

UNLESS YOU'RE DEAD CERTAIN OF the long-term direction of the markets, odds are that you, as a prudent investor, divide your investment funds between equity securities for growth and the less-risky, income-producing kind.

If you have a self-directed individual retirement account, you must decide how to deploy your investments between your taxable personal account and the tax shelter provided by your IRA. That seemingly arcane decision can affect your post-retirement lifestyle more than you think.

The present tax law has a big spread between, on the one hand, the 15% maximum tax rate on dividends and net long-term capital gains and, on the other, a top marginal 35% rate on interest income and on withdrawals from retirement plans. Combined with the magic of growth compounded over the long term, taxes point the way to the most financially effective allocation of assets between your personal portfolio and a tax-deferred haven such as an IRA or 401(k) plan. You should hold lightly taxed stocks in your personal, fully taxable account, and put income-producing securities such as bonds and real estate investment trusts, which are taxed at higher, ordinary-income rates, in your exempt account.

Let's compare two opposite strategies. Say, for simplicity, that you (a 35%-bracket taxpayer) have a retirement account worth \$100,000 and slated to be withdrawn (and taxed) 20 years from now. You also hold a similar amount in your personal (taxable) account. We'll also assume the present income tax rates will con-

TAXING SUBJECT

New and overlooked corners of the revenue code • By Joseph F. Gelband

Divide and Allocate *Put stocks in taxable accounts, bonds in IRAs*

tinue—a dicey assumption, to be sure.

In Program A, you invest your personal taxable funds in \$100,000 (market value) of a high-grade, zero-coupon corporate bond yielding 6% before a 35% income tax, or at a net 3.9% per year. For your IRA, you buy a composite equity investment, such as a broad-based index fund, with growth that we'll project at 8% annually over the next 20 years.

Fast forward 20 years, and your personal account, which holds the bond as well as accumulated interest (out of which you have been paying annual income taxes), is now worth \$214,937. Meanwhile, the stock in your IRA has grown to \$466,096. Upon its withdrawal, however, it is clipped by \$163,134, the 35% tax imposed not merely on its growth over the 20 years, but on its full value, including your \$100,000 basis—leaving \$302,962. Add that \$302,962 to the \$214,937 in your personal account, and you cash out with \$517,899. Not bad, but no cigar—you could have done better.

Now, in Program B, we'll reverse the investment strategy and shelter the bond in the IRA, while keeping the stock in your

own portfolio. Your IRA, growing via accumulations of interest at a full 6%, will have increased to \$320,713 but will shrink to \$208,464 after its 35% haircut when you take it out. Your stock, having grown at an annual 8% rate, will be worth \$466,096. (To avoid stacking the deck in favor of Program B, dividends were not taken into account, but they could more than offset the tax on any occasional capital-gains distribution paid from the index fund.)

Combining the \$208,464 after-tax proceeds of the IRA and the \$466,096 value of your stock produces a total of \$674,560. But since you may want to sell at least some of the stock when you retire, we'll reduce your personal account by \$54,914, the 15% capital-gains tax on its \$366,096 growth above your \$100,000 basis. So, net of taxes, you take home \$411,182 of your stock portfolio plus \$208,464 from the bonds and accumulated interest in your IRA. The total: \$619,646.

The bottom line: By sheltering the bonds in your IRA while holding the stock in your personal account, you improved your investment performance by \$101,747

(\$619,646 from Program B less \$517,899 from Program A)—over 50% of the \$200,000 we started with.

Since stocks, with their return largely unimpeded by annual income taxes, can grow almost as rapidly outside the IRA as inside, priority space in your IRA should be reserved for income securities, including those that pay little or no current interest (such as inflation-protected bonds), whose yield consists of their built-in growth but nonetheless are subject to the 35% tax on each year's accretion.

A further consideration is that equities are more vulnerable to losses than fixed-income securities. If realized in your personal account, losses can be cushioned by tax deductions, whether against capital gains or higher-bracket ordinary income. No such relief is available for losses taken in an IRA.

In addition, taxes withheld from dividends paid on American depository receipts can be recovered each year via the foreign tax credit on your personal income-tax return. The credit, of course, is not available to an exempt fund.

Many company 401(k)s offer a stable-value fund that yields 4%-5%—better than 10-year Treasuries with virtually no risk of loss. You could stash your retirement funds there and take risks with your taxable account—sharing any losses with Uncle Sam.

A note of caution: Don't readjust your holdings between your IRA and your personal account by transferring securities from one to the other. That would be a "prohibited transaction" that carries major penalties, including loss of exempt status for the IRA, with a personal income tax as though it had distributed all its assets to you. ■