



Net Capital Loss in Long-Short Investing: Turning Losses into Tax Advantages

Investment losses are typically viewed as setbacks. In long-short investing, however, losses can serve a strategic role.

Understanding the Basics

A net capital loss occurs when realized capital losses exceed realized capital gains during a tax year [1]. While this may sound undesirable, in certain portfolio structures it can be intentionally generated to improve after tax outcomes.

Long-short investment strategies involve buying securities expected to rise (long positions) and selling borrowed securities expected to fall (short positions) [2]. In this context, net capital losses can emerge as a deliberate feature of the strategy, not just an unfortunate outcome.

How Losses Can Be Strategic

Long-short portfolios are designed to profit from both rising and falling prices. Managers can realize losses from long positions that have declined and from short positions that have moved against them.

This flexibility doubles the opportunity to capture tax-deductible losses while maintaining the portfolio's intended market exposure [3]. SWA has observed that in some cases, portfolios may generate positive returns while also producing a net capital loss for tax purposes.

As Daren Blonski, President & CEO of SWA, noted, "Tax efficiency is not about avoiding risk. It is about structuring outcomes in a way that supports long term wealth preservation."

Tax Value

Net capital losses may:

- Offset capital gains from other investments [4]
- Offset up to \$3,000 of ordinary income annually [4]
- Carry forward indefinitely, creating a valuable tax asset for future use [5]

For higher income investors, offsetting gains taxed at long-term capital gains rates plus the 3.8% net investment income tax may create meaningful savings [6].

Why It Matters

Although individual results may vary, SWA's research suggests that a long-short strategy that consistently generates net capital losses while delivering competitive returns creates a powerful combination: investment growth plus a stream of tax benefits. This is particularly valuable for investors with significant capital gains from other sources, such as business sales, real estate transactions, or concentrated stock positions.

In long-short investing, net capital losses are not a sign of failure. When managed thoughtfully, they can be a deliberate, valuable feature that enhances after-tax wealth.

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References

- [1] IRS. Topic No. 409. [Capital Gains and Losses](#).
- [2] Investopedia. [Understanding Long-Short Strategies](#).
- [3] AQR Capital. [Tax Aware Investing](#).
- [4] IRS Publication 550. [Capital Loss Limits](#).
- [5] Investopedia. [Capital Loss Carryover](#).
- [6] IRS. [Net Investment Income Tax Overview](#).

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