by Andrew Huber and Lester Law

Asset Location: Why Attorneys Should Bridge the Perceived Investment Gap

When it comes to investments, the buzzwords today are "asset allocation." While asset allocation is a critical step in the process of portfolio design, of equal importance is *asset location* — the process of "locating" assets in appropriate accounts. This article addresses the perceived gap that exists between advice provided by the client's investment advisor and estate planning attorney, and how the attorney can help close this gap by informing the client of the significance of "asset location."

Consider the following scenario: Client, Hayley, a 71-year-old widow, visits with her attorney, Jordan, seeking estate planning advice. Hayley's financial situation is summarized in the chart below.

In the course of his review, Jordan observes that the documents created by Hayley's late husband include 1) a generation-skipping transfer (GST) exempt credit shelter trust, which entitles Hayley to income for her life, with assets to continue to be held in trust upon her death in multi-generational descendants' trusts; and 2) a non-GST exempt marital trust entitling Hayley to income for her life, with assets to be distributed upon her death to Hayley's adult daughter, Sophie. Jordan also notes that Hayley's estate plan (a pour-over will with revocable trust) is a mirror image of her late husband's plan. The provisions governing the payment of estate taxes do not allocate any such taxes to the IRA or other nonprobate assets.

Finding Hayley's will and revocable trust adequate, Jordan explains the fluidity of the estate tax laws and that Hayley should revisit her plan when there is more certainty (perhaps later in 2010). In the financial review process, Jordan discovers that Hayley's revocable trust is unfunded; thus, he suggests funding the trust with Hayley's $2.5 million taxable investment account. Jordan further advises that Hayley should keep her traditional IRA, miscellaneous assets (comprising primarily tangible personal property), and the home (her homestead under Florida law) in her individual name.[1] Jordan also reviews Hayley's beneficiary designation for the traditional IRA and finds that it is left to Sophie. Assuming Hayley's estate will be subject to estate tax laws similar to what is in effect in 2009, it is likely that most of Hayley's net after-tax assets (other than her traditional IRA) will be held in a GST exempt trust upon death.

After meeting with Jordan, Hayley meets separately with each of her various investment advisors (from Financial Institutions A, B, C and D). Hayley, perhaps like some of your clients, holds to the theory (whether right or wrong) that she should not "put all of her (investment) eggs in one basket" by housing everything with only one manager. Hayley, though, takes it one step further — she does not want communication between the managers. In each meeting, the advisors discuss the state of the economy, its consequent impact on markets in general, and her separate portfolio in particular.

Assets	Fair Market Value	Manager
Cash	$500,000	Self
Home	750,000	Self
GST Exempt Credit Shelter Trust	1,500,000	Financial Institution A
Non-GST Exempt Marital Trust	2,000,000	Financial Institution B
Taxable Investment Account	2,500,000	Financial Institution C
Traditional IRA (rolled over)	1,000,000	Financial Institution D
Miscellaneous	250,000	Self
Total	**$8,500,000**	

Hayley explains that she has a moderate risk tolerance for her age and level of wealth. Due to recent market events, each manager recommends a slightly revised asset allocation.

The Challenge

The attorney, Jordan, and the investment advisors, financial institutions A, B, C, and D, appeared to perform their perceived jobs; yet, there are gaps in the collective advice given to Hayley. What went wrong? As exclaimed by the captain in Paul Newman's iconic film, *Cool Hand Luke*, "What we've got here is ... failure to communicate," and perhaps, failure to understand. To be more precise, the investment advisors engaged the client without interacting with one another and/or with the attorney. Lack of communication is certainly not unique to the estate planning and investment worlds. But here, of course, the lack of communication has resulted in a failure on the part of Hayley's advisors to develop a cohesive plan. This was due to the client's reluctance to share information among the advisors; however, we find this reluctance can also spring from advisors who may fear stepping beyond their respective professional "zones" of expertise. Further, we understand the realities of clients who, motivated by the desire to control legal costs, direct their attorney to keep things "simple" by not discussing investment matters with financial advisors.

Why Should the Estate Planning Lawyer Care?

If you were Hayley's attorney, why should you care about her investments? The most important reason is that her interests are perhaps not being served as well as they might be. Lack of communication and understanding may lead to duplication of investments among the financial institutions, unnecessary concentrations in a particular type of asset or sector, higher fees, and lower overall performance given the client's circumstances, perhaps resulting in the reduced efficacy of the plan you, as Hayley's attorney, designed for her. As counselor, you can perform a great service by encouraging clients to provide necessary information about their estate plan to investment advisors, thereby allowing those managers to understand the planning goals with respect to each investment vehicle (*e.g.*, the various trusts). Taking it one step further, you should encourage clients to share their complete financial picture with all of the financial institutions so they can make better asset allocation and location decisions. The remainder of this article is designed to give you the tools to help make this happen.

Portfolio Design Begins with Asset Allocation

Most are aware that asset allocation describes the initial portfolio design process of diversifying assets among a variety of asset classes. Asset classes include such categories as cash and cash equivalents; U.S. large-, mid- and small-cap equities, international developed equities; emerging market equities; aggregate bonds; international developed bonds; high-yield bonds; hedge funds; private equity; real estate and commodities. The investment advisor allocates the portfolio among the various classes based on the client's stated cash-flow needs, risk tolerance, age, health, and a variety of other factors.

Generally speaking, clients with a higher risk tolerance will allocate more to equities relative to cash and fixed-income. Conversely, those with lower risk tolerance will allocate more to cash and fixed-income relative to equities. Equities generally are viewed as producing higher risk (with a corresponding expectation of higher returns), and cash and fixed-income generally are viewed as lower risk (with a corresponding expectation of lower returns). For purposes of this article, and to simplify our examples, we will speak in terms of allocating between equities and fixed income.[2]

What sometimes is overlooked is that asset allocation decisions can be made more effective by applying the allocation strategy to the full array of portfolios over which the client has an interest, and then applying the principles of asset location, discussed below, to decide which accounts should be used to implement the asset allocation goal.

The Next Step in Portfolio Design Is Asset Location

Asset allocation is just the first step. Asset location, by comparison, takes wealth management to the next level. What is asset location?[3] Many planners instinctively know what it is, even if they do not have a precise definition of the term. Asset location refers to the placing of assets into specific investments based on their tax characteristics, efficiencies, expected rates of return and the tax characteristics and efficiencies of the investment vehicles (*i.e.*, type of account) in which each investment may be located.[4]

Asset location, like asset allocation, is a process. The first part of the asset location process requires investment advisors to understand the client's objectives and the nature of the investment vehicles currently employed.

Second, the advisors should understand and discuss with the client the different *types* of assets (*e.g.*, cash, equities, fixed-income, etc.) and how they are taxed. For instance, the client must understand that different types of assets are subject to income tax at different rates (*e.g.*, interest income, qualified dividends and capital gains) or are not taxed at all (*e.g.*, municipal bonds). Although it is fairly easy to explain the taxability of some investments (*e.g.*, corporate and municipal bonds and stocks), it is often more difficult to determine the taxability of others due to the differing tax efficiency (discussed below) of a particular asset.

Third, not only should the taxability of the different types of investments be explained, understood, and communicated to the client, but advisors should also look at the specific investment vehicles and analyze their tax characteristics. The income tax and gift, estate, and GST tax ramifications of the vehicle should be examined.

From an income tax perspective, taxablé vehicles include assets owned individually, in trusts, and in various entities (*e.g.*, partnerships, corporations, etc.); tax-deferred vehicles include traditional IRAs, 401(k) plans, and nonqualified deferred compensation plans. Nontaxable vehicles include Roth IRAs and 529 plans. The income tax characteristics must be compared to the transfer tax characteristics for each vehicle. For example, from an income tax perspective, Hayley's GST exempt credit shelter trust likely would pass all taxable income through the trust to her, yet will likely not be subject to gift, estate, and GST tax. By further example, from an income tax perspective, her non-GST exempt marital trust would pass the income to her, but likely would be subject to estate tax and possibly GST tax at her death.

Intuitively, we know that the difference in taxation among planning vehicles requires analysis of what types of investments should be placed into each vehicle. The issue is that the vehicle's tax characteristics are sometimes not well understood by the client and/or the investment advisors.

Fourth, in addition to tax characteristics, the specific investment should be analyzed by its tax efficiency, which is a measure of the asset's total return after taking into consideration all income tax ramifications. For example, taxable bonds are subject to ordinary income tax rates, whereas municipal bonds are not taxable. Thus, municipal bonds are generally viewed as being more tax efficient. This may be true, however, only in taxable accounts. In non-taxable accounts or tax-deferred accounts, corporate bonds are more tax efficient than municipal bonds. By further example, assets that generate short-term capital gains (perhaps due to a high frequency of turnover) are viewed as being less tax efficient than assets that generate a higher relative amount of long-term capital gains.

The message — you must understand and analyze the tax characteristics and the tax efficiencies of the vehicles and the investments contained therein. The next step is implementation of the asset location plan. The following example illustrates this phase of the process.

Hayley as Your Client

Let's revisit Hayley's situation, this time with you as her attorney. Although we generally would not think that Hayley is managing her own assets, she might nevertheless be considered self-directed. This is so because Hayley does not allow full communication among her advisors, and is directing each of them separately. Recall that Hayley has a few million dollars invested in a GST exempt credit shelter trust and a non-GST exempt marital trust (for her primary benefit), and similar amounts in her traditional IRA and revocable trust (into which she placed her taxable investment account). Let's also assume that she is in the highest income tax bracket. Finally, assume that her investment advisors (after explaining her risk tolerance to them separately), encourage her to invest each of the accounts in equities and fixed-income on a 50-50 basis.[5] She is advised that her traditional IRA's investment in fixed income should be in taxable bonds, and the fixed income held by the various trusts should be a mix of municipal and taxable bonds.

What are the asset location challenges in this example? There are several. Let's begin by looking at the income tax considerations. Since Hayley is taxed at the highest income tax rate, it may make the most sense to hold little or no taxable bonds in her trusts. Equally challenging are the traditional IRA investments. Clearly, the investment advisor was astute not to place tax-exempt fixed income in the traditional IRA; however, based on Hayley's total financial picture, more growth assets (*e.g.*, equities) in this income tax-deferred account would have been, perhaps, suitable. Additionally, since the investment advisors are unaware of her other investments, one must have heightened concern that Hayley may at some point become subject to the wash sale rules.[6]

Next, let's look at the interrelationship of the income tax implications of investments in a trust that is exempt from gift, estate, and GST taxes (such as Hayley's GST exempt credit shelter trust). Although exempt from estate tax, the final amount passing to Hayley's daughter, Sophie, would be impacted by the income passing out to Hayley during her lifetime. Thus, a strategy where investments generate long-term capital gain (versus short-term capital gain or fixed income) might be better for such a trust.

Now look at the asset location strategy from an estate and GST tax perspective. Consider, on the one hand, that the GST exempt credit shelter trust will not be subject to either estate or GST tax. On the other hand, the non-GST exempt marital trust will be includible in Hayley's estate for estate and, potentially, GST tax purposes. Because the income beneficiary and presumptive remainder persons are almost identical, perhaps one should look at these two trusts in tandem, being careful to consider applicable prudent investor rules (discussed below), and locate more equities (which generally are viewed over the long term as having the potential for greater appreciation than fixed income) in the GST exempt credit shelter trust and locate more fixed income investment in the estate taxed trusts.[7]

Finally, one must establish whether the managers are allocating on a pre-tax or after-tax basis.[8] Depending upon the tax characteristics and efficiencies of the vehicle and investments therein, a pre-tax asset allocation may be equally allocated to equities and fixed income, whereas an allocation on a post-tax basis might instead call for a 60-40 allocation to equities and fixed income. The point — it is important to understand the nature of the vehicles as well as the investments, and that what may appear to be a much more "bullish" position (*i.e.*, a 60-40 equity/fixed-income allocation) may, once tax considerations are taken into account, yield identical results to an apparent

"non-bullish" position.

Some Caveats with Trusts

Let's recall that with trusts, especially irrevocable trusts, trustees are constrained not only by the specific terms of trust instruments, but also by the applicable trust code,[9] the prudent investor rule,[10] and principal and income act.[11] Thus, sometimes asset allocation and asset location decisions must be accomplished without regard to the client's other assets. Practically speaking, when dealing with these constraints, allocation and location decisions are much easier to make if the trustees are identical, and the beneficiaries are well-informed of the overall allocation and location strategy.

All General Principles Have Exceptions

Although much of the scholarly work on asset location accepts the general principle that equities are better placed in taxable accounts, and taxable fixed income in tax-deferred and nontaxable accounts, commentators recognize this is not always the case.[12] To properly locate investments into their respective vehicles, it takes, among other things, an understanding of economic and market conditions, the tax characteristics of the investments and the vehicles, cash flow needs, beneficiary/owner desires, as well as the costs of rebalancing existing portfolios (*e.g.*, taxes, commissions, etc.). Hopefully, it is apparent that several questions must be answered to find the correct asset location for each client. The attorney may be the best person suited to provide some of those answers.

The Solution

The solution to proper asset location begins with robust communication between the client's legal and financial advisors. Specifically, you, as the attorney, can provide guidance on the tax characteristics and implications of the various entities you design for your clients. Additionally, the attorney should become as well-versed as possible in asset allocation methodologies (*e.g.*, pre-tax and after-tax) that are utilized by particular investment advisors. In short, the attorney is an integral part of the investment planning process.

Conclusion

As an attorney, you should be aware of the asset location process to better assist your clients in making informed investment and funding decisions. For estate planning attorneys, it should be evident that much of the asset location process is and should be led by investment professionals; however, in many cases, the lawyer's role can be very powerful because there are a multitude of planning strategies and consequent legal entities used to achieve a client's tax or wealth management objectives. Better communication brings enhanced coordination among the client's team of advisors, better asset allocation and location decisions, and ultimately higher net after-tax results for the client.[13]❑

[1] The authors realize that there are differing views on the advisability of placing the widow's homestead into her revocable trust. They acknowledge both views and have, only for purposes of this example, assumed that Jordan believes that keeping the homestead out of the revocable trust is appropriate.

[2] The authors realize that under today's investment allocation models, allocation *only* to equities and fixed income is inappropriate, and that allocations should also include, by way of example and not limitation, cash, cash equivalents, and alternative investments. It is beyond the scope of this article to discuss the actual asset allocation that would be appropriate in this example; the authors' goal is simply to illustrate how asset allocation and location affect the client's investments.

[3] Currently, the vast majority of "asset location" literature has been written by and for economists, accountants, or financial planners. *See, e.g.*, William Reichenstein, *Calculating After-Tax Asset Allocation Is Key to Determining Risk, Returns, and Asset Location*, J. of Financial Planning (July 2007); Richard B. Toolson & Caroline K. Craig, *When Should Investments in Equities Earmarked for Retirement Be Placed in Taxable Accounts Instead of Retirement Accounts*, Taxes – The Magazine (August 2006); Gobind Daryanani & Chris Cordaro, *Asset Location: A Generic Framework for Maximizing After-Tax Wealth*, J. of Financial Planning (January 2005); Robert M. Dammon, Chester S. Spatt, & Harold H. Zhang, *Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing*, 59 J. of Finance (June 2004); John B. Shoven & Clemens Silam, *Asset Location in Tax-deferred and Conventional Savings Accounts*, 88 J. of Public Economics (January 2004). These articles also provide empirical data to support the thesis that asset location is critical to proper investment and estate planning.

[4] *See* Sean Gillia, *Think Forward, Act Now: Wealth Management for the New World*, Capital Acumen (Fall 2009), *available at* http://www.ustrust.com/publish/ust/pdfs/UST_Standalone-coverfeature%2010.6.09.pdf.

[5] The authors assume a simplistic asset allocation for purposes of this example. In addition to equities and fixed income, the authors acknowledge that models today include, by way of example and not limitation, allocations to cash, cash equivalents, and alternative investments.

[6] The wash sale rules not only *defer* recognition of losses, but in certain cases will *deny* the loss if the client attempts to sell loss stock in his or her taxable account and buy it back in the IRA before or after 30 days. It is irrelevant if this was done inadvertently. *See* Rev. Rul. 2008-5.

[7] The authors acknowledge that the advisors might want to coordinate efforts by communicating with Sophie to see if that investment strategy would be amenable to her (and her descendants).

[8] Some commentators advocate making the asset allocation decision on an after-tax basis. *See* note 3.

[9] *E.g.*, Fla. Stat. Ch. 736 (2009).

[10] *E.g.*, Fla. Stat. Ch. 518 (2009).

[11] *E.g.*, Fla. Stat. Ch. 738 (2009).

[12] *See* note 3.

[13] The views and conclusions expressed in this article are those of the authors and not necessarily those of Bank of America, N.A.

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