TAX MATTERS

The Enduring Appeal of Gain Deferral, Part 1

February 1, 2024

Deferring the realization of gains is generally a good thing. The basic idea is that when compounding wealth, you're better off compounding pre-tax dollars than after-tax dollars.[1] But how big is this benefit, and is deferral always a good idea?

In this two-part post, we look at:

1. The value of gain deferral, and

2. Whether gain deferral is still a good idea if you think tax rates might be higher in the future.

In both parts, we'll illustrate the conclusions using a hypothetical $1M portfolio with an 80% unrealized gain and a 7% expected return, net of fees.

Let's start with #1—how valuable is deferral? In the table below, we compare two choices for our hypothetical portfolio: In the first ("Defer Gains"), we defer unrealized gains until the end of our investment horizon; and in the second ("Crystallize Gains"), we realize gains today in hopes of paying a smaller tax bill later. The last two columns show the difference, both in dollars and as a percentage of starting portfolio value. To make our analysis apples-to-apples, at the end of the holding period we liquidate both portfolios and pay taxes on liquidation gains (i.e., these are post-liquidation values).

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The results are clear. If tax rates don't change, deferring gains is expected to lead to higher wealth, regardless of investment horizon – and like any edge in investing, this result becomes more and more powerful the longer you go.

Of course, real investor situations are more complex than this example. Real-world portfolios have a range of ongoing taxable transactions, from trades in underlying investments to regular portfolio rebalancing, and complete deferral may not always be possible. Regardless, strategies that help defer gains can be highly beneficial, irrespective of the investment horizon – and especially over the long term.

Post-liquidation Wealth for a Hypothetical $1M Starting Portfolio

Horizon (years)	Portfolio Value (post-liquidation): Defer Gains	Portfolio Value (post-liquidation): Crystallize Gains	Advantage of Deferral: In Dollars	Advantage of Deferral: As a % of Starting Value
1	$862,940	$852,784	**$10,156**	**+1%**
5	$1,116,344	$1,057,940	**$58,404**	**+6%**
10	$1,546,569	$1,406,250	**$140,319**	**+14%**
15	$2,149,982	$1,894,773	**$255,209**	**+26%**
20	$2,996,300	$2,579,952	**$416,348**	**+42%**
25	$4,183,304	$3,540,950	**$642,353**	**+64%**
30	$5,848,138	$4,888,801	**$959,338**	**+96%**

Source: AQR.

We compute future post-liquidation wealth starting with an hypothetical investment with $1M value and $0.2M cost basis and assuming a full liquidation at the end of the investment horizon. The future post-liquidation wealth per dollar invested for deferring the gain till the end of the investment horizon scenario is $(1+r)^{n}*(1 - T) + B*T$, whereas the future post-liquidation wealth per dollar invested for crystalizing the gain today is $W*(1+r)^{n}*(1 - T) + W*T$, where $W = (1 - T) + B*T$ is the after-tax investable capital after crystalizing the gain today. We define r as the expected annual net-of-fee pre-tax return (with all the return treated as price appreciation, taxable upon liquidation), B as the cost basis as a percentage of the portfolio market value, T as the 2023 long-term capital gains tax rate, and n as the investment horizon in years. We assume that $r = 7\%$, $T = 23.8\%$, and $B = 20\%$. We find that varying expected returns or the cost basis does not meaningfully change the conclusion.

Read Part 2 Here

[1] There are exceptions of course. For example, in the case of appreciated concentrated stock, the upfront liquidation tax might be worth paying to reduce the high risk of catastrophic pre-tax losses that characterize poorly diversified portfolios. In such situations, an investor might use tax-aware strategies whose losses could help offset the gains realized upon liquidation of the appreciated asset.

be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

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