



## Tax Matters

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### The Enduring Appeal of Gain Deferral, Part 1

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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.<sup>1</sup> 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

Investment Horizon (Years)	Portfolio Value (post-liquidation)		Advantage of Deferral	
	Defer Gains	Crystallize Gains	In Dollars	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 crystallizing 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 crystallizing 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.

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