



## Tax Matters

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### The Enduring Appeal of Gain Deferral, Part 4

#### The Value of Tax-Aware Transition

March 19, 2025

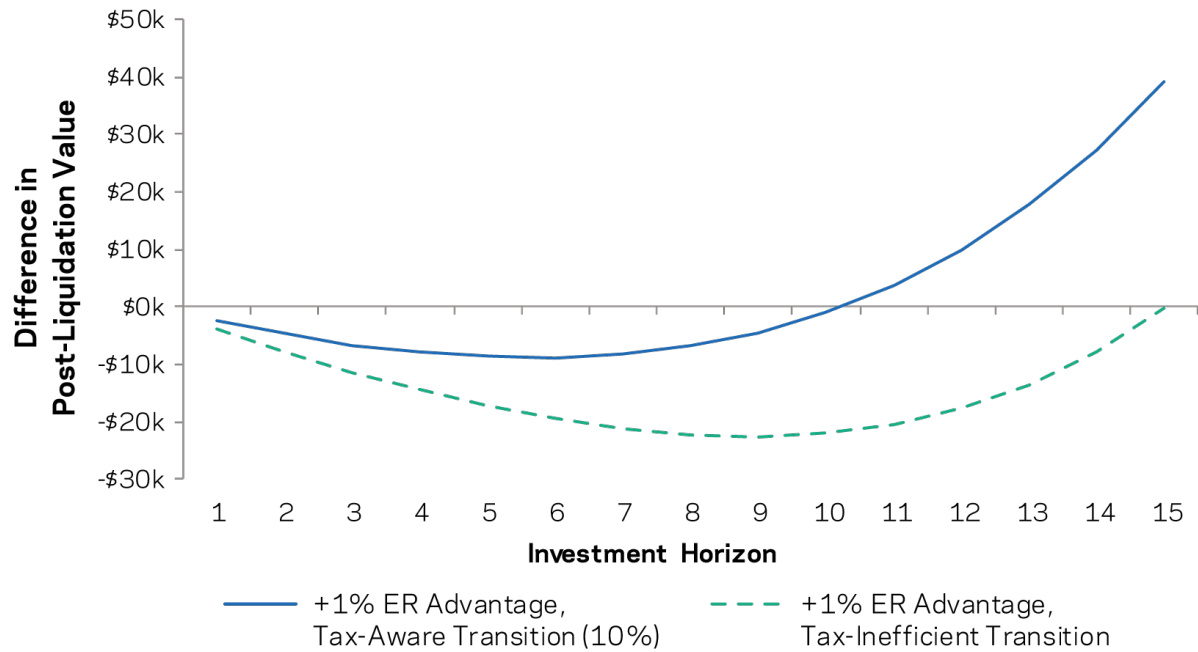
Our [first post](#) in this series showed the power of deferral for building wealth; our [second](#) showed how robust the value of deferral is to changes in future tax rates on capital gains; our [third](#) considers whether deferral is still the right choice if an investor is able to find a strategy with a higher expected return (i.e., when is an investor better off compounding a larger portfolio at a lower rate of return; and when is the investor better off compounding a smaller portfolio at a higher rate of return?<sup>1</sup>)

Here, we build on Part 3 by adding a tool investors and advisors increasingly have access to: tax-aware transition.<sup>2</sup> What if the investor had capital losses available to facilitate the transition from the lower-returning strategy to the higher-returning strategy?

Consider an investor who holds a \$1M equity strategy with an 80% unrealized gain. This investor identifies a similar strategy, but with a +1% expected return advantage.<sup>3</sup> Should they make the switch? We know from Part 3 that for horizons of less than 16 years, this investor is better off sticking with the original strategy (as shown in the dashed curve below).<sup>4</sup> But what if they are able to make the transition more tax-efficiently?

Suppose the new strategy realizes 10% of NAV in net capital losses in the first year, which are used to offset some of the tax cost of transition (solid curve below).<sup>5</sup> In this case, the investor realizes a modest benefit from the tax-aware transition (about 2.4% of NAV), and the higher expected return strategy requires a shorter, 10-year investment horizon to outpace the foregone deferral benefit.<sup>6</sup> In other words, the investor who previously needed an investment horizon of more than 15 years to be better off switching to the higher expected return strategy, is now *better off switching in only 10 years*.

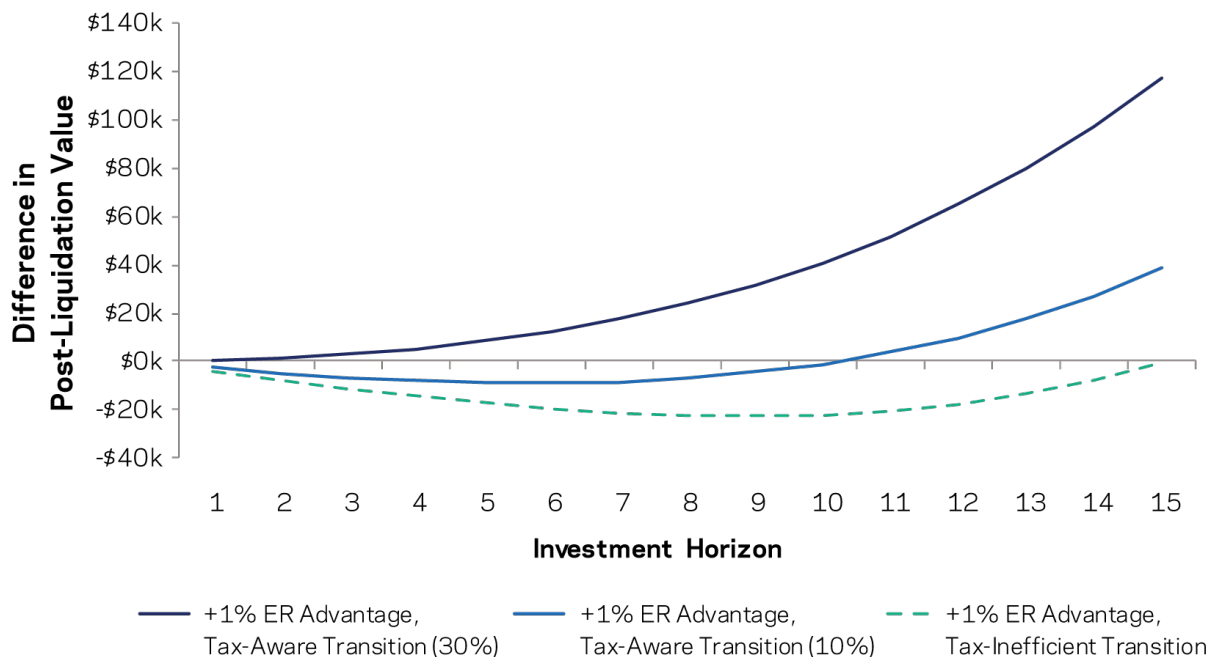
## The Advantage of Tax-Aware Transition



Source: AQR. Chart shows difference in post-liquidation values for comparability. The hypothetical base case portfolio starts with \$1M value and \$0.2M cost basis with an annual pre-tax return of 7%. The two lines show the post-liquidation value advantage (over base case) of scenarios in which the investor immediately liquidates the gain and pays taxes to switch to a higher 8% pre-tax annual return investment. The dotted green line assumes no tax-efficient transition, i.e., no net capital losses to offset the gain/taxes paid. The blue line assumes a 10% tax-efficient transition, i.e., \$0.1M in net capital losses to offset the gain, resulting in a starting portfolio value of  $NAV_{new} = \$1M - (\$0.8M - \$0.1M) \times 23.8\% = \$833,400$  and new portfolio cost basis of  $B_{new} = NAV_{new} - 10\% \times \$1M = \$733,400$ . The post-liquidation value for any portfolio with return  $r_i$  is calculated as  $S(1+r_i)^n(1-T) + B \times T$ , where  $S$  is the starting portfolio value,  $n$  is the investment horizon,  $T$  is the tax rate (23.8%), and  $B$  is the portfolio cost basis.

Of course, a 10% net capital loss is not an upper limit; some transitions can be made more efficiently than that.<sup>7</sup> The chart below adds one curve to the preceding chart: a transition facilitated with capital losses amounting to 30% of NAV. Clearly, there is plenty of value in making any portfolio transition tax-efficient—in the specific case of the top curve, making the investor better off switching to the higher expected return strategy *over any investment horizon*.

Clearly, there is plenty of value in making any portfolio transition tax-efficient



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[1] A key part of the answer to part 3 is the amount of unrealized gain in the starting portfolio. In our example, an investor with a 20% unrealized gain would be better off selling that portfolio and reinvesting the proceeds into one with a 1% expected return advantage – regardless of investment horizon. In contrast, if that starting portfolio had an 80% unrealized gain, then for investment horizons less than 16 years, the investor would be better off sticking with the starting portfolio.

[2] See, for example, [Sosner and Krasner \(2021\)](#).

[3] Here we assume a 7% expected return for the starting portfolio, and an 8% expected return for the second. For simplicity, we also assume the pre-tax return is the same as the after-tax return for the two strategies. Examples of these are described in [Sialm and Sosner \(2018\)](#).

[4] To make this analysis apples-to-apples, these comparisons use post-liquidation values.

[5] I.e., in this case, net capital losses of \$100,000 used to offset \$100,000 long-term capital gains.

[6] While a net loss of 10% of \$1M NAV may seem like a large benefit to the tax bill, there is a counter-acting force of basis depletion of the new strategy due to the immediate capital loss. So in Year 1, this \$100k lower basis leads to a lower post-liquidation value, which contributes to the negative difference in the first 10 years.

[7] See for instance [Lieberman et al. \(2023\)](#) and [Sosner and Krasner \(2021\)](#), which shows that active long-short strategies with pre-tax return objectives can also realize net capital losses through regular portfolio rebalancing. The authors show these net capital losses are typically larger than those achieved by long-only strategies, particularly when the starting portfolio is highly appreciated.

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