



Tax Matters

The Impact of Liquidation Taxes on the Lifecycle Benefits of Tax-Aware Long-Short Strategies

July 31, 2025

Tax-aware long-short (TA LS) strategies tend to accumulate significant built-in gains. When the time comes to wind down the strategy, those gains are realized, triggering what is known as a liquidation tax. This post addresses frequently asked questions about the impact of this tax on investors and provides examples that illustrate the post-liquidation value a TA LS strategy can deliver over its lifecycle, compared with other investment options.

Common Questions

How much built-in gain does a TALS strategy tend to accumulate—and is that good news or bad?

At all times, the built-in gain of a TA LS strategy equals the sum of three components: the initial built-in gain (which is zero if funded with cash), the cumulative net-of-cost pre-tax performance, and the cumulative net tax losses realized since inception.¹

For example, consider a strategy seeded with positions having a built-in gain of \$100. If the strategy subsequently generates \$200 in pre-tax profits, pays \$20 in dividends, and realizes \$250 in cumulative net capital losses, the built-in gain would be \$530 (= \$100 + \$200 + (\$250 - \$20)).

A high built-in gain is good news. It reflects a combination of strong pre-tax performance and tax-efficiency, indicating that the strategy has fulfilled its objectives—generating pre-tax alpha and realizing significant net capital losses. As the strategy ages, the built-in gain is expected to grow. The example shown in **Exhibit 1** below illustrates the evolution of built-in gains.

Won't investors lose all accrued tax benefits upon liquidation of the TALS strategy?

The short answer is no.² First, the tax deferral benefits allow the strategy to compound at the pre-tax rate of return, which is not reduced by the tax burden. Second, the deferred taxes compound at the rate of return of the overall investment portfolio. The combination of these two factors leads to substantial after-tax wealth accumulation, typically not undone by liquidation taxes.³ Moreover, this largely holds true regardless of whether the short-term losses realized by the strategy are used to offset short-term or long-term gains, and whether the strategy is liquidated all at once or unwound gradually. That said, as with all tax-related matters, thoughtful planning for liquidation typically yields better after-tax outcomes (see the answer to the next question and the examples further below).

What are the options for unwinding a TALS strategy?

Options for unwinding a TA LS strategy depend on the reason for unwinding it. Consider the following three reasons for unwinding a strategy, either partially or fully:

- 1 Reducing Active Risk:** If the investor is satisfied with the manager but wants less active risk, the strategy's risk can be reduced over a few years in a tax-efficient manner. Importantly, the risk reduction tends to occur non-linearly, with the majority happening early in the process.
- 2 Replacing the Manager:** If the manager is to be replaced, a new tax-aware long-short manager can take over with minimal gain recognition and gradually reposition the portfolio to align with the new strategy in a tax-efficient manner. Alternatively, only the long and short extensions can be liquidated with tax efficiency in mind, leaving a long-only appreciated portfolio in the account (see the example in **Exhibit 2** below). The investor can then hire a long-only direct-indexing manager to manage this portfolio in a tax-aware manner or contribute the portfolio to an ETF using a Section 351 exchange without recognizing any gains.
- 3 Liquidity Needs:** If the investor needs cash and the amount is modest relative to the portfolio size, a simple redemption may not trigger

gains. For charitable gifting, appreciated positions can be donated directly from the strategy's portfolio. If full liquidation is required, all deferred gains are realized. The impact of full liquidation will depend on various factors such as account age, leverage, and past activity (see the example in **Exhibit 3** below).

Heirs may also benefit from a basis step-up at death, further enhancing the strategy's long-term tax efficiency (see the example in **Exhibit 3** below).

Lifecycle Benefits of TA LS Investing

Methodology

In the examples below, we use the following assumptions:

The TA LS strategy is a 150/50 strategy with a target beta of 1.0 and a tracking error of 2%. It is compared to a Direct Indexing (DI) strategy and an index ETF (ETF). All investments are benchmarked to the Russell 1000 Index.⁴ Short-term capital losses offset long-term gains, and the resulting tax benefits⁵ are reinvested at a 7.4% after-tax rate of return.

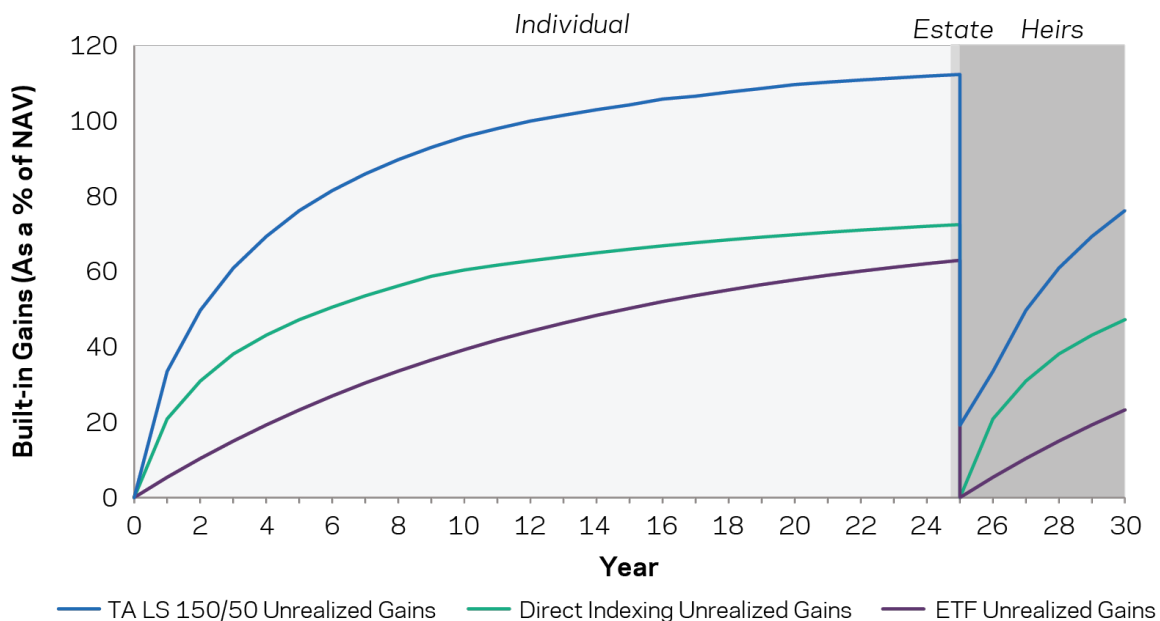
The initial investment is \$100M, and the investment horizon is 30 years. The investor passes away in year 25, with long positions receiving a step-up in basis at that time. The heirs continue to hold the strategy through year 30. The annual excess pre-tax return, net of all costs, is 0.7%, -0.25%, and 0% for TA LS, DI, and the ETF, respectively.

Evolution of Built-In Gains

Exhibit 1 shows the evolution of built-in gains. Built-in gains for TA LS are significantly higher than those for DI and the ETF—112% vs. 72% and 63% of the current NAV, respectively, at year 25. After a basis step-up at death, built-in gains reset to 0% for DI and the ETF and begin to accumulate again. For TA LS, short positions are not stepped up, resulting in a small remaining built-in gain of 19% of the current NAV. By year 30, built-in gains are 47%, 23%, and 76% of the current NAV for DI, the ETF, and TA LS, respectively.

Exhibit 1: Hypothetical Built-in Gains (As a Percentage of Account NAV)

Assumes initial \$100M cash investment in TA LS 150/50, Direct Indexing, and Index ETF, alternatively



Source: AQR. For illustrative purposes only. Assumes TA LS has an annual pre-tax return equal to the market return (7.4%) plus an excess return of 0.7%, net of a 0.45% management fee per annum. Expected Russell 1000 return is the nominal US total arithmetic return assumption as of December 31, 2024 based AQR's Capital Market Assumptions ("CMA") methodology. Hypothetical potential tax benefits and realized and unrealized gains and losses are based on simulations starting each year from January 1, 1986 to January 1, 2021. There is no guarantee, express or implied, that long-term return and/or volatility targets will be achieved. Realized returns and/or volatility may come in higher or lower than expected. Changes in the assumptions may have a material impact on the information presented.

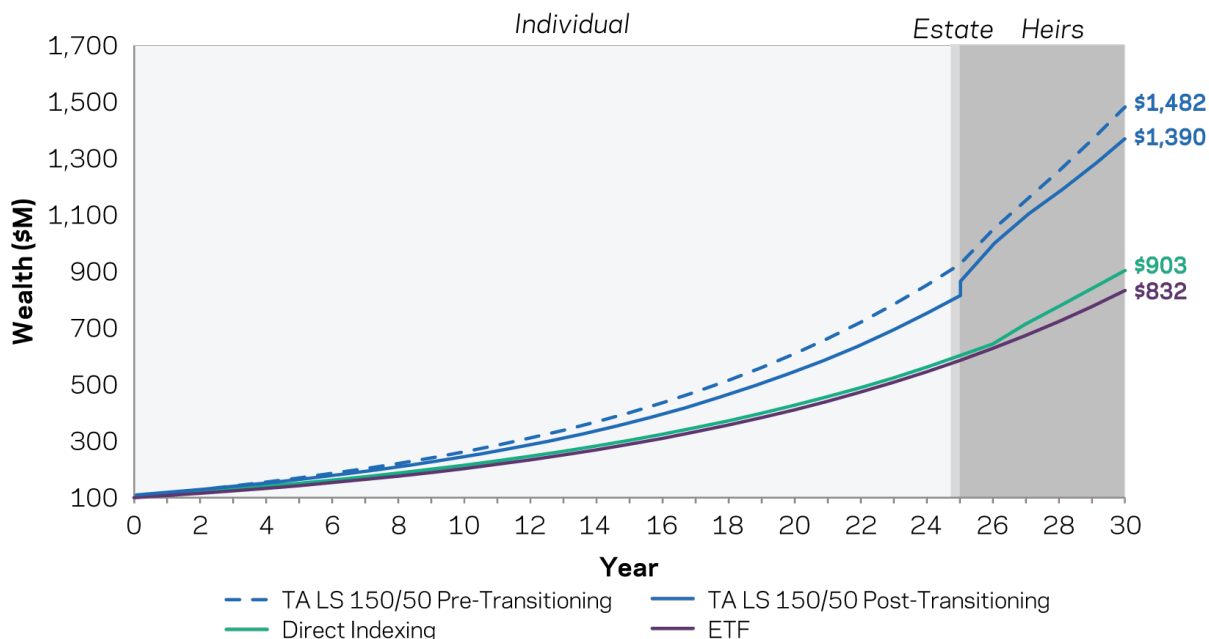
Unwind Scenarios and Wealth Evolution

For the TA LS strategy unwind, we illustrate two scenarios: (1) liquidating long and short extensions and transitioning to a long-only portfolio, and (2) fully liquidating the strategy to cash.

Exhibit 2 shows the first scenario—transitioning to long-only. Post-transition wealth with TA LS remains higher than that with DI or the ETF, despite the tax cost from liquidating the extensions. If heirs hold the portfolio from years 26 to 30, TA LS delivers post-transition-to-long-only wealth of \$1,390M compared to \$903M for DI and \$832M for the ETF. This translates into incremental annual after-tax returns of 1.6% and 1.9%, respectively.

Exhibit 2: Hypothetical After-Tax Wealth before and after Transition to Long-Only

Assumes initial \$100M cash investment in TA LS 150/50, Direct Indexing, and Index ETF, alternatively

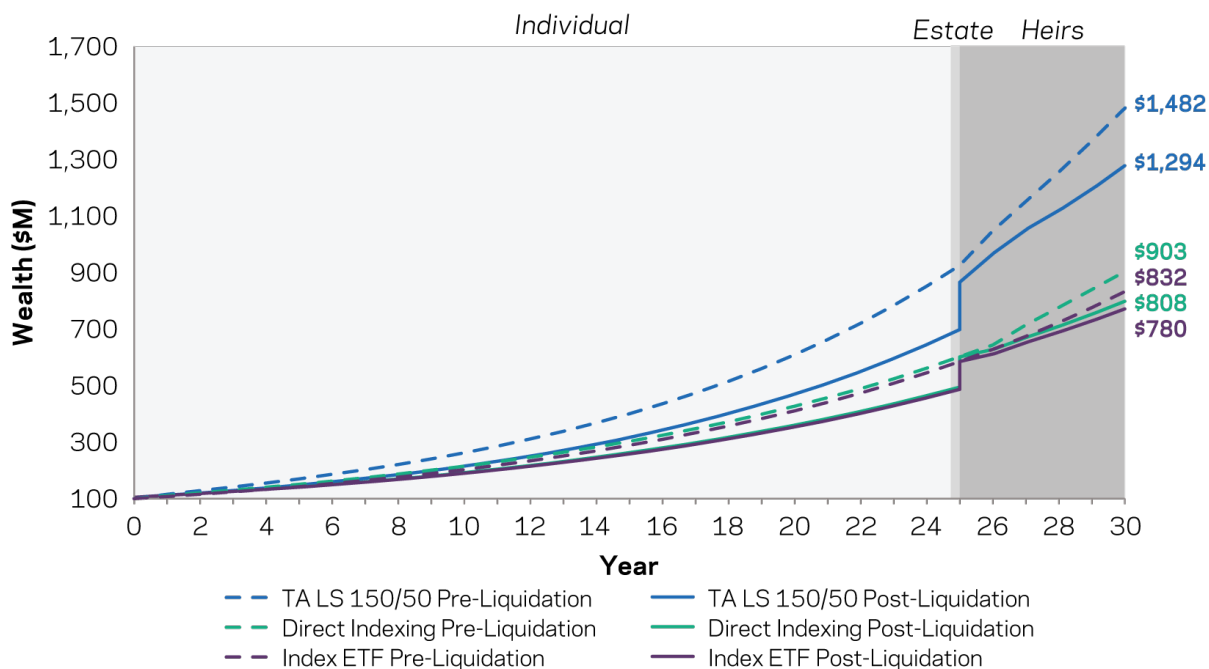


Source: AQR. For illustrative purposes only. Assumes TA LS has an annual pre-tax return equal to the market return (7.4%) plus an excess return of 0.7%, net of a 0.45% management fee per annum. Expected Russell 1000 return is the nominal US total arithmetic return assumption as of December 31, 2024 based on AQR's Capital Market Assumptions ("CMA") methodology. Hypothetical potential tax benefits and realized and unrealized gains and losses are based on simulations starting each year from January 1, 1986 to January 1, 2021. The tax benefit calculation assumes short-term losses offset long-term gains from other investments unrelated to the investor's investment in the strategy. This analysis assumes the potential tax benefit (liability) is reinvested at the market return of 7.4% annually. There is no guarantee, express or implied, that long-term return and/or volatility targets will be achieved. Realized returns and or volatility may come in higher or lower than expected. Changes in the assumptions may have a material impact on the information presented.

Exhibit 3 shows the second scenario—full liquidation to cash. Here, liquidation taxes are higher than in the first scenario, particularly for TA LS. Nevertheless, TA LS still outperforms, delivering post-liquidation wealth of \$1,294M compared to \$808M for DI and \$780M for the ETF. This translates into incremental annual after-tax returns of 1.7% and 1.8%, respectively.

Exhibit 3: Hypothetical After-Tax Wealth before and after Liquidation to Cash

Assumes initial \$100M cash investment in TA LS 150/50, Direct Indexing, and Index ETF, alternatively



Source: AQR. For illustrative purposes only. Assumes TA LS has an annual pre-tax return equal to the market return (7.4%) plus an excess return of 0.7%, net of a 0.45% management fee per annum. Expected Russell 1000 return is the nominal US total arithmetic return assumption as of December 31, 2024 based AQR's Capital Market Assumptions ("CMA") methodology. Hypothetical potential tax benefits and realized and unrealized gains and losses are based on simulations starting each year from January 1, 1986 to January 1, 2021. The tax benefit calculation assumes short-term losses offset long-term gains from other investments unrelated to the investor's investment in the strategy. This analysis assumes the potential tax benefit (liability) is reinvested at the market return of 7.4% annually. There is no guarantee, express or implied, that long-term return and/or volatility targets will be achieved. Realized returns and or volatility may come in higher or lower than expected. Changes in the assumptions may have a material impact on the information presented.

It should be noted that TA LS strategies can employ significantly higher leverage than 150/50. Active risk, which typically increases with leverage, translates into higher expected excess returns and greater realized net capital losses. These losses are the source of the strategy's tax benefits. Together, higher pre-tax returns and tax benefits lead to greater compounded wealth compared to DI or an index ETF.

Conclusion

Liquidation taxes are an important consideration for TA LS strategies. However, even in a "worst-case" scenario of full, instantaneous liquidation, TA LS is still expected to outperform DI and ETF approaches in terms of after-tax post-liquidation wealth creation. This is due to higher expected pre-tax returns and cumulative tax benefits. Importantly, investors with more flexibility or planning can do even better: partially redeeming, reducing risk, eliminating extensions, and gifting long positions held for longer than a year are all ways to improve the post-liquidation value of a TA LS investment.

[1] Additional in-kind contributions to, and distributions from, an account will also impact the built-in gain of the account.

[2] A more nuanced answer is that reducing the tax burden effectively increases the capital available for investing. If the investments made with this capital were to generate negative after-tax returns, deferring taxes might offer no benefit.

[3] The tax benefits of the strategy allow the investor to keep more capital invested in the overall portfolio, which includes the TA LS strategy as well as other investments.

[4] For the construction methodology of the 150/50 and DI strategies, see our "Beyond Direct Indexing" article.

[5] For calculating tax benefits and liabilities, we assume the 2025 federal top-bracket tax rates: long-term capital gains (losses) and qualified dividend income are taxed at 23.8%, and short-term capital gains (losses) and ordinary income are taxed at 40.8%.

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The hypothetical performance results contained herein represent the application of the quantitative models as currently in effect on the date first written above and there can be no assurance that the models will remain the same in the future or that an application of the current models in the future will produce similar results because the relevant market and economic conditions that prevailed during the hypothetical performance period will not necessarily recur. Discounting factors may be applied to reduce suspected anomalies. This backtest's return, for this period, may vary depending on the date it is run. Hypothetical performance results are presented for illustrative purposes only. In addition, our transaction cost assumptions utilized in backtests, where noted, are based on AQR Capital Management, LLCs, ("AQR")'s historical realized transaction costs and market data. Certain of the assumptions have been made for modeling purposes and are unlikely to be realized. No representation or warranty is made as to the reasonableness of the assumptions made or that all assumptions used in achieving the returns have been stated or fully considered. Changes in the assumptions may have a material impact on the hypothetical returns presented. Actual advisory fees for products offering this strategy may vary.

Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

The Russell 1000 Index measures the performance of the large-cap segment of the US equity universe. It includes the ~1,000 largest US stocks, representing ~93% of the value of the US equities market.

CMA Disclosure

Our equity return assumption is based on the average of a payout-based model (composed of dividend yield + net buyback yield + average of historical earnings growth and forecasted GDP growth) and an earnings-based model ($0.5 * \text{Shiller E/P} * 1.075 + 1.5\%$, where the 1.5% term is assumed long term real earnings per share (EPS) growth; the 0.5 multiplier reflects the long-term payout ratio; and the 1.075 multiplier accounts for EPS growth during 10-year earnings window). For more information on the payout and earnings-based models, please refer to the Q1 Alternative Thinking.

Description of Backtest Construction

Source: AQR, Bloomberg, XpressFeed, Barra.

Benchmark / Universe: US Large Cap (Roughly Russell 1000)

Methodology: We construct 36 investment simulations using monthly data, each with a different starting year from January 1986 through December 2021. We simulate 20-year histories where possible and have 17 histories that span a 20-year period. Given data availability, we use data in years 1-20 of each vintage for the purpose of this analysis and forward fill years 21-30 by scaling year 20 data by 90%.

January 1986 - December 2005	January 1987 - December 2006	January 1988 - December 2007	January 1989 - December 2008	January 1990 - December 2009	January 1991 - December 2010
January 1992 - December 2011	January 1993 - December 2012	January 1994 - December 2013	January 1995 - December 2014	January 1996 - December 2015	January 1997 - December 2016
January 1998 - December 2017	January 1999 - December 2018	January 2000 - December 2019	January 2001 - December 2020	January 2002 - December 2021	January 2003 - December 2021
January 2004 - December 2021	January 2005 - December 2021	January 2006 - December 2021	January 2007 - December 2021	January 2008 - December 2021	January 2009 - December 2021
January 2010 - December 2021	January 2011 - December 2021	January 2012 - December 2021	January 2013 - December 2021	January 2014 - December 2021	January 2015 - December 2021
January 2016 - December 2021	January 2017 - December 2021	January 2018 - December 2021	January 2019 - December 2021	January 2020 - December 2021	January 2021 - December 2021

Assumptions are as follows:

TE	Fee (Per Annum)
Benchmark ETF	0.0% mgmt. fee
Direct Indexing 1.0%	0.25% mgmt. fee
Tax-Aware Long-Short 2.0%	0.45% mgmt. fee

Returns are net of fees, financing, and transaction costs.

The following tax rates were used: For short-term capital gains and losses, and for ordinary income and deductions, the highest U.S. federal marginal income tax rate is 37.0% plus the 3.8% net investment income tax, for a combined rate of 40.8%. For long-term capital gains and qualified dividend income, the highest U.S. federal marginal tax rate is 20% plus the 3.8% net investment income tax for a combined rate of 23.8%.

The tax benefit calculation assumes short-term losses offset long-term gains from other investments unrelated to the investor's investment in the fund. Actual tax benefits achieved may vary and could be lower or higher than reported due to the investor's specific tax circumstances.

The Tax-Aware Long-Short strategy uses numerous investment ideas to evaluate and form a view on the attractiveness of all stocks within the selected universe. Expected active pre-tax returns are derived from an alpha model based on value, momentum, and quality investment themes, or factors, with each factor receiving an equal risk weight.

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