k) or IRA. In order to distinguish them we will refer to the "normally" taxed accounts as "taxable" and the accounts with special tax advantages as "tax-qualified."

Over the past few years, many tax-qualified plans like 401(k)s and IRAs have been giving account holders more control over how their money is invested. Farm Creek recommends you use this flexibility to maximize your after-tax returns by carefully separating your investments into your taxable and tax-qualified accounts.

This may sound complicated and difficult, but it is really not that hard. This short report, a little patience and some basic math are all you need. Here is the plan:

- I. First, read the overview to see the big picture and how the strategy works.
- II. Next, learn some important features of taxable and tax-qualified accounts. Or, you can skip this section without losing continuity.

- III. Now make a list of your major investments. Investments such as stocks, bonds and mutual funds should be included, but you can leave out real estate and other investments that are difficult to hold in a tax-qualified account. This section requires some patience.
- IV. We will now walk you through the steps to calculate the “potential” tax for each investment. This part calls for a little basic math.
- V. You will finish by creating a “road map” which will be your guide for efficiently separating your investments into taxable and tax-qualified accounts.
- VI. Finally, read this last section to see how we arrived at our estimates of the strategy’s potential savings. This part may also be skipped.

We want to remind readers that when evaluating investment strategies, they should carefully consider all their unique circumstances before making decisions. These include but are not limited to:

- Liquidity needs
- Investment objectives and time horizon
- Risk tolerance
- Transaction costs
- Potential legal and tax considerations

Please do not work to capture 0.30 - 0.50% with this strategy and inadvertently throw away 1.00 – 2.00% or more in the process. For individual tax advice, please contact a tax professional.

I. Strategy Overview

The key to the strategy is that the government allows us, in fact encourages us, to have both taxable and tax-qualified accounts, which are not surprisingly taxed at different rates at different times. But, the after-tax return for many investments can be greatly affected by the type of account in which they are held. In most cases, investors need to determine which of their investments would be best held in their tax-qualified accounts. The basic rule of thumb is to hold your investments with highest “potential” taxes in your tax-qualified account.

Here is a simple example (although it may not seem simple until you finish this report). Suppose you have two investments: \$50,000 in a stock index fund and \$50,000 in a bond index fund. If your IRA (a tax-qualified account) has room for \$50,000 of investments, which investment should you hold in the tax-qualified account? All else being equal, the rule of thumb is that you should hold investments with the highest “potential” tax in the IRA. So we need to look at the income from these two investments and how they are taxed. If the bond fund has interest income of 4% a year; and this income is taxed at 25%, the “potential” tax is 1.00% of your investment ($0.04 * 0.25 = 0.01$ or 1%). If the stock fund generates dividend income of 2%, which is taxed at 15%, you potentially lose

0.30% to taxes ($0.02 * 0.15 = 0.003$ or 0.3%). Therefore, in order to earn the highest after-tax returns it is best to hold the bond fund in the IRA and the stock fund in your taxable account.

II. Some Basics of Tax-Qualified Accounts

The basics of how tax-qualified accounts work are relatively simple. Tax-qualified plans such as a 401(k), 403(b) or Traditional IRA are generally funded with pre-tax income and the assets are allowed to grow untaxed. When funds are removed from the plan they are taxed at the investor's ordinary tax rate at that time. Except under special circumstances funds cannot be removed before age 59½ without a penalty and after age 70½ you are required to make annual withdraws. Tax-qualified plans are very attractive since they allow investors to invest pre-tax dollars. Even though you have to pay taxes on the income eventually, it is a big advantage to have more cash to invest today. If your marginal tax rate is 25%, you get to invest \$100 per-tax instead of \$75 after-tax. To give you a sense of how important this is, your overall returns could be 1-2 percentage points higher per year over a 10 year period. The exact result will depend on market behavior and actual tax rates in the future. The most important reason investors would not want to do this would be if they thought their tax rates would be much higher when the money is withdrawn. There are also other positive aspects to these plans which include:

- Possible matching contributions by your employer.
- The hope or expectation that your tax rate will fall before the funds are withdrawn.
- You actually own the plan. Most pension plans are just promises made to you by a company, union or the government and these promises can be broken.

One thing to note in this discussion is that there are differences between Roth IRAs and Traditional IRAs. Roth IRAs are funded with after-tax dollars unlike Traditional IRAs which are mostly funded with pre-tax dollars. For some investors Roth IRAs are very attractive as all income earned on assets goes untaxed if withdrawn properly. We caution readers that the main focus of this report covers Traditional IRAs, not Roth IRAs. With Roth IRAs, we would alter the analysis to more thoroughly take into account capital gains which occur on an ad hoc basis, but we do not think the changes would be significant.

Let us move on to taxable accounts, which do not have any special tax or savings benefits. These accounts, like an IRA will probably be located at a brokerage firm, a mutual fund company or a bank. Collectively we will refer to your investments in these accounts as "taxable." How they are taxed can be very complicated and that is why tax professionals are very important. But for this note we want to lay out a few important highlights.

- Gains on investments are called capital gains and are generally only taxed when the investment is sold. If the investment is held for less than one year gains are taxed as a "short-term capital gain." Under current law, short-term capital gains are taxed at the same rate as a person's other or "ordinary" income. Gains on investments held for more than one-year, are taxed as "long term capital gains" at

a lower preferential rate of 5% or 15% or a combination of both depending on the taxpayer's marginal tax rate.

- Many mutual funds must annually distribute their realized short and long-term capital gains. Owners of these funds are responsible for the taxes even if they do not sell the fund.
- Dividend income now comes in two types, "qualified" and "non-qualified." "Qualified" dividend income is taxed at your preferential rate, the same as long-term capital gains. "Non-qualified" dividends are taxed as ordinary income.
- Taxable interest income is taxed just like short-term capital gains, at the taxpayer's ordinary tax rate. Importantly, this income is taxed even when there is no actual payment of interest as with zero-coupon bonds or adjustments to Treasury Inflation Protected Notes (TIPs). Interest on municipal bonds is generally untaxed at the Federal level.
- This analysis excludes real estate investments. We also exclude any impact of the Alternative Minimum Tax (AMT) and state and local tax issues from this analysis.

III. Listing Your Major Investments

The easiest way to tackle this is to list your investments and associated tax considerations as shown below and in Table 3. (We recommend using a spreadsheet, but you do not need to.) When listing your major investments, do not go crazy itemizing everything; grouping similar stocks, bonds or funds together is fine, especially at this point. When making decisions, if you find some of the investments fall on the cusp, you can always go back and drill down further. While it does not really matter in what order you list your investments, here is a simple example that makes sense.

Short-term Fixed Income

- CDs
- Treasury Bills
- Exchange Traded Funds
- Short-term Fixed Income Mutual Funds

Bonds - Intermediate & Long Term Fixed Income

- Exchange-Traded Funds (ETFs)
- Individual Bonds
- Bond Mutual Funds

Tax-Free Bonds

- Municipal Bond Funds
- Individual Municipal Bonds

Stocks

- Exchange-Traded Funds (ETFs)
- Index Funds

Individual Stocks (as a group)
 Stock Mutual Funds
 REIT Funds

IV. Calculating Each Investment's Potential Tax

Now that you have your list of investments, continue with these steps to calculate the “potential” tax.

1. For each investment determine the amount of annual income you expect in percentage terms. For instance, short-term fixed income investments might yield income of 1% and corporate bonds around 5%. For stocks and stock index funds, use their dividend yield as your income estimate. Remember, some investments generate more than one type of income. This is especially true with mutual funds which must distribute their short and long-term capital gains. If you use our suggested layout in Table 3 this information should be entered in column B.
2. For each income stream listed in step 1, determine what type of income it is (see Table 1). Bonds generate Interest Income while stocks and stock index funds generate mostly Qualified Dividends. This information goes in column C.
3. Find your marginal tax rates in Table 2. Investors will have two tax rates; one for ordinary income which includes interest income and short-term capital gains, and a lower preferential rate for qualified dividends and long-term capital gains. In the Table 3 we use hypothetical tax rates of 25% for ordinary income and a 15% preferential rate. Your correct rates should be entered in column D.
4. Now to calculate the “potential” tax, multiply the expected income (col. B) by the tax rate (col. D). For example, the Short Gov't. Fund has an expected income of 2% that would be taxed at 25%. This would result in a “potential” tax of 0.50% ($0.02 * .25 = 0.005$ or 0.50%). Enter these results in column E.
5. Finally rank your investments from the highest to the lowest by their “potential” tax and put the result in column F.

Table 1

Types of Income and Federal Tax Rates

<u>Type of Income</u>	<u>Tax Rate Category</u>
Short-term Capital Gains	Ordinary Income
Long-term Capital Gains	5% or 15% (See Table 2)
Nonqualified Dividends (i.e. REITS)	Ordinary Income
Qualified Dividends	5% or 15% (See Table 2)
Interest Income	Ordinary Income
Interest on Municipal Bonds	Zero

Table 2

Marginal Tax Rates for 2004

Total Income greater than:	<u>Filing Status</u>		Ordinary <u>Tax Rate</u>	Preferential Rate for Qual. Divs. & LT Gains
	<u>Single</u>	<u>Married</u>		
0	0	0	10%	5%
7,150	14,300	14,300	15%	5%
29,050	58,100	58,100	25%	15%
70,350	117,250	117,250	28%	15%
146,750	178,650	178,650	33%	15%
319,100	319,100	319,100	35%	15%

Table 3

Potential Federal Tax if Assets are Held in Taxable Account

<u>Asset</u> (A)	Hypothetical Estimated <u>Income</u> (B)	<u>Income Type</u> (C)	<u>Tax*</u> <u>Rate</u> (D)	Potential <u>Tax</u> (E)	<u>Tax Bite</u> <u>Rank</u> (F)
<u>Fixed Income</u>					
Short Gov't. Fund	2%	Interest	25%	0.50%	5
Bond Fund	4.0	Interest	25	1.00	
	0.5	LT Cap. Gains	15	<u>0.08</u>	
		Total		1.08	3
Municipal Bond Fund	4.0	Municipal Interest	0	0.00	
	0.5	LT Cap. Gains	15	<u>0.08</u>	
		Total		0.08	7
<u>Stocks</u>					
Stock Index Fund	2.0	Qualified Divs.	15	0.30	6
Value Mutual Fund	0.5	ST Cap. Gains	25	0.13	
	2.0	LT Cap. Gains	15	0.30	
	2.0	Qualified Divs.	15	<u>0.30</u>	
		Total		0.73	4
Aggressive Growth Fund	5.0	ST Cap. Gains	25	1.25	
	2.0	LT Cap. Gains	15	<u>0.30</u>	
		Total		1.55	1
REIT Fund	5.0	Nonqualified Divs.	25	1.25	
	1.0	LT Cap. Gains	15	<u>0.15</u>	
		Total		1.40	2

* Hypothetical Rates: Ordinary Income at 25% and Preferential Income at 15%.

V. Shift investments between accounts in order to minimize tax payments.

Now take the information from Table 3 and re-sort the order of your investments based upon their rankings in column F. The result should resemble the format illustrated in Table 4. This is your road map for making decisions. To the extent reasonable, you will want to fill your tax-qualified accounts with the investments at the top of your list and work your way down.

In our example the asset with the greatest “potential” tax is the Aggressive Growth Fund. It has a “potential” tax of 2.5% due to short-term capital gains of 10% and a tax rate of 25% ($0.10 * 0.25 = 0.025$). The second most highly taxed investment is the REIT fund where dividends are treated as ordinary income and do not qualify for preferential tax treatment. Near the bottom of Table 4 are stock index funds which distribute a small amount of dividends and little or no capital gains. And of course tax-free municipal bonds, upon which you pay no federal income tax, are at the bottom.

Table 4

Assets Ranked by Potential Tax Liability

<u>Strategy</u>	<u>Rank</u>	<u>Potential Tax</u>
Aggressive Growth Fund	1	1.55
REIT Fund	2	1.40
Bond Fund	3	1.08
Value Mutual Fund	4	0.73
Short Gov't. Fund	5	0.50
Stock Index Fund	6	0.30
Municipal Bond Fund	7	0.08

Before you start rebalancing your portfolio, remember these points:

- Use common sense and plan before you start executing.
- You may not be able to do everything you want. But do not change a well planned portfolio simply to gain a small savings. It is not sound portfolio management.
- Be aware of all transaction costs before trading, including potential taxes.
- This analysis does not take everything into account. In particular, it does not factor in investments which generate large capital gains on a regular basis. If large capital gains are expected every few years, the asset may deserve a higher ranking in Table 4. On a related point unrealized gains are left out also. But unless an investor plans to realize these gains often, the analysis stands up.
- Lastly, never take money out of your tax-qualified accounts without consulting a tax expert.

One issue which at first confuses many investors is holding investments likely to be sold in an emergency, in a tax-qualified account where they can not be touched. Here is our recommended solution - in an emergency, if you need \$5,000 from the short term bond

fund in your IRA; you should sell \$5,000 of an asset in your taxable account (i.e. stock index fund) to get the cash you need. Then in the IRA, move \$5,000 from the short term bond fund to a stock fund. After the transactions your short-term investments will be reduced while your other investments will remain unchanged. Obviously you don't want to do this very often if your transaction costs are high as this took three transactions rather than one to complete the transfer. Also, there could be a tax liability on the sale of the fund in the taxable account.

We have seen some professionals suggest that a portion of each investment belongs in your tax-qualified account. But having all your investments represented in your tax-qualified account, you will most likely be able to rebalance your portfolio each year while only making trades in the tax-qualified account and this should help avoid potential capital gains taxes. All of this is true, but we are not convinced that the potential savings are worth the added paperwork and complexity especially taking into account that putting stocks in tax-qualified plans and potentially forcing bonds into the taxable accounts has an immediate cost.

VI. Potential Savings

As mentioned in the beginning, the affect of “correctly” and “incorrectly” separating your investments can potentially result in a return difference of 0.30 – 0.50% of assets a year. In this section we will use an example to illustrate this difference in hypothetical returns. We will start with the same assumptions we used in section I.

1. The investor has two investments: \$50,000 in a stock index fund and \$50,000 in a bond index fund.
2. The investor's tax-qualified account has \$50,000 in it and therefore can hold either all the stocks or all the bonds. The other must sit in a taxable account.
3. Should the investor put the bonds or stocks into the tax-qualified plan?
Hopefully, everyone now knows the answer!

It turns out that under the current tax code it is always more advantageous to hold the bond fund in the tax-qualified plan and the stock fund in the taxable account. If done the other way around, returns would be 0.30 – 0.50% lower every year.

Table 5 shows the hypothetical after-tax returns of holding the investments in either configuration. Investments in both accounts grow at the same rate but are taxed differently. In the taxable account interest income and/or dividends are taxed at the appropriate rate and reinvested each year while capital gains are only taxed at the end of the period. In the IRA the only tax liability occurs when the assets are withdrawn after ten years.

It is interesting to note that while it would generally be assumed that the tax-qualified plan would be the optimum account for either asset, it is not true. The tax code's preferential treatment of long-term capital gains and qualified dividends overwhelms the power of dividend income growing tax-free and the stock fund performs better outside a

tax-qualified plan at all tax rates. On the other hand, it is almost always more advantageous to hold your interest-bearing investments in a tax-qualified account since interest is taxed at ordinary rates.

Table 5

Account Holding Effect on After-Tax Returns

Annual Rates with a 10-Year Holding Period

<u>More Tax Efficient</u>		<u>Less Tax Efficient</u>		<u>Difference</u>
				<u>More-Less</u>
Taxable: Stocks	7.04%	IRA: Stocks	6.45%	0.59%
IRA: Bonds	3.94%	Taxable: Bonds	3.75%	0.19%
Total	5.49%	Total	5.10%	0.39%

Tax, Rate and Return Assumptions:

Marginal Tax Rate:	25%	Stock Capital Gains:	6.5%
Interest Rate:	5.0%	Dividends:	1.5%

Now is the time to take action. If you have gotten this far, collecting the information and doing the work will not be that hard. Do it!