

Location, Location, Location

The critical but often overlooked role of asset location in portfolio performance.



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Many investors and advisors consider asset allocation the final step in investment planning. Having determined their investment goals, risk threshold and mix of equity and fixed income investments, they look forward to relaxing and watching their portfolios grow. But they are missing an extremely important step: asset location.

Asset Location

Asset location involves the correct distribution of assets and asset classes within accounts and entities to optimize an investor's overall after-tax return. Investors can best maximize the growth potential for their overall portfolios if they consider factors such as tax efficiency and time horizon when placing assets in different account types. For instance, if a corporate bond with a face value of \$50,000 paying interest income semi-annually at 6% is held in a taxable investment account, federal and state income taxes will be due on the \$3,000 in interest income each year until the bond matures. This corporate bond may be better held in an IRA or other account where the income is tax deferred until withdrawals are made.

The first section of this paper focuses on allocating the monies assigned to specific asset classes among taxable vs. tax-deferred accounts. The second part explores the additional dimension of asset location available from the optimal placement of asset classes in estate planning structures.

In considering this topic, however, it is important to note that the ideas conveyed in this paper are intended for informational purposes only and are not intended as tax or legal advice. Any client-specific strategy should be developed in concert with the appropriate legal and other professionals.

This paper presents hypothetical situations using: (1) 2012 tax rules and rates; and (2) historical returns of certain benchmarks as described in the endnotes. The hypothetical situations are presented solely to illustrate the points made in the text of this paper. Tax rules and rates may change. Past performance is no guarantee of future results and investments may not be profitable.

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Asset Location in Taxable vs. Tax-Deferred Accounts

The Growing Impact of Asset Location

Asset location has gained in importance over the past years for several reasons, both demographic and regulatory.

Asset Growth in Tax-Deferred Investment Accounts

Since the introduction in the 1970s of tax-deferred savings vehicles, such as Individual Retirement Accounts (IRA) and 401(k) plans, retirement assets have represented an increasingly large proportion of investors' total wealth. Individuals have made more and better use of tax-deferred investment opportunities through traditional, Roth and employer-sponsored IRAs as well as through 401(k) plans. As of December 31, 2010 the assets held nationwide in 401(k) and IRA accounts were \$3.1 and \$4.7 trillion, respectively.¹ In 2011, approximately 40% of American households had an IRA.²

The task of investing these retirement vehicles rests with the account owner. This burden has compounded in recent years, as investors have been faced with more choices. In recent years, employers offering 401(k) plans have greatly increased their number of investment options, often including a dizzying array of sector funds, target data funds and self-directed alternatives—with varying and often complex fees and costs.³ At the same time, selecting the right investment from among these numerous options has become increasingly important as the size of tax deferred accounts has become a more substantial part of the investor's whole portfolio. Gone are the days when employees of large corporations could expect to have their retirement benefits securely invested by others in defined benefit plans.

Key Legislation

When determining the proper asset location within a comprehensive investment plan, investors are wise to consider the various tax rates which will be applied to the income or capital gains received in that portfolio. The Jobs and Growth Tax Relief Reconciliation Act of 2003 changed the tax rate structure and applied a maximum rate of 15% on long-term capital gains from investments as well as on qualified dividends. This was scheduled to increase after 2008, but further legislation extended these rates through year-end 2012.

The enactment of the Pension Protection Act of 2006 (PPA) impacted asset location opportunities in defined contribution plans in two significant ways. First, it mandated diversification. Plan sponsors now must offer employees the choice of at least three investment options other than employer stock. Secondly, the PPA provided a safe harbor for employers who offer automatic enrollment in employer-sponsored defined contribution plans.

Future legislation impacting the tax benefits of retirement funds may be supportive or restrictive, given the tension between the national budget shortfall and the need to provide for generations without the safety net of generous pensions.

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Considerations for Creating the Optimal Asset Location

While each investor situation varies, a general rule of thumb suggests placing tax-efficient assets in taxable accounts and tax-inefficient assets in tax-deferred accounts.

Tax-Efficient vs. Tax-Inefficient Assets

The term “tax-efficient assets” refers to assets that are taxed at relatively favorable tax rates or that create fewer taxable events. One example is large cap equity stocks held for longer than a year, in which realized capital gains and qualified dividends are taxed at 15%. Another is municipal bonds, especially those that are not subject to federal, state or city taxes.

An increase in capital gains tax rates may narrow and possibly even eliminate the advantage of holding the equities in the taxable account. However, if ordinary income tax rates increase commensurately, the advantage would likely remain. The key is the differential between capital gains and ordinary income tax rates.

On the other hand, tax-inefficient assets are those that are subject to less favorable tax-rate structures. Examples of these include corporate bonds, because their income is taxed at the ordinary income tax rate of the investor, and high-turnover equity mutual funds, as their capital gain distributions do not qualify for a preferential tax rate.

Taxable vs. Tax-Deferred Accounts

The term “tax-deferred account” indicates preferential tax treatment for the entire account. By deferring taxes on the contributions, income, and growth of assets until they are withdrawn, tax-deferred accounts provide powerful tools for wealth accumulation.

However, tax-deferred accounts do not win on every front. Assets held in a taxable account offer several other benefits, including:

Tax-Loss Harvesting

The ability to harvest gains and losses offers an important advantage when holding assets in a taxable account. By having the flexibility to choose which assets to sell and the timing of sales an investor can opportunistically offset capital gains with capital losses, reduce taxable income by up to \$3,000 per year, and carry forward excess losses.

Step-Up on Embedded Gains

Another advantage to taxable accounts is the step-up in basis at the death of the account owner. This “step-up” refers to the opportunity to adjust the cost basis of the decedent’s assets to the fair market value at the time of the decedent’s death. Any tax on the embedded capital gains is completely foregone.

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Charitable Gifting with Low Basis Stock

An investor with charitable inclinations has a further opportunity in the taxable, but not the tax deferred, arena. A gift of low-basis stock is valued at fair market value at the time the gift is made to the qualifying charitable organization. Depending on the structure of the gift, tax on the embedded capital gains is either deferred or eliminated.

Flexibility in Accessing Funds

A final difference between taxable and tax-deferred accounts is the ease and cost of accessing funds. Penalties and complex legal restrictions limit investors' access to funds in tax deferred accounts prior to reaching age 59½, whereas no such barriers exist when withdrawing investments from taxable accounts. Most tax-deferred accounts also require investors to take distributions once they reach age 70½ or be faced with large penalties. If the assets in a tax-deferred account are significant, these distributions can push the investor into a higher tax bracket. Taxable accounts require no mandatory distributions.

Exhibit 1 summarizes the advantages and disadvantages of investing in taxable vs. tax-deferred accounts. The relative benefits are highlighted in boldface type.

Exhibit 1

Advantages and Disadvantages of Taxable vs. Tax-Deferred Accounts

	Traditional IRA	Taxable Account
	Conventional Considerations	
Contributions	Deductible annual contributions within income limits and other criteria	No tax deduction for contributions
Current Taxation	Tax-deferred growth	Current taxable income and gains are taxable
Tax Rate	Ordinary income tax rates on distributions	Qualified dividends and long-term capital gains taxed at maximum 15% rate until 12/31/12
Required Distributions	Complicated distribution rules Required at age 70½ and for non-spouse	No required distributions
Voluntary Withdrawals	Penalties for early withdrawals Tax on withdrawals	Access funds without penalty or complexity Flexibility in making distributions and incurring gains and losses
	Wealth Planning Opportunities	
Lifetime Gifting	No tax benefit for IRA gifts during life*	Securities gifted to charity during life avoid capital gains tax on appreciation
Taxation at Death	Face heavy tax and no step-up at death	Step-up basis on death
Estate Planning	Estate planning expertise required	More easily integrated with estate plan
Creditor Protection	May enjoy creditor protection	Extra structures generally needed to achieve creditor protection

*Minor exceptions for some charitable gifts 2006-2011; these may be extended for 2012 and beyond.

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What Should Go Where?

Based on the preceding information, it would seem clear that fixed income, in the form of taxable bonds, is probably best held in tax-deferred accounts, while tax-efficient large cap equity assets are more appropriately placed in taxable accounts. This is a good general rule of thumb.

Exhibit 2 offers a “barbell guide” to locating asset classes in the most appropriate accounts for the maximization of after-tax wealth.

One asset class that always should be placed in a taxable account is municipal bonds.

Exhibit 2

Best to IRAs	Best to Taxable Accounts	Best to IRAs
Taxable Fixed Income (e.g., corporate bonds, high yield bonds, short-term bonds)	Tax-Efficient Equities (e.g., large cap tax-efficient equities)	Tax-Inefficient Equities (e.g., REITs, hedge funds, actively traded equities, small cap, emerging markets)

While an investor’s unique financial situation must be considered, the above provides a starting point for dividing asset classes among accounts after determining an overall asset allocation strategy. Short-term and corporate bonds (including high yield bonds), which have the highest yield but are subject to ordinary income tax, receive the most benefit from deferred taxes when placed in a tax-deferred account. Assets such as REITs, hedge funds and actively-managed equities have the potential for high returns but also frequently make significant taxable distributions. Thus, these asset types are less tax-efficient and also should be considered as appropriate assets for tax-deferred accounts. Meanwhile, tax-efficient assets, such as large cap equities purchased to hold for the medium to long term, often are better placed in the taxable account. One asset class that always should be placed in a taxable account is municipal bonds; there is no reason to purchase these in a tax-deferred account.

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However, additional factors may counteract this general guidance, and should be considered carefully. These include:

Existing Locations of Assets and Level of Embedded Gains in Taxable Portfolios

Depending on current location of assets, little or no benefit may be derived by moving them to a different type of account.

Need for Cash Flow

If withdrawals are being taken, asset allocation rebalancing may be required, thus changing the asset location dynamics.

Possible Changes to Tax Rates and Tax Brackets By the Time of Withdrawal

The potential elimination of the 15% long-term capital gains rate would lessen the advantage of placing low-turnover equities in the taxable account. However, as noted previously, if ordinary income tax rates increased commensurately, the original benefit would still exist.

Relative Size of Taxable vs. Tax-Deferred Accounts

Asset location strategy has the greatest impact if the taxable and tax-deferred accounts are relatively close in size.

Investment Time Horizon/Age of Investor

Younger investors typically have more years to compound, thus strengthening the impact of asset location.

What Actually Goes Where?

Unfortunately, what might seem like common sense often is not practiced. Many investors end their investment planning with asset allocation, thus forgoing the benefits of optimizing asset location.

This may be evidenced by statistics compiled by the Investment Company Institute (ICI). As of September 30, 2011, 50% of IRA funds and 55% of 401(k) funds were invested in equities.⁴

Furthermore, ICI research shows a change in recent years for new cash flows into long-term mutual funds in retirement accounts. Hybrid and fixed income funds now capture a much greater share of new contributions than equities.⁵

Exhibit 3

New Cash Flows into Mutual Funds in IRAs and Defined Contribution Plans

\$ Billions

	2005	2008	2011*
Equity Funds	\$52	(\$122)	(\$87)
Hybrid Funds	\$76	\$32	\$47
Bond Funds	\$12	\$31	\$11

First three quarters of 2011.

The question remains whether most investors, or their advisors, are moving beyond asset allocation to fully and effectively consider the opportunities presented by asset location. Or is this shift away from adding to equities a function of the recent stock market declines—a phenomenon that will reverse when the market recovers?

Many investors end their investment planning with asset allocation, thus forgoing the benefits of optimizing asset location.

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Case Study

The following example quantifies the advantages of proper asset location within taxable and tax-deferred accounts. In this illustration, a 50-year-old client has chosen a 60% stock/40% bond asset allocation, based on his risk tolerance and long-term objectives. The client has \$2.5 million each in an IRA and a taxable investment account. We run the following two scenarios:

1. **Mirrored Portfolio:** In this scenario, our client does as many investors appear to do – he invests both accounts with similar asset allocations.
2. **Optimized Portfolio:** In this scenario, the investor more carefully chooses the location of tax-efficient and tax-inefficient assets. He places his fixed income first in his IRA, and the equities in the taxable account.

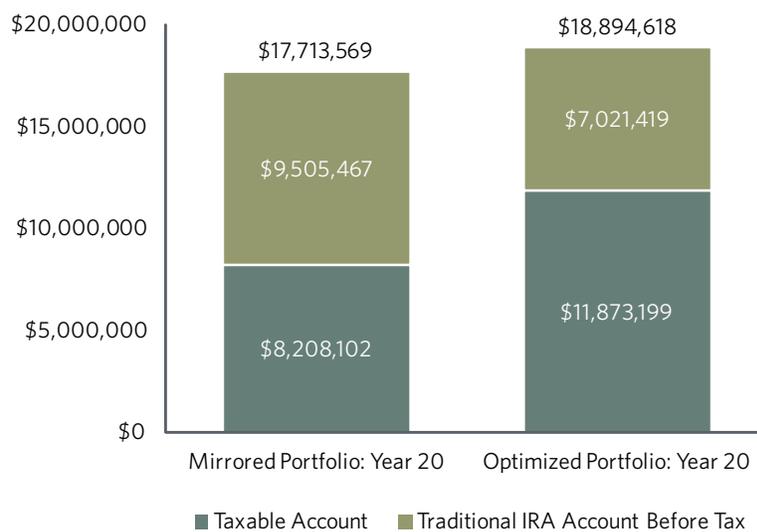
Exhibit 4

Asset Size	\$2.5M in taxable account \$2.5M in IRA
Asset Allocation	60% equity/40% fixed income overall asset allocation
Age	50 years old
Federal Tax Bracket	35%
State Tax Bracket	6%
Investment Options	Mirrored portfolio Optimized portfolio
Account Termination	At age 70

Over a 20-year time horizon, as illustrated in Exhibit 5, the optimized portfolio grows by approximately \$1.2 million more than the mirrored portfolio. This is due solely to the placement of the fixed income assets in the tax-deferred account.

Exhibit 5

Benefit of Selecting Appropriate Account Type for Assets



For illustrative purposes. See endnote 6.

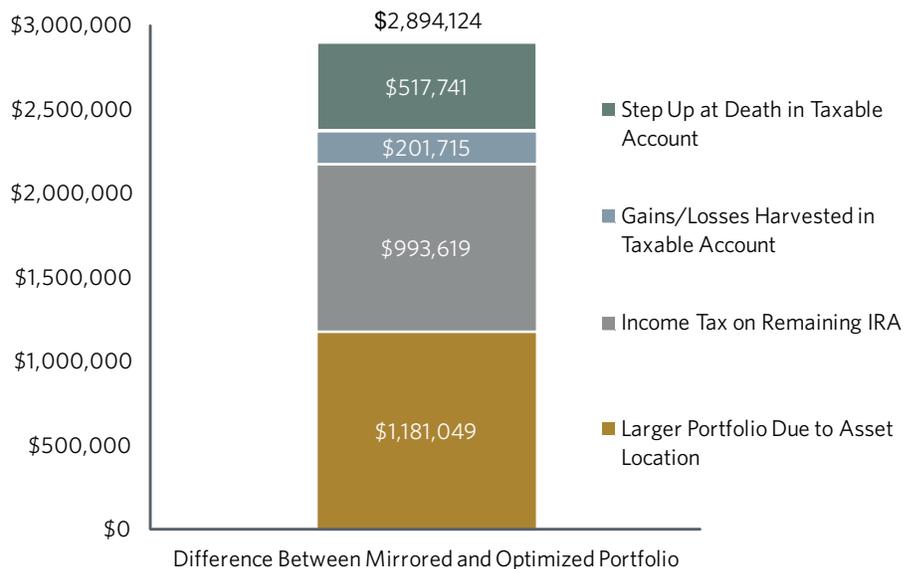
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Incremental advantages of the optimized portfolio grow to an astounding \$2.9 million!

But this is only the beginning. Under the optimized scenario, the growth in the equity-heavy taxable account can be expected to outpace that of the tax-deferred account, which is invested entirely in fixed income. Furthermore, in the optimized scenario, the basis step-up at death is more significant, and the effect of the embedded income taxes in the tax deferred account is reduced. Finally, throughout the twenty-year investment life of the portfolio, there is greater ability to offset gains with losses when all the equities are held in the taxable account. These additional benefits, as illustrated in Exhibit 6, bring the incremental advantages of the optimized portfolio to an astounding \$2.9 million!

Exhibit 6

Benefit of Selecting Appropriate Account Type for Assets



For illustrative purposes. See endnote 6.

Investors and their advisors frequently apply a blanket, one size-fits-all allocation to all accounts.

Asset Location in Tax and Estate Planning Entities

Despite the increased sophistication in creating trusts and other estate planning structures, wealth management professionals have paid relatively little attention to asset allocation within and among these vehicles. Trustees may address the particular objectives or tax implications of some of their trusts by favoring specific asset classes in those accounts. However, investors and their advisors frequently apply a blanket, one-size-fits-all allocation to all accounts. Asset location rarely is considered in terms of the role the specific entities play in the overall portfolio.

In this section we explore the benefits of matching the goals of each estate planning entity with the most appropriate asset allocation. When implemented within the context of the client's entire portfolio, this is known as strategic asset location. A simple case study illustrates the incremental value of coordinating investments with an individual's estate and financial plans. We conclude with an overview of the potential impact asset location can have on advanced estate planning entities.

Asset Location Over Multiple Generations

Wealthy families can benefit from viewing their portfolios in the context of their overall, multi-generational family. Often, the major payback for taking this more expansive approach occurs upon the deaths of the patriarch and matriarch.

The following case study illustrates the benefits of coordinating investment decisions with financial and estate planning. We have deliberately restricted this example to basic estate planning entities, and the asset classes to standard fare.⁷ Our goal is to demonstrate the advantages of an integrated strategy, rather than present an exhaustive list of possible estate planning and investment options.

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Case Study

Pete and Donna Rogers are a retired couple. Exhibit 7 outlines this couple's pertinent details.

Our case study presents three scenarios. In the first scenario, we illustrate the potential wealth that can be accumulated over a decade through sound investing. The second scenario demonstrates the advantages of engaging in financial and estate planning in addition to maintaining a sound investment program. The final scenario highlights the significant additional benefits of integrating estate planning within an investment program.

Exhibit 7

	Pete and Donna Rogers
Marital Status	<ul style="list-style-type: none">Married (first marriage)
Age	<ul style="list-style-type: none">Both age 70
Living Descendants	<ul style="list-style-type: none">Two children, three grandchildren
Tax Brackets	<ul style="list-style-type: none">Combined effective federal and state income tax rate: 38.9%Combined effective federal and state capital gains tax rate: 18.9%
Goals	<ul style="list-style-type: none">Maintain sufficient income to support their lifestyle and reserves to cover emergenciesConsolidate and protect family wealthProvide for the smooth and efficient transfer of wealth to children and grandchildren, without destroying their work ethicSupport selected charities, particularly if this also provides tax and other benefits to the couple and its family
Asset Size	<ul style="list-style-type: none">Combined property of \$15.0 million\$13.8 million in investment management accounts\$1.2 million in Pete's IRA
Asset Allocation	<ul style="list-style-type: none">Balanced portfolio: 60% equity/40% fixed income, based on discussions with portfolio manager and risk profile
Investment Strategy	<ul style="list-style-type: none">Diversified portfolios across and within asset classes

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Scenario One: Sound Investing

In consultation with their portfolio manager, Pete and Donna have decided that a 60% equity/40% bond allocation is appropriate for their goals and risk tolerance. They have diversified the equity portion into various sub-classes.⁸ Over the next decade, these investments perform in line with the asset class assumptions used in the first case study.⁹

Pete and Donna have done minimal estate planning. To avoid probate at the death of the first spouse, they have placed their assets in a joint account with rights of survivorship. Pete has named Donna as the primary beneficiary of his IRA. The couple also has established custodial accounts for their children and grandchildren, into which they have made annual exclusion gifts for the past several years. Going forward, they plan to increase these gifts to the maximum annual exclusion amount. The custodial accounts follow the same 60% equities/40% fixed income asset allocation in all of their family accounts. Exhibit 8 diagrams the couple's strategy.

Assuming Pete and Donna rebalance their portfolio at regular intervals, Donna will receive approximately \$25.3 million if Pete dies in ten years. Assuming Donna dies later that year, the children will inherit approximately \$19.2 million after taxes.¹⁰ This illustrates the value of a solid investment program and the power of compounding over a decade.

Exhibit 8

Sound Investing But No Planning



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Scenario Two: Sound Investing and Sound Planning

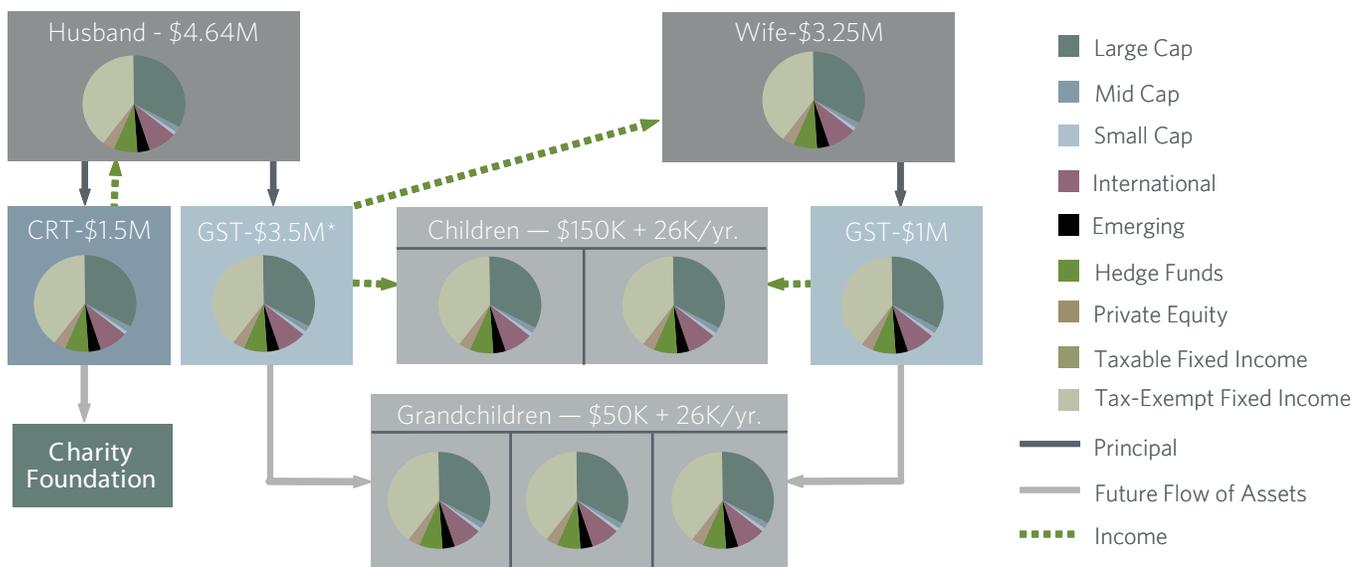
Pete and Donna maintain the same investment program as in the first scenario. Additionally, they have done some basic planning:

- Placed \$1.5 million in a charitable remainder trust with a 7.5% annual payout
 - Current income stream to Pete for his life and then to Donna;
 - After the second death, pays out to a family foundation
- Funded generation skipping trusts
 - Pete's trust = \$3.5 million; Donna's trust = \$1 million
 - Discretionary income to Donna and the children's trusts (from Pete's GST trust) and to their children's trusts (from Donna's GST trust)
- Severed the joint ownership of their personal assets
 - Pete's \$3.44 million and Donna's \$3.25 million are now titled in their individual names¹¹
 - Pete's \$1.2 million IRA is still in a separate IRA account
- Created trusts to receive the annual exclusion gifts to their children and grandchildren
 - Trusts were specifically created to take advantage of the longest permissible rule against perpetuities and the current federal estate tax and generation skipping tax exemptions.¹²

A diagram of the couple's estate plan is illustrated in Exhibit 8. By establishing these estate planning vehicles, Pete and Donna have significantly increased their children's inheritances. As illustrated in Exhibit 12 on page 15, after Donna passes away the children will inherit approximately \$19.9 million—3.5% more than they would have received under the first scenario, with no estate planning. Furthermore, the Rogers' charities enjoy the benefits of a \$1.5 million endowment. All this comes at a minimal downside—the need to invest a little time and money in planning, and Donna's forgoing direct access to approximately \$1.5 million.¹³

Exhibit 9

Sound Investing and Planning But No Integration



*Gift taxes of \$1,110,000 on funding of GST were deducted from husband's account.

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Scenario Three: Sound Investing Sound Planning and a Coordinated Program

It's not unusual for wealth management professionals to counsel clients of moderate wealth to invest and plan as presented in the second scenario. However, it is rarer to take the next step and integrate the investments with the estate plan.

In the prior scenario, Pete and Donna made no effort to customize the investments in any of their trusts. Although the goals, time horizons and risk profiles vary significantly between their personal accounts and the different trusts, they apply the same 60/40 asset allocation identically to each of their family's accounts. In so doing, they relinquish significant benefits.

This scenario illustrates the power of overlaying comprehensive asset location on a well structured estate plan combined with sound investment management. Exhibit 10 outlines the asset allocation decisions made in each account to integrate the investments with the estate plan.

Exhibit 10

The Rogers' Integrated Plan

Pete's Accounts	<ul style="list-style-type: none">▪ \$3.44 million personal account: large cap equities¹⁴▪ \$1.2 million IRA: all taxable fixed income
Donna's Accounts	<ul style="list-style-type: none">▪ \$3.25 million personal account: tax-exempt bonds¹⁵
Children's Trusts	<ul style="list-style-type: none">▪ Invested for growth¹⁶▪ Heavy equity weighting▪ 34% in higher return/higher risk equity classes
Grandchildren's Trusts	<ul style="list-style-type: none">▪ Invested for aggressive growth¹⁷▪ Entirely equities▪ Approximately 50% in higher return/higher risk stocks
Charitable Remainder Trust	<ul style="list-style-type: none">▪ 50% equities/50% bonds¹⁸▪ Balanced portfolio to support mandatory annual income payout

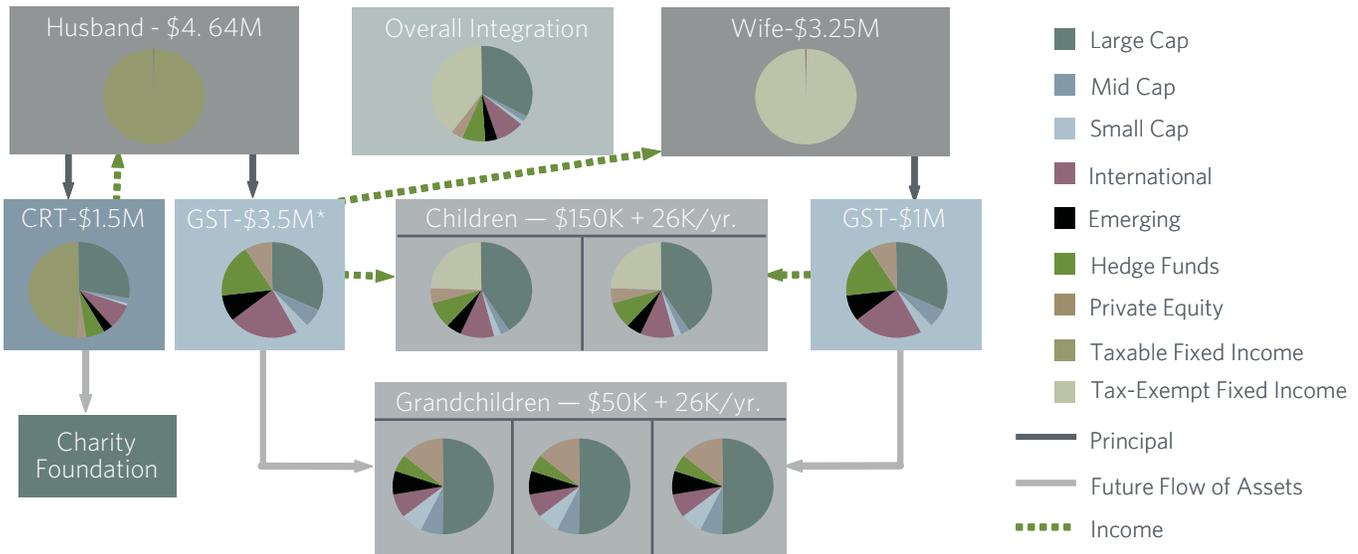
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In this scenario, the Rogers retain the previous estate plan and investment program. Their portfolio on a combined basis is still invested 60/40. However, they do not routinely apply the same asset allocation across the board. Instead, they tailor the asset allocation of each account to suit the time horizon and objectives of that entity, while best contributing to the long-term growth of the overall relationship. Exhibit 11 illustrates the Rogers' integrated plan.

The goal is to maximize the tax efficiency of the overall family portfolio by concentrating the highest growing assets within the entities with the longest time horizons. Typically, higher growth assets are allocated to younger family members and to the entities designed to continue for the longest term. Individuals and vehicles likely to be subject to high income and transfer taxes in the near future hold lower growth asset classes.

Exhibit 11

Sound Investing, Planning and Integration



*Gift taxes of \$1,110,000 on funding of GST were deducted from husband's account.

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As summarized in Exhibit 12, this approach results in a startling improvement in the bottom line over even one generation. At Donna's death, the children's inheritance is approximately 7.9% larger than if an investment plan alone were considered. This is achieved with the same overall family asset allocation, no change in investment performance or assumptions, and no additional investment risk.

These scenarios illustrate that, even with these basic investments and planning, the family realizes significant benefits by integrating their investments with their planning. Furthermore, very high net worth couples who are willing to take on more complex structures may further enhance their results. This is the power of strategic asset location!

Before leaving this case study, it is important to mention two important caveats:

- These results are only possible with a collaborative approach
 - The Rogers' attorney, portfolio manager and other advisors coordinated their recommendations to best achieve the family's goals.
- The family must work as a unit
 - This may be easy while the wealth is controlled by the original matriarch and patriarch; however, it may be more difficult as subsequent generations come of age. The impact of family governance on such plans is the subject of other articles published by BNY Mellon Wealth Management.

Exhibit 12

Total Value of Each Scenario in Ten Years

	Scenario 1: Sound Investing	Scenario 2: Sound Investing and Planning	Scenario 3: Sound Investing, Planning and Integration
After Husband			
Net assets passing to wife after husband's death	\$25.3M	\$21.5M	\$21.8M
After Wife			
Net assets passing to children after parent's death	19.2M	19.9M	20.7M

Scenario 3: 7.9% increase over scenario 1 and \$1.5M to charity

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Asset Location In Advanced Estate Planning Entities

The previous case study highlights the importance of integrating investment strategy with estate and financial planning. However, these basic scenarios are only the beginning. Asset location also is a key determinant of the success of a wider variety of more complex estate planning vehicles.

This section outlines some general rules of thumb regarding the integration of asset location with more advanced estate planning vehicles. Most of these comments are based on legal and tax ramifications associated with each of these entities. However, these guidelines come with the cautionary note that the selection of investments in any vehicle depends on a client's goals, appetite for risk, family situation and overall portfolio composition. As illustrated in the case study, coordinating the choice of asset classes for each entity with attention to its place in the total family portfolio can result in significant benefits.

I. Typical Strategies for Basic Trusts

Corporate trustees typically agree on some general practices when allocating equities and fixed income in the most commonly used trusts. Often, the investments in an exemption (credit shelter) trust are skewed to growth, with an offsetting overweight in fixed income in the companion marital trust. Growth is most useful in the exemption trust because it is free of estate tax at the death of the surviving spouse. Conversely, since the marital trust is taxed at the second death, it often provides the better place for lower growth assets.¹⁹ Favoring bonds in the marital trust also better supports a higher income stream to the spouse—a further, practical motivation.²⁰

Similarly, the GST Exemption Trust is often invested more aggressively than most of the other trusts. Since the GST Exemption Trust is usually designed to last for generations without being depleted by estate taxes, it has a natural bias to equities, particularly the more aggressive sectors and sub-classes.²¹

These traditional asset location strategies continue to offer significant tax savings for affluent clients who have sufficient assets to fund marital trusts and divide GST trusts into exempt and non-exempt shares.

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II. Strategies for More Complex Estate Planning Entities

Very wealthy individuals should tend to make more extensive use of complex estate planning structures. This section examines a few of these vehicles and presents some suggestions regarding the selection of assets at inception and throughout the duration of the entities.²² In these structures the asset allocation is often dynamic, adjusting to changes both within and outside of the entity and the family.

Grantor Retained Annuity Trusts (GRAT)

The GRAT has been a tried and true vehicle for transferring wealth to future generations. Successful GRATs are those which significantly leverage the transfer of wealth to remaindermen. To do so, the assets must generate a return that exceeds the IRS' mandated hurdle rate at the time of formation.²³ Traditionally, GRATs were funded with assets that were expected to appreciate significantly and/or generate a strong cash flow. These assets were held for the duration of the GRAT.

Since GRATs have been longtime estate planning tools, planners have the benefit of a number of studies and real life investment experiences. The aforementioned traditional asset allocation strategy continues to work, but only if a number of conditions play out as planned:

- Low interest rates at inception are important;
- The investment itself must appreciate and/or throw off income well above the hurdle rate;
- The grantor survives the term of the GRAT; a premature death may significantly affect the plan.

In recent years, planners and academics have explored alternative approaches to asset selection in GRATs. A number of analyses indicate that, rather than setting up one or two long-term GRATs, a series of rolling, short-term GRATs often offer a higher probability of success. Multiple short-term GRATs reduce interest rate risk and afford more flexibility. They also can be funded and invested more aggressively. A concentration in one or a few stocks increases the chance of any given GRAT being either a wild success or an abject failure; however, since the failure of one does not affect the success of others, this strategy may transform the volatility of concentrated stocks into a positive force.²⁴

Congress, the Administration and the IRS are increasing their scrutiny of these approaches with talk of curtailing various benefits. It is critical that anyone considering implementing these structures work with an experienced team of wealth planners.

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In tandem with choosing the appropriate durations for GRATs, the selection of assets in these trusts may best be viewed as a dynamic process. Provided the GRAT is a grantor trust in which the trust document allows the grantor to exchange assets between the trust and himself, assets can be swapped between the trust and the grantor without tax implications. As a result, some creative strategies can be considered:

- As a successful GRAT nears the end of its term, transfer the trust's appreciated securities to the grantor in exchange for some of the grantor's personal assets that have a higher basis. Refreshing the cost basis within a GRAT reduces potential capital gains for the remaindermen.²⁵ This works particularly well for elderly grantors whose personal assets will get a basis step-up at their death. For the risk adverse, less volatile assets can be transferred in, thus freezing the value for the remaindermen and protecting the gains already earned.
- Alternatively, rescue less than stellar GRATs mid-term by replacing depreciated positions with more promising securities from the grantor's individual account. The losses may be useful to the grantor to offset his or her personal gains.²⁶
- Combining Intentionally Defective Grantor Trusts (IDGTs) with installment notes (often self-canceling) is a technique that is close in concept to a GRAT. In these arrangements, the same asset location guidelines usually apply, as well as a few additional, more aggressive options. For instance, if the assets have declined in value and the IDGT appears destined for failure, the IDGT can be abandoned by prepaying the note. If the assets are expected to rise dramatically in value in the more distant future, a new IDGT can be funded at a lower gift tax "cost" to the grantor.

Family Limited Partnerships (FLP) and Limited Liability Companies (LLC)

FLPs and their close cousins, LLCs, were the darlings of advanced estate planning professionals for several decades. Although repeated assaults by the Internal Revenue Service have taken some of the luster off these vehicles, they continue to be recognized structures for leveraging the transfer of wealth to future generations, for providing some protection from creditors, and for centralizing control of a family's wealth.

The choice of assets within an FLP or LLC is driven largely by practical considerations related to the primary purpose in forming the entity. From an estate planning perspective, wealth transfer at reduced gift and/or estate taxes is usually a major goal in creating a FLP or LLC. If gifting is the objective, the cost and ease of valuing the assets is a major factor. Generally, tax efficiency also is important, as FLPs and LLCs are flow-through entities for income tax purposes. Thus, growth assets usually are preferable to income producers.

Advanced estate plans sometimes use a master FLP or LLC, with various family trusts owning interests in the FLP or LLC. To the extent units of the FLP or LLC are the predominant assets owned by these trusts, the asset allocations in each of the trusts will be similar. Provided the objectives and terms of these trusts are reasonably similar, this approach provides a useful way to centralize control and simplify investment management.

Location, Location, Location

Charitable Remainder Trusts (CRTs)

Some planners also have discovered the value of a dynamic, rather than static, investment strategy for CRTs. CRTs, perhaps more than any other vehicle, are well suited to a customized approach. The relative importance the grantor places on the potential objectives of his or her CRT can have a major impact on the investment strategy's success. Does the grantor want to maximize income stream, charitable deductions or the ultimate gift to the charity? In weighing these competing priorities, the interplay between the payout rate, the term, and the grantor's own tax bracket determines the appropriate asset allocation. General rules of thumb are anything but universal. However, the following considerations may be useful:

- Funding should not consist predominantly of illiquid and underproductive assets unless it is a NICRUT, NIMCRUT or FLIP CRUT.
 - Funding with interests in an ongoing business must be done with great care, since Unrelated Business Income (UBI) is taxed at 100%.²⁷
 - A possible solution to the UBI problem is to have potential buyers "waiting in the wings," to facilitate a quick sale and thus minimize the UBI. This may be attractive where it is believed that the business can be sold quickly. However, this must not be a prearranged sale!
- Since the income tax liability flows out to the payout recipient, tax consequences are a key factor.²⁸ In most cases it is important to:
 - Avoid short term gains
 - Harvest losses vs. gains
 - Avoid investments that are not tax efficient (e.g., REITs, hedge funds)
- To sustain value over many years and provide funds for the regular payout, a blend of fixed income and equities usually is advisable.
 - A modest income payout allows for a bias towards equities
 - Favoring equities does NOT apply if the required payout is high
- Over shorter time horizons tax-exempt bonds may produce greater overall after-tax returns than taxable bonds.
- If funded with appreciated securities, as is often the case, the payout recipient may receive greater wealth with a lower payout over a longer term than a short-term CRT with a higher payout.

NICRUTs, NIMCRUTs and FLIP CRUTs offer the greatest obvious possibilities for dynamic asset allocation. Unlike other CRUTs and CRATs, these instruments are well suited to funding with illiquid and unproductive assets. The settlor contributes, and the trustee retains, non-income-producing property until the pivotal moment when the trust is transformed from an accumulation vehicle to an income generator. Interests in FLPs often are useful, as these allow outside control of income flow.

Strategic asset location can increase the bottom line dramatically without increasing risk.

Charitable Lead Trusts (CLT)

A constant, well diversified asset allocation is typically more appropriate for CLTs.

Intervivos CLTs often are established as non-grantor trusts. They should not be funded predominantly with concentrated, low-basis stock positions, as these will likely need to be sold for diversification or to produce an income stream. Since CLTs are not tax exempt, the capital gains produced by these trusts may greatly exceed the charitable deductions for the annual payout to the charity, thus causing a tax liability to the trust or, if established as a grantor trust, to the grantor.

As ongoing investments, steady income-producing assets are usually well suited for CLTs. It may be appropriate to invest in some assets with low tax efficiency, provided the net taxable income and capital gains approximately match the annual charitable payout. As such, the trust will be income tax neutral on an ongoing basis. Additionally, some appreciating assets are desirable to maximize the gift to the remaindermen.

Conclusion

Investment professionals have long recognized the importance of asset allocation to the performance of an overall portfolio. However, identical asset allocations in all entities rarely optimize wealth. Strategic asset location can increase the bottom line dramatically without increasing risk.

Asset location may span multiple generations. It often is a dynamic process requiring the coordinated efforts of attorneys, money managers and other advisors. It is not always easy. However, as illustrated in this paper, when implemented correctly, asset location can be very powerful.

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About the Author

Joan Crain

Senior Director, Wealth Strategist

Joan Crain is a senior director of BNY Mellon Wealth Management. As a family wealth strategist, Joan works closely with portfolio managers and sales officers to provide comprehensive wealth management advice to clients and their families.

Joan joined the firm in 2001 and has more than 25 years of experience in financial services, banking, and investments. Joan specializes in retirement, business succession and philanthropic planning. She has considerable experience working with large multi-generational families. She is frequently invited to speak to professional and client groups, and has been featured in numerous business publications.

Joan received a master of business administration from Rollins College, a bachelor of education from Queens University, and a bachelor of music from McGill University. She is a Certified Financial Planner® professional and has earned the designations of Certified Trust and Financial Advisor and Certified IRA Specialist from the American Bankers Association. She was named as the 2009 Trust Banker of the Year by the Florida Bankers Association (FBA). She is a past chair of the Trust Legislative Committee and current member of the Executive Committee for the Florida Bankers Association. Joan also serves on the Board of Directors for the Community Foundation of Broward.

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Endnotes

¹Investment Company Institute. "The U.S. Retirement Market, Third Quarter 2011," December 21, 2011, Washington, DC

²Investment Company Institute. "The Role of IRAs in U.S. Households Saving for Retirement," November, 2011, Washington, DC

³Investment Company Institute, "The Economics of Providing 401k Plans: Services, Fees, and Expenses", Washington D.C., Investment Company Institute, 2010

⁴See endnote 1.

⁵See endnote 1.

⁶For illustrative purposes. Returns are hypothetical.

Calculation: Equal to the difference between the harvested / donated benefit of the optimized portfolio vs. mirrored portfolio. Benefit of gain/loss harvesting calculated as the sum of 90 basis points of beginning year value every year for 20 years. Step-up at death @ 20% embedded gains on equities in IMA at death after 20 years = net \$517k; income tax liability @ 40% income tax rate on remaining IRA balance = net \$993k.

Each of the mirrored and optimized portfolios begin with \$2,500,000 in the taxable account and \$2,500,000 in the tax-deferred account.

Asset class assumptions:	Return	Yield	Turnover
Large Cap Stocks	8.00%	1.80%	5.00%
Mid Cap Stocks	8.75	1.25	20.00
Small Cap Stocks	9.50	1.50	10.00
International Stocks	7.80	1.00	10.00
Emerging Markets Stocks	10.00	0.00	10.00
Taxable Bonds	4.00	4.00	0.00
Tax-Exempt Bonds	3.60	3.60	0.00
High Yield Bonds	7.00	7.00	0.00
Emerging Markets Debt	7.50	6.20	100.00
Private Equity	12.00	0.00	10.00
Long/Short Strategies	7.50	0.00	75.00
Absolute Return Strategies	6.00	0.00	75.00
Real Estate	7.50	3.50	15.00
Commodities	7.00	3.50	100.00
Managed Futures	6.00	0.00	100.00

Assumed tax burden during the 20-year period: The combined effective Federal and State assumed income tax rate was 38.90%. The combined effective Federal and State assumed cap gain tax rate was 18.90%. Our assumptions were based on an individual with the current highest marginal tax rate of 35% living in a state with a 6% state income tax.

All performance data is provided gross of fees.

⁷For simplicity, we have elected to exclude many advanced techniques and investment options, including leveraged structures, life insurance, more complex alternative investments, real estate and commodities.

⁸The Rogers' asset allocation is as follows:

Equities:	60.0%
Large Cap	33.0%
Mid Cap	2.4%
Small Cap	1.2%
International (Developed)	9.0%
International (Emerging)	3.6%
Hedge Funds	7.2%
Private Equity	3.6%
Fixed Income:	40.0%
Tax-Exempt Fixed Income	40.0%

⁹See endnote 6 for asset class assumptions.

Assumed tax burden during the 10-year period: The combined effective Federal and State assumed income tax rate was 38.90%. The combined effective Federal and State assumed cap gain tax rate was 18.90%. Our assumptions were based on an individual with the current highest marginal tax rate of 35% (Federal) living in a state with a 6% state income tax. This analysis does not account for state estate tax. Calculations based on 2012 estate and gift tax rates: 35% maximum federal estate tax, \$5 million exemption for federal estate tax and Generation Skipping Tax, \$5 million lifetime gift tax exemption, \$13,000/donee gift tax annual exclusion.

All performance data is provided gross of fees.

¹⁰For simplicity we have assumed that Donna withdrew all the funds from the IRA, paid the income taxes and added the balance to her taxable account. We have also kept the time frame short. Had we extended Donna's lifetime, our conclusion would have been more powerful but the analysis more complex.

¹¹Depending on state law and local preferences, these asset could also be placed in revocable living trusts or, in the case of community property states, a joint trust drafted to coordinate the estate tax exemption with community property laws.

¹²Assumed annual gift tax exclusion of \$13,000/donee.

¹³Donna will receive a 7.5% income stream from the CRT for the rest of her life; however, she cannot touch the principal.

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¹⁴In keeping with the recommendations from the first section of this paper, Pete has invested his \$1.2 million IRA entirely in fixed income, and placed large cap equities in his \$3.44 million taxable personal account.

¹⁵Donna owns bonds for two reasons:

- Assuming Pete predeceases her, his assets will get a basis step-up at death and so his account is the better location for investing for growth
- Donna is more risk averse and requires an income stream.

¹⁶ Asset Allocation of Children's trust

Equities:	75.0%
Large Cap	41.0%
Mid Cap	3.0%
Small Cap	2.0%
International (Developed)	11.0%
International (Emerging)	5.0%
Hedge Funds	9.0%
Private Equity	5.0%
Fixed Income:	25.0%
Tax-Exempt Fixed Income	25.0%

¹⁷ Generation Skipping Trusts. Note: Grantor (Pete) cannot access principal or income; however, as a last resort, Donna can

Equities:	100.0%
Large Cap	32.0%
Mid Cap	6.0%
Small Cap	4.0%
International (Developed)	22.0%
International (Emerging)	9.0%
Hedge Funds	18.0%
Private Equity	9.0%
Fixed Income:	0.0%

¹⁸ Asset Allocation of CRT

Equities:	50.0%
Large Cap	28.0%
Mid Cap	2.0%
Small Cap	1.0%
International (Developed)	8.0%
International (Emerging)	3.0%
Hedge Funds	6.0%
Private Equity	3.0%
Fixed Income:	50.0%
Taxable Fixed Income	50.0%

¹⁹Silfen, Martin. "A Systematic Approach to Asset Location," CFA Institute Conference Proceedings, 2005. Page 17.

²⁰ The inclination to fill a marital trust with income-producing assets is particularly high if the trustee is the surviving spouse and has a need and/or desire for significant cash

²¹Silfen, Page 17.

²² This paper does not include detailed descriptions of the technical features of each of these structures.

²³To value the annuity and remainder interests, planners must use the IRS Section 7520 rate in effect at the time of the gift. This rate is based on monthly bond yields. At funding, the terminal value of the initial amount that the grantor contributes to the GRAT is a gift to the ultimate beneficiaries. When the term expires the remaindermen receive assets at their then current market value. To the extent that the return between the funding and the termination has exceeded the hurdle rate, the excess received by the remaindermen is free of gift tax.

²⁴ One example of harnessing the potential advantages of concentrated positions through multiple short term GRATs is to fund each GRAT with a different stock. This works best if the stocks are not strongly correlated, resulting in one GRAT doing very well if the other fails.

²⁵Assets distributed to the remaindermen do not receive a basis step-up. Consequently, it is usually better not to dump highly appreciated assets on the beneficiaries at the end of the term of the GRAT.

²⁶ Brunel, Jean L. P. "Asset Location – The Critical Variable: A Case Study," *The Journal of Wealth Management*, Summer 2001. Page 40

²⁷ IRC Section 664(c)(2)(A)

²⁸Under IRC Section 664, specific ordering rules govern the taxation of the payout to the recipient.