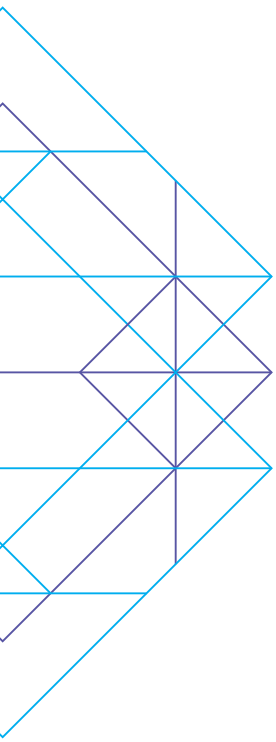

April 2019

Understanding the Tax Efficiency of Relaxed-Constraint Equity Strategies

Executive Summary

Tax-aware strategies can provide valuable tax benefit opportunities to investors. However, the numerous nuances around tax benefits can lead to investors expecting tax benefits even when there are none. To help investors and their advisors intuitively understand the kind of tax benefits they can derive under different circumstances, we decompose the total tax benefit into character and deferral components. We illustrate this decomposition on three beta-one equity strategies: tax-managed passive-indexed, tax-aware long-only and tax-aware relaxed-constraint.

We find that tax-aware relaxed-constraint strategies may be more attractive to taxable investors than their long-only counterparts, due to their higher character benefits. Finally, we provide practical guidance on the tax benefits of the tax-aware relaxed-constraint strategy by listing some caveats and the potential impact of the Tax Cuts and Jobs Act of 2017.

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Introduction

For taxable investors, wealth appreciates at the after-tax rate of return. Tax-aware strategies aim to increase the proportion of returns investors receive after paying taxes and may thereby accelerate the process of wealth accumulation. One technique widely used in tax-aware strategies is capital gains management, which entails deferring the realization of capital gains and accelerating the realization of capital losses (the latter is also known as loss harvesting). Despite the popularity and widespread use of capital gains management, the tax benefits it can create are complex and not well understood. This lack of understanding can make tax-aware strategy investors expect tax benefits where there are none.[1]

To shed light on the tax benefits of tax-aware strategies, Sosner, Krasner and Pyne (2019) propose a decomposition of the total tax benefit into character and deferral components. We believe that this character-deferral decomposition could assist investors with the complicated problem of understanding how the tax benefits of tax-aware strategies apply to their specific situations.

We apply the decomposition to three simulated beta-one equity strategies: tax-managed passive-indexed (TMPI), tax-aware long-only (TALO), and tax-aware relaxed-constraint (TARC). We find that the TARC strategy may be more attractive to taxable investors than its long-only counterparts, TMPI and TALO, due to its meaningfully higher character benefits. We then outline caveats that might alter this conclusion and discuss the potential effects of the Tax Cuts and Jobs Act of 2017 (TCJA) on the tax benefits of TARC.

Character and Deferral Tax Benefits

Sosner, Krasner and Pyne (2019) argue that it is helpful to decompose tax benefits into two types: character and deferral. For simplicity of exposition, we illustrate this decomposition with an investment strategy that allocates only capital gains and losses and ignore ordinary income (losses) and qualified dividends.

The *character benefit amount* of a tax-aware strategy is equal to the matching amount of realized long-term gains and short-term losses. The product of the character benefit amount and the difference between the short-term and long-term capital gains tax rates is defined as the *character benefit*.[2] Thus, the character benefit is higher when short-term gains are taxed at a significantly higher rate than long-term gains, like in the case of U.S. federal taxes.

1 An important caveat is that the tax benefits of a strategy arise when its losses offset gains from other investments in the investor's portfolio. This assumption will be employed throughout the article. The tax benefits are an estimate of the end of year tax benefits/liabilities and do not reflect an investor's actual taxes.

2 Technically speaking, capital gains (and losses) and ordinary income (and deductions), are the only two true categories of "character." Long-term and short-term capital gains are subcategories within the capital gains character. However, they are often referred to as having a different character because under the current U.S. tax law they are subject to different tax rates.

The *deferral benefit (liability) amount* is a net realized loss (gain) across all characters. The product of the deferral benefit amount and the appropriate tax rate is defined as the *deferral benefit*. For example, if the short-term losses realized by a strategy exceed its realized long-term gains, the excess realized loss is defined as a positive deferral amount (creating a deferral benefit). As this loss allows the investor to reduce the amount of short-term capital gains taxable in the current year, the applicable tax rate is the short-term rate. Conversely, if the long-term gains realized by a strategy exceed its realized short-term losses, the excess realized gain is defined as a negative deferral amount (creating a deferral liability) and the applicable tax rate is the long-term rate.

To clarify, Sosner, Krasner and Pyne (2019) define character and deferral benefits (or liabilities) with reference only to a given tax-aware strategy and not to the individual investor's tax situation. The benefits thus represent the *potential* for the strategy to yield tax savings under certain assumptions about the investor's overall tax situation.[3] In particular, these benefits will be realized as contemporaneous tax savings if the investor has short-term capital gains from other sources at least equal to the tax-aware strategy's short-term losses.[4]

In the case of an investor with more than enough realized gains to be offset by a tax-aware strategy's realized losses, the character and deferral benefits of the tax-aware strategy possess a simple interpretation: the former produces tax savings by increasing the ratio of long-term realized gains to all realized gains, long-term and short-term, while the latter creates savings by increasing the ratio of unrealized gains to all gains, realized and unrealized.

Exhibit 1 is a stylized illustration of the concept of the current period character and deferral tax benefits. Consider a multi-strategy portfolio that realizes a total of $100 of capital gains, comprising $50 of realized long-term gains and $50 of realized short-term gains. We add a tax-aware strategy to this portfolio.[5]

Assume the tax-aware strategy realizes a long-term gain of $20 and a short-term loss of $30, for a net total capital loss of $10, as shown in Panel A. After netting the respective gain realizations, the overall portfolio realizes $70 in long-term gains and $20 in short-term gains. Thus, the addition of the tax-aware strategy changes the character of the gains favorably from equal amounts of long-term and short-term ($50 and $50) to mostly long-term ($70 versus $20). We define the matching amount of increase in long-term gains and decrease in short-term losses (here, both are $20), as the *character benefit amount* of the tax-aware strategy. Further, the tax-aware strategy reduces the total realized gains of the portfolio from $100 ($50 long-term plus $50 short-term) to $90 ($70 long-term plus $20 short-term). This $10 reduction in total realized gains is the *deferral benefit amount*.

3 Both the character and deferral benefits represent the potential for current tax savings, but whereas the character benefit is permanent, i.e., tax liabilities are reduced permanently by paying tax at a lower rate, the deferral benefit or liability is temporal to the extent that deferring capital gains leads to an increase in unrealized gains and thus a relatively larger potential tax liability in the future. Still, despite its temporal nature, a current deferral benefit adds real value as it allows the investor's wealth to appreciate (compound) at a faster rate, even after adjusting for the higher liquidation tax in the future that results from gain deferral.

4 This is an important assumption but not the only one. The specifics of the investor's tax situation must allow for the short-term losses of the tax-aware strategy to be used to offset the short-term gains. One potential limitation on such an offset is discussed below in the section on the Tax Cuts and Jobs Act. There are others that are beyond the scope of this paper.

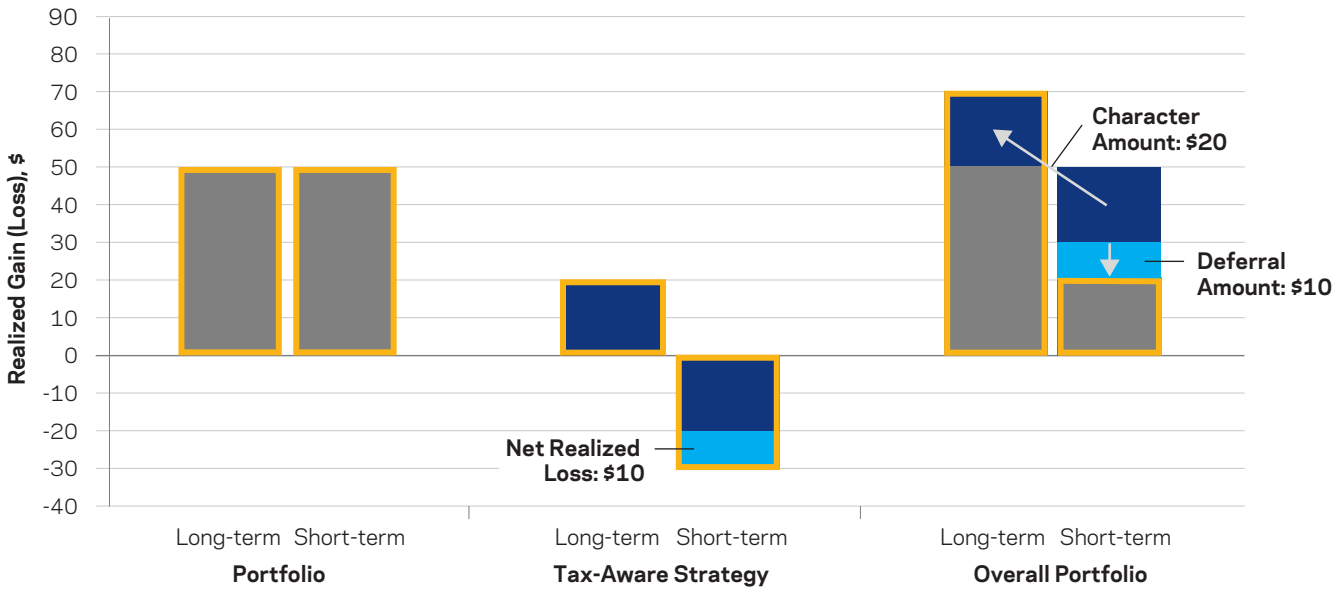
5 To simplify the example, we add the tax-aware strategy to the portfolio instead of allocating to it while simultaneously reducing the allocation to other strategies.

Panel B illustrates a scenario in which the tax-aware strategy realizes a long-term gain of $30 and a short-term loss of $20, for a net total capital gain of $10. In this case, the character benefit amount is $20 as before. However, the deferral benefit is negative, i.e., a deferral liability, as the total amount of realized gains at the portfolio level increases from $100 ($50 long-term plus $50 short-term) to $110 ($80 long-term plus $30 short-term).

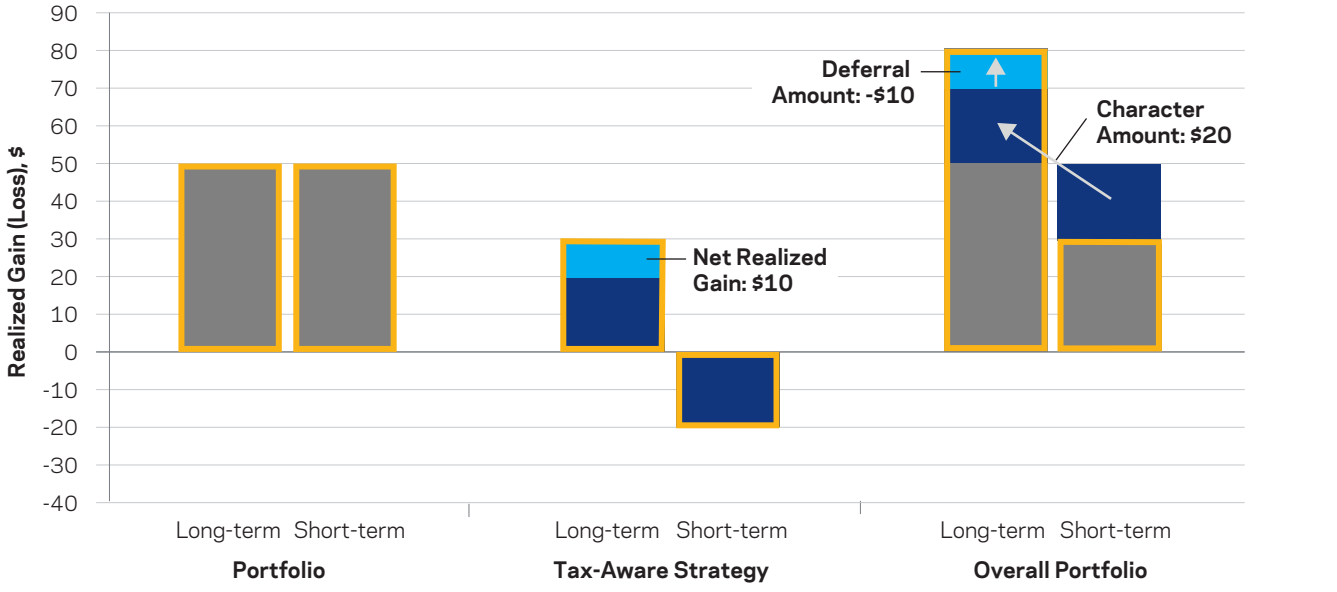
Exhibit 1

Illustrative Example of Character and Deferral Benefit Amounts

Panel A: Tax-Aware Strategy with a Net Realized Loss



Panel B: Tax-Aware Strategy with a Net Realized Gain



Source: AQR. For illustrative purposes only and not representative of an actual portfolio that AQR currently manages.

It is clear from the examples in Exhibit 1 that the character benefit of a tax-aware strategy would not materialize for investors who have no short-term gains from other sources. On the other hand, a deferral benefit can be created by a tax-aware strategy that realizes a net capital loss as long as the investor has *any* type of capital gains, long-term or short-term, with the caveat that the current value of this benefit is lower for investors with only long-term gains from other sources.

Taxable investors and their advisors may benefit from understanding the character and deferral decomposition of tax-aware strategies precisely because it allows for a rapid and intuitive understanding of the ways in which such strategies might reduce tax liabilities of investor portfolios.

A Comparison of Tax-Aware Equity Strategies

We simulate three beta-one investment strategies. TMPI closely tracks the Russell 1000 index while harvesting losses. TALO is an actively managed long-only beta-one strategy that utilizes value and momentum signals as sources of alpha. TARC is also an actively managed beta-one strategy that relies on the same value-momentum alpha model as TALO but, in contrast to TALO, allows shorting. It uses 30% leverage and 30% shorting such that, similar to TMPI and TALO, its weights still sum to 100%.[6]

As described in Ang, Michalka and Ross (2017), relaxing the long-only constraint makes the implemented portfolio closer to the ideal alpha model portfolio. Thus, assuming that the alpha model adds value, a relaxed-constraint strategy is expected to provide a higher active return than a long-only strategy utilizing the same alpha model. **Exhibit 2**, which compares the performance of simulated tax-aware strategies TMPI, TALO and TARC, shows that after taxes, the advantages of a relaxed-constraint strategy are magnified further.

Notably, on average, TARC realized potential tax benefits relative to the Russell 1000 index, as seen from the 0.58% active tax, while TALO realized tax liabilities (-0.26% active tax).[7] TMPI also realized tax benefits relative to the Russell 1000 index (0.30% active tax) and was more tax-efficient than TALO but not as efficient as TARC. In contrast to TARC and TALO, TMPI did not generate any active pre-tax return. Thus, of the three strategies, TARC had the highest after-tax return and information ratio and was the most tax efficient.

6 The TARC and TALO strategies are simulated from January 1988 to December 2017 using a quantitative industry-neutral stock-selection model. The model ranks US large-cap stocks (roughly the Russell 1000), equally on value (book-to-price) and momentum (previous 12 months' return excluding the last one month), within each industry. The strategies are rebalanced monthly. The TALO and TARC strategies target 4% tracking error annually while the TMPI strategy targets a lower tracking error of 1% annually. The tax rates used in the simulation are constant across time and roughly correspond to the federal tax rates for a U.S. individual in the top federal marginal income tax bracket in 2018: 20% on long-term capital gains and dividends, and 35% on short-term capital gains and interest expense. We also assume that the effective tax rate applicable to unrealized gains is 10%. Tax lot accounting used is HIFO (Highest-in, First-out). See Sosner et al. (2019) for further details on methodology and assumptions.

7 Total tax is the strategy's tax benefit or liability whereas active tax is the strategy's total tax in excess of the total tax benefit or liability of the relevant benchmark. As shown in Exhibit 2, the expected active tax benefit of the TARC strategy is positive though its expected total tax benefit is negative (a liability), as its expected total tax liability is still lower than that of its benchmark.

Exhibit 2
Hypothetical Pre-tax and After-tax Returns of Tax-Aware Beta-One Equity Strategies

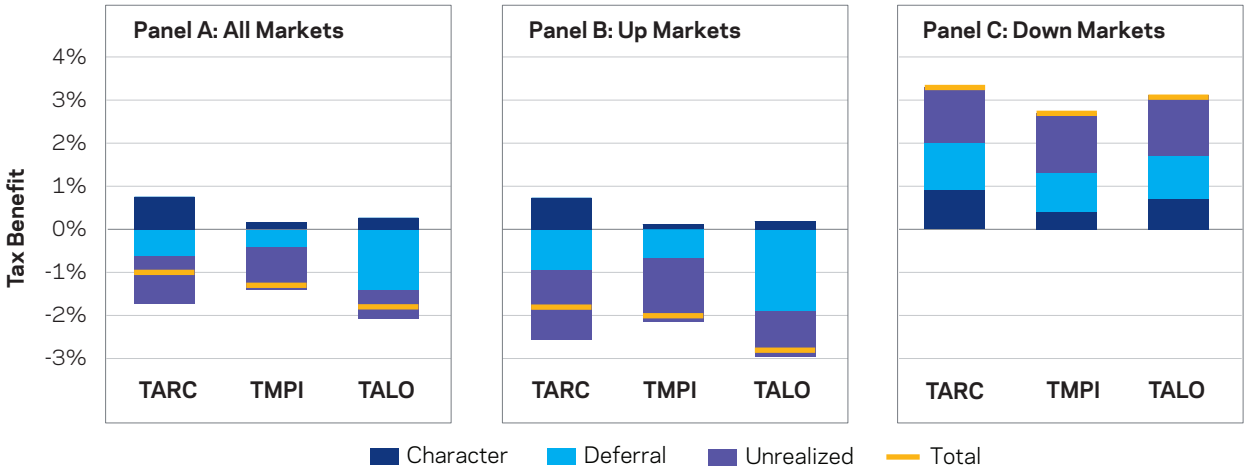
	Tax-Aware Relaxed-Constraint (TARC)	Tax-Managed Passive-Indexed (TMPI)	Tax-Aware Long-Only (TALO)
Active Annual Returns			
Pre-Tax, Gross	3.19%	0.24%	2.04%
Transaction Costs	-0.38%	-0.02%	-0.24%
Costs of Leverage	-0.30%	0.00%	0.00%
After-Tax, Net	**3.09%**	**0.52%**	**1.54%**
Active Annual Risk			
Pre-Tax, Net	5.36%	1.15%	5.00%
After-Tax, Net	4.61%	1.13%	4.31%
Annual Information Ratio			
Pre-Tax, Net	0.47	0.19	0.36
After-Tax, Net	**0.67**	**0.46**	**0.36**
Taxes			
Active Tax	**0.58%**	**0.30%**	**-0.26%**
Total Tax	-0.97%	-1.25%	-1.81%
Turnover and Gross Notional Value			
Annual Turnover, % of NAV	153%	32%	104%
Gross Notional, % of NAV	160%	100%	100%
Annual Turnover, % of GNV	96%	32%	104%

Source: AQR. Data from January 1, 1988, to December 31, 2017. See footnote 6 for details on the simulation. All strategies are benchmarked to the Russell 1000. Active tax is the potential incremental federal tax benefit (liability if negative) relative to the Russell 1000. Potential federal tax benefits and after tax returns assume no state taxes and assume that the tax payer has sufficient business or other income, long-term capital gains and short-term capital gains from sources outside this portfolio to offset any net deductions, long-term capital losses and short-term capital losses, respectively, realized within this portfolio. Returns are gross of fees and transaction costs. Not representative of an actual portfolio that AQR currently manages. Hypothetical data has inherent limitations, some of which are disclosed herein.

What explains the higher tax efficiency of the TARC strategy? We dig deeper into the sources of each strategy's tax benefits by decomposing the current period total tax benefit into character and deferral components and also consider the increase in unrealized gains, as presented in **Exhibit 3**. Each strategy's total tax benefit reported in Exhibit 2 is the sum of its respective character benefit, deferral benefit (or liability) and expected tax cost of unrealized gains shown in Exhibit 3.

Exhibit 3

Hypothetical Character-Deferral Decomposition of Potential Federal Tax Benefits of Beta-One Equity Strategies, 1988–2017



Source: AQR. Data from January 1, 1988, to December 31, 2017. See footnote 6 for details on the simulation. Up and down markets are defined as periods when the benchmark Russell 1000 returns are positive and negative respectively. Returns are gross of fees and transaction costs. Potential federal tax benefits assume no state taxes and assume that the taxpayer has sufficient business or other income, long-term capital gains, and short-term capital gains from sources outside this portfolio to offset any net deductions, long-term capital losses, and short-term capital losses, respectively, realized within this portfolio. Not representative of an actual portfolio that AQR currently manages. Hypothetical data has inherent limitations, some of which are disclosed herein.

Exhibit 3, Panel A, shows that TARC owes its relative tax efficiency to its high character benefit, i.e., its ability to allocate matching amounts of short-term capital losses and long-term capital gains. Compared to the relatively passive TMPI, it had a slightly higher level of deferral liability, whereas compared to actively managed TALO, it had a much lower level of deferral liability. TARC clearly dominated both TMPI and TALO in character benefits.

Exhibit 3, Panels B and C, show that TARC maintained its relative tax efficiency in both rising and falling markets as its total tax benefit and character tax benefit were higher than those of the TMPI and TALO strategies. In particular, its character benefit remained high and stable across all market regimes. In falling markets, as depicted in Panel C, all the strategies realized a similar amount of deferral benefit due to easily available losses, but TARC realized a higher level of character benefit. In rising markets, as depicted in Panel B, despite an average position being at a gain, TARC still managed to realize significant character benefits. This is thanks to the short portfolio positions of TARC, many of which realized losses in rising markets. In addition, in rising markets, actively managed TARC realized a somewhat higher deferral liability than passive TMPI but a substantially lower deferral liability than actively managed TALO.

Thus, Exhibit 3 suggests that a sustainable source of tax benefit for all the tax-aware beta-one strategies is the character benefit. As a result, over the long term all three strategies are expected to provide a potential tax benefit only to those investors who can take advantage of the character benefit—investors with short-term capital gains from other strategies in their portfolios. Importantly, TARC could be more beneficial to such investors than TMPI or TALO because of its potential for a relatively high and stable level of character benefit.

Practical Applications

Where does TARC fit in the investor's portfolio?

Like traditional actively managed equity strategies, relaxed-constraint strategies aim to provide investors with the potential to outperform a particular benchmark.[8] Tax-aware relaxed-constraint strategies offer investors access to enhanced benchmark returns tax-efficiently and with the potential to create substantial tax benefits. TARC, for example, can play the role of a tax-efficient core in a "core and satellite" structure where a beta-one tax-efficient core strategy helps offset capital gains realized by tax-inefficient satellite managers.

Does it matter which investment vehicle is used to manage TARC?

To achieve its tax benefits, TARC must be managed in a separately managed account or in a pass-through entity such as a limited partnership or an LLC. While separately managed accounts and limited liability partnerships have differences whose discussion is out of the scope of this paper, in both cases, investors can deduct losses realized by the strategy from gains realized by other strategies. A mutual fund cannot distribute losses to its investors and as result cannot serve as a tax-efficient core.

Is TARC more effective than TMPI as a tax management tool?

Historically, TMPI-type strategies may have been viewed as the tax-efficient core. However, the character-deferral decomposition suggests that TARC might be a better alternative. This is because, based on our empirical analysis, both TMPI and TARC produce a similar type of tax benefit, but TARC just yields more of it. During our simulation, on average, the tax benefits of both TMPI and TARC came from character, not deferral, implying that both yield a tax benefit when satellite managers realize a substantial amount of short-term capital gains. However, TARC realized a significantly higher character benefit and thus, assuming the presence of satellite managers with short-term gains, could yield a higher tax benefit than TMPI. Moreover, the character benefit of TARC tends to remain high and stable in rising markets where it is arguably more valuable because other investments might be at a gain.

What if other strategies don't realize short-term capital gains?

If satellite managers realize predominantly long-term capital gains, both TMPI and TARC partially lose their attractiveness as a tax-management tool because they tend to realize deferral benefits only in down market years. Not only are down markets relatively infrequent, but also in such markets deferral benefits are less valuable as many other investments are likely to be at a loss.

8 It is, of course, the case that relaxed-constraint strategies employ leverage and shorting and so some have argued they should be viewed as alternatives. We prefer to categorize strategies by their economics and the role they typically play in portfolios rather than by their mechanics and instruments they happen to trade.

Can actively managed tax-aware strategies still generate pre-tax alpha?

Our simulations show that both TARC and TALO have reasonably high pre-tax alpha and information ratio. Actively managed systematic and diversified strategies like the ones considered here can combine tax awareness with pre-tax alpha generation.

Why not use TALO instead of TARC?

We find that TALO is unlikely to function as a beta-one tax-efficient core nearly as effectively as TARC: Our analysis suggests its character benefit is a fraction of the character benefits of TARC, while its negative deferral—acceleration of gains realization—is twice as high as that of TARC.

Caveats Related to TARC

TARC manager's alpha

Any actively managed strategy relies on the manager's alpha skill and introduces tracking error to the benchmark. As a result, compared to TMPI, TARC manager selection may have a bigger effect on after-tax returns.[9]

Transaction and financing costs

As actively managed strategies, TARC and TALO will have a significantly higher turnover than TMPI. In addition, TARC will incur financing costs to support the 30/30 extensions. These costs might be low for professional active managers, but if an individual investor were to attempt to manage TARC on their own, these costs could be quite onerous.

Gifting of appreciated positions and strategic capital gain realization

Managing TARC in a separately managed account might be costly and inefficient, especially for smaller investors as the costs they face may be higher than those borne by larger sophisticated investors. As a result, it is possible and even likely that such a strategy would be managed by a professional manager in a commingled fund. Investment through a commingled fund, however, makes other tax management techniques, such as gifting highly appreciated individual stock positions to charity or strategically realizing unrealized capital gains, virtually impossible.[10] As a result, TMPI or TALO, which are easier to manage in a separate account, could in practice demonstrate higher tax efficiency compared to what our sample analysis reveals.

9 Manager selection is key in relaxed-constraint strategies as they require a certain level of sophistication. Firstly, the use of leverage and shorting warrants additional risk management. Secondly, managers of relaxed-constraint strategies must identify not only promising companies to overweight, but also poor prospects to underweight or short. These considerations apply to relaxed-constraint strategies in general, not just the tax-aware realized-constraint strategies, and we believe the benefits of relaxed-constraint strategies can outweigh any additional complexity involved. There is no guarantee that this strategy will be successful. There is a potential for loss.

10 Even though individual positions cannot be gifted, it is still possible to gift to charity interests in commingled funds.

What Changed with the Tax Cuts and Jobs Act of 2017

Marginal tax rate

The TCJA changed the top marginal tax rate, applicable to ordinary income and short-term capital gains, from its prior value of 39.6% to 37%. This change reduced both the potential character and deferral benefits of tax-aware strategies: the former because it is proportional to the difference between the top rate and the long-term rate, which decreased, and the latter because it is proportional to the top marginal tax rate, which also decreased.[11] At the same time, in high-tax states (e.g., California) and localities (e.g., New York City), the TCJA limitation on state and local tax deduction to $10,000 might have increased the deferral benefit by increasing the total—state, local and federal—marginal tax rate.[12] These changes do not alter the conclusions of this paper, which we note applies rounded hypothetical tax rates of 35% to short-term gains and ordinary income, and 20% to long-term gains and qualified dividend income.

Deductibility of investment management fee expenses

The TCJA changed the tax treatment of investment management fees for investor funds and for separately managed accounts treated as engaged in an investor activity. Fees paid to the investment manager of such funds or accounts were deductible by investors as a miscellaneous itemized deduction prior to the TCJA, subject to some limitations on miscellaneous deductions. Under the TCJA, however, these fees became a nondeductible expense for the investor. In contrast, investment management fees of trader funds (funds that are traders in securities) were treated as deductible ordinary expenses prior to the TCJA (and so not subject to limitations on miscellaneous deductions) and continue to be so under the TCJA.[13] In our experience, TARC strategies tend to be employed in funds classified as trader funds whereas TMPI strategies are typically employed in investor funds or SMAs treated as investor activity (with TALO strategies being more evenly divided between trader and investor vehicles).

11 When tax-aware strategies allocate losses, they tend to allocate them as short-term. As a result, any excess loss, which we define as deferral benefit amount, is likely to be short-term, and thus the tax rate applicable to it is also likely to be short-term.

12 To see this, note that state and local taxes provide a deduction against ordinary income. Prior to the TCJA, a marginal dollar of short-term capital gains and ordinary investment income was taxed at the rate equal to 39.6%+3.8%+9.57%-(9.57%-3%)×39.6%=50.37% and a marginal dollar of long-term capital gains and qualified dividend income was taxed at 20%+3.8%+9.57%-(9.57%-3%)×39.6%=30.77%, assuming the following tax rates: federal rate (39.6%), Medicare surtax rate (3.8%), state and local rate (9.57%), and state and local deduction subject to 3% Pease phase-out (9.57%-3%), respectively, which represent tax rates faced by a U.S. individual in the top marginal federal income tax bracket and also subject to state and local taxes. The difference between the two rates is the same as the difference between the 39.6% and 20% federal rates, i.e., 19.6%, because the rest of the terms are the same in both cases. The TCJA has eliminated state and local tax deduction for a marginal dollar of gains or income once state and local taxes exceeded $10,000. As a result, a marginal dollar of highly taxed items is now taxed at 37%+3.8%+9.57%=50.37% (equal to the pre-TCJA level) and a marginal dollar of low-taxed items is now taxed at 20%+3.8%+9.57%=33.37% (a 2.6% increase from the pre-TCJA level). For state and local tax rates above the 9.57% level assumed here, the TCJA has increased the total marginal tax rates applicable to highly taxed items in the highest federal income tax bracket. For example, in California, where the highest marginal state tax rate is 13.3%, the total marginal tax rate on highly taxed items has increased from 52.62% to 54.10%.

13 Sometimes, managers of trader funds structure their performance compensation as a fee rather than an allocation, and that performance fee also continues to be deductible under the TCJA. The deductibility of fees for trader funds under the TCJA is not unlimited, however, as it is subject at minimum to the rules governing excess business losses mentioned below.

Limitation on excess business losses

The TCJA introduced a new limitation on excess business losses that may render losses and expenses of trader funds less likely to provide a tax deduction in certain situations. The scope of the new business loss limitation has been the subject of much uncertainty throughout 2018. All of the details of this limitation are still not clear as of the writing of this article and alternative interpretations of the new statute have been put forward.[14] The limitation currently applies to excess business losses for the years 2018 to 2025.

There is an annual safe harbor amount of $250,000 for singles and $500,000 for married filing jointly. This means that investors can still utilize up to $250,000/$500,000 of excess business loss allocated by trader funds as an offset against their income and gains of the same character from investor activities such as holding stocks, bonds, or mutual funds as a long-term investment or investing in investor funds. Investors who have other significant sources of business income, e.g., regular operating business income or income from other trader funds, may be unlikely to experience a net business loss that exceeds the 250,000/500,000 annual safe harbor amount, even when some of their trader funds allocate a loss.

Limitation on business interest expense

The TCJA introduced a limitation on business interest expense, which caps allocations of net interest expense of trader funds such as TARC, at 30% of earnings before interest, taxes, depreciation and amortization (with any excess carried forward and potentially deductible the following year and, at worst, upon redemption).[15] While this could theoretically reduce the tax benefits of a trader fund, in practice the cap is quite unlikely to be reached in a TARC trader fund. The reason is that meaningful interest expenses normally arise from outright borrowing, whereas the leverage of TARC is essentially "self-financing," i.e., cash from positions sold short is used to finance long positions. Such leverage results in ordinary expenses correctly classified as brokerage fees and not as an interest expense on funds borrowed outright.

Summary of the effects of TCJA on TARC

To summarize: the change in marginal tax rates reduces the tax benefits of TARC slightly, investment management fees of TARC remain fully deductible, the limitation on excess business losses, while still not fully clear as of the time of this writing, is not expected to have a material adverse effect on potential TARC tax benefits in most circumstances, and the limitation on business interest expense has no impact on TARC tax benefits.

14 Technical Note. The TCJA introduced Internal Revenue Code Section 461(l) titled "Limitation on excess business losses of noncorporate taxpayers," the precise application of which resulted in much debate among tax professionals. On December 28, 2018, the IRS released final Form 461 and its instructions, which have not resolved the uncertainty regarding the scope of the business loss limitation under Section 461(l). In particular, it is unclear whether *capital losses* from a trade or business are subject to this limitation. Although there is no explicit exclusion of capital losses from the new rule, the statute and the form instructions both define an excess business loss as the amount by which *total deductions* from trades or businesses exceed *total gross income or gains* from trades or businesses, leaving one to wonder whether the omission of the phrase "or losses" is intended as an implicit exclusion of business capital losses from the limitation. Moreover, Form 461 itself and its instructions require consideration of business gains and losses reported on the face of the tax return whereas the face of the tax return can never reflect a net capital loss (with the exception of the $3,000 allowance against ordinary income). This might lead one to conclude that capital losses are intentionally excluded. There is an alternative view that the word "deductions" in the statute was intended to be inclusive of losses. Losses are technically deductions, but then again gains are technically gross income, and nonetheless gains are mentioned explicitly. Those with the latter perspective that deductions do include capital losses are of the view that new Form 461 implicitly requires that gross losses from a trade or business be taken into consideration. This technical note gives the reader the idea of the level of complexity involved in understanding this new limitation.

15 Until 2022, at which point the limitation changes.

Conclusion

We find TARC to be a good choice for investors seeking a tax-efficient active equity strategy, as well as a useful tax management tool for investors with short-term capital gains. This is because it may realize high and stable character benefits. On the basis of its potential tax benefits, TARC might be more attractive than more traditional long-only strategies such as TMPI and TALO. In addition to its tax benefits, TARC may generate a substantial pre-tax alpha as well, thus—in combination with tax benefits—providing a taxable investor with a high after-tax alpha.

TARC can play the role of tax-efficient core in a core-satellite portfolio structure where satellites are tax-inefficient managers realizing short-term capital losses. However, investors considering the inclusion of TARC in their portfolios should be mindful of caveats such as its higher trading and financing costs in comparison to traditional long-only strategies, its tracking error to a benchmark, and its dependence of manager alpha.

Finally, it is our opinion that the new laws and regulations under TCJA of 2017 are unlikely to have any meaningful impact on the tax benefits realized by TARC.

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Disclosures

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