



TAX AWARE

The Tax Benefits of Relaxing the Long-Only Constraint: Do They Come from Character or Deferral?

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In this study we propose a decomposition of the total tax benefit (or liability) of a strategy into what we define as character and deferral components. Our decomposition is mathematically straightforward and intuitive and it allows for a quick and informative assessment of tax benefits of different tax-aware strategies without modeling various investor-specific situations. We use this character-deferral decomposition to identify the source of tax benefits resulting from relaxation of the long-only constraint. Our empirical evidence shows that for tax-aware strategies, relaxing the long-only constraint results in a drastic increase in their tax benefits, in particular due to an increase in the character benefit. We conclude that tax-aware relaxed-constraint strategies are more attractive to taxable investors than their long-only counterparts.

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