Tax Mitigation Strategies for Concentrated Stock Positions

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After a multi-year bull market, investors sitting on large, low-basis stock positions face a problem that represents one of the hottest topics in the wealth management industry today. Whereas selling triggers a tax bill. Holding preserves concentration risk. That is a tension that is hard to reconcile. Of course, Wall Street has devised creative solutions for this and charges for the privilege. The three approaches commonly utilized to address this problem are direct indexing, tax-aware long/short strategies, and Qualified Opportunity Zone (QOZ) funds. Each creates value through a fundamentally different mechanism, and each strategy is a trade-off of what to give up in exchange for tax efficiency, namely liquidity, simplicity, cost, market exposure, or time.

However, because the industry loves to plagiarize at least two of the three main solutions, direct indexing and tax-aware long/short, investors now face capacity limitations from their providers as popularity has squeezed their margins for error and do not work in all market conditions.   To make matters worse for these liquid strategies, they have drawn growing IRS scrutiny into wash-sale rules, economic substance-over-form, straddles, short sale timing, and at-risk exposure.

We have thought much about these trade-offs and believe that a hybrid approach combining a liquid tax-aware long/short and private QOZ can work most effectively to substantially reduce an embedded tax burden. However, it is fair to raise questions on whether the losses required to be generated by the long/short approach could potentially show up in a tax return after an IRS Examiner asks hard questions. As a result, we have placed our chips on the one method that enjoys bipartisan support in Congress and is promoted by the IRS and Treasury Department, the QOZ program. This is why we manage our own QOZ funds but will outsource the other approaches to meet client needs.

Three Different Engines

Direct indexing keeps an investor largely invested in public equities while generating value through systematic tax-loss harvesting. The portfolio tracks an index closely, losses are harvested along the way, and those losses offset realized gains elsewhere. The appeal is that it requires no exotic structuring and offers daily liquidity, but the tradeoff is that it only chips away at embedded gains and provides diversification over time rather than eliminating these issues up front. The tax benefit here is mostly deferral, dressed up as ongoing efficiency. In a rising market, fewer loss creation opportunities exist and over time the strategy runs out of gas as the portfolio stops creating losses through rebalancing. Further, with growing popularity of these passive tools these opportunities tend to evaporate sooner than desired.

Tax-aware long/short strategies work differently. Rather than simply harvesting losses passively, these strategies actively hedge a concentrated position, generating losses through a combination of long and short exposures while pursuing genuine alpha on top of the tax benefit. This lets an investor diversify economically without an immediate full sale of the underlying stock. The cost is higher fees, leverage, complexity and manager dependency. The strategy gives up some pure market beta in exchange for that flexibility in the form of greater tracking error. Popularity and widespread concentrated gain positions in large cap technology stocks have also resulted in gate keeping as managers have a harder time accepting more of the same few names and hedging them effectively. Fidelity and Schwab have raised account limits to account for this. Most importantly, however, is that Treasury has come out with statements warning that certain tax focused products may cross the line into abusive financial engineering for tax avoidance. Because the original gain may not be realized if the strategy succeeds and if losses are disallowed in any way it just exacerbates the tax problem in exchange for diversification – so that is another trade off.

QOZ funds take an entirely different approach, but it is also the most illiquid one. Here, an investor actually realizes the capital gain, providing immediate diversification, then reinvests some or all of it into a Qualified Opportunity Fund. Under new QOZ rules that take effect in January 2027, that reinvestment defers the tax on the original gain for five years, with a basis step-up of 10% at the five-year mark, or 30% for funds invested in designated rural areas. The largest part of the benefit shows up later in that if the QOF investment itself is held for ten years or more, all of the appreciation on that investment can be excluded from federal tax entirely (and in the interim distributions from refinancing and/or free cash flow can be treated as return of capital and otherwise shielded from tax by debt and depreciation without any recapture upon exit). The tradeoff for this outsized benefit is a long lock-up, concentration in private and often illiquid assets, and execution risk tied to the underlying project(s) inside the QOF.

Now the most desirable approach would be to combine the previous two options of the tax-aware long/short and the QOZ fund. Assuming the IRS does not crack down on the tax-aware long/short approach, it could be combined with a QOZ investment to generate sufficient losses during the deferral period such that at the end of the five years the investor would have sufficient losses to offset the remaining unabated portion of the original gain (the portion not eliminated by the 10 or 30% step up). That may be a big risk but if successful would be the only way to have your cake and eat it too by deferring and ultimately eliminating the embedded gain while at the same time diversifying into an uncorrelated private investment.

What the Numbers Suggest, and Why They Shouldn't Be Read at Face Value

Modeling a hypothetical $1 million capital gain over a ten-year holding period, with a combined 30% capital gains tax rate, produces a widespread in outcomes. Direct indexing, assumed to earn an 8 percent pre-tax return with roughly 1 percent of annual tax alpha from harvesting, ends up around $1.8 million after tax, a multiple of about 1.8x. The tax-aware long/short strategy, modeled at a 9% pre-tax return with 1.5% of annual tax alpha, finishes closer to $2.1 million, or about 2.1x. QOZ funds, modeled with a 12% pre-tax return reflecting private-market assumptions, land well ahead of both at roughly $3.1 to $3.2 million, somewhere around 3.1x to 3.2x, with rural QOZ funds pushing slightly higher still given the larger basis step-up.

It would be easy to look at those numbers and conclude that QOZ funds are simply the better choice. That conclusion misses the point of the exercise. The three strategies were never modeled with equivalent risk. A 12% return assumption for a QOZ investment carries private-market and execution risk that has no real analog in an 8% public equity index assumption. Sensitivity analysis reinforces this: as the assumed rate of appreciation on a QOZ investment rises from 8% to 15% , the value of the tax exclusion grows from roughly $350,000 in avoided federal tax to over $900,000. That sensitivity cuts both ways. The upside is real if the underlying investment performs, but so is the downside if it doesn't, and unlike a diversified equity portfolio, a QOZ investment concentrates that risk in a single illiquid vehicle for a decade or more.

A more granular breakdown of the QOZ mechanics makes the deferral and abatement math concrete. On a $1 million gain, the same 12% annual appreciation assumption grows the investment to roughly $3.1 million after ten years. Because the initial tax is deferred rather than paid upfront, the full $1 million continues to compound rather than the roughly $700,000 that would remain after paying tax immediately. Add in the deferral benefit from the 5% interest credited on the reserved tax liability and the basis step-up at year five, and the net after-tax IRR comes out to about 12.1% for a standard OZ fund and 13.1% for a rural one, compared with 9.5% for simply paying the tax and investing what's left. None of this changes the underlying risk profile. It just quantifies what an investor is being compensated for accepting.

Choosing Among Them

The right fit depends less on which strategy produces the highest after-tax outcome and more on what an investor actually needs and can tolerate. Direct indexing suits someone who wants daily liquidity, values transparency, and is comfortable realizing gains gradually as losses are harvested along the way. A tax-aware long/short approach fits an investor who wants immediate economic diversification without an outright sale, is willing to tolerate added complexity and higher fees, and trusts a manager's ability to generate losses and alpha across different market environments as well as accepting the risk of IRS scrutiny. QOZ funds make sense for an investor who is comfortable trading liquidity for reducing the immediate tax impact of their original gain as well as being able to plan for the deferred tax with a known timeline and a shot at eliminating tax on future appreciation entirely. We would suggest that clients discuss these issues with their Portfolio Manager and think about which set of tradeoffs they can actually live with for the next decade.

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law, which may change. Certain strategies, including Qualified Opportunity Funds, involve additional risks and eligibility requirements that are not fully described here. Investors should consult with their investment, tax and legal advisors before taking action. Any examples or potential benefits discussed are illustrative only and are not guarantees of future results or tax outcomes. Tocqueville does not provide tax or legal advice.