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Taxable and Tax-Deferred Investing: A Tax-Arbitrage Approach

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Abstract

We analyze an intertemporal portfolio problem with both taxable and tax-deferred retirement accounts. Using a tax-arbitrage argument, we identify conditions under which the optimal location decision (where to place an asset) is *separable* from the allocation decision (how much to allocate to each asset). Investors place highly taxed assets in the tax-deferred account to maximize the tax benefit and adjust their taxable portfolios to achieve the optimal risk exposure. We show that the two-account problem can be reduced to a taxable-account-only problem. The results are robust to capital gains tax deferrals, consumption and contribution decisions, and stochastic tax rates.