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# How to Avoid Overreacting to Taxes

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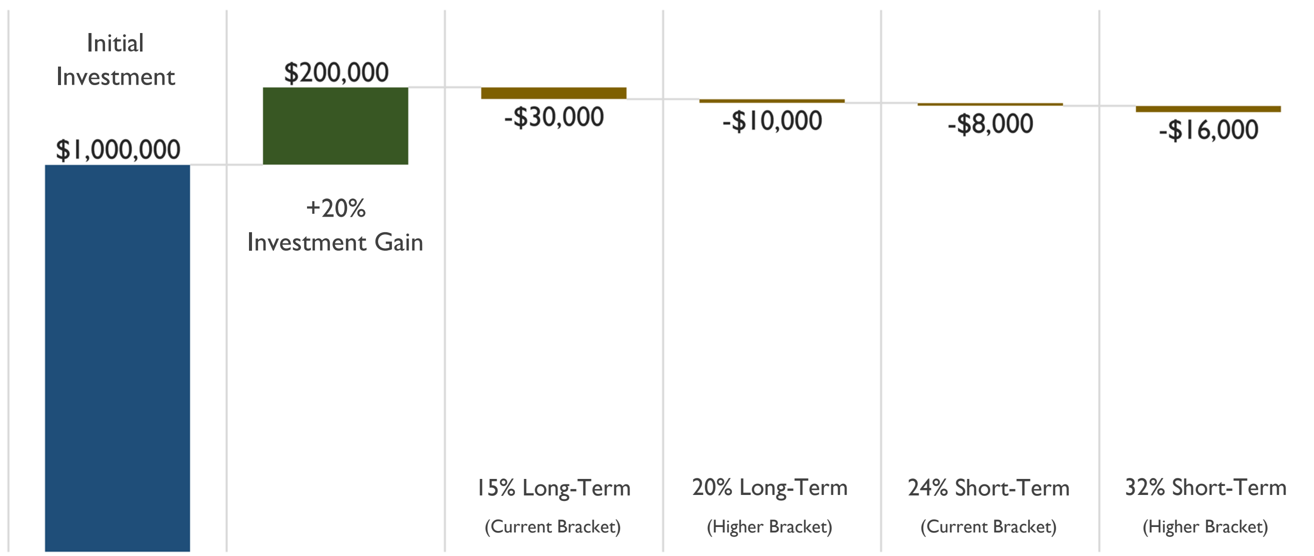
With the sharp market rebound, investors may find sizeable gains and tax consequences in their portfolios. Few things generate a more emotional response than taxes. Deciding to hold or sell an investment based purely on the tax consequences is usually at odds with maintaining a disciplined investment process. Ultimately, marginal differences in tax treatments are not as significant as we might imagine.

The analysis below highlights the tax consequences of a 20% gain on a $1 million dollar portfolio under a range of potential tax treatments. The difference between the more and less favorable scenarios is a negligible 3% change in the overall portfolio value.

VARIOUS TAX CONSEQUENCES OF A 20% GAIN IN A $1 MILLION PORTFOLIO




Source: IRS 2021 (https://www.irs.gov/publications/p15t)

The chart above shows the outcome of an individual who is in the middle federal income tax bracket, achieves a 20% return on a million-dollar portfolio, along with the cumulative outcome of moving from the least to most impactful tax treatment. In the most favorable scenario, the gain is taxed at the long-term capital gains rate in the current tax bracket. In the least favorable scenario, the entire gain is taxed at the marginal income rate in the next higher level-tax bracket. The difference between the two is $34,000.

Despite making $200,000 from investment gains, we can get undone by the thought of having to write a big check to the government. Fortunately, for most investors, there are a handful of straightforward tax strategies that can help build long-term wealth without compromising your investment process. These strategies include taking advantage of tax-deferred accounts, accelerating or deferring distributions, and gifting. Working with an experienced advisor, accountant, or attorney can help navigate this area and tailor solutions for your unique situation without compromising your investment process.

The main point is to separate our investing strategy from tax management. Grow investments first, then manage the tax consequences. After all, an investment gain is almost always a good thing!

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# From the Behavioral Viewpoint

## What is going on?

1. We **anchor** on the gross value of a gain and see anything less as a loss.
2. We perceive taxes as a capital loss, which engages our **two-for-one loss aversion**, where we feel twice as bad about a loss than an equivalent gain. "I lost $64,000 in taxes!"
3. We lose numerical **perspective,** by focusing on the tax rather than the overall positive impact of a large capital gain on a portfolio.
4. We use **heuristics** to simplify complex problems and satisfy emotional urges. "Taxes are bad, I want to avoid them."

## What can we do?

1. Realize that achieving gains and paying taxes are a normal part of building long-term wealth.
2. Separate investment decisions from tax management and keep the relative long-term impact of taxes in perspective.
3. Use needs-based planning to put investments in tax advantaged accounts and to help manage timing of activities.
4. Consider gifting appreciated securities to avoid taxes and increase giving impact.
5. Work with a skilled advisor to develop a plan to stay on track towards meeting real needs.

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