Prepaid Variable Forwards: Hedging Risk and Deferring Taxes
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Think of the name Lauder and the first thing that probably comes to mind is cosmetics. But mention the family to a savvy tax and estates attorney, or a financial adviser who is adept at arranging tax-advantaged transactions, and you may be surprised to hear the words “prepaid variable forward contract.” That’s because, Ronald Lauder, Estée’s heir, was recently the subject of a front page feature in the New York Times on the ways in which the family has artfully avoided taxes.

According to the article, Lauder used a prepaid variable forward (PVF) — also known as a variable prepaid forward — to sell $72 million of stock to an investment bank in 2014 at a price of around 75% of its present value in exchange for cash. Because the IRS does not classify this transaction as a sale, taxes are deferred until the time the shares are actually delivered.

It turns out this was not the first time PVFs had appeared in the news. A couple of weeks earlier, Jesse Drucker, a reporter at Bloomberg News, wrote about Billy Joe “Red” McCombs, cofounder of Clear Channel Communications Inc., and how his use of a PVF had landed him in hot water with the IRS. And in 2010 billionaire Philip Anschutz made the headlines after he lost a high-profile case involving the use of PVFs. He appealed the decision, but in late December the U.S. 10th Circuit Court of Appeals in Denver upheld the tax court’s 2010 ruling that Anschutz owes at least $17.3 million in taxes. (For more coverage of this case, read the TaxProf blog.)

PVFs even came up at a recent Congressional hearing.

My interest piqued, I wanted to learn more. So I got in touch with Robert Gordon, president of Twenty-First Securities Corporation and coauthor of Wall Street Secrets
for Tax-Efficient Investing. Twenty-First has helped clients execute hundreds of millions of dollars of PVFs every year.

But first, let’s back up and get some context. When the Estée Lauder Companies went public in 1995, Estée and Ronald used a perfectly legal strategy called “shorting against the box” — borrowing the same number of shares of the company and selling them short — to avoid paying up to $95 million in capital gains taxes on the profits they made when they sold stock in the family company. (Shorting against the box essentially creates a market neutral position so that any further appreciation in the stock is offset by losses. If the stock goes up, the short position loss offsets the stock advance and if the stock goes down, the gain from the short position is offset from the holdings. Instead of having an immediate tax liability on the stock, the only cash outflows are trading costs and interest paid on the short shares.)

Washington took note, however, and effectively killed this technique with the Taxpayer Relief Act of 1997, which amended the rules for what is known as a “constructive sale” — a transaction that is considered a sale for tax purposes, even if no shares are exchanged.

Enter the PVF.

“A PVF is really nothing more than a collar, which is buying a put and selling a call, married with a third leg, which is called monetization, but is basically loaning someone money,” Gordon explained. “A PVF, if broken into its aggregate pieces, is buying a put, selling a call, and borrowing money. It is nothing more than a Wall Street invention that puts all those three things together as a financial product.”

(The “variable” part refers to the fact that the contract is to sell a specific value of a security in the future — so this means the number of shares that will be delivered will depend on the stock’s value at the time of delivery.)

What a PVF does is allow anyone who has a big chunk of highly appreciated stock to get an upfront payment — say 80% of the value of the shares — in exchange for agreeing to deliver the shares in the future.

On the face of it, a PVF looks like a win-win: the client gets cash and hedges his risk while deferring taxes. Not surprisingly, it’s a very popular technique.

But there are caveats. First, these transactions have to be constructed carefully so as not to run afoul of the stock lending provision, also known as Section 1058. Under this provision, a stock lender “is not considered to have sold the stock lent to the stock borrower and will not pay tax on the stock lending transfer, if the borrower returns identical securities, makes dividend payments the stock lender would otherwise receive, and the stock lender does not reduce the risk of loss or
opportunity for gain as a result of the transfer,” according to an article by Washington International Business Counsel.

And second, a PVF is not for everyone. Gordon, who is speaking at CFA Institute’s Annual Conference in May 2012, believes certain clients would be better served by simply buying a put, selling a call, and borrowing the money — at least, those clients who are “sophisticated enough to deal with the pieces and want to see what is really going on and want to know: ‘What’s the price of my put? What’s the price of my call? What’s my interest rate?’”

When you split a PVF into its components you can also be more creative. For example, you can place the put in a grantor retained annuity trust, or GRAT, Gordon said. “All of a sudden we are milking a possible estate tax benefit out of it, whereas when you do a PVF you can’t do that.”

Similarly, he added, clients who bought stocks before 1984 are throwing away a potential current interest expense deduction when they use a PVF, as a PVF automatically builds the interest cost into its price.

The take-away? “Wealth advisers should be talking to their clients about hedging and monetizing and which tool they use to do that is probably going to be dictated by which firm they work at,” Gordon said. “There is a way to get money out of the stock and not pay the tax and it is perfectly legal.”

To learn more, read Gordon’s article “The 21st Century Solutions to Hedging Low-Basis Stock” in the Journal of Wealth Management. And look out for an upcoming blog post on how financial advisers can play a key role in the sale or monetization of a privately owned business.