

Key Wealth Institute

Beyond Allocation: Why Asset Location is Critical for Long-Term Wealth

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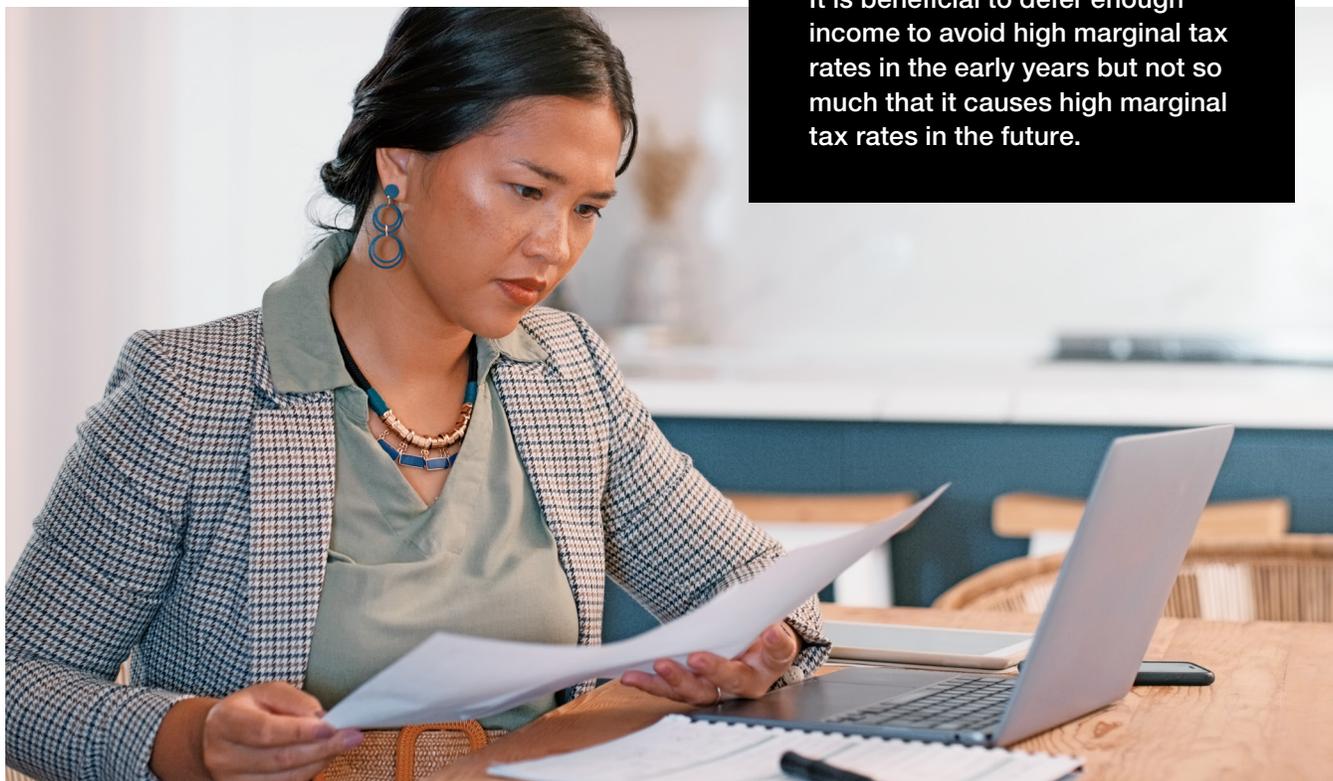
In today's tax environment, successful investing requires more than smart asset selection. It requires strategic placement. Asset location is the discipline of aligning investments within the appropriate account types, and it can significantly improve after-tax returns. This article explores how thoughtful asset location can quietly add millions to long-term wealth without increasing risk.

As an investor, you already understand that wealth accumulation is only part of the equation. How you keep and grow wealth, especially after taxes, is equally critical.

While most conversations focus on asset allocation, there's another powerful, often overlooked strategy you can leverage called asset location.

When implemented thoughtfully, asset location doesn't require more risk or a different investment mix, just smarter placement. It simply places the right assets in the right accounts while dramatically improving your after-tax results over time.

It is beneficial to defer enough income to avoid high marginal tax rates in the early years but not so much that it causes high marginal tax rates in the future.



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Different investments, different tax treatments

Every asset you hold behaves differently under the tax code. Knowing these differences and using them to your advantage is a hallmark of sophisticated wealth management.

Strategic asset location isn't just tax efficiency — it can be risk-free tax alpha. For investors, aligning asset types with account structures is a critical step in maximizing after tax returns, enhancing portfolio resilience, and preserving wealth.

Investment Types	Tax Treatment	
Cash, CDs	Interest income:	Taxed at ordinary income rates
Stocks (equities)	Long-term capital gains:	If held for more than one year, gains are taxed at preferential long-term capital gains rates (0%, 15%, or 20%, depending on income).
	Qualified dividends:	Often taxed at the same favorable rates as long-term capital gains.
	Strategy:	Stocks are often best placed in taxable accounts to take advantage of lower capital gains tax rates.
Bonds (fixed income)	Taxable bonds:	Interest is taxed as ordinary income, making them less tax-efficient in taxable accounts.
	Municipal bonds:	Generally exempt from federal income tax (and possibly state taxes), making them more suitable for taxable accounts.
	Strategy:	Place taxable bonds in tax-deferred accounts to defer taxes on interest income.

Different accounts, different tax rules

Account Types	Tax Characteristics
Taxable accounts	<ul style="list-style-type: none"> Primarily taxed as capital gains. Offer the ability to realize capital losses, which can offset gains. Strategy: Use for tax-efficient investments like stocks or ETFs with low turnover, tax-loss harvesting. Treatment at owner death: Step-up in cost basis to date of death value.



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Different accounts, different tax rules

Account Types	Tax Characteristics
Tax-deferred accounts (e.g., traditional IRAs, 401(k), 403(b))	<ul style="list-style-type: none">• Contributions may be tax deductible and investments grow tax free until withdrawal.• Withdrawals are taxed as ordinary income. Distributions prior to age 59½ incur a 10% premature distribution penalty unless an exception applies.• Required Minimum Distributions (RMD) must start by age 73.• Strategy: Ideal for tax-inefficient investments (like bonds) to defer taxes.• Treatment at owner death: Distributed per beneficiary designation; in most instances non-spouse beneficiaries must take over 10-year distribution period.
Tax-exempt accounts (e.g., Roth IRAs)	<ul style="list-style-type: none">• Contributions are made with after-tax dollars, not deductible but qualified withdrawals are tax free.• Ideal for high-growth investments due to tax-free growth.• No RMD during original owner and spouse lifetime.• Strategy: Place assets expected to appreciate significantly over time, such as growth stocks.• Treatment at owner death: Distributed per beneficiary designation; in most instances non-spouse beneficiaries must take over 10-year distribution period.

Why asset location matters even more for high-income investors

At top income levels, the tax difference is magnified:

- Ordinary income: 40.8% (37% + 3.8% net investment income tax (NIIT))
- Long-term capital gains and qualified dividends: 23.8% (20% + 3.8% NIIT)

Over time, that 17% tax spread can translate into a meaningful advantage.

Strategic asset location creates “tax alpha,” or a consistent, low-risk value-add of roughly 0.05% – 0.60% per year by minimizing unnecessary tax drag across accounts.

Source: [Asset location can lead to lower taxes | Vanguard](#)

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Strategic asset location: How to structure your portfolio

- **Tax-inefficient assets** (e.g., high-yield bonds, REITs, actively managed funds with high turnover) are best placed in tax-deferred accounts to defer ordinary income taxes.
- **Tax-efficient assets** (e.g., individual stocks, broad-market equity ETFs, municipal bonds) can be held in taxable accounts due to their favorable capital gains treatment or tax-exempt status.
- **High-growth assets** (e.g., small-cap stocks, emerging markets) are ideal for Roth accounts, where all future gains are tax free, maximizing the benefit of compounding.

Asset location implementation is complex due to several factors:

- **Investor-specific constraints:** Account types and balances vary widely, and some investors may have limited Roth space or legacy holdings with embedded gains.
- **Blended investment vehicles:** Many mutual funds and ETFs combine multiple asset classes (e.g., balanced funds, target-date funds), making it difficult to assign them to a specific tax bucket. These vehicles obscure the underlying asset class exposure and tax characteristics. Consider also that in addition, regardless of underlying asset class, mutual funds are less tax efficient because they are required to distribute capital gains annually.
- **Rebalancing and liquidity needs:** Maintaining target allocations across accounts while minimizing tax drag requires careful coordination, especially when rebalancing triggers taxable events.
- **Asset class purity:** To implement asset location effectively, investors should favor “asset class pure” vehicles — such as single-asset-class ETFs or separately managed accounts — so that each asset class can be precisely located in the most tax-efficient account type.

Net investment income tax (NIIT) 3.80% surtax

The net investment income tax (NIIT) is an additional 3.8% surtax applied to investment income earned by high-income individuals, estates, and trusts. It was introduced by the Affordable Care Act in 2013 to help fund Medicare.

The NIIT applies on top of regular income taxes and affects certain types of income, but only above certain income thresholds.

Who pays the NIIT?

Individuals pay the 3.8% surtax if their modified adjusted gross income (MAGI) exceeds:

- \$250,000 for Married Filing Jointly
- \$125,000 for Married Filing Separately
- \$200,000 for Single or Head of Household

Estates and trusts also face NIIT once their income exceeds a much lower threshold (around ~\$15,000 in 2025, inflation adjusted annually).

What Types of Income Are Subject to NIIT?

The tax applies to net investment income, which includes:

- Interest
- Dividends (qualified and nonqualified)
- Capital gains (long- and short-term)
- Rental and royalty income
- Passive income from partnerships, S corporations, and trusts
- Income from businesses in which the taxpayer does not materially participate.

Important:

Wages, self-employment income, and distributions from IRAs and qualified retirement plans are not considered investment income for NIIT purposes (though they count toward MAGI when determining if you hit the threshold).

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How asset location helps reduce estate taxes

Asset location is strategically placing different types of assets in taxable, tax-deferred, and income-tax-free accounts — and it isn't just about income tax efficiency during life. It can also significantly impact estate taxes and the taxes paid by heirs after inheritance.

Step-up in cost basis for taxable accounts

When someone dies, assets held in taxable accounts generally receive a step-up in cost basis to their fair market value at the date of death (or an alternative valuation date if chosen).

- Example: If you bought stock for \$100,000 and it is worth \$500,000 at your death, the heir's new cost basis becomes \$500,000. If they sell immediately, there is little to no capital gains tax.
- This step-up erases unrealized capital gains, effectively avoiding income taxes on the growth during your lifetime.

Because of this, holding high-growth assets like stocks, real estate, or private investments in taxable accounts can dramatically reduce income taxes for heirs — and shrink the effective size of the taxable estate for estate tax purposes if values are carefully managed.

Assets in retirement accounts (IRA, 401(k), Roth IRAs etc.) do not receive a step-up in basis

- Instead, when beneficiaries inherit these retirement accounts, in most instances they must fully distribute them within 10 years (due to the SECURE Act rules).
- Every dollar withdrawn from a pre-tax retirement account is treated as ordinary income to the beneficiary and taxed at their personal income tax rates. If the account grows during the 10 years, the beneficiary will owe even more tax on the growth.
- Every qualified distribution withdrawn from a Roth account is tax free to the beneficiary, albeit they still must fully distribute the balance within 10 years. If the account grows during the 10 years, the beneficiary will generate even more tax-free growth.

Due to the step-up in cost basis at the date of death, holding high-growth assets like stocks, real estate, or private investments in taxable accounts dramatically reduces income taxes for heirs.

Estate tax implications

- Assets in taxable accounts can benefit from the step-up and pass on with little to no income tax liability.
- Assets in qualified accounts may be fully income-taxable to heirs, and their value counts towards the gross estate for estate tax calculation — a potential double tax hit (if you do not receive a deduction for estate tax paid on income in respect of a decedent).
- Having too large a retirement account at death can mean facing both estate taxes (if over the exemption amount) and income taxes on the same dollars when heirs withdraw them. There may be a deduction for estate tax paid on income in respect of a decedent.

Strategic asset location to minimize taxes

A thoughtful strategy might include:

- Grow taxable assets with investments that are likely to appreciate significantly (equities, real estate), allowing heirs to benefit from step-up in basis.
- Spend down tax-deferred qualified accounts during life more aggressively (especially after age 59½ but before RMDs), particularly if you are in a lower tax bracket than your heirs would be.
- Use Roth conversions during lower income years to move assets from taxable IRA/401(k)s into Roth IRAs — Roth IRAs still must be distributed within 10 years, but distributions to heirs are tax free. Also consider backdoor Roth IRAs for high earners.

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Real estate asset location strategy

Real estate is a core asset class in many portfolios, offering both diversification and unique tax advantages. Unlike traditional financial assets, real estate investments come with distinct tax treatments that can significantly impact after-tax returns, particularly when held in taxable versus tax-advantaged accounts.

Taxable accounts for real estate assets: Strategic advantages

When held in taxable accounts, real estate offers several compelling tax benefits:

Depreciation deductions: Investors can deduct a portion of the property's value each year as depreciation, reducing taxable income, even if the property is appreciating in market value.

1031 exchanges: Section 1031 of the Internal Revenue Code allows for deferral of capital gains taxes when one investment property is exchanged for another of "like kind." This enables investors to compound returns tax deferred over time.

Capital gains treatment: Long-term appreciation is taxed at favorable capital gains rates, and investors may also benefit from step-up in basis at death, potentially eliminating capital gains altogether for heirs.

Tax-advantaged accounts for real estate assets: Proceed with caution

While it may seem appealing to shelter real estate income in tax-advantaged accounts like IRAs—particularly self-directed IRAs (SDIRAs), this approach introduces significant complexity and risk.

Prohibited transactions: The IRS imposes strict rules on SDIRAs. Engaging in transactions with "disqualified persons" (e.g., the account holder, family members, or entities they control) can trigger a full distribution of the IRA, resulting in taxes and penalties.

When held in taxable accounts, real estate offers several compelling tax benefits.

Unrelated business taxable income (UBTI): If the real estate is debt financed, any income attributable to the financed portion may be subject to UBTI, which is taxed at trust tax rates — often much higher than individual rates.

Liquidity constraints: Real estate is inherently illiquid. This can pose challenges for RMDs from traditional IRAs, especially if the property cannot be easily sold or fractionally distributed.

Valuation difficulties: Accurate, IRS-compliant valuations are required for reporting and RMD calculations. Real estate appraisals can be costly and subjective, increasing administrative burden and audit risk.

Strategic considerations for real estate assets

Given these dynamics, real estate is generally best held in taxable accounts, where its tax benefits can be fully realized and managed. Tax-advantaged accounts may be appropriate in limited cases — such as holding REITs or real estate funds that don't involve direct property ownership — but direct real estate in IRAs should be approached with caution and professional guidance.

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Staying ahead of tax law changes: A dynamic landscape

Tax laws are not static — and neither should your wealth strategy be. Legislative and regulatory changes can significantly alter the effectiveness of long-standing planning techniques, including those related to step-up in basis, Roth IRAs, and asset location.

Recent developments to watch

Roth Catch-Up Contributions (Effective 2026): Under the SECURE 2.0 Act, high-income earners (those with FICA wages over \$145,000) who are contributing to employer-sponsored retirement plans will be required to make any catch-up contributions on a Roth after-tax basis starting in 2026. This eliminates the option for pre-tax catch-up contributions for these high-income earners and may influence decisions around Roth conversions and contribution timing.

Note: This is only a requirement for catch-up contributions. Regular retirement plan contributions can still be treated as made with pre-tax dollars.

Step-up in basis under scrutiny: While no legislative changes have been enacted as of the writing of this article, the step-up in basis at death remains a topic of policy debate. Proposals to limit or eliminate this provision could have major implications for estate planning and the tax efficiency of holding appreciated assets in taxable accounts.

The importance of periodic review

Given the evolving nature of tax policy, it is essential to review your asset location strategy regularly with your advisor. What is optimal today may become suboptimal — or even problematic — under new rules.

Conclusion: Location is leverage

Asset location is one of the most effective yet underutilized strategies in tax-aware portfolio construction. By aligning the tax characteristics of each investment with the most appropriate account type — taxable, tax-deferred, or tax-exempt — investors can enhance after-tax returns without altering their overall asset allocation or risk exposure.

This strategy doesn't require new investments or added risk. It simply asks: Where should my existing investments reside to work most efficiently? For investors, the answer can quietly add millions in long-term, after-tax wealth.

As tax laws evolve — such as recent changes to Roth contribution rules and ongoing discussions around the step-up in basis — strategies must adapt. Regular reviews with an advisor ensure your portfolio remains optimized for both current regulations and future opportunities.

Tax efficiency isn't just smart — it's well located.

For more information, [please contact your advisor](#).

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