Structuring To Optimize Tax-Efficiency

Recent Developments and Innovations in Single Stock Concentration Risk Management

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Editor's Note: This is the second article in a two-part series focusing on recent developments and innovations in single stock concentration risk management. "Portfolio Margining" appeared in the January–February 2010 I&WM.

Investors' expectations regarding future returns have moderated considerably over the past decade, with several repercussions.

First, more emphasis is being placed on developing new asset allocation and portfolio construction methodologies.

Second, investors are more focused on reducing trading costs and investment management fees.

Third, investors and their advisors once again are concentrating on tax-efficient investing. After all, it's not how much you earn that is important, but rather how much you keep. For instance, tax-lot accounting and loss harvesting are now commonplace, and structured products often are used to gain desired exposure with favorable tax results.

But little has changed within the very specialized discipline of hedging a stock position. Investors wishing to hedge a single stock position often do so with little or no thought to the tax consequences. The first article in this series introduced how the new portfolio margining rules under Reg T can be used to achieve greater tax-effectiveness while reducing tax and Internal Revenue Service (IRS) audit risk. This article introduces numerous structuring opportunities that well-advised investors can use to achieve greater tax-efficiency when the objective is to hedge (or hedge and monetize) a concentrated stock position.

The Basics of Hedging with a Collar

Investors holding a concentrated stock position can hedge against a decline in the price of a stock, retain some upside potential, defer capital gains tax, and avoid any out-of-pocket expenditure by implementing a cashless (or zero-premium) collar.

The investor buys puts with a strike price that is either at or (more typically) slightly below the current stock price. The investor must pay a premium to acquire the puts and in return is fully protected (subject to the credit risk of the counterparty) from any loss should the stock price fall below the strike price of the puts. Simultaneously, the investor sells calls with the same maturity as the puts with a strike price that is above the current price of the stock and in return receives premium income. The strike price of the calls is set at the level that brings in exactly the amount of premium required to pay for the puts. In other words, the sale of the calls fully finances the purchase of the puts.

Therefore, although the investor forfeits some of the upside potential of the underlying stock (the amount the stock price is above the call strike at maturity), using a cashless collar requires no out-of-pocket expenditure.

For example, assume the following: An investor owns shares of ABC Corporation that are trading at $100. Assume ABC one-year puts with a strike price of $90 are trading at $5 and ABC one-year calls with a strike price of $120 are trading at $5. The investor simultaneously sells the calls and buys the puts with the $5 premium received for selling the calls, fully financing the $5 premium paid to acquire the puts.

Let's assume the stock price increases above the $120 strike price at maturity and the calls are exercised. The investor would deliver its long shares and receive $120 ($120 from the exercise of the calls, plus the $5 call premium received, less the $5 put premium paid).

If ABC closes between $90 and $120 at expiration, both the puts and calls will expire worthless and the investor will have paid the $5 put premium and received the $5 call premium.

If the stock price falls below the $90 strike price at maturity and the puts are exercised, the investor would deliver its long shares and receive $90 ($90 from the exercise of the puts, plus $5 from the sale of the calls, less the $5 cost of the puts).

Figure 1 depicts the payoff profile of a stock position combined with a cashless collar.

Tax Considerations Related to Collars

Investors wishing to implement collars should consider carefully the implications. Below is an overview of the key provisions that need to be taken into account.

Constructive Sale Rules

If structured properly, the use of a collar to hedge a highly appreciated stock position should not trigger a constructive sale under Code Section 1259 (the constructive sale rules).

The legislative history of the constructive sale rules (e.g., both the Senate Finance Committee and House Ways and Means Committee reports) contains an example of a collar with a 15-percent band: a $100 stock combined

with a long put with a $95 strike price and a short call with a $110 strike price. The consensus among tax practitioners is that this example was put into the legislative history to give the investment and tax communities some guidance about the magnitude of potential risk and reward required to avoid triggering a constructive sale.

Because of this example, most tax practitioners are comfortable with collars that have at least a 15-percent band between the put and call strike prices and with strike prices that either straddle or touch the market price at the time the hedge is implemented. For example, if the stock is trading at $100, 95/110, 90/105, 100/115, and 85/100 collars should each satisfy the constructive sale rules.

The legislative history does not contain any guidance about the maximum permissible length of a collar. However, most tax practitioners, as a rule of thumb, are comfortable so long as the collar term does not exceed five years. If the term exceeds five years, most tax practitioners would suggest the band be considerably wider than 15 percent.

Practically speaking, except for collars with a fairly short maturity, the constructive sale rules are typically not an issue for cashless collars because, by their very nature, cashless collars usually have a band greater than the requisite 15 percent. That's because the idea of a cashless collar is to have as wide a band as possible to put a floor under the stock but give the stock plenty of room to appreciate in the future.

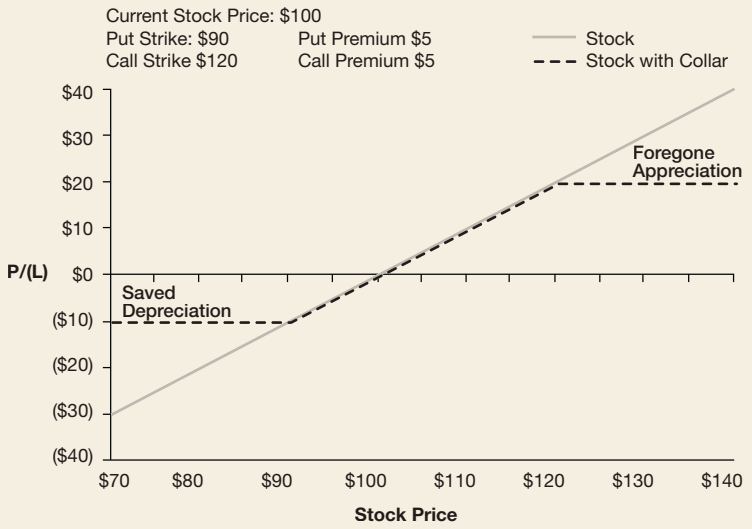
Holding Period

If the shares being hedged have not yet accrued the requisite one-year holding period necessary to achieve long-term capital gain treatment, the use of a collar will terminate any holding period that has accrued.

If the shares have already accrued the requisite one-year holding period before implementation of the collar (e.g., the shares were already long-term capital gain property), the use of a collar will have no impact on the holding period of the shares being hedged.

FIGURE 1: ZERO PREMIUM (CASHLESS) COLLAR

Shareholder eliminates downside exposure below $90 and foregoes appreciation above $120 with no upfront cash outlay



Dividend Holding Period Rules

Long shares combined with a collar do not satisfy the dividend holding period requirements of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Tax Act). Therefore, any dividends received on the long shares will not be treated as "qualified" dividend income taxed at the long-term capital gains rate but instead will be taxed at the ordinary rate (currently 35 percent).

Straddle Rules

The combination of the concentrated stock position and collar may constitute a straddle for tax purposes. This will depend on when the investor acquired his or her shares. The key date is March 1, 1984. If the shares were acquired before that date, the straddle rules should not apply and therefore a straddle should not be created.[1] If the shares were acquired on or after this date, the straddle rules will apply and a straddle will be created.

If a straddle is created, any losses with respect to the collar will be treated as deferred, long-term capital losses, while any gains will be taxed and treated as short-term capital gains; if any funds were borrowed with the collared stock pledged as collateral, any interest expense would have to be capitalized.

Structuring to Optimize Tax Efficiency—Key Planning Concepts

Wall Street has created a variety of financial tools and instruments that have financial equivalency. That is, an investor wishing to collar a stock can use a variety of tools, such as exchange-traded options, over-the-counter options, and swaps to accomplish that goal. However, the tax treatment of each of these tools can vary considerably. Well-advised investors can take advantage of this incongruity.

In addition, when structuring collars to achieve maximum tax-efficiency, factors relating to both 1) the shares or other instruments (i.e., nonqualified stock options and stock appreciation rights) being hedged and 2) the hedging tool used to implement the collar should be taken into consideration.

The following four examples demonstrate these valuable concepts, which too often are ignored by even very experienced investors and advisors.

Example #1: Using Listed Options. There are two types of options: 1) listed and 2) over-the-counter (OTC). A listed option is traded on an exchange, whereas an OTC option is a privately negotiated contract between the investor and a derivative dealer.

When an investor uses listed options to implement a cashless collar, there are necessarily two contracts, one for the calls and one for the puts. Continuing with our earlier example, an investor might enter into a cashless collar where calls are sold with the investor receiving a premium of $5 per share and puts are purchased with the investor paying a premium of $5 per share. The sale and purchase of the calls and puts, respectively, can be executed on an options exchange simultaneously as a spread order (i.e., without concern that the investor buys the puts without selling the calls, or vice versa). Nonetheless, there still will be two separate contracts, and this can result in adverse tax consequences for certain investors.

For instance, assume the shares being hedged were acquired on or after March 1, 1984 (i.e., the tax straddle rules apply) and the cashless collar described in our earlier example expires when the stock price is between the $90 put strike and the $120 call strike prices (i.e., both the put and call end up worthless). In this case, the investor faces an immediate taxable gain on the expired call. That is, the $5 premium received on the sale of the call will be taxable as a short-term capital gain in the year the options expired. However, the investor cannot deduct the $5 premium paid to acquire the put in the year the options expire; rather, the investor will have a deferred, long-term capital loss that increases his or her basis in the shares that were hedged.

On the other hand, if the investor's shares were acquired before March 1, 1984, the straddle rules should not apply. Therefore, the premium paid to acquire the put should be deductible against the premium received on the sale of the call in the year the options expired. In our example, the premiums should net to zero, thereby avoiding an adverse tax result.

So from a tax perspective, for shares acquired before March 1, 1984 (where the straddle rules should not apply), the use of listed options to implement a collar should not cause any tax disadvantage to the investor because the premiums for the put and call should net against each other.

When comparing listed (i.e., exchange-traded) options with OTC options, listed options also have other advantages.

First, because the AAA-rated Options Clearing Corporation is the counterparty for listed options, the investor incurs less counterparty credit risk. With an OTC option, the investor incurs the credit risk of the single dealer counterparty that executes the transaction.

Second, the investor can close out listed options before maturity by acquiring exactly offsetting positions with any market participant. With an OTC-based collar, the investor can try to negotiate an early termination of the collar, but the dealer can—and usually does—extract a price for early termination.

Third, by their very nature, listed options should achieve robust price discovery. A request for quote (RFQ) is disseminated to dealers and floor traders and each trade is executed on the options exchange. An OTC contract is priced via negotiation with a single dealer, although most sophisticated investors get bids from several OTC dealers to ensure that some price discovery has occurred.

Fourth, though it is not an advantage per se, listed options include Equity Flexible Exchange (E-FLEX) options that allow the investor to customize the key terms of the contract. Put simply, E-FLEX options grant investors most of the flexibility of OTC options. For instance, the strike price of both the put and the call can be set at any level (i.e., not just the customary $2.50 or $5 increments) so that a cashless collar is possible (i.e., there won't need to be a small debit or credit as when regular listed options are used to collar a stock). The term of the contract can be as long as 15 years. And perhaps most importantly, just as with OTC options, listed option contracts can be European-style. That means the calls the investor sells are exercisable only at the expiration of the calls, making an early exercise of the calls by the holder impossible.

The lesson is that for shares acquired before March 1, 1984 (for which the straddle rules should not apply), using listed (E-FLEX) options to implement a collar should not disadvantage the client from a tax perspective (the put and call premiums should offset each other) and should bestow significant non-tax advantages upon the investor.

What Financial Tool Should Be Used to Hedge Stock Through a Collar? It All Depends

- If hedging shares that were acquired on or after March 1, 1984
  - » Use OTC collar documented as a single contract
  - » Avoids whipsawing of straddle rules
- If hedging shares that were acquired before March 1, 1984
  - » Use exchange-traded (E-FLEX) options
  - » No tax disadvantage to using exchange-traded options
  - » Significant non-tax advantages
- If hedging non-qualified stock options or stock appreciation rights
  - » Use swap embedded with the optionality of a collar
  - » Avoids mismatch in character between gain on the NQO/SAR and loss on the hedge

Example #2: Use of OTC Single-Contract Collar. If the shares were acquired on or after March 1, 1984 (i.e., the straddle rules apply), an investor who uses listed options to implement a collar will be whipsawed by the straddle rules as described above. That's because with listed options, two contracts are involved—one for the puts and another for the calls—and the straddle rules don't allow the cost of the puts to offset the premium received on the sale of the calls.

The solution to this dilemma is to turn to the OTC derivative market to implement the collar. Because the terms of such a collar are negotiated with a dealer, the collar can be structured as a single contract. In contrast, the exchanges don't yet allow a collar to be structured as a single contract. A single-contract cashless collar won't show the cost of the call and put separately; it instead will show a net cost of zero. Most tax practitioners have become very comfortable with this structure.

The lesson is that for shares acquired on or after March 1, 1984 (where the straddle rules apply), the use of an OTC options-based collar documented as a single contract delivers a more efficient tax result than the use of listed options. That is, it should spare the investor from being whipsawed by the straddle rules. The cost to the investor is forfeiture of the non-tax advantages of listed options. Most investors and advisors feel this is a fair price to pay for the tax-efficiency of an OTC options-based collar documented as a single contract.

Example #3: Use of Swap with Embedded Collar to Hedge Nonqualified Employee Stock Options. The previous two examples assumed the investor is hedging shares of common stock. But what if the investor is hedging either nonqualified employee stock options or stock appreciation rights (NQOs)? Would the investor be better off selecting a different tool to implement the collar?

The key tax issue that arises when hedging NQOs is the potential whipsaw that can occur if the NQOs and the hedging tool produce income and loss of a different character.

Here's some background: When an investor exercises NQOs, ordinary income is created. In contrast, an options-based collar (or prepaid variable forward contract) will give rise to capital gain or loss. Therefore, the use of an options-based collar (or prepaid variable forward contract) to hedge NQOs creates the potential for ordinary income on one side and capital loss on the other. That is, if the underlying stock continues to appreciate above the strike price of the call, the employee will have ordinary income on the NQOs and a capital loss on the hedge, each in the same amount. Unless the employee has capital gains from other sources, the capital losses would not be deductible.

Assume an executive hedges NQOs using an options-based collar and that the underlying stock increases by $10 million above the strike price of the call options while the hedge is in place. Economically, the client has not benefited from this stock price increase because the $10 million of income on the NQOs is exactly offset by a $10-million loss on the call options. However, when the collar matures and the investor exercises the NQOs, the executive will have $10 million of ordinary income and $10 million of capital losses, resulting in a mismatch in character between the income on the NQOs (ordinary) and the loss on the hedge (capital). Unless the investor has

Comparison of Prepaid Variable Forward versus Swap Structure

Prepaid Variable Forward

- Losses generated by cash settling are long-term capital losses with a 15-percent benefit
- Carrying costs are not currently deductible as interest expense
  - » Instead they are deferred and effectively converted to long-term capital loss with a 15-percent benefit
- The IRS' position with respect to PVFs has been very inconsistent over the past decade and audit risk is high
- There are no absolutely limitations on the use of the proceeds

Swap and Margin Loan

- Losses generated by cash settling are either ordinary losses with a potential 35-percent benefit or long-term capital losses with a 15-percent benefit, at the option of the investor
  - » Investor has a free call option on a potential 20-percent tax benefit as the stock price increases above the call strike
- Carrying costs may be currently deductible as interest expense with a 35-percent benefit
  - » May be partially or completely deductible if the shares were acquired on or after March 1, 1984 (through specific identification of collateral for the loan other than the collared shares)
  - » Should be completely deductible if shares were acquired before March 1, 1984
- The swap structure eliminates the tax uncertainty surrounding PVFs
- There are absolutely no limitations on the use of the proceeds because the loan is extended under the new portfolio margining rules of Reg T

sufficient capital gains against which to offset these capital losses, he or she can deduct only $3,000 of the capital loss against ordinary income each year. Therefore, while this hedge provided the desired economics (downside protection), it also created $9,997,000 of ordinary income in the current year with no offsetting deduction.

A possible solution is to use a swap that has the optionality of a collar embedded within it. In this structure, if the stock rises above the embedded call strike and a loss is incurred on the swap, under current tax law, if the investor allows the swap to run to its stated maturity and makes a payment to the dealer to terminate its obligation under the swap, such a payment is treated as an ordinary deduction. Therefore, the subsequent appreciation of the NQOs and the loss on the swap should be treated as ordinary income and ordinary deduction, respectively.

The lesson here is that swaps solve the whipsaw problem by matching the character of income from the NQOs with the loss from the swap.

However, the use of swaps poses several potential challenges.

First, the ordinary deduction relating to such swap losses should be treated as an "other" itemized deduction for federal tax purposes and these deductions may only be taken to the extent that in the aggregate they exceed 2 percent of the investor's adjusted gross income.

Second, ordinary swap losses cannot be deducted for purposes of determining the alternative minimum tax (AMT).

Third, back in 2004, Treasury issued proposed regulations that could result in adverse tax consequences for investors who use swaps. These proposed regulations would have a retroactive application date should they ever become either temporary or final regulations (e.g., and have the force of law). However, because of their extreme complexity, and the fact that no action has been taken on them in almost six years, many tax practitioners do not believe that these proposed regulations will ever become either temporary or final regulations with the force of law.

Example #4: Use of Swap with Embedded Collar to Hedge and Monetize Stock Acquired before March 1, 1984. Example #1 showed that it was probably better to use listed options instead of OTC options if the straddle rules do not apply, because using listed options should result in no tax disadvantage but it does come with other benefits such as reduction of counterparty credit risk. But might a swap deliver an even better tax result if the shares hedged aren't subject to the straddle rules?

The tax implications of using swaps are intriguing. If the stock price increases above the call strike, the investor can choose how to treat the loss on the swap. If the swap is allowed to expire at its stated maturity, the loss on the swap will be treated as an ordinary deduction.

If the straddle rules don't apply, this ordinary deduction will be currently deductible against ordinary income—such as salary and income from the exercise of nonqualified employee stock options—with a potential 35-percent benefit.

If the swap is terminated before its stated maturity, the loss will be a currently deductible capital loss, and if the swap was held open for more than 12 months this loss will be a long-term capital loss with a potential 15-percent benefit.

On the other hand, the appreciation of the stock that was hedged will be taxed at the long-term capital gain rate (now 15 percent).

Therefore, in the right circumstances, the investor may be able to take advantage of the potential 20-percent tax benefit. That is, as the stock price increases above the embedded call strike, gain on the stock will be taxed at the 15-percent rate while loss on the swap could be deductible at the 35-percent rate. This result could be achieved if the investor has ordinary income during the year the swap expires. The lack of ordinary income or the limitations discussed in Example #3 (i.e., deduction subject to the 2-percent-of-AGI limitation, no deduction for AMT purposes, etc.) could prohibit the investor from achieving the full 35-percent benefit. In any event, the investor could simply terminate the swap before its stated expiration and under Code Section 1234A, and the result would be a deductible capital loss, which is exactly the same result that would have resulted had options or a prepaid variable forward (PVF) been used.

In other words, the use of a swap to collar the shares gives the investor the equivalent of a free call option on a potential 20-percent tax benefit.

It should be noted that the investor does not need to decide at the time the swap is put on whether to terminate the swap early or let it expire; rather, the investor can decide around the date when the swap is set to expire, when the investor and advisors should have a good handle on what the best course of action should be.

If the investor is not simply hedging the position but decides to monetize (i.e., borrow against) the hedged position, the interest expense on the loan should be deductible without limitation against investment income, including short-term capital gains, with a 35-percent benefit. In contrast, if a PVF was used to hedge and monetize the stock position, the interest or carrying charge for borrowing is effectively capitalized and deferred. That is, it is reflected as either a lesser amount realized (if the shares are delivered in satisfaction of the PVF) or as a capital loss (if the PVF is cash-settled), in each case with a 15-percent benefit.

The lesson here is that, if the straddle rules do not apply, the use of a swap to collar a concentrated stock position combined with a margin loan against the hedged position to monetize is superior to a PVF for a number of reasons.

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is the one-time opportunity to stretch this income tax liability over multiple tax years. Satisfying this tax liability with non-IRA assets is generally best.

Conversions early in the year are best. We all have a tax mulligan called recharacterization. Roth conversions are not all-or-nothing decisions; you can convert some or all of your eligible assets. The opportunity to convert continues beyond 2010. To maximize the conversion opportunity, consider a coordinated savings plan including your traditional IRA as well as your company-sponsored retirement plan (provided the plan contains certain provisions).

Finally, and most importantly, the Roth IRA conversion decision and ongoing management is complicated and not for everyone. To make an informed decision, it is critical to include in the process your financial advisory team. Together, you can evaluate whether a Roth conversion should be a part of your overall financial plan.

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- The investor benefits from the economic equivalent of a free call option on a potential 20-percent tax benefit.
- Interest expense on the loan should be deductible at the 35-percent rate instead of being deferred and capitalized at the15-percent rate.

And as discussed in the January/February 2010 *Investments & Wealth Monitor* article:

- Prepaid variable forwards have been subject to intense IRS scrutiny during the past several years and the use of a swap combined with a margin loan eliminates the tax and audit risk surrounding PVFs.
- Because the margin loan can be extended under the new portfolio margining rules of Reg T:
  - » There are no limitations on the use of proceeds. That is, just like with a PVF, the investor can invest loan proceeds in publicly-traded stocks.
  - » The amount of cash released to the investor should exceed the amount that the investor could access through a PVF.

Conclusion

Investors can use a wide variety of tools and techniques to optimize the tax-efficiency of hedging a concentrated position in a publicly-traded stock through a collar.

To those unfamiliar with hedging tools and how hedging transactions are taxed, such disparate tax treatment among various hedging tools that achieve essentially identical results may seem odd. Others are surprised to learn that it is our Internal Revenue Code that gives investors this opportunity.

The U.S. Congress and Treasury may revamp our tax system so that economically equivalent strategies are taxed the same, but that time seems a long way off. Until then, well-advised taxable investors should take advantage of this tremendous flexibility to choose the hedging tool that optimizes their tax efficiency.

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Endnote

[1] The literal language of the legislation relating to the effective date of Code Section 1092 (d) states that both "positions" (e.g., the stock position and the offsetting hedge position) must be acquired on or after the effective date (March 1, 1984) for there to be a straddle. Most tax practitioners in this area point to the detailed discussion of this issue contained in: 1) Bradley L. Ferguson et al., "The Latest Stock Hedging Regulations," 67 Tax Notes1795 (1995) and 2) New York State Bar Association Tax Section, "Report on Proposed Regulation Section 1.1092(d)-2," 95 Tax Notes Today 199 (1995). Each concludes that a reasonable reading of the effective-date language of Section 1092(d) is that the straddle rules don't apply to stock positions acquired before the effective date.

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