



FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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Asset Location

You've heard of *asset allocation* before, but you've probably never heard of *asset location*, which is just as important. When you buy a security, you have to decide which type of account to use to hold the asset; that's asset location. Income tax considerations drive the answer to this question, though someday estate tax considerations may also come into play once again. There are three main types of accounts: taxable, tax-deferred and tax-free. Below I discuss the income tax considerations for each type of account and the best types of assets to put into each.

By "taxable account," I mean a plain old brokerage account. In such an account, realized long-term capital gains and qualified dividends get taxed at a rate of either 0% (if your marginal federal income tax return is 12% or below) or 15%. All other income (interest, ordinary dividends, realized short-term capital gains and dividends from REITs) is taxed as ordinary income.

If you realize a capital loss, you can apply it against realized capital gains and then against up to \$3,000 of ordinary income per year. Any remaining capital loss can be carried forward to future years indefinitely.

If a foreign government withholds income tax from dividends paid by a foreign stock held

in a taxable account, you can generally receive a dollar for dollar Foreign Tax Credit for the amount of taxes withheld if you file Form 1116 with your income tax return.

You can gift appreciated shares (your holding period should be long-term) to either a charity or a taxpayer who's currently in a low income tax bracket. In both cases, they could sell the shares and no tax would be due on the gain.

When the owner of a taxable account passes away, his/her heirs receive a step-up in tax basis to the fair market value on the date of death, allowing the heirs to sell the assets without having to pay income tax on the realized gain.

A taxable account is also the ideal account that can be used to fund the credit shelter trust (set up by their Will, if they've done some moderately advanced estate planning) of the first spouse to die, which can significantly reduce the decedent's estate tax exposure.

A taxable account is the simplest, most versatile type of account and has no required minimum distributions, early withdrawal penalties or complex rules and regulations, (ironically) the greatest amount of tax benefits (in my opinion) and the least amount of political risk (especially since this is the type of account in which most politicians have the vast majority of their own wealth).

The best types of assets to hold in a taxable account include equities, especially those that pay no or a low dividend, those that you plan to hold for a long time (e.g., Dividend Aristocrats), those that have a high expected return, and those that pay qualified dividends.

Tax-deferred accounts (such as a traditional IRA or a traditional 401(k)) grow tax-deferred until withdrawn, at which point any gain is taxed as ordinary income at your highest marginal rate (which may be as high as 37% federal). Unless you meet one of the exceptions, distributions before age 59.5 are also subject to a 10% early withdrawal penalty. If you ever fail to take the annual required minimum distribution (say, because you didn't understand the rules, which are kind of complicated), the penalty is 25% of what you should have taken out but did not. Nice retirement plan!

By the way, the period over which the beneficiaries of a traditional IRA can take required minimum distributions was recently shortened from over their remaining life expectancy to just 10 years (when the beneficiaries will probably be in their peak earning years, resulting in the distributions being taxed at higher rates).

For these reasons, tax-deferred accounts are like a ticking time bomb, so the best assets to place in them are those that have the lowest expected return (especially money market mutual funds and bonds or bond funds), REITs, high-yielding stocks, stocks that don't pay a qualified dividend, and foreign dividend-paying stocks that don't have taxes withheld by their government.

Finally, tax-free accounts (a Roth IRA or Roth 401(k)) grow tax-free as long as (1) the account is at least five years old, (2) distributions are taken after age 59.5, and (3) the

politicians who are then in power keep the promise made by politicians in 1997 to not tax the gains (which is a HUGE assumption, as I'll write about soon). Roth accounts do not currently require the owner to take required minimum distributions.

Usually Roth accounts comprise a relatively small percentage of a portfolio, so I prefer to leave much or most of them in cash to serve as “dry powder” for when a life-changing investment opportunity comes along, which is not very often. Such enormous gains can be made even more so by avoiding paying income tax on them.

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