gc_logo_small

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Strategies for Managing**

**Concentrated Wealth**

© 2016 Greene Consulting Associates, LLC INTENDED SOLELY FOR USE BY REGISTERED USERS NOT TO BE REPRODUCED OR CIRCULATED

## ABOUT GREENE CONSULTING ASSOCIATES, LLC

Greene Consulting Associates was founded in 1979 and provides consulting and training services solely to the financial services marketplace. Located in Atlanta, Georgia, Greene Consulting has worked with the top providers of investment management and wealth management in both the United States and abroad. Focused on helping firms generate incremental revenue growth through more effective sales and relationship management strategies, Greene Consulting offers customized training programs in Financial Services Sales, a Sales Management program, Presentation Training that integrates proprietary products, and a comprehensive suite of online learning courses related to investments and wealth management.

For more information about Greene Consulting or any of its products and services, write Greene Consulting at Waterstone Building, 4751 Best Road, Suite 450, Atlanta, Georgia 30337. Or, visit the company's website at [www.greeneconsults.com](http://www.greeneconsults.com).

## Table of Contents

Introduction

Why Do People Hold Large Concentrated Positions of Wealth?

The Primary Problem of Concentration

The Problem with Selling a Concentrated Stock Position

Strategies for Dealing with Concentrated Positions

Monetization Strategies: The Systematic Sale

Monetization Strategies: Borrowing Against the Stock

Monetization Strategies: Short-Against-The-Box

Constructive Sale Rules

Short-Against-The-Box Revisited

Review Exercise

Variable Prepaid Forwards

How a Variable Prepaid Forward Works

Illustration of a Variable Prepaid Forward

Tax Implications of VPFs

VPFs Are Not For Everyone

Review Exercise

Hedging Strategies: Using Options

Hedging Strategies: Buying Puts

Hedging Strategies: Zero-Premium Collars

The Popularity of Zero-Premium Collars

Tax Considerations of Collars

Diversification Strategies: Exchange Funds

Diversification Strategies: Equity Swaps

Wealth Transfer Strategies: Charitable Remainder Trusts

Understanding the Charitable Remainder Trust

Wealth Transfer Strategies: Charitable Lead Trust

Transfer Tax Benefits of Charitable Lead Trusts

Wealth Transfer Strategies: GRITS, GRATS, GRUTS and QPRTS

Selecting the Best Strategy

Review of Alternative Strategies

Review Exercise

Conclusion

## Introduction

Most people, given a free hand to make changes to their portfolio, would prefer that their portfolio be well diversified. But the fact is that many portfolios contain one or more concentrated positions, and investors find themselves either prohibited from selling off the concentrated position because they are restricted or control stocks, or are reluctant to do so because of tax implications or other personal reasons. Furthermore, the likelihood of these concentrated positions occurring increases in proportion to the wealth of the individual.

Many wealthy clients have excessive risk in their portfolios because they are unaware that strategies exist to help them manage the risk of concentrated positions. By presenting clients with viable alternatives, wealth management professionals can significantly reduce the risks for their clients, enhance the clients' perceived value of their relationship, and increase revenue for their organization. This may at first seem like a daunting task because some of these strategies can be quite complex, requiring the expertise of attorneys and tax experts. But the principles governing the strategies themselves are actually fairly simple and straightforward.

|  |
| --- |
| Objectives  This module will not give you the knowledge to replace the attorneys and tax experts; in fact, it will caution you that they are an integral part of some of these solutions. But it will give you the knowledge you need to help your clients identify potential strategies to meet their needs and goals. In particular, by studying this module, you will:   * Become knowledgeable about the various strategies employed to manage concentrated wealth, with particular emphasis on concentrated stock positions. * Understand the tax issues, such as the constructive sale rules and straddle rules, which place some limits upon what can be accomplished. * Be better equipped to effectively communicate alternatives to your client and explain how they work. * Be able to identify the strengths and weaknesses of each strategy so that you can better advise a client on approaches that best meet their specific needs and goals. |

## Why Do People Hold Large Concentrated Positions of Wealth?

The reasons individuals hold concentrated stock positions span the spectrum from entrepreneurs who have gone public to longtime holders of a security whose equity position has gone untrimmed until it now accounts for a significant portion of their wealth. Some understanding of these causes is necessary before recommending a specific solution. The following list presents some common reasons for concentrated positions that you may encounter.

Click each cause to learn more.

|  |
| --- |
| **Restricted Stock** |
| To freely sell stocks in the open market, they must be registered under the Securities Exchange Act of 1933. This registration process can be an expensive and time-consuming process. Companies will often forego this registration process and issue unregistered securities, particularly when dealing with mergers, acquisitions, employee stock compensation, or legal settlements. These unregistered stocks are "restricted," and are subject to certain limitations on their sale. Many times, the owners and executives of a firm will hold large positions in their company stock. Often times, those portions are "restricted." |
| **Control Stock** |
| Certain key individuals associated with a company who control or influence the company's activities are deemed to be "control persons." Also, anyone who owns 10% or more of the stock is considered a "control person," unless the owner can prove otherwise. Any stock owned by a "control person" is considered control stock, and its sale may be subject to certain filings and restrictions. |
| **Low Tax Basis** |
| Often times, there is a reluctance to sell a stock concentration due to significant appreciation and the capital gains cost of the sale. This reluctance can be particularly acute with an owner who is advanced in age because the stocks may be eligible for a step-up in basis upon the owner's death, and the capital gains tax could be entirely avoided by holding it until death. |
| **Emotional Attachment** |
| Sometimes the attachment is because the stock was an inheritance or gift; at other times it is because the stock is in a company in which the owner has had a long-term relationship as an employee or as its original founder. Regardless of the cause, people often form an attachment to a stock from which they may be emotionally unwilling to part. |
| **Desire to Maintain Control** |
| Shareholders, particularly when they are "control persons," often retain stock for the power it gives them over shaping the activities and direction of the company through their voting rights. Diversifying or selling any part of the position reduces their power. |

## The Primary Problem of Concentration

The primary problem of stock concentration is the high exposure to company-specific risk, which could be avoided through proper diversification. This risk was particularly noticeable in 2008 when the epic recession that really gained steam in October of 2008 devastated the markets.

Other problems frequently cited are lack of liquidity and low current income. While the owner of the stock may have significant wealth on paper, the owner may need current income to fund his or her lifestyle and expenses. For stocks with a small dividend, the owner's ability to utilize the wealth is limited unless the stock is hedged, sold or diversified - each option containing potential drawbacks and tax implications. Whatever the reason for maintaining the concentration, the investor is limited from diversifying into higher income-producing securities and reducing risk.

|  |  |  |
| --- | --- | --- |
| |  |  | | --- | --- | | DocumentationIcon_32px | **Click the icon to view an illustration of company specific risk.** | |
| **Company Specific Risk**  An investor holding 500,000 shares of Las Vegas Sands (LVS) in October of 2007 would have been worth over $72 million. By March 2009, less than a year and a half later, that same investor’s worth would have declined to approximately $710,000, representing a 99% decline in value.  LVS |

## The Problem with Selling a Concentrated Stock Position

The simple solution to a concentrated stock position is to sell the security outright, if possible, and diversify into a portfolio that is allocated to meet the needs of the client. But if the security is sold:

* The client can no longer participate in its appreciation.
* A client would lose their voting rights on the shares, which for some individuals is an important aspect of the ownership position
* An immediate tax liability may be created.
* For very large holdings or thinly traded issues, the sale may place downward pressure on the stock price, as illustrated in the newswire quoted in the sidebar.

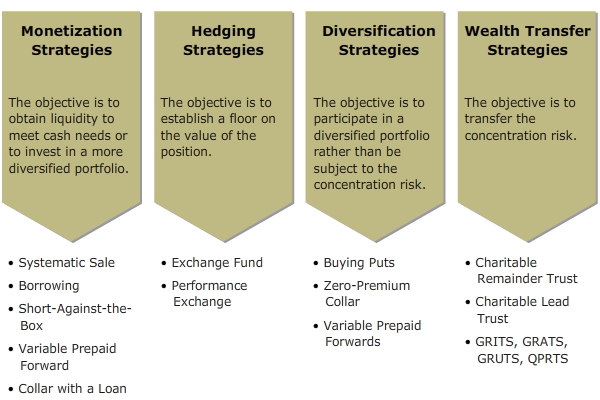
|  |
| --- |
| **DaimlerChrysler Confirms Block Of 10M Shares Sold Friday**  *Friday, January 12, 2001 09:20 AM ET*  FRANKFURT (Dow Jones)--DaimlerChrysler AG (DCX, news, msgs) Friday confirmed a market rumor that a block of 10 million DaimlerChrysler shares were sold Friday morning.  A company spokesman told Dow Jones Newswires that he didn't know whom the shares had belonged to or who bought them, but confirmed the transaction was organized by Bank of America (BAC, news, msgs).  Separately, a person close to the deal, who declined to be named, said the shares were sold at EUR43.25 each.  DaimlerChrysler shares were dragged lower by the report of the sale and at 1415 GMT, the stock was down EUR0.96, or 2.1%, at EUR44.05 on the DAX.  *--By Beth Reigber, Dow Jones Newswires; 49-69-297-255-00* |

Therefore, investors frequently look for other solutions.

## Strategies for Dealing with Concentrated Positions

Numerous strategies have been developed for dealing with concentrated wealth. While some of these strategies have multiple objectives, for simplicity, this training module divides them into four groups.

Below is a graphical representation of these groupings. Take a few minutes to study it, as it will serve as the outline for the remainder of this training module. We will then look at each group of strategies in more detail, beginning with the monetization strategies.



## Monetization Strategies: The Systematic Sale

Instead of selling the security all at one time, a client can begin a program of systematic sales, which is defined as a disciplined process of incrementally selling the security over a period of time. The methods range from simplistic approaches such as selling a fixed number of shares on a recurring schedule, to more sophisticated techniques where more shares are sold in periods of time when the stock is outperforming the market and less are sold when it is underperforming the market. The goal in either case is to average out the price fluctuation over time and, where possible, spread the tax impact over more than one year. The advantages and disadvantages of such an approach are listed below.

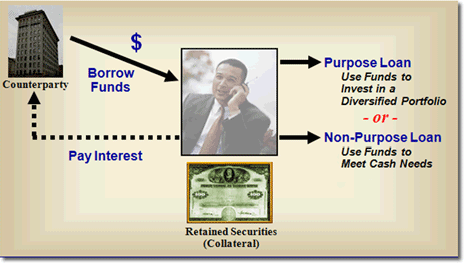
|  |
| --- |
| **Advantages**   * Eliminates the concentration risk over time * Immediate liquidity * Flexibility to reinvest however desired   **Disadvantages**   * Generates tax liability * Selling large holdings may affect the market price * May not be possible to sell because the stock is restricted or control stock * Loss of future appreciation on sold stocks * Loss of voting rights * Loss of dividend payments |

## Monetization Strategies: Borrowing Against the Stock

A second, and again very basic, approach involves borrowing against the stock. This provides the liquidity to invest the borrowed funds into a portfolio that will offer some diversification against the concentrated security or to meet cash needs.

Loans secured by stock or bond positions can be classified as one of two types: purpose and non-purpose. The classification of the loan depends on the use of the proceeds. A “**purpose loan**” is used to invest in securities. A “**non-purpose loan**” is a loan used for anything other than purchasing securities.

Purpose loans are exempt from Regulation U (Reg U) but must comply with Regulation T (Reg T). Reg T limits the extension of credit up to 50% of the value of the securities. However, most brokerage firms have more conservative margin limits. If the value of the security falls below the specified equity to loan ratio (margin/Reg T requirement) the brokerage firm will make a margin call, which may force a sale of the securities if the client cannot provide other liquid funds to their account to maintain their Reg T minimums.



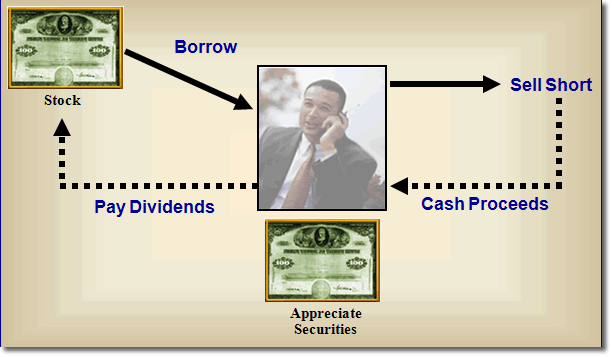
|  |
| --- |
| **Advantages**   * No tax liability is triggered * Provides liquidity for diversification or to meet cash needs * Continued opportunity to participate in stock appreciation * Retention of ownership, voting rights, and dividends   **Disadvantages**   * Interest expense of the loan * No protection against stock price declines (except for the protection offered by the diversification) * Loan size is capped by margin rules * Potential forced liquidation at low price if there is a margin call |

## Monetization Strategies: Short-Against-the-Box

The third, and more complex monetization strategy, is termed a "short-against-the-box" transaction. While once very popular, tax legislation passed in 1997 has reduced its use. However, it remains important to understand because under some circumstances the strategy is still viable. We will first discuss the basics of the strategy as it has historically been used, followed by a review of the constructive sale rules levied in 1997 that dramatically impact this strategy today.

A short sale is one in which the investor sells a stock and borrows the stock from a counterparty for delivery to the purchaser. The investor is then said to be ***"short"*** the stock, must pay interest on the borrowed stock, and will eventually have to ***"cover"*** or ***"close"*** the short position by purchasing the stock and delivering it back to the party from whom it was borrowed.

If the investor already owns the stock before going short, and can cover the short position at any time by simply delivering the shares already owned, this strategy is called *"short-against-the-box."* It is diagramed below:



Using this strategy, the shareholder essentially receives the benefit of selling the stock without generating the tax liability. He/she has effectively:

* Received the current market value of the shares.
* Protected against any price decline and forfeited any participation in a price increase
* Forfeited any participation in income because the dividends must be delivered to the party from whom the shares were borrowed.

But there is one major problem with the short-against-the box strategy, and that is the ***Constructive Sale Rules.***

## Constructive Sale Rules

The short-against-the-box strategy was very popular until Congress passed the Taxpayer Relief Act of 1997. Among other things, this Act specifically targeted the short-against-the-box and similar strategies. It stated that certain hedging strategies were essentially the equivalent of a sale of the stock, deemed them ***"constructive sales,"*** and directed that they be taxed as if the underlying stock had actually been sold. The constructive sale rules are important to understand as they may impact any hedging strategy utilized by an investor.

For most purposes, the Taxpayer Relief Act of 1997 put an end to the use of the short-against-the-box strategy. However, the Act left some viability for short-term use of such strategies, as long as some very specific conditions (listed below) are met.

|  |
| --- |
| **Constructive Sales Scenarios**  A constructive sale occurs in scenarios where:   1. Substantially all the risk of a loss in the security is eliminated   AND   1. The opportunity for income and gain regarding the appreciated asset is eliminated |

|  |
| --- |
| **How to Avoid a Constructive Sale**   1. The transaction must be closed before the end of the 30th day after the end of the investor's tax year. 2. Once the open position is closed, the investor must hold the appreciated asset for another 60 days. 3. During the 60-day holding period, the investor must not engage in any activity that would reduce his/her risk of loss on the security. |

## Short-Against-the-Box Revisited

Working with the specific parameters required to avoid a constructive sale, it is still possible to make limited use of the short-against-the-box strategy, provided that the open position is closed within 30 days beyond the current tax year. Once closed, after the 60-day waiting period is observed between transactions, a new short-against-the-box position can be created. This transaction can be repeated indefinitely, going to the open market to purchase the shares needed to close the open position rather than delivering the underlying shares that are owned. **Click the icon to view an example.**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **How to Evaluate**  Suppose the stock is currently selling at $100 a share when the short-against-the-box transaction is initiated, and it is selling at $80 when the position is closed the following year. Further suppose that after waiting 60 days the price is unchanged and the investor again goes short-against-the-box, closing the position again next year when the price is at $120. The scenario looks like this:   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | **Year 1 Transaction** |  | **Year 2 Transaction** | | |  | **Year 3 Transaction** | | Receive $100/share from sale of borrowed stock |  | Pay $80/share to cover open position | + | Receive $80/share from sale of borrowed stock |  | Pay $120/share to cover open position |   As can be seen, the scenario is little different from what would happen if it were possible to engage in a single hedging transaction for two (or more) years. Effectively, the investor has hedged the stock at the current price of $100. But the 60-day waiting period does subject the holding to a period of risk that would not be present if a multi-year hedging strategy were available, such risk being considerable in a volatile market. There are also the increased transaction costs. |

Because it is less effective, involves more effort to carry for multiple years, and has increased transaction costs, it is obvious that the short-against-the-box strategy, while still possible, has significantly less utility than prior to the Taxpayer Relief Act of 1997. For this reason, investors have looked for other monetization strategies. One that has grown considerably in popularity, and which is increasingly seen as more effective than was the short-against-the-box in its heyday, is the ***Variable Prepaid Forward.***

## Review Exercise

Before proceeding, take a few moments to review your knowledge of monetization strategies by answering the questions below.

**Select the correct response to the following questions.**

1. **Mr. Samuelson thinks GE has reached its high and will soon go down in price. If he owned any shares, he would quickly sell them. Since he does not own shares, he decides to make the sale anyway, and then covers the sale by borrowing the stock. He figures he can buy the stock back when the price goes down, use the newly purchased shares to cover his loan, and pocket the difference. This strategy of borrowing stock from a counterparty and selling it in the open market is referred to as a:**

* Long Sale

**Incorrect**. Try again.

* **Short Sale**

**Correct**.

* Short-Against-the-Box

**Incorrect**. Try again.

* Rollover Sale

**Incorrect**. Try again.

1. **If Mr. Samuelson had owned 50,000 GE shares, but borrowed 50,000 shares to sell, this would be known as:**

* Going Long

**Incorrect**. Try again.

* Going Short

**Incorrect**. Try again.

* **Going Short-Against-the-Box**

**Correct**.

* Rolling Over

**Incorrect**. Try again.

1. **Mr. Samuelson can avoid a constructive sale by:**

* Closing the position before the end of the 30th day after the end of his tax year

**Incorrect**. Not the only correct answer. Try again.

* b. Once the open position is closed, Mr. Samuelson must hold the appreciated asset for another 60 days

**Incorrect**. Not the only correct answer. Try again.

* c. During the 60-day holding period, Mr. Samuelson must not engage in any activity that would reduce his risk of loss on the security

**Incorrect**. Not the only correct answer. Try again.

* **d. Performing all of the above**

**Correct**.

* e. Performing both a. and b.

**Incorrect**. Try again.

1. **Complete the following statement by filling in the word that best completes the sentence. A \_\_\_\_\_\_\_\_\_ strategy is one where the primary objective is to establish a floor on the value of the position.**

* Monetization

**Incorrect**. Try again.

* Diversification

**Incorrect**. Try again.

* **Hedging**

**Correct**.

* Wealth Replacement

**Incorrect**. Try again.

1. **Complete the following statement by filling in the word that best completes the sentence. A \_\_\_\_\_\_\_\_\_\_ strategy is one where the primary objective is to obtain liquidity to meet cash needs or invest in a more diversified portfolio.**

* **Monetization**

**Correct**.

* Diversification

**Incorrect**. Try again.

* Hedging

**Incorrect**. Try again.

* Wealth Replacement

**Incorrect**. Try again.

1. **All of the following are advantages of borrowing against the stock as a monetization strategy EXCEPT:**

* No tax liability is triggered

**Incorrect**. Try again.

* Continued ability to participate in stock appreciation

**Incorrect**. Try again.

* Continued participation in dividend income

**Incorrect**. Try again.

* Retained ownership of the stock

**Incorrect**. Try again.

* **Protection against downward shift in the stock price**

**Correct**.

1. **Because of the Taxpayer Relief Act of 1997, the short-against-the-box strategy's popularity has waned and it is not commonly used as a long-term strategy for monetization of a wealth concentration.**

* **True**

**Correct**.

* False

**Incorrect**.

## Variable Prepaid Forwards

One of the reasons the short-against-the-box strategy was so popular was the fact that it was possible to borrow up to 95% of the locked-in value of the asset and use all the money to reinvest in a diversified portfolio. But the Taxpayer Relief Act of 1997 made it very difficult to effectively put this strategy into practice for long-term protection. Yet no other strategy, short of an outright sale, provided nearly as much liquidity.

|  |  |
| --- | --- |
| **Variable** | Settlement amount depends upon future market price of stock |
| **Prepaid** | Seller receives an advance payment |
| **Forward** | Stock to be sold at a future point in time |

To address the need for long-term protection with high current liquidity, institutions developed what is known generically as a ***Variable Prepaid Forward*** (VPF). VPFs are commonly executed by company insiders looking to protect concentrated positions while retaining upside appreciation potential. Additionally, VPFs can be structured without the prepayment feature for clients seeking protection but do not have a need for liquidity.

Essentially, a VPF is a contract to sell shares at a future point in time ("to sell forward"). The party buying the securities, the counterparty, provides an advance payment upon execution of the contract; hence, it is "prepaid." When the time comes to close the contract, the amount of the settlement with the counterparty will depend upon the market value of the stock at the time of settlement; hence, it is "variable." It is this uncertainty regarding the number of shares to be delivered and their exact cash value when the contract is closed out that keeps this arrangement from being treated as a constructive sale.

## How a Variable Prepaid Forward Works

A VPF contract is an agreement to "sell forward" shares of stock and is typically structured as shown in the diagram below.

Click each hyperlink to learn more.

|  |  |  |
| --- | --- | --- |
| **Time Line** | **Owner** | **Counterparty** |
| Pre-VFP Establishment | Owns 50,000 shares at a total value of $25,000,000. | Brokerage firm acts as the counterparty. |
| VPF Established | Owner agrees to sell shares at a future date. | Brokerage firm agrees to buy shares at a future date. |
| Owner receives a cash advance, with the added benefit of tax deferral (if structured properly with the constructive sale guidelines). | Brokerage firm agrees to pay a discounted present value of the future settlement price as an advance. |
| Owner reinvests the proceeds in a diversified portfolio or uses the cash for other purposes.  Owner receives:   * Benefit of continued stock ownership * Protection against market value decline * 100% participation in market value appreciation to a specific level * Possible participation in market value appreciation after exceeding that level |  |
| Maturity Date | Upon maturity, the Owner settles by delivering stocks or cash (tax consequences vary based on settlement election). | Brokerage firm receives settlement. |

|  |
| --- |
| **Cash Advance**  The contract can be structured to generate up to 90% of the current market value of the securities as a cash advance. The range is somewhat dependent upon the degree to which the owner wishes to retain some participation in the future growth of the stock.  Note that this is NOT a loan, but a cash advance against a forward sale; therefore, there are no restrictions on the use of the cash and all of it can be reinvested in other securities or used for other purposes. |

|  |
| --- |
| **Benefit of Tax Deferrals**  One of the benefits of this arrangement is that taxes on the sale of the securities are generally deferred by the owner until the time of settlement. Not only can taxes be deferred, but it is possible to generate a cash advance that may be larger than an outright sale, once taxes are taken into consideration. There are, however, numerous tax requirements that must be met. For instance, any shares posted as collateral have to be held by the counterparty and not sold. |

|  |
| --- |
| **Benefit of Continued Stock Ownership**  Another benefit is that the owner continues to enjoy the benefits associated with owning the stocks. In fact, the VPF can be structured so that the owner can continue to retain ownership of the shares at maturity by delivering cash that is equal to the value of the shares to be delivered.  Alternatively, the owner could elect to purchase securities at that time for delivery, rather than having to deliver appreciated shares. Provided the shares are not loaned to the counterparty, the individual is still considered to be the owner of the securities and will maintain voting rights and continue to receive dividend payments. |

|  |
| --- |
| **Protection Against Market Value Decline**  In a worst-case scenario, the owner of the stocks will settle the contract upon maturity by delivering all the securities. Since the owner has already received the cash advance based on the current market value of the shares, the owner has fixed the bottom price that can be obtained for each share. |

|  |
| --- |
| **100% Participation in Market Value Appreciation to a Specific Level**  Typically, VPFs are structured so that the owner gets to keep 100% of the appreciation in the shares up to a specific level. For example, the owner may get to keep all of the appreciation up to 30% of the current price. If the stock is trading at $40 per share when the contract is executed, but moves up to $52 per share by the maturity date, then the owner gets to keep the $12 of appreciation (30% of $40 = $12).  The contract can be structured to make the potential profit from appreciation greater or smaller, depending upon the size of the cash advance to be provided. A large cash advance might result in lower participation in appreciation; a small cash advance might result in higher participation in appreciation. |

|  |
| --- |
| **Partial Participation in Market Value Appreciation After Exceeding That Level**  If the stock appreciates beyond the level at which the owner keeps 100% of the appreciation, then the VPF could allow the owner to receive partial participation in the additional appreciation. Continuing with the example of a stock currently selling at $40, the contract might indicate the owner keeps 100% of the appreciation up to 30% of the current price, but can only keep 20% of the appreciation thereafter. If the stock price moved to $80 by the maturity date, then the owner gets to keep the full $12 of appreciation up to a $52 price, and keeps $5.60 (20% of $28 = $5.60) from the $28 of appreciation in price from $52 to $80. However, in most cases, the appreciation is capped at a certain level and there is not participation in additional upside. |

|  |
| --- |
| **Maturity Date**  The contract will establish a fixed maturity date at which time securities are delivered or cash settlement is made. There is great flexibility in selecting a maturity date, which typically ranges from 1 to 10 years, with 3 to 5 being the most common. The exact number of shares to be delivered or cash to be paid will depend upon the market price of the securities upon the maturity date, which will be explained on the next page.  Note as well that it may also be possible to further defer tax by “rolling” into a new VPF at maturity. |

## Illustration of a Variable Prepaid Forward

The best way to understand a VPF is to look at an actual example, including the various possible scenarios at settlement. The following example builds off the example that was used in the preceding page. The owner owns 500,000 shares of HC (Hypothetical Company), with a current market price of $40. The owner would like to raise funds to invest in a diversified portfolio, but either does not desire to sell the shares at this time or is prohibited from doing so.

|  |
| --- |
| **Terms of the Variable Prepaid Forward**   * Number of shares: 500,000 * Current market price: $40 per share ($20 million total) * Term of maturity: 5 years * Retained appreciation:   + Owner retains all appreciation up to 30% of the current market price   + Owner retains 20% of appreciation thereafter * Cash advance: 80% of current market value of securities * Settlement terms: Owner is required to pay the full amount ($20 million) or 100% of shares if the price falls below $40 per share, plus 80% of appreciation over 130% of the current market value |

|  |  |
| --- | --- |
| **Overview** | Depending upon the price of the security when the maturity date is reached, there are three possible settlement scenarios (left). Before reading the material associated with each scenario, first think through what you would expect to happen; then compare your thoughts to the associated material. **Click each scenario to learn more.** |
| **Stock Price less than or equal to $40** | **Stock Price less than or equal to $40**  Owner surrenders all the securities. |
| **Stock Price between $40 and $52** | **Stock Price between $40 and $52**  Owner delivers sufficient stock to meet the required $20 million and keeps the remaining shares. For example, suppose the market price is $50 per share at maturity. The total shares are worth $25 million, but the owner is only obligated to deliver $20 million. Therefore, the owner delivers 400,000 shares (400,000 shares x $50 per share = $20 million) and keeps the remaining 100,000 shares. |
| **Stock Price greater than or equal to $52** | **Stock Price greater than or equal to $52**  Owner delivers sufficient stock to meet the required $20 million plus 80% of appreciation over $52 per share market price. For example, suppose the price per share upon maturity is $80 per share. The appreciation above $52 per share is $28, of which the owner owes the counterparty 80%, or $22.40. Thus the owner must deliver $20 million plus $11.2 million of appreciation ($22.40 x 500,000 shares = $11.2 million), for a total of $31.2 million. This can be accomplished by delivering 390,000 shares (390,000 shares x $80 per share = $31,200,000), and keeping the balance of 110,000 shares. |

## Tax Implications of VPFs

A properly structured VPF (which provides the investor with sufficient participation in either the upside or downside with respect to the underlying shares) should not result in a taxable event when the contract is entered into. So, for tax purposes, the owner gets liquidity without actually selling the shares. The tax impact takes place when shares are delivered for settlement. Generally speaking, the capital gain will be the difference between the cost basis of the shares surrendered and the cash advance received.

***This technique has tax risk.*** While the process sounds simple, it is important to remember that VPFs are considered "tax straddles" (where a position is taken on both sides of a security's price) and as such are subject to tax treatment that can be very complex. Clients must also be mindful of the constructive sale risk as discussed earlier in the section on short-against-the-box transactions. It is important that the client's tax advisor review the transaction before its execution.

The importance of the tax advisor's involvement is further emphasized because of the continued scrutiny that the IRS displays toward VPFs. For example, a recent Internal Revenue Service Field Service Advice (FSA 200111011) suggests that the use of a VPF may create an immediate taxation of the underlying shares. This Advice is essentially an informal letter issued by the IRS National Office to an IRS examining agent. While such letters are not considered binding, this letter nonetheless indicates that VPFs are not immune to attack and the IRS may eventually take the position that these transactions create an immediate taxable sale of the underlying shares.

## VPFs Are Not For Everyone

The benefits of VPFs are considerable: liquidity, downside protection, participation in appreciation, deferment of capital gains, and the fact that the owner is not locked into a sell decision but could ultimately settle the contract with cash. But they are not for every investor with a large concentration.

They are generally appropriate for investors who remain bullish on the stock. For owners who are bearish, this could be an expensive proposition, as the owner will be paying considerable financing costs on a stock that may to depreciate in value.

Since these transactions are fairly complex, they are also not typically suitable for less-sophisticated investors. Nor are they appropriate for investors with less than $5 million.

The type of security may also have some bearing on whether or not a VPF is appropriate. VPFs may be difficult to obtain for stocks that have low market capitalization, that are thinly traded, or that are severely depressed in price.

Below are important advantages and considerations pertaining to VPFs.

|  |
| --- |
| **Advantages**   * Tax-deferred forward sale with retained upside * Immediate proceeds available * Hedges downside risk via up-front proceeds   **Disadvantages**   * Upside capped at upper strike price * Proceeds received on a discounted basis |

## Review Exercise

**Select the correct answer for each question.**

1. **The money received up front on a prepaid variable forward (VPF) is treated as a loan; therefore, the amount that can be used to purchase other assets is somewhat limited.**

* True

**Incorrect**.

* **False**

**Correct**.

1. **The most common time span until maturity for a VPF is:**

* Less than 1 year

**Incorrect**. Try again.

* 1-2 years

**Incorrect**. Try again.

* **3-5 years**

**Correct**.

* 6-10 years

**Incorrect**. Try again.

* Over 10 years

**Incorrect**. Try again.

1. **Because the VPF involves a loan against the value of the stock position, the loan cannot exceed 50% of the market value of the position.**

* True

**Incorrect**.

* **False**

**Correct**.

1. **One of the advantages of a VPF is that it might be possible to settle with delivery of only a fraction of the shares of the concentrated position.**

* **True**

**Correct**.

* False

**Incorrect**.

1. **A VPF would be a reasonable strategy for which of the following:**

* An investor who is bearish on the stock he/she is attempting to monetize

**Incorrect**. Try again.

* Investors with less than $5 million in assets.

**Incorrect**. Try again.

* Unsophisticated investors

**Incorrect**. Try again.

* **A concentration in a big cap stock**

**Correct**.

* A concentration in a stock that is thinly traded

**Incorrect**. Try again.

1. **An investor who is interested in maximizing his/her participation in appreciation on a variable prepaid forward will probably have to settle for a smaller cash advance.**

* **True**

**Correct**.

* False

**Incorrect**.

## Hedging Strategies: Using Options

Fundamentally, options are very simple instruments. In fact, many people have used similar agreements in their everyday life without realizing it.

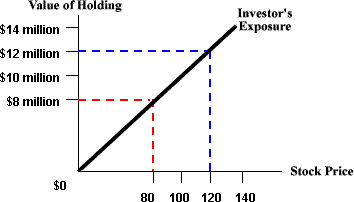
|  |  |  |
| --- | --- | --- |
| |  |  | | --- | --- | | DocumentationIcon_32px | **Click the icon to view an example.** | |
| **Example**  Suppose you are being transferred to a new job in San Francisco. Your spouse goes to San Francisco on a house-hunting trip and finds the “perfect home.” But your spouse doesn’t want to buy it until you can come to San Francisco and see it. Knowing that the house will potentially sell before the two of you can see it together, the real estate agent arranges for you to pay the seller a non-refundable fee of $1,000 to give you 30 days to put in a contract on the house. It is stated in the contract that you have the right to purchase the home at the offered price at any time during the 30 days.  When you execute that contract, you have just used the basic structure of an option. You pay a fee, non-refundable, for the right, but not the obligation to buy the house within the next thirty days for a given price. The homeowner gets the $1,000 for agreeing to take the house off the market for thirty days and is obligated to sell at the agreed upon price if the option holder chooses to exercise the option. You feel it is worth the $1,000 to get the option to buy for the next month. The homeowner feels the $1,000 pays his opportunity cost.  This everyday situation reflects the basic structure of an option on a security. Options can be excellent ways to manage risk. Generally speaking, a stock option gives its owner either the right to buy a stock or sell it at a predetermined price. By predetermining the price, some of the uncertainty and risk associated with the stock can be curtailed. |

***An option is simply a contract between two parties whereby one party has the right to trade a defined security at a given price during a finite time period.*** As such, option contracts are of two types:

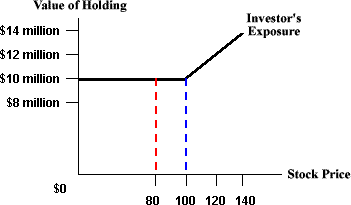
1. **Call Option** - Provides the right to BUY the underlying security at a specified price
2. **Put Option** - Provides the right to SELL the underlying security at a specified price

## Hedging Strategies: Buying Puts

Suppose an investor owns 100,000 shares of 3M Corporation, at a current market value of $120. The investor does not wish to sell the stock, but is worried that the price will fall below $100 per share. As the chart below shows, at a price of $120 per share, the investor's holding is worth $12 million. But if the price declined by 1/3 to a price of $80, then the value of the investor's holding would fall by 1/3 as well, falling to $8 million. In other words, the investor's exposure is shown by a straight line, depicting that the investor has 100% exposure to the market; for every percentage change in the market price, the investor's holding is subject to the same percent change.



Now suppose the same investor purchased a Put Option, the terms of which allowed the investor to sell the stocks at any time prior to the option's expiration date for $100 per share. The diagram below shows how the investor's exposure has changed. No longer is the exposure a straight line. Now, no matter how low the price goes, the investor has locked in the value of the holding at $10 million. For example, if the market price of the stock falls to $80 per share (red dashed line), the investor can exercise the put and still have $10 million.



This strategy eliminates most of the downside risk, while allowing the investor to continue to receive the income on the asset and to participate in its growth. Since income and growth are not curtailed, it does not trigger the constructive sale rules.

Much like a term insurance policy, owning the put option gives the investor protection against downward pressure on the stock price. The expense associated with that protection is the cost of the option itself. However, the stock and the put are considered to be a tax straddle. As a result, the gain on the put will be short-term capital gains regardless of the holding period, and the loss on the put will be deductible under the straddle rules only to the extent that it exceeds the unrecognized gain on the concentrated position.

Listed below are some advantages to this strategy as well as some of the considerations a client should be aware of.

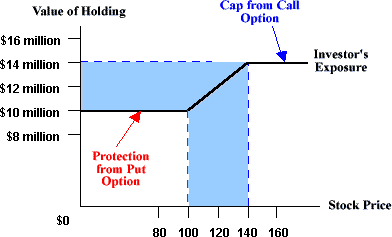
|  |
| --- |
| **Advantages**   * Minimizes or eliminates downside risk * Retain full appreciation in share appreciation   **Disadvantages**   * Can be very expensive for large positions requiring a large outlay of cash |

## Hedging Strategies: Zero-Premium Collars

While holding a put option can provide protection against downside risk, which is the greatest risk to an equity concentration, the cost of the put option is not a negligible expense. To offset that expense, investors will often generate the income needed to pay for the put by writing a call option on the stock.

To illustrate, let's continue with the example of the investor who holds 100,000 shares of 3M Corporation, currently selling at $120 per share, on which a put option has been purchased that allows the investor the option of selling the stock at $100 per share. Suppose the investor writes (sells) a call option that gives the holder of the option the right to buy the stock at $140 per share. Let's further suppose that the maturity date of the call option coincides with that of the put option previously purchased and that the price of the call option is the same as was paid for the put option. The result is that when the investor sells the call option, he/she uses the income from the sale to pay for the put option. The end result is that this combination of purchasing a put option and writing (selling) a call option is at "zero cost" to the investor.

The investor's exposure is depicted in the diagram below. The writing of the call option causes the investor's exposure line to go horizontal at $140 per share. If the market price of the stock exceeds $140 per share, the option will be exercised. But the most the investor can now receive is $140 per share, no matter how high the price goes in the market.



As can be seen by the shaded area in the diagram, when the investor writes a call option in combination with purchasing a put option, a range is created in which the price may move without either option being exercised. Whenever this combination of a put and a call option is created, it is referred to as a "***collar.***" In other words, the investor has placed a "collar" around the current price of $120. Within the range of that collar, the investor will participate in the gain or loss in the stock price, but the investor's opportunity and risk cannot go outside of those bounds. When such a collar is structured so that the cost of the put equals the income from the call, it is referred to as a "***zero-premium collar***." Its advantages and disadvantages are briefly listed below.

|  |
| --- |
| **Advantages**   * Provides protection against any price decline below the strike price of the put option * Retention of ownership, voting rights and dividends * Not considered a constructive sale if sufficient spread is maintained * Retains appreciation potential up to call strike price * May customize option strike prices, maturities, settlement features   **Disadvantages**   * No appreciation above the call strike price * Investor must be willing to accept some risk of decline * Must post stock as collateral for the short call position * Potential tax issues |

## The Popularity of Zero-Premium Collars

The effectiveness of zero-premium collars, coupled with the fact that they require no cash outlay, has made them a popular means of managing concentration risk. To make use of them, an investor only has to sacrifice some upside potential and be willing to accept the risk of an untimely forced sale or the risk that the investor will have to settle the call with cash rather than delivering the shares.

These collars may be structured with ***European-style options*** that can only be exercised upon the option's expiration date, or with ***American-style options*** that can be exercised at any time during the term of the option.

As the chart below shows, significant losses have been avoided through the use of zero-premium collars. Given the rapid decline in technology stocks in 2000 and 2001, people are more sensitive than ever before to the risks associated with concentrated holdings, and zero-premium collars will probably increase in popularity.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **High Profile Individuals Who Utilized Collars in 2000**  In 2000, many individuals used collars and other hedging strategies to protect shares in their companies' stock. The value of many of these shares plummeted over the course of the year. Depicted below are just a handful of people who made use of collars. The chart shows the losses that would have been avoided by their collars if they had been exercised on December 22, 2000.   |  |  |  |  | | --- | --- | --- | --- | | **Insider** | **Company** | **Shares Collared** | **Losses Avoided** | | Paul Allen | Microsoft | 76.15 million | $970.8 million | | Halsey Minor | CNET | 1.55 million | $22.0 million | | William Sinclair | JDS Uniphase | 260,000 | $20.1 million | | Wylie Plummer | Semtech Corp. | 100,000 | $2.3 million |   *Source: "Undermining Pay for Performance," by Louis Lavelle, Business Week, January 15, 2001.* |

Most people think in terms of downside risk and are drawn to the fact that equity collars provide downside protection. But do not overlook that the risk of a stock dramatically appreciating in value is nonetheless a real risk for the holder of the collar. This is illustrated by a recent event involving Ted Turner, who used a collar to protect his 4 million shares of Time Warner stock. The top of the collar was $30.45, but when America Online and Time Warner announced their merger, the stock price soared to more than $90. Not only did Ted Turner miss out on the big gains, but he found himself facing a choice between selling his stock or going into the open market and purchasing $238 million of new shares to close the call position. For most investors in that position, a forced sale would be a foregone conclusion.

## Tax Considerations of Collars

There are three key tax considerations regarding collars.

Click each consideration to learn more.

|  |
| --- |
| 1. **Constructive Sale Rules** |
| If a collar “eliminates effectively all” the risk of holding a stock, then its creation could be treated as a constructive sale. But what does it mean to “effectively eliminate” the risk? Obviously, with a collar, the investor is still subject to some risk. But a collar could be structured with a range of 10% around the current price or 20% around the current price. Which one, if either, "effectively eliminates" the risk?  The IRS is expected to eventually publish more concrete guidelines on this, but until then the acceptable range might depend upon the interpretation of the attorney or tax expert involved. In Ruling 2003-7, the IRS indicated that a three-year forward sale contract with a 25% range was sufficiently wide enough to avoid constructive sale of the underlying stock. This is regarded by most practitioners in this area as a “safe harbor” for trades up to three years. Tighter collars and longer terms may be acceptable, based on particular facts and circumstances. |
| 1. **Straddle Rules** |
| Any time you have two offsetting positions, as with a collar, it is termed a "straddle" and subject to the IRS straddle rules. When utilizing over-the-counter options to create the collar, these straddle rules dictate that:   * A loss from a position (e.g., the purchase of puts that expire) that is part of a straddle is only deductible to the extent that such loss exceeds the unrealized gain in the underlying long position of the stock. For tax purposes, the put cost cannot be offset by the call sales proceeds.   + Example: If an investor has $100,000 of unrealized gain while holding Stock X long, and has put costs (losses) of $16,000 resulting specifically from the collar (or collars) on that position, that loss is not deductible until either:   1. The value of Stock X has an unrealized gain that is less than $16,000 (the loss can be taken only to the extent that the unrealized gain is less than $16,000; a full deduction can be taken when the unrealized gain in the stock is less than or equal to zero); OR  2. The long position in the stock is realized by sale.  Generally, any gains from cash settlement of option sales are short-term capital gains.  Thus, if an investor establishes a zero-premium collar on a stock using over-the-counter options and the collar expires unexercised, the straddle rules may prevent the investor from deducting the cost of the put, while requiring the investor to pay short-term capital gains tax on the expired call. If the investor's marginal tax bracket is 35%, this can create a significant after-tax cost on the collar. A “zero-premium” collar now has a cost! Thus, if an investor purchased put options for $16,000 and sold call options for $16,000, the cash cost would be zero. However, if the $16,000 "put loss" does not exceed the unrealized or realized gain in the long position, the "real cost" of the straddle is the income taxes payable on the sale of the call option.  Note that this *does* mean that the loss on the put sales *may* never be deducted *if*the stock is never sold during the life of the owner. The IRS has noted that a perpetually collared (at no cost to the owner) long stock position with substantial unrealized gains is not likely to be sold prior to death when the stock obtains a stepped up cost basis (under current law). Thus, the denial of deductions of the collared put positions allows the Treasury to receive some revenue and *the incentive to maintain a collared position is somewhat depleted by the after-tax cost of the puts.*  However, the straddle rules do not come into play if the put and call are combined into a single contract. Under the scenario of a ***one-contract collar***, if the collar expires unexercised, it will create no taxable income or loss. Thus, no tax burden is created by utilizing the strategy. These one-contract collars can be created either with options or variable forwards. If options are used, they must be privately negotiated in the over-the-counter market in order to place them in a single contract.   * **Straddles stop the capital gains clock.** Upon entering into a typical straddle position, the capital gains holding period on any underlying long position stops. If the long position already qualifies for long-term capital gains treatment, this is not an issue for the client. However, if the underlying long position is short-term, the capital gains “clock” is frozen and is actually reset (i.e., the "purchase date" for tax purposes is moved to the day the straddle position expires). This rule is important for a client to understand if they are looking at a straddle as a way to hedge a concentrated position while waiting for long-term capital gains treatment (it will not work). * **Tax deductibility issues.** Typically, interest expenses and associated “carrying charges” are deductible items. Under the straddle rules, any interest or carrying charges associated with the straddle position are not currently tax deductible, but must be capitalized (added to cost basis) during the time the client is in a hedged position. |
| 1. **Qualified Dividends** |
| The Jobs & Growth Tax Relief Reconciliation Act of 2003 created a reduced tax rate for qualified dividends. A taxpayer who is in the highest marginal income tax bracket might be able to pay tax on qualified dividends at preferential rates. |

For reasons such as those discussed above, it is important to consult a tax specialist before entering into any hedging strategy, as the tax ramifications can be significant and complex.

## Diversification Strategies: Exchange Funds

An Exchange Fund is designed specifically to address the needs of the investor seeking to diversify a concentration. By contributing the shares to an Exchange Fund, the investor can achieve the benefits of diversification without ever having to sell the shares.

An Exchange Fund is a Limited Partnership into which numerous investors (50-499), who must meet certain qualifying standards, place their acceptable stock holding in return for a limited partnership interest in the fund that results from all the contributions. Even restricted stock contributions may be accepted. Provided the fund holds at least 20 percent of the capital in non-liquid assets, such as real estate, this is considered a nontaxable exchange. Equally important, it is NOT considered a constructive sale.

As a Limited Partnership, the fund does have a General Partner who approves all contributions. Thus, to contribute to the fund, the General Partner must be interested in adding the investor's stock to the fund. This is most likely to happen when the holding is a security that meets the fund’s investment criteria, i.e., large or mid cap type of portfolio. In exchange for acceptable contributions, investors receive back interests in the partnership that are proportional to the value of their contributed stocks.

Once an exchange fund is formed, it is closed to new investors and generally is passively managed. To achieve non-recognition of gain or loss on the contribution, Federal requirements are for a holding period of 7 years. If an investor makes a withdrawal before that time, the investor will likely incur early withdrawal penalties assessed by the fund and the investor may only receive their own shares back. Thus, investors should generally consider an exchange fund only when they can comfortably commit to leave the contribution in the fund for the long term.

The fund may operate for a fixed number of years, or be open-ended with no specific termination date, passing out earnings to the limited partners. When the fund is closed/terminated, ***participants do NOT generally receive back their contributed stocks***. Instead, they receive back a portion of the shares held in the fund. The end result is that investors eventually receive outright ownership in a diversified portfolio with deferral of the capital gains tax.

|  |
| --- |
| **Advantages**   * Provides diversification * Tax-free exchange * Not a constructive sale * May accept restricted shares   **Disadvantages**   * Front-end load (typically 2-3%) * Annual management fee (comparable to other investment management fees) * Not usually available for holdings in small companies * Loss of voting rights * Limited liquidity * Early withdrawal penalty * 7-year holding requirement * May have to pay tax when no cash distributions are provided. |

## Diversification Strategies: Equity Swaps

Another diversification alternative is an Equity Swap, which in some ways is similar to participating in an Exchange Fund. With this strategy, however, no exchange of shares actually takes place. Instead, what is exchanged is the performance of an equity index, such as the S&P 500, for that of the concentrated stock. For the duration of the swap, the investor must deliver the total return of the concentrated security in exchange for the total return (gain plus dividends) of the S&P 500 Index.

In short, the investor receives protection similar to having invested in the S&P 500. The investor's risk is that the concentrated stock might outperform the market, but receives protection from the stock under performing the market. And since the investor's stock is not sold, no tax is triggered by this event.

The advantages and disadvantages of this arrangement are listed below.

|  |
| --- |
| **Advantages**   * Provides the benefit of diversification * Tax deferral * Investor continues to vote the stock   **Disadvantages**   * Typically costs 2-3% per year to obtain this benefit * Typically requires assets of several million dollars or more |

## Wealth Transfer Strategies: Charitable Remainder Trusts

When the investor has charitable intent, a viable option for dealing with a concentrated wealth position may be through a ***charitable remainder trust***. A charitable remainder trust is one where the asset is placed in an irrevocable trust for the ultimate benefit of a charity. During the life of the trust, the income beneficiary, usually the donor, receives an income stream from the trust, and the charity receives the contributed asset when the trust terminates. The donor may also receive an income tax deduction for the present value of the future gift to the charity.

The charitable trust can be structured for one or more beneficiaries for a fixed period of up to 20 years, or it can be set up for the life of one or more beneficiaries. The annual payout to the income beneficiary(ies) cannot be less than 5% or more than 50% of the value of the trust, and may include distributions of principal when the income generated by the trust is insufficient to fulfill the required payout. This "income stream" can be set as a fixed annuity, in which case the trust is referred to as a ***charitable remainder annuity trust (CRAT)***. Alternatively, it can be structured to pay out a fixed percentage that is applied each year to the market value that is current at that time, which is known as a ***charitable remainder unitrust (CRUT)***.

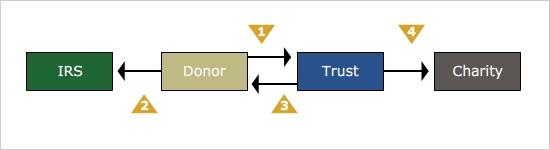
The charitable trust, since it is exempt from income taxes, can sell the gifted asset without having to pay capital gains. Thus the trust now possesses more investable assets than could have been achieved by the original investor, after selling the asset and paying the gains tax. This places the charitable trust in a better position to generate income for the donor than the donor could have achieved for himself/herself.

|  |
| --- |
| **Advantages**   * Donor doesn’t pay capital gains upon contribution of assets * Reinvest gross sale proceeds of asset, not net after tax * Asset sale proceeds can be invested in diversified portfolio * Potential for increased lifetime income * Receive a charitable income tax deduction * Donor receives an income tax deduction for the value of the remainder interest   **Disadvantages**   * Loss of ownership of contributed assets * Terms of the trust are irrevocable * Set-up and administration fees |

## Understanding the Charitable Remainder Trust

To gain a better understanding of how a charitable remainder trust works, study the diagram below.

Click each to learn more.



|  |
| --- |
| **1**  While the donor can technically fund the trust with any type of property, it is generally advisable to not use leveraged property; nor is it generally advisable to use property that has declined in value from its purchase price, as such assets will be valued at their current market value and the possibility of using the loss to offset income taxes will be lost. Generally speaking, appreciated property should be given first priority. This is because no capital gain taxes are payable when the property is donated. If the trust later sells the asset, again there are no capital gain taxes. Only if the capital gain gets paid out to the income beneficiary would the beneficiary be subject to the tax.  Note that the remainder value must have an actuarial value that is at least 10% of the initial value of the property contributed to the trust. Anything less will prevent the trust from qualifying as a charitable remainder trust. |

|  |
| --- |
| **2**  The donor gets an immediate Federal income tax deduction. The tables that are used to calculate the amount that may be deducted will take into account the number of years before termination and distributions to the donor. If the trust is for the lifetime of the income beneficiary(ies), the tables will also take life expectancy into consideration. |

|  |
| --- |
| **3**  When the income beneficiary receives the required distributions, the income taxes assessed to that distribution are determined using a tiering methodology. This income is paid out and taxed on a four tier system, in order:   1. Ordinary income 2. Capital gain income 3. Tax-exempt income 4. Tax-free distributions of principal   Income at the trust level is allocated for accounting purposes to the appropriate tier. The taxation of each distribution is determined by first applying the Tier 1 accounting allocation until exhausted, then tier 2 until exhausted, and so on.  Keep in mind that the trust assumes the donor's cost basis in the property/asset contributed. Thus, if the contributed property is subsequently sold by the trust, the income realized as a result of the sale is allocated to the appropriate tier to be applied against future distributions. Though any gain on the contributed property is avoided by the grantor, it is likely to be in turn taxed to the income beneficiary as distributions are received. Thus, if the grantor is also a beneficiary, the gain may not be ultimately avoided. |

|  |
| --- |
| **4**  Upon termination, the charity receives the corpus of the trust. This amount may be more or less than was originally contributed, depending upon investment performance and the degree to which income was allowed to accumulate and principal was not encroached. |

## Wealth Transfer Strategies: Charitable Lead Trusts

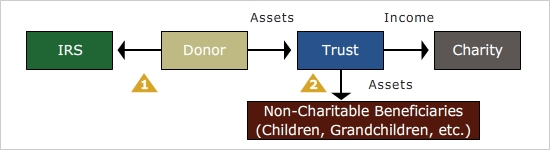
With a ***charitable lead trust*** (CLT), once the donor makes a contribution to the trust, it is the charity that enjoys the benefit of income from the contribution for a period of time. When the trust terminates, assets are transferred to beneficiaries designated by the donor.

The following features are found in the trust document of a charitable lead trust:

1. Similar to a charitable remainder trust, a charitable lead trust may be structured to pay income either as a ***charitable lead annuity trust (CLAT)*** or ***charitable lead unitrust (CLUT)***.
2. The trust may last for the lifetime of the donor or another individual named by the donor, or for a specific number of years. Unlike a CRT, there is no limit of 20 years if a specific number of years is chosen.
3. The trust can be structured as a revocable grantor trust, but it is more commonly structured as an irrevocable, non-grantor trust, in which case the trust gets the charitable income tax deduction instead of the donor.
4. Unlike a CRT, no minimum payout is required.

The diagram below outlines the mechanics of a charitable lead trust. More detail can be learned by reading the material contained in each of the numbered bullets.

Click each to learn more.



|  |
| --- |
| **1**  A taxable gift may be involved in assigning the remainder interest of the trust assets. The gift tax would be based on the present value of the remainder beneficiary’s right to receive the assets at some future time. Calculation of the tax depends upon the duration of the trust, the payout amount, and the rate used in the IRS tables. But due to the discounting that is derived from giving the charity years of income off the assets, considerable discounting can take place resulting in significant savings over transferring the assets directly to the remainder beneficiaries. |

|  |
| --- |
| **2**  Upon the termination of the trust, the remainder beneficiaries receive assets from the trust. Since any transfer taxes were taken into consideration when the trust was funded, this transfer then takes place with no additional gift or estate taxes. This is quite significant, indicating that any appreciation in the market value of the assets within the trust will transfer to the beneficiary(ies) free of gift or estate taxes. The same is true of any accumulated income that was not needed to make the required payments to the charity. |

## Transfer Tax Benefits of Charitable Lead Trusts

Although there is some benefit to the charity, the primary reason for creating a charitable lead trust is to efficiently transfer assets. Because the non-charitable beneficiaries receive the assets many years into the future, the donor is able to receive substantial discounts on the value of the gift, thus reducing the taxation of the transfer. For example, using a federal rate of 4.2%, a $100,000 contribution to a 20-year charitable lead annuity trust, paying 7.5% annually (as valued when the trust was funded) to a charity, has a gift tax value of $0.

Not all situations lead to a $0 gift tax value. Other situations, while reducing the gift tax value of the transfer, may still have a taxable value, but it may be possible to avoid paying any gift taxes through use of the Applicable Credit Amount. Nonetheless, you can readily see that this method makes it possible to transfer substantial assets in a tax-efficient manner.

## Wealth Transfer Strategies: GRITS, GRATS, GRUTS and QPRTS

Similar wealth transfer strategies to those already discussed have been developed for non-charitable beneficiaries. Obviously, since no charity is involved, these techniques receive no income tax deduction.

Like the charitable lead trust strategy, these are essentially techniques for transferring a future interest to the remainder beneficiaries. The asset is placed in an irrevocable trust for a period of time, during which time the grantor enjoys income from the trust or enjoys the use of the asset. When the trust terminates, the asset is transferred to the remainder beneficiaries, such as the grantor's children.

The funding of the trust is potentially subject to gift taxes. But because the remainder beneficiaries do not receive the gift until a passage of time, the gift to them is discounted to a present value, which is used for computing the gift tax.

Click each strategy example to learn more.

|  |
| --- |
| **Grantor Retained Income Trust (GRIT)** |
| The grantor continues to receive the income from the contributed assets for the duration of the trust. |
| **Grantor Retained Annuity Trust (GRAT)** |
| The grantor receives a fixed annuity from the trust until its termination. |
| **Grantor Retained Unitrust (GRUT)** |
| The grantor receives a fixed percentage that is annually applied to the market value of the trust until its termination. |
| **Qualified Personal Residence Trust (QPRT)** |
| The grantor transfers a residence, which the grantor continues to use until the termination of the trust. This is essentially a GRIT where the income is replaced with use of the property. |

A primary purpose and advantage of the above is the ability to avoid or minimize transfer taxes when passing wealth to heirs. When properly structured, the gift tax impact is minimized or eliminated. Numerous rules are associated with the structure of these instruments, so it is advisable that the client's estate planning attorney be involved in making a determination as to their appropriateness. Also, future legislation could limit the benefits.

## Selecting the Best Strategy

Selecting the best strategy for a client is typically not confined to any single strategy. More often than not it involves multiple approaches. Which ones are most appropriate may depend upon such variables as the primary objective of the client, the type of asset involved, the client's charitable intent, and the client’s overall financial condition/status. Thus, developing a solution is more of an art than a science.

The actual execution of some of these strategies is quite intricate, and may require the assistance of one or more professionals such as an attorney or CPA. But the basic concepts around which these solutions are structured are fairly simple and straightforward. With the information available in this module, it should be possible to intelligently discuss alternatives with your client and narrow in on possible strategies.

To assist you in differentiating the strategies, and weighing the pros and cons of each, the following page presents a summary of the strategies presented in this training module. Study this summary until you are comfortable that you can distinguish reasons why you might use one or the other for given situations. Then check your application knowledge in the review exercise that follows.

## Review of Alternative Strategies

Click each strategy to view review material.

|  |
| --- |
| **Monetization Strategies** |
| The objective is to obtain liquidity to meet cash needs or to invest in a more diversified portfolio.   |  |  |  | | --- | --- | --- | |  | **Advantages** | **Disadvantages** | | **Systematic Sale** A disciplined process of selling the concentration over a period of time. | Totally eliminates the concentration risk  Immediate liquidity  Flexibility to reinvest however desired | Generates tax liability  Selling large holdings may affect the market price  May not be possible to sell because the stock is restricted or control stock  Loss of future appreciation on sold stocks | | **Borrowing** An approach that uses the concentrated asset as collateral for a loan. | No tax liability is triggered  Provides liquidity for diversification or to meet cash needs  Continued opportunity to participate in stock appreciation  Retain ownership, voting rights, and dividends | Interest expense of the loan  No protection against the stock moving down (except for the protection offered by the diversification) | | **Short-Against-the-Box** A strategy that borrows securities similar to those already owned, then turning around and selling the borrowed securities. The party lending the securities must be made whole on any dividends issued while lending and must also be paid interest on the loan. | Receive the current market value of the shares  Deferred taxation on gains  Protection against market price decline | Forfeit participation in appreciation  Forfeit participation in income  Constructive sales rules restrict this to a short-term approach  Must annually resubmit to 60 days of market risk  Long term usage results in annual restructuring and added expense | | **Variable Prepaid Forward** A strategy where a commitment is made to sell the securities at a future time, in return for which a cash advance is received. Features typically include the right to some level of participation in future growth up to the time of maturity. | Receive liquidity for up to 90% of current market value  Full protection against market decline  Full participation in appreciation up to a specified level  Partial participation in appreciation beyond a specified level  Tax deferral  Benefits of continued ownership | Complexity  Not appropriate for stocks with poor future prospects | |
| **Hedging Strategies** |
| The objective is to use options to manage the risk of the concentration.   |  |  |  | | --- | --- | --- | |  | **Advantages** | **Disadvantages** | | **Buying Puts** A strategy of buying puts to protect against a decline in price. | Provides protection against any price decline below the strike price of the put option  Ability to participate in appreciation  Retention of ownership, voting rights and dividends | Investor must be willing to accept a modest amount of decline | | **Zero-Premium Collar** A strategy that involves simultaneously buying a put and writing a call, both of which have the same maturity, and the combined price of which is at zero-premium. | Provides protection against any price decline below the strike price of the put option  Retention of ownership, voting rights and dividends  Not considered a constructive sale if sufficient spread is maintained  Retains appreciation potential up to call strike price  Ability to customize option strike prices, maturities and settlement features | No appreciation above the call strike price  Investor must be willing to accept some risk of decline  Must post stock as collateral for the short call position  Potential tax issues | | **Variable Prepaid Forwards** | (see Monetization Strategies) | | |
| **Diversification Strategies** |
| The objective is to participate in a diversified portfolio rather than be subject to the concentration risk.   |  |  |  | | --- | --- | --- | |  | **Advantages** | **Disadvantages** | | **Exchange Fund** A limited partnership into which numerous investors (50-499) place their single-stock holding in return for a limited partnership interest in the fund. When the fund is terminated, each partner receives back their portion of the assets in the fund rather than the assets they originally contributed. | Provides diversification  Tax-free exchange  Not a constructive sale  Restricted stocks are acceptable | Front-end load  Annual management fee  Not usually available for holdings in small companies  Loss of voting rights  Limited liquidity  Early withdrawal penalty  7-year holding requirement | | **Performance Exchange** A strategy that exchanges performance of an equity index for that of the concentrated stock. | Provides the benefit of diversification  Tax deferral  Investor continues to vote the stock | Typically requires assets of several million dollars or more | |
| **Wealth Transfer Strategies** |
| The objective is to transfer the concentration risk.   |  |  |  | | --- | --- | --- | |  | **Advantages** | **Disadvantages** | | **Charitable Remainder Trust** A strategy in which part or all of the concentrated asset is contributed to an irrevocable trust naming a charity as the remainder beneficiary. The donor receives an income tax deduction for the present value of the remainder interest and an income stream for a period of years or for life. | Avoid capital gains  Reinvest gross not net  Assets can be invested in diversified portfolio  Potential for increased lifetime income  Receive a charitable income tax deduction  Avoid paying estate taxes on gifted assets | Assets are irrevocably removed from donor's estate  Terms for the trust are irrevocable  Ongoing trustee fees | | **Charitable Lead Trust** An estate planning technique whereby assets are transferred into trust for the benefit of a charity for a period of years or for the donor's lifetime. Upon termination, assets are distributed to non-charitable beneficiaries, such as the donor's children. Since the final transfer takes place in the future, a substantial discount is given on the gift for gift tax purposes. | Reduced valuation on gifted assets for gift tax purposes  Makes possible substantial transfer tax savings | Donor typically forfeits all interest in and control over the assets once the transfer is made | | **GRITS, GRATS, GRUTS, QPRTS** An estate planning technique whereby the grantor transfers assets into trust for a period of time, during which the grantor enjoys income or the use of the asset. Upon termination, the asset transfers to non-charitable beneficiaries, such as the donor's children. Since the final transfer takes place in the future, a substantial discount is given on the gift for gift tax purposes. | Reduced valuation on gifted assets for gift tax purposes  Makes possible transfer tax savings | Future limitations could limit their benefits  Numerous rules for setup and implementation | |

## Review Exercise – Answer Key

Check your knowledge of the material covered since the last Review Exercise by answering the following questions.

1. **What happens when an exchange fund is terminated?**

* The assets are liquidated and each partner receives cash.

**Incorrect**. Try again.

* Each partner receives back the asset he/she originally contributed

**Incorrect**. Try again.

* **The portfolio is broken into portions based on the value of each partner’s original contribution, and each partner receives a portion made up of all the contributed assets.**

**Correct**.

* Nothing. Exchange funds do not close, they are perpetual.

**Incorrect**. Try again.

1. **Among the advantages of an exchange fund are all the following EXCEPT:**

* Diversification

**Incorrect**. Try again.

* **Retention of voting rights**

**Correct**.

* Not construed as a constructive sale

**Incorrect**. Try again.

* Restricted stocks may be acceptable

**Incorrect**. Try again.

* Not a constructive sale

**Incorrect**. Try again.

1. **Advantages of a zero-premium collar include:**

* Protection against any price decline below the strike price of the put option

**Incorrect**. Try again.

* b. Retention of appreciation up to the call strike price

**Incorrect**. Try again.

* c. Retention of ownership, voting rights and dividends

**Incorrect**. Try again.

* **d. All the above**

**Correct**.

* e. a. and b. only

**Incorrect**. Try again.

1. **An investor constructs a collar around a stock holding by purchasing a put with a strike price that is 5% below the current market price and selling a call with a strike price that is 6% above the current market price. Consensus holds that the range on this collar is probably sufficient to avoid triggering the constructive sale rules.**

* True

**Incorrect**.

* **False**

**Correct**.

1. **A charitable remainder trust can be established to last for how long?**

* The life of the grantor

**Incorrect**. Try again.

* The life of the grantor and the grantor’s spouse

**Incorrect**. Try again.

* 20 years

**Incorrect**. Try again.

* **All the above**

**Correct**.

1. **The annuity or unitrust payment of a charitable remainder trust must be at least \_\_\_\_\_.**

* 1%

**Incorrect**. Try again.

* 2%

**Incorrect**. Try again.

* **5%**

**Correct**.

* 6%

**Incorrect**. Try again.

* 8%

**Incorrect**. Try again.

Now check your knowledge of the advantages and disadvantages of all the approaches discussed in this module and your ability to match strategies to clients needs and goals by selecting the best (most complete) answer for the following questions.

1. **Which of the concentration strategies discussed in this training module is best described by the following list of advantages:**

**Provides liquidity of up to 90% of the current market value**

**Provides protection against downside risk**

**Provides some degree of participation in appreciation**

* Borrowing against the stock

**Incorrect**. Try again.

* Exchange Fund

**Incorrect**. Try again.

* **Variable Prepaid Forward**

**Correct**.

* Zero-Premium Collar

**Incorrect**. Try again.

* Charitable Remainder Unitrust.

**Incorrect**. Try again.

1. **If an investor has a concentration of $1 million, which of the following would probably NOT be a viable consideration?**

* Borrowing against the stock

**Incorrect**. Try again.

* Short-against-the-box

**Incorrect**. Try again.

* **Performance Exchange**

**Correct**.

* Zero-Premium Collar

**Incorrect**. Try again.

* Charitable Remainder Trust

**Incorrect**. Try again.

1. **If the investor desires to retain the voting rights on the concentrated stock, which of the following strategies would be inappropriate?**

* Buying Puts

**Incorrect**. Try again.

* **b. Exchange Fund**

**Correct**.

* c. Variable Prepaid Forward

**Incorrect**. Try again.

* d. Borrowing Against the Stock

**Incorrect**. Try again.

* e. Both b. and c. would be inappropriate

**Incorrect**. Try again.

1. **Which of the following strategies results in the transfer of an asset but no immediate capital gains tax for the transferor at the time of the transfer?**

* **Charitable Remainder Trust**

**Correct**.

* b. Zero-Premium Collar

**Incorrect**. Try again.

* c. Variable Prepaid Forward

**Incorrect**. Try again.

* d. All the above

**Incorrect**. Try again.

* e. Both a. and c.

**Incorrect**. Try again.

1. **Which of the following strategies provides no protection against a downward move in the stock price?**

* Buying a Put

**Incorrect**. Try again.

* Short-Against –the-Box

**Incorrect**. Try again.

* Zero-Premium Collar

**Incorrect**. Try again.

* **Borrowing against the stock**

**Correct**.

* Exchange Fund

**Incorrect**. Try again.

1. **Which of the following strategies requires that the investor be exposed to market risk for a period of time each year?**

* **Short-Against-the Box**

**Correct**.

* b. Zero-Premium Collar

**Incorrect**. Try again.

* c. Performance Exchange

**Incorrect**. Try again.

* d. All the above

**Incorrect**. Try again.

* e. Both a. and c.

**Incorrect**. Try again.

## Conclusion

This concludes the material for this subject. At this time you may return to any sections in which you feel the need for further study.