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MOVING BEYOND PREPAID VARIABLE FORWARDS

Most investors holding highly appreciated, publicly-traded stock have used prepaid variable forwards (PVFs) to hedge, monetize and defer taxes on their positions. The primary reason investors have used PVFs is because that tool is not subject to the 50% initial margin requirement of Reg T, meaning there are no limitations on the amount of proceeds that can be used to re-invest in publicly-traded stocks, which is what most investors wish to do with the proceeds in order to diversify.

However, PVFs are being closely scrutinized by the IRS. In each of 2006, 2007 and 2008 the IRS issued memorandums holding the use of a PVF triggers a “taxable event”. The 2007 memorandum directed IRS agents to search for and then audit investors who executed PVF transactions. The 2008 memorandum concluded that a PVF might be a “tax shelter” subject to a host of penalties. As a result, even though most tax advisors believe a properly structured PVF should pass muster under current tax law, there is hesitancy amongst sophisticated investors, especially fiduciaries, to use PVFs due to the real or perceived tax risk and heightened IRS audit risk.

Intelligent Edge Advisors has crafted a new technique that addresses the concerns surrounding PVFs. The key ingredient to this strategy is the innovative and expert application of the new portfolio margining rules. We are pleased that Doug Engmann, the senior executive who led the US securities industry in the adoption of portfolio margining and former Chairman of the Pacific Stock Exchange, has joined Intelligent Edge as Senior Advisor. Doug is regarded in the US securities industry as the “dean” of portfolio margining.

This new technique, like a PVF, is not subject to the 50% initial margin requirement of Reg T. That is, just like a PVF, there is no limitation on the amount of the proceeds that can be used to re-invest in publicly-traded stocks. The investor is free to do anything it wants with the monetization proceeds, which can be as high as 97% of the value of the stock that is being hedged, a higher loan to value ratio than is possible with a PVF.

Depending upon the specifics of the stock being hedged, this strategy can actually produce a superior tax result versus a PVF. And there can be a number of non-tax advantages, including a dramatic reduction in counter-party credit risk, which in the current environment can be especially important to investors.

In sum, this cutting edge hedging solution achieves the same attractive results that investors get by using PVFs, but in a way that eliminates the tax risk and heightened audit risk associated with PVFs. The bottom line is that if an investor would like to execute a PVF, but is reluctant to do so, there is now an economically equivalent alternative to a PVF with none of the tax and audit risk.

We at Intelligent Edge believe the ramifications, opportunities and potential benefits of the new portfolio margining rules for ultra-high-net-investors are enormous, and Intelligent Edge is the “go to” firm that savvy professional advisors and investors turn to when they wish to take advantage of portfolio margining.

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