TAX AWARE

The Enduring Appeal of Gain Deferral, Part 2

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Our previous post showed the power of deferral for building wealth. But one key assumption in that analysis was that tax rates remain constant.

What if instead tax rates in the future are higher than they are today—could an investor be better off recognizing gains at today's lower tax rates?[1] How much higher would future tax rates have to be for deferral to be a bad idea, and over what horizon?

Let's return to our previous example of the hypothetical $1M portfolio with a 7% expected return, net of fees, and 80% unrealized gains. For brevity, we'll focus on the *advantage* of deferral, that is, the difference between post-liquidation values of the "Defer" and "Crystallize" approaches, rather than looking at each standalone. Consider three scenarios:

1. The maximum capital gains tax rate stays at 23.8%[2] (i.e., what we looked at last time)
2. This tax rate increases to 28.8%, and
3. This tax rate increases to 43.4%.

The table below shows our results, with Scenario 1 as our baseline (i.e., deferring is always valuable). Let's look at Scenario 2, where the assumed tax rate is 5% higher than it is today. We find that even at this higher rate, it's still *almost always* better to defer gains (unless the investment horizon is 3 years or less, but even over those short horizons the differences are pretty small).

What if future tax rates shoot all the way up to 43.4%? In other words, what if future maximum long-term capital gains tax rate is set to match maximum ordinary income tax rate before the Tax Cuts and Jobs Act of 2017? Even here, there's a pretty strong case to make for deferral. If our hypothetical investor plans to hold their portfolio for 10-15 years,[3] they're better off compounding today and deferring till later, despite the higher future tax rate.

Advantage of Deferral In Three Scenarios

Investment Horizon (Years)	Scenario 1: Tax Rate Unchanged at 23.8%		Scenario 2: Tax Rate Increases to 28.8%		Scenario 3: Tax Rate Increases to 43.4%	
	In Dollars	As a % of Starting Value	In Dollars	As a % of Starting Value	In Dollars	As a % of Starting Value
1	$10,156	+1%	($30,510)	- 3%	($149,256)	-15%
5	$58,404	+6%	$14,572	+1%	($113,418)	-11%
10	$140,319	+14%	$91,112	+9%	($52,574)	-5%
15	$255,209	+26%	$198,463	+20%	$32,764	+3%
20	$416,348	+42%	$349,028	+35%	$152,456	+15%
25	$642,353	+64%	$560,204	+56%	$320,328	+32%
30	$959,338	+96%	$856,389	+86%	$555,779	+56%

Source: AQR. We compute future post-liquidation wealth starting with an 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 $(1+r)^n*(1 - T_{future}) + B*T_{future}$, whereas the future post-liquidation wealth per dollar invested for crystalizing the gain today is $W_{current}*(1+r)^n*(1 - T_{future}) + W_{current}*T_{future}$, where $W_{current} = (1 - T_{current}) + B*T_{current}$ 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 market value, $T_{current}$ as the 2023 long-term capital gains tax rate, T_{future} as the long-term capital gains tax rate at the end of the investment horizon, and n as the investment horizon in years. We assume that $r = 7\%$, $T_{current} = 23.8\%$, and $B = 20\%$. We vary T_{future}. We find that varying expected returns or the cost basis does not meaningfully change the conclusion.

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[1] For instance, some have argued the size of national debt may lead Congress to curb spending, raise taxes, or both.

[2] I.e., 20% long-term capital gains plus 3.8% net investment income tax.

[3] OK, technically 13.

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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