TAX AWARE

Why You Might Defer Your Gains, Even When Tax Rates Are About to Increase

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We have argued before that it's generally better to reduce taxes (e.g., by deferring gains), as the capital used to pay a tax bill foregoes the benefits of future compounding. However, gain deferral also exposes an investor to the risk of higher future tax rates. The increase in federal debt have led some to argue that tax increases might be on the horizon. With the current proposals for (and the future expectations of) various tax rate hikes, investors with appreciated portfolios might feel like sailing into a storm and wondering, *is it still better to defer gains if tax rates were to increase?*

> *"Under reasonable expectations about capital gains tax rate increases, investment horizons, and expected returns, deferring gains to the future is better than crystallizing gains today"*

Our calculations show that in many circumstances it is still preferable to defer gain recognition. Under reasonable expectations about capital gains tax rate increases, investment horizons, and expected returns, deferring gains to the future is better than crystallizing gains today.

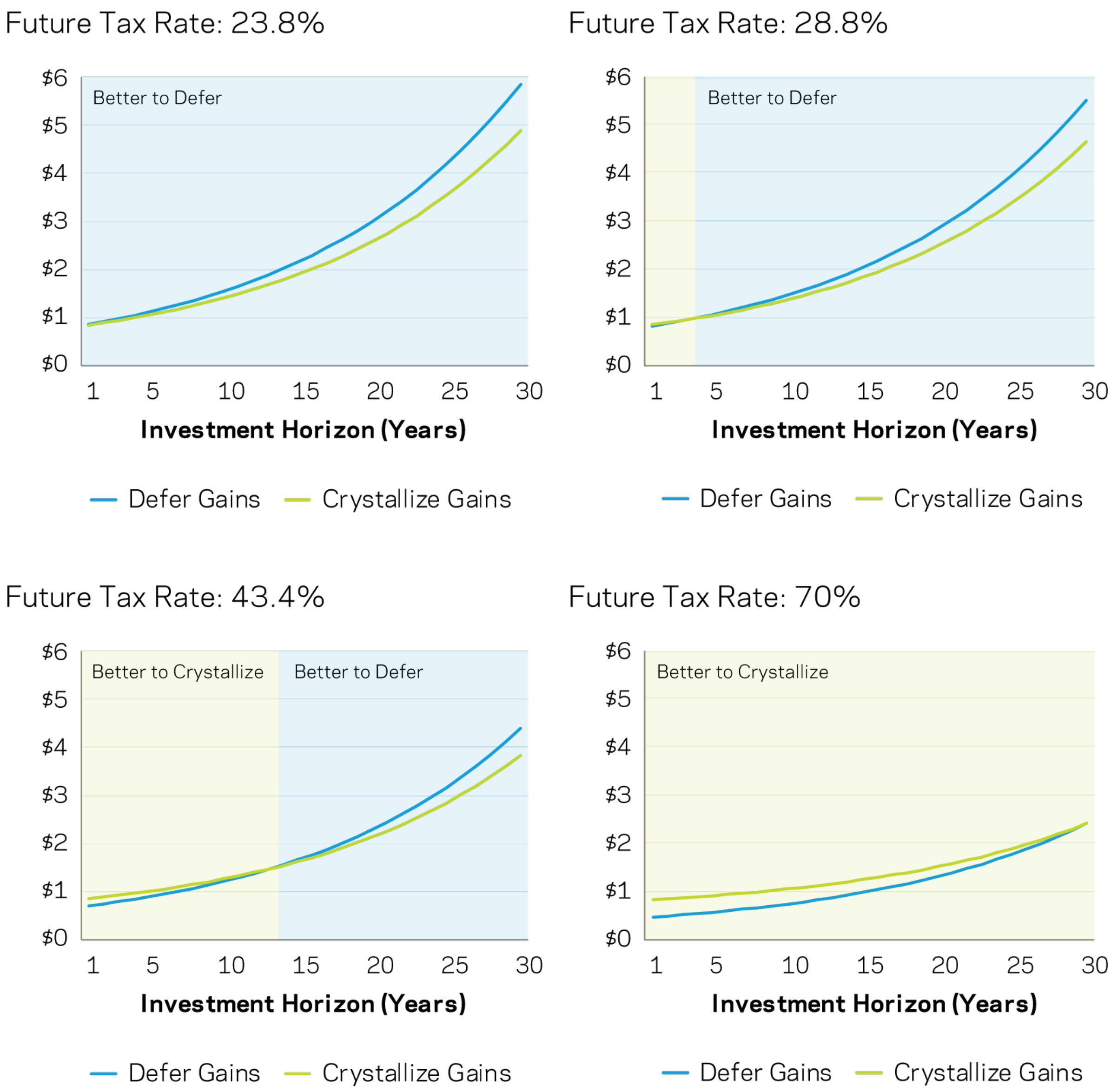
In Figure 1, we compare post-liquidation wealth under two scenarios: (1) crystallizing built-in capital gains now and (2) deferring them until the end of the investment horizon. The top left chart reminds us that, if the capital gains tax rate remains unchanged at 23.8%, deferring built-in gains results in a higher post-liquidation wealth at any investment horizon.

If, on the other hand, the tax rate rises modestly from 23.8% to 28.8%[1] (top right chart), it is still generally better to defer gains, unless an investor has a very short investment horizon. If the tax rate were to rise to 43.4%[2] (bottom left chart), liquidating would be optimal for investment horizons of up to 14 years. Even so, the economic advantage of crystallizing built-in gains declines rather quickly with investment horizon: the two lines are almost indistinguishable even around year 10.

What level does the tax rate need to increase to for crystallizing gains to become more attractive than deferring for all investment horizons of up to 30 years? The answer is: around 70% (bottom right chart).

Figure 1: The Benefits of Gain Deferral Remain under Most Future Tax Rate Scenarios

Ending Post-Liquidation Wealth for (1) Deferring Gains until the End of Investment Horizon and (2) Crystallizing Gains Today, Starting from an Investment with Hypothetical $1 Value and $0.20 Cost Basis and Assuming an Expected Return of 7% and a Current Tax Rate of 23.8%



Source: AQR. We compute future post-liquidation wealth starting with an investment with $1 value and $0.20 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 until the end of the investment horizon scenario is $(1 + r)^n(1 - T_{future}) + bT_{future}$, 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 $w_{current} = 1 - T_{current} + bT_{current}$. We define r as the expected annual 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 2020 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. We assume that r = 7%, $T_{current}$ = 23.8%, and b = 20%. We vary T_{future}. The cost basis of 20% approximates that of an investor who invested in the S&P 500 Index 10 years ago. We find that varying expected returns or the cost basis does not meaningfully change the conclusion. Hypothetical performance results have many inherent limitations, some of which, but not all, are described herein. No representation is being made that any fund or account will or is likely to achieve profits or losses similar to those shown herein. Hypothetical performance results are presented for illustrative purposes only. Hypothetical performance is gross of advisory fees, net of transaction costs, and includes the reinvestment of dividends. If the expenses were reflected, the performance shown would be lower.

Two important notes are worth making. First, we assumed that the investment is fully liquidated at the end of the investment horizon and, therefore, all built-in gains are fully realized and taxed at that point. A permanent gain deferral through donating assets to charity or step-up in their cost basis upon death would only make the case for deferring capital gains stronger.

Second, we assumed that there aren't better investment opportunities out there. An investor might tolerate a tax burden of liquidating an appreciated asset if she identifies another asset with a higher expected return and/or with a lower risk. 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 investments. In such situations, an investor might use loss-harvesting strategies whose losses could help offset the gains realized upon liquidation of the appreciated asset.

[1] Although the most recent version of the Build Back Better plan proposal has dropped an increase in the long-term capital gains tax rate from 20% to 25%, it introduced a 5% surcharge on AGIs above $10 million, and an additional 3% surcharge on AGIs above $25 million. In one form or the other, now or later, there is a possibility of an increase in tax rates on capital gains. We use a 28.8% rate, which is the sum of a 25% capital gains rate and a 3.8% net investment income tax, and which is close to a 28% rate generally viewed as a revenue-maximizing level of capital gains tax rate.

[2] The plan issued by the Biden presidential campaign proposed to increase long-term capital gains tax rates to the level of ordinary income tax rates for high earners and increase the highest bracket ordinary income tax rate from 37% to 39.6%. Neither of these proposals made it into the most recent version of the Build Back Better plan.

Risks of Tax Aware Strategies (Not Exhaustive)

1. **Underperformance of pre-tax returns:** tax aware strategies are investment strategies with the associated risk of pre-tax returns meaningfully underperforming expectations.

2. **Adverse variation in tax benefits:** deductible losses and expenses allocated by the strategy may be less than expected.

3. **Lower marginal tax rates:** the value of losses and expenses depends on an individual investor's marginal tax rate, which may be lower than expected for reasons including low Adjusted Gross Income (AGI) due to unexpected losses and the Alternative Minimum Tax (AMT).

4. **Inefficient use of allocated losses and expenses:** the tax benefit of the strategy may be lower than expected if an investor cannot use the full value of losses and

expenses allocated by the strategy to offset gains and income of the same character from other sources. This may occur for a variety of reasons including variation in gains and income realized by other investments, at-risk rules, limitation on excess business losses and/or net interest expense, or insufficient outside cost basis in a partnership.

5. **Larger tax on redemption or lesser benefit of gifting:** gain deferral and net tax losses may result in large recognized gains on redemption, even in the event of pre-tax losses. Allocation of liabilities should be considered when calculating the tax benefit of gifting.

6. **Adverse changes in tax law or IRS challenge:** the potential tax benefit of the strategy may be lessened or eliminated prospectively by changes in tax law, or retrospectively by an IRS challenge under current law if conceded or upheld by a court. In the case of an IRS challenge, penalties may apply.