Approved Prep Provider CFA Institute

Level III

Concentrated Single Asset Holdings

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Contents

1. Introduction

Frequently, the wealth of individuals and families is concentrated in an asset or group of assets that has played a role in their (or their forebears') accumulation of wealth

A holding is generally considered "concentrated" if it represents more than 25% of an investor's wealth

As private wealth managers we need to help our clients decide whether to hold on to concentrated positions or to monetize and reinvest

2. Concentrated Single-Asset Positions: Overview

i. Publicly traded single stock holdings

- IPO
- Stock options and stock-based compensation
- Buy and hold strategy

ii. Privately Held Businesses

- Entrepreneurs
- Generation to generation

iii. Investment Real Estate

- Sell business but keep property
- Inheritance

2.1. Investment Risks of Concentrated Positions

The owners of concentrated positions face systematic risk and non-systematic risk, which can be company-specific or property-specific risk. Exposures to any of these risks may not be consistent with the individual's willingness and capacity to bear risk or may be suboptimal with respect to asset allocation.

- Systematic risk
- Company-specific risk
  - The higher volatility associated with company-specific risk of single-stock holdings significantly lessens the benefit of higher expected capital accumulation over time.
- Property-specific risk
  - Property-specific risk is the non-systematic risk that is specific to owning a particular piece of real estate. It is the possibility that the value of that property might fall because of an event that could affect that property but not the broader real estate market.

3. General Principles of Managing Concentrated Single-Asset Positions

1. Objectives in Dealing with Concentrated Positions
2. Considerations Affecting All Concentrated Positions
3. Institutional and Capital Market Constraints
4. Psychological Considerations
5. Goal-Based Planning in the Concentrated-Position Decision-Making Process
6. Asset Location and Wealth Transfers
7. Concentrated Wealth Decision Making: A Five-Step Process

3.1 Objectives in Dealing with Concentrated Positions

Irrespective of the form of the concentrated position — there are three objectives that are frequently considered in discussions with the client:

- Reduce risk of wealth concentration
- Generate liquidity to satisfy spending needs
- Optimize tax efficiency

Understand client objectives and concerns; there might be good reasons to retain the risk associated with concentrated positions

- Concentrated stock: 1) executive incentive, 2) maintain voting control
- Privately owned business: 1) too early to sell, 2) pass business to the next generation
- Investment real estate: 1) essential asset, 2) price appreciation, 3) pass on to next generation

3.2. Considerations Affecting All Concentrated Positions

Tax Consequences of an Outright Sale

- Concentrated positions are often highly appreciated versus their original cost
- Selling the asset outright will usually trigger a significant taxable capital gain for the owner
- Tax cost basis is generally very low relative to current value
- Large tax obligation is often not palatable

Liquidity

- With the possible exception of concentrated positions in publicly traded stocks, concentrated positions are generally illiquid
- Sale of private business equity does not resemble the sale of shares of publicly traded stock
- Direct ownership of investment real estate illiquid; different classes of potential buyers may place different values on that property
- Illiquidity acts as a constraint on the choice of strategies for dealing with a concentrated position.

3.3. Institutional and Capital Market Constraints

There will often be capital market constraints and institutional constraints on an investor's ability to reduce a concentrated position:

- Laws and Regulations
- Margin-Lending Rules
- Contractual Restrictions and Employer Mandates
- Capital Market Limitations
  - Certain characteristics of the underlying stock ultimately determine the feasibility of hedging different concentrated positions and in what degree they can be hedged

3.4. Psychological Considerations

Various psychological considerations of clients can act as constraints to dealing with concentrated positions

Emotional biases

- Overconfidence and familiarity
- Status quo bias
- Naïve extrapolation of past returns
- Endowment effect
- Loyalty effects

Cognitive Biases

- Conservatism
- Confirmation
- Illusion of control
- Anchoring and adjustment
- Availability heuristic

Example 1: Constraints and the Concentrated Position Decision-Making Process

1. Identify primary investment objectives for the Bailer family's concentrated single-asset position.

2. Identify primary constraints that might impede the Bailer family's ability to achieve their primary objectives.

3. On the basis of the information given, discuss what emotional and cognitive biases may affect decision making of Mr. and Mrs. Bailer.

3.5. Goal-Based Planning in the Concentrated-Position Decision-Making Process

Goal-based planning can highlight the consequences of selecting an asset allocation that is riskier than is appropriate for a particular investor.

A goal-based methodology expands the traditional Markowitz framework by incorporating several notional "risk buckets." Asset allocation occurs within each risk bucket.

- Personal risk bucket
- Market risk bucket
- Aspirational risk bucket

Will selling or monetizing concentrated position provide for owner's lifetime spending needs?

- Primary capital versus surplus capital

Wealth managers should have a holistic view of their clients' finances, an understanding of their personal long-term financial objectives, and expertise in investment management.

Example 2: A Business Owner and the Concentrated-Position Decision-Making Process (1)

"Personal" Risk 4% Protective Assets		"Market" Risk 6% Market Assets		"Aspirational" Risk 90% Aspirational Assets	
Home	$1,000,000	Equities	$1,500,000	Family Business	$40,000,000
Mortgage on Primary Residence	$0	Intermediate- and Long-Term Fixed Income	$1,500,000	Investment Real Estate	$5,000,000
Cash/Short-Term Treasury Bonds and Notes	$1,000,000				
Total	$2,000,000	Total	$3,000,000	Total	$45,000,000

Using a goal-based planning framework (i.e., personal, market, and aspirational risk buckets), identify and highlight the significant risk(s) that Garcia is currently facing.

Using a goal-based planning framework, describe the initial step that Wharton should work through with Garcia to help determine whether selling or monetizing his business might make sense.

After carefully considering Garcia's lifetime spending needs, Garcia and Wharton determined that a primary capital requirement of $35 million should be more than sufficient to sustain Garcia's current lifestyle with very little or no risk of running out of capital during his lifetime, even after considering such potential factors as severe market shocks, tax rate increases, inflation, and an unexpectedly long life span. Later in the reading, after providing the tool set for addressing the problem of obtaining the needed primary capital amount, we will return to Garcia's needs in Example 6.

Explain how this knowledge—that the sale or monetization should meet Garcia's $35 million primary capital requirement—should be helpful to Garcia in making a decision as to whether to sell or monetize his business.

3.6. Asset Location and Wealth Transfers

Asset Location

- The choice of where to place specific assets is often referred to as the *asset location decision.*
- The tax regime ultimately determines the relative importance of asset location.

Wealth Transfers

- If possible, plan wealth transfer *early* in the ownership life of a concentrated position
- Estate tax freeze plan: owners transfer a junior equity interest to the children. Any gift or wealth transfer tax is based on the current market value of the interest transferred; future appreciation of the equity position transferred will not be subject to gift or transfer tax.
- Classic corporate estate tax freeze: recapitalize; older generation gets preferred shares with voting rights, next generation gets common shares which have a nominal value.
- If significant appreciation has occurred: contribute the concentrated position to an entity such as a family limited partnership. The parents retain the general partnership interest and therefore retain control.
- Charitable giving.

Example 3: A Corporate Estate Tax Freeze

John and Barbara Wilson live in a country that imposes a current gift tax of 40% on the transfer of any property directly (or indirectly through trusts) from parents to children that exceeds $10 million during their lifetimes. The Wilsons have already used the $10 million exemption by making prior gifts to their children. The Wilsons own a business currently worth $10 million, but they believe the business is poised for explosive growth that will begin shortly. Their children are already involved with the business. The Wilsons eventually want to pass control of the business to their children, but at this point, they feel their children don’t have the necessary experience to run the business, so the Wilsons would like to retain control. However, they would like the growth that is expected of the business to directly benefit their children, as contrasted with having that appreciation remain in their estate. Based only on the above information, address the following.

1. Would a direct gift of the company stock from the Wilsons to their children satisfy their objectives?
2. Would a direct gift of the company stock from the Wilsons to a trust set up for the benefit of their children satisfy their objectives?
3. Would a corporate estate tax freeze satisfy the Wilsons’ objectives?

3.7. Concentrated Wealth Decision Making: A Five-Step Process

1. Identify and establish objectives and constraints.
2. Identify tools/strategies that can satisfy these objectives.
3. Compare tax advantages and disadvantages.
4. Compare non-tax advantages and disadvantages.
5. Formulate and document an overall strategy.

4. Managing the Risk of Concentrated Single-Stock Positions

Broad tools for managing the risk of any concentrated position: outright sale, monetization strategies, hedging value of concentrated assets.

4.1. Tax consideration: implement the *form* of a transaction that delivers the optimal economic and tax result.

4.2. Non-tax considerations when deciding between exchange traded and OTC instruments

- Counterparty Credit Risk
- Ability to Close Out Transaction Prior to Stated Expiration
- Price Discovery
- Transparency of Fees
- Flexibility of Terms
- Minimum Size Constraints

4.3. Strategies

Three primary strategies that investors use in the case of a concentrated position in a common stock:

- Equity monetization
- Hedging
- Yield enhancement

Equity Monetization: investor receives cash for his/her stock position through a manner **other than an outright sale** in a way that avoids triggering a current taxable event.

Equity monetization useful when:

- The investor may be subject to restrictions that are applicable to a sale of stock
- The investor may not wish to cede control of the company
- The investor may be subject to contractual provisions, such as an IPO lockup or an employment agreement or policy, that prohibit the sale of shares

Equity Monetization (Continued…)

Equity monetization entails a two-step process:

- remove a large portion of the risk inherent in the concentrated position
- borrow against the hedged position

Four basic tools an investor can use to establish a short position in a stock:

1. Short sale against the box
2. Total return equity swap
3. Forward conversion with options
4. Forward sale contract or single-stock futures contract

Understand tax implication of monetization strategies.

Exhibit 5: Classification of Income Tax Regimes.

Lock In Unrealized Gains: Hedging

- Purchase of puts

- Cashless (zero-premium) collars
  - Buy puts and sell calls
  - Investor is able to: (1) hedge against a decline in the price of a stock, (2) retain a certain degree of upside potential with respect to the stock, (3) defer the capital gains tax while avoiding any out-of-pocket expenditure and (4) retain dividend income and voting rights
  - A collar hedges the value of the concentrated position. The value of the concentrated position can concurrently be monetized by means of a margin loan.

- Prepaid variable forwards
  - Hedge and the margin loan are combined in one instrument
  - Example: an investor holding ABC Corp. shares currently trading at $100 might enter into a PVF requiring the dealer to pay the investor $88 up front in exchange for the right to receive a variable number of shares from the investor in three years based on a preset formula

Example 4: Hedging a Concentrated Position

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In the country where LeMesurier is domiciled, like many other countries, the tax code does not treat all financial instruments that achieve the same economic result the same. The tax code in her country treats the call premium received on short calls as a current short-term capital gain whereas the premium paid to acquire puts is treated as a deferred long-term capital gain that merely increases the tax cost basis of the shares that were hedged.

- Can this treatment result in a less-than-optimal tax result?

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- Could OTC derivatives deliver a potentially more tax-efficient result than exchange-traded options?
- Would there have been a cost to LeMesurier if she decided to implement her collar with OTC derivatives in lieu of exchange-traded options?

Example 5: Mismatch in Character

A key tax issue that arises when hedging restricted shares and employee stock options is the potential tax inefficiency that can result if the instrument being hedged and the tool that is being used to hedge it produce income and loss of a different character. This problem is called a ***mismatch in character***.

David Hawk, a senior executive at US-based Garner-Price Corp., receives a large portion of his compensation in the form of stock options. These options will be taxed as ordinary income upon their exercise. Hawk decides to hedge his employee stock options using an option-based collar. During the period the collar is in place, the employee stock options increased in value by $10 million above the strike price of the collar.

1. Taking no account of either potential tax implications or the net cost of the collar, has Hawk benefitted economically from this increase in value?
2. Explain the problem of "mismatch in character" in hedging.
3. Describe the mismatch in character that potentially affects Hawk.

Yield Enhancement and Other Tools

- Yield can be enhanced by using a covered call strategy but downside risk is retained
- **Tax-optimized equity strategies** seek to combine investment and tax considerations in making investment decisions. They start with the generic concept of tax efficiency and quantitatively incorporate dimensions of risk and return in the investment decision-making process. In the context of managing the risk of a concentrated stock position, these strategies are used in two primary ways: (1) as an index-tracking strategy with active tax management and (2) in the construction of completeness portfolios.
- In certain circumstances, it may not be possible for an investor to directly hedge a position. In such a case, the investor might wish to consider an indirect or ***cross hedge*** by using derivatives on a substitute asset with an expected high correlation with the investor's concentrated stock position.
- An **exchange fund** is an investment fund structured as a partnership in which the partners have each contributed their low-basis concentrated stock positions to the fund. Each partner (contributor to the fund) then owns a pro rata interest in the partnership potentially holding a diversified pool of securities.

5. Managing the Risk of Private Business Equity

1. Profile of a Typical Business Owned by a Private Client
2. Profile of a Typical Business Owner
3. Monetization Strategies for Business Owners
4. Considerations in Evaluating Different Strategies

5.3. Monetization Strategies for Business Owners (1/2)

- Sale to Strategic Buyers
- Sale to Financial Buyers
- Recapitalization
- Sale to Management or Key Employees
- Divestiture (Sale or Disposition of Non-Core Assets)

Monetization Strategies for Business Owners (1/2)

- Sale or Gift to Family Member or Next Generation
- Personal Line of Credit Secured by Company Shares
- Going Public through an Initial Public Offering
- Employee Stock Ownership Plan

5.4. Considerations in Evaluating Different Strategies

- Objective: maximize the after-tax proceeds that are available to the business owner to re-invest as opposed to simply maximizing the sales price.
- A strategic buyer will typically pay the highest amount for a business.
- Consider how much is paid up front in cash (or stock) and how much is deferred or contingent (and how likely it is that it will actually be received).

Example 6: A Business Owner and the Concentrated-Position Decision-Making Process (2)

Recall that Fred Garcia had been persuaded by his financial advisor, Bill Wharton, that a sale to a strategic buyer or a recapitalization would satisfy his primary capital requirement of $35 million. Wharton then introduced Garcia to an investment banking firm to explore all exit strategies. The following facts were established:

- The government in Garcia's country is expected to increase the tax rate on capital gains, effective the following year.
- Garcia wants to spend more time with his family.
- Garcia is very attached to his identity as CEO of an aircraft business.
- Garcia believes that if his company had a capital infusion, his company would be positioned to triple its earnings within several years.
- The financial data are shown from Exhibit 3, repeated here.

Personal" Risk, 4%, Protective Assets		"Market" Risk, 6%, Market Assets		"Aspirational" Risk, 90%, Aspirational Assets	
Home	$1,000,000	Equities	$1,500,000	Family Business	$40,000,000
Mortgage on Primary Residence	$0	Intermediate- and Long-Term Fixed Income	$1,500,000	Investment Real Estate	$5,000,000
Cash/Short-Term	$1,000,000				
Total	**$2,000,000**	**Total**	**$3,000,000**	**Total**	**$45,000,000**

Example 6 (Cont…)

1. Discuss which factors favor a sale to a strategic buyer and which factors favor a recapitalization.
2. Suppose that Garcia decides on a recapitalization. Garcia receives 80% of the value of the company in cash from a private equity firm, taxed at the current 15% capital gains tax rate. Investment real estate is included in the transaction. Assume that $10 million of proceeds are added to Garcia's personal risk bucket and the remaining balance of proceeds is added to his market risk bucket. The private equity firm shares Garcia's optimism about the potential growth of the company and is ready to extend debt financing to it on favorable terms.
   A. Calculate the (after-tax) amount monetized by the recapitalization and the value of his stake in the business immediately after recapitalization.
   B. Explain the meaning of primary capital in this context. Evaluate whether the amount monetized, combined with his existing portfolio, meets Garcia's requirement for $35 million in core capital. Justify your answer.
3. Describe a likely management objective of the recapitalized company.

Example 7: Short Sale against the Box

Sam Smith, age 73, is the founder and 100% owner of ScreenTime, Inc., a technology company. The investment banker of Peak Products, Inc., a publicly traded competitor, has approached Smith with a two-pronged offer to buy. Smith engages the investment banker, Beverly Capital (BC), to evaluate Peak's offer. Other pertinent facts are as follows:

- One offer is $300 million, all cash, for all of Smith's shares.
- A second offer is $350 million in Peak shares in exchange for all of Smith's shares, with no cash consideration.
- The capital gains tax rate is 25%.
- BC advises that, as structured, the second offer qualifies as a tax-free stock swap (i.e., a type of business sale transaction that does *not* trigger an immediate taxable event). The tax cost basis that Smith has in ScreenTime shares, essentially zero, would become his tax cost basis in Peak shares transferred to the Peak shares.
- Although referred to as a tax-free stock swap, the actual result is a deferral of the capital gains tax. That is, a taxable gain would occur if and when Smith sold his Peak shares.
- Smith is domiciled in a country where the current tax regime allows for a stepped-up basis in shares held at the time of the investor's death. That is, upon Smith's death, the Peak shares received by Smith's estate or beneficiaries would receive a tax cost basis equal to fair market value on the date of Smith's death. Thus, at death, accrued gains permanently escape income taxation.
- Smith is unwilling to bear the risk of holding Peak shares. Suppose that if Smith accepts a tax-free stock swap, he is able to sell the Peak shares short against the box. He would realize 99% of the value of the Peak shares with no limitations on the use of proceeds. The after-tax cost to access the proceeds would be locked in at 30 bps per year. Smith would be able to keep the position in place indefinitely.

Example 7 (Cont…)

1. Discuss the implication of Smith's unwillingness to bear the risk of the Peak shares.
2. Determine the value of the all-cash offer.
3. Determine the value of the tax-free stock swap offer with immediate sale of the Peak shares.
4. Determine the value of the tax-free stock swap offer with a short sale against the box.
5. Recommend a strategy to Smith.

6. Managing the Risk of Investment Real Estate

Monetization Strategies

- Outright Sale
- Mortgage Financing
- Real Estate Monetization for the Charitably Inclined
- Sale and Leaseback
- Other Real Estate Monetization Techniques

Example 8: Refinancing or Sale Leaseback?

Albert Lee is the owner of a medium-size business and is seeking to raise capital to facilitate the growth of the business. Lee wishes to either (1) sell and leaseback or (2) refinance his free and clear warehouse to raise capital. The warehouse is worth $5 million. Assume the following facts:

- By refinancing, Lee can achieve an LTV ratio of 75% and raise $3.75 million. By using a sale and leaseback, Lee can raise, on a pre-tax basis, 100% of the value of the warehouse, or $5 million.
- The warehouse is owned by Lee, not by the business, and is not key to the success of the business.
- Lee has $1.5 million of capital loss carryforwards.
- The capital gains tax rate is 25%.

State and justify two reasons in favor of a sale and leaseback (to the corporation) rather than a refinancing.

Summary 1/4

A holding is generally considered "**concentrated**" if it represents of ≥25% of an investor's wealth. Concentrated positions include publicly-traded single-stock, privately held businesses, and investment real estate.

Investment risks of concentrated positions:

a) Systematic risk
b) Company-specific risk
c) Property-specific risk

Objectives in managing concentrated positions:

1) To reduce concentration risk
2) To generate liquidity to satisfy spending needs
3) To achieve objectives 1 & 2 in a tax-efficient manner

- **Tax considerations:** Selling concentrated position with low cost basis and highly appreciated current market values trigger a significant tax event. Therefore we should take steps to defer, reduce or even eliminate this liability.
- **Liquidity considerations:** Concentrated positions in privately owned companies and real estate are illiquid. Also concentrated position in a publicly traded stock may be illiquid either due to low free float or selling constraints. Therefore, selling these positions can be time consuming and can have high transaction costs.
- There may also be psychological considerations associated with concentrated positions, i.e. the existence of any cognitive or emotional biases.

Capital market and institutional constraints:

- Laws and regulations: e.g. prohibition from selling during black-out periods / insider trading.
- Margin-lending rules: maximum amount (as a percentage of the asset's value) that a financial institution is allowed to lend.
- Contractual restrictions and employer mandates;

Capital market limitations: e.g., average daily trading volume and liquidity of the underlying stock would determine the feasibility of hedging different concentrated positions.

Psychological considerations:

- Emotional biases: overconfidence and familiarity, status quo, naïve extrapolation, endowment effect, loyalty effects.
- Cognitive biases: conservatism, confirmation, illusion of control, anchoring and adjustment, & availability.

- Goal-based planning considers asset allocation within the context of three "risk buckets". Each bucket has a distinct investment objective and asset allocation.

Personal risk bucket
Goals:
Protect against poverty or dramatic decrease in income
Asset Allocation
Primary residence and low-risk, low-return investments (e.g. T-bills)

Market risk bucket
Goals:
Maintain current standard of living
Asset Allocation
Well-diversified portfolio of assets offering average risk-adjusted returns

Aspirational risk bucket
Goals:
Increase standard of living
Asset Allocation
High-risk, high-return assets (e.g. concentrated positions)

- Capital allocated to personal and market risk buckets is called "primary capital".
- Capital allocated to aspiration risk bucket is called "surplus capital".

- **Asset location**: locating/placing investments in appropriate accounts, depending on the tax regime. Assets that are taxed heavily (favorably) should be held in tax deferred and tax exempt accounts (taxable accounts).

- **Wealth transfers planning**: determining the most tax-efficient method and timing of wealth transfer.

Summary 2/4

Transfer tax minimization strategies	
Before substantial appreciation of the value of the concentrated position	After substantial appreciation of the value of the concentrated position

• Direct gifts to family members
• Direct gifts to long-term trusts
• Estate transfer freeze: transfer a junior equity interest to children.
  • any gift or wealth transfer tax is based on current market value of the interest transferred
  • future appreciation of the equity position transferred is not subject to gift or transfer tax
	• Contribute concentrated position to a limited partnership and gift the limited partnership interests to the next generation
	  • Due lack of marketability and control, the value of a limited partnership interest < proportionate value of assets held in partnership
	• Charitable giving

Corporate estate tax freeze: In this strategy the company is recapitalized. The older generation gets preferred shares with voting rights and the next generation gets common shares which have a nominal value.

Strategies	Pros	Cons
Equity monetization: Hedge risk and borrow against equity position. Loan proceeds can be reinvested. Use when there are selling restrictions and/or when investor wants to retain control.	• Risk-less asset is created → high LTV ratio • Eliminates downside risk • Capital gain tax is deferred	• Limited upside potential
<u>Equity monetization tools:</u> 1. Short sale against the box: creates risk-less position → high LTV ratio. It is the least expensive method. 2. Total return equity swap: due to dealer spread, money market return < short sale against the box. 3. Forward conversion with options: long put + short call. Riskless asset is created → investor can earn money market return and can have high LTV ratio. 4. Equity forward sale contract: Riskless asset is created → investor can earn money market return and have high LTV ratio but limited upside potential.		
<u>Hedging tools</u>: 1. Protective put 2. Cashless (zero-premium) collar 3. Prepaid variable forwards: combination of hedge and margin loan	• Protective put provides downside protection, retains upside potential, and defers capital gain tax. • Cashless collar helps in deferring capital gains tax while avoiding any out-of-pocket expenditure.	• Protective put incurs cost in the form of option premium. • Cashless collar results in a cap on upside potential.
<u>Yield enhancement:</u> Writing covered call → long stock + short out of money call. Use when stock price is expected to move in a trading range for the foreseeable future.	• Helps in psychologically preparing the owner to dispose of his/her shares. • Generates premium income.	• Provides limited upside potential.

Summary 3/4

Other strategies using put options to reduce cost of hedging:

A. Buy at-the-money or slightly ***out-of-the-money put*** options with relatively low option premium.

B. Use "***put-spread***" strategy → long put option with a higher exercise price and short an otherwise identical put option with a lower strike price but with the same maturity as the long puts.
   - ➢ Pros: Selling put generates premium income.
   - ➢ Cons: Lose downside protection if the stock price moves below the strike price of the short put.

C. Using a "***knock-out***" put option in which once the stock price increases to a certain level, the downside protection disappears before its stated expiration date.

➢ Pro: less expensive than a 'plain vanilla' option.

➢ Con: Lose downside protection if stock price rises to the level that causes the expiration of the knock-out option.

<u>Other tools for managing concentrated positions in publicly traded common:</u>

A. *Index-tracking strategy with active tax management*: Track a broad-based market index on a pre-tax basis and outperform it on an after-tax basis.

B. *Completeness portfolio:* Concentrated holdings + other liquid securities

C. *Cross/indirect hedge:* Using derivatives on a substitute asset that has an expected high correlation with the investor's concentrated stock position

D. *Exchange fund*: Investment fund structured as a partnership, each partner owns a pro rata interest in the partnership.

Mismatch in character: When instrument being hedged and the tool that is being used to hedge it produce income and loss of a different character. Example: Having ordinary income on the concentrated position but capital loss on the hedge.

<u>Characteristics of a Tax-efficient hedging tools:</u>

- Long term gain generated by the hedge is preferable.
- Short term and currently deductible losses are preferable.
- Long term gain in physically settled contracts is preferable.
- Currently deductible monetization carrying costs are preferable.
- Hedging transaction having no impact on the taxation of dividends or distributions received on the shares is preferable.

Strategies for managing concentrated positions in privately held businesses:

Strategy	Pros	Cons
Sale to strategic buyers.	• Strategic buyers pay the highest price. • Seller can avoid higher tax rate in future. • Relieves the seller from running the business.	• Strategic buyers are difficult to find.
Recapitalization: Sell a large portion of business equity while retaining a minority ownership interest. This is considered as "staged" exit strategy.	• Reduce concentration risk and generate liquidity without selling the business entirely. • Investor can invest after-tax cash proceeds in other asset classes.	• Receive lower price compared with strategic buyer. • Cede control of the company.
Sale to financial buyers.	• Easier to find compared with strategic buyers.	• Financial buyers pay lower price compared to strategic buyer.
Sale to management or key employees.	• Like strategic buyers, a company's managers and key employees have in depth knowledge of its operations.	• Significant amount of the purchase price is deferred.
Sale or disposition of non-core assets.	• Generate some liquidity to diversify without losing control of the business.	• Does not eliminate entire concentration risk.
Personal line of credit secured against company shares.	• Generate liquidity without losing control of the business and without incurring an immediate tax liability (if structured properly). • Interest expense on the loan is tax deductible	• The loan gives the lender a "put" option, which if exercised, triggers a taxable event to the business owner. • Bank could take ownership of the company in the event of a default.
Going public through an IPO	• Suitable to use if owner wishes to remain actively involved in the company for near future. • May generate the highest cash proceeds for the owner.	• Expensive strategy. • Owners lose their privacy and authority. • Face higher scrutiny.
Employee stock ownership plan	• Do not incur immediate capital gains tax liability. • Retain control of the company and any upside potential. • May eliminate capital gains tax by a possible step-up in basis at death.	• Involves significant setup and maintenance costs.

Summary 4/4

Strategies for managing concentrated positions in real estate:

Strategy	Pros	Cons
Outright sale	▪ Relatively easy and common strategy	▪ Triggers a taxable event.
Mortgage financing	▪ Loan proceeds do not represent "taxable income". ▪ If an investor achieves a cash flow-neutral LTV ratio, there are no limitations on the use of the loan proceeds. ▪ Potential upside is retained.	▪ Does not eliminate economic risk of underlying property.
Donate	▪ Ownership is transferred without triggering a taxable event. ▪ Tax deductible.	▪ Only suitable to those who are charitably inclined.
Sale and leaseback	▪ Investor can obtain 100% LTV ratio. ▪ Rental payments are 100% tax deductible. ▪ Remove debt from the balance sheet. ▪ Available even during periods of tight credit markets.	▪ Investor has to pay capital gain tax due to which the after-tax proceeds will be <100%.