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Financial Planning: High Net Worth

Strategies For Hedging Concentrated Stock Positions (Part 2)

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You own 10,000 shares of stock in your company. The stock's cost basis is very low -- only $1 per share. Now your shares are worth $100 each. So the 10,000 shares are now worth $1 million before taxes.

In Part 1 we discussed the basics of puts and calls and the economics of collars, along with some tax rules and restrictions on these transactions. Once you've decided on the economics of your collar, you should answer two questions:

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1. Did you acquire the stock before or after January 1, 1984?
2. Do you wish to borrow against the stock?

Your answers to these questions, along with whether your goals go beyond risk management to generate liquidity for personal use or investment diversification, will dictate your choice of hedging tool. There are three basic tools for creating the economics of a collar: listed or over-the-counter options, variable forwards, and swaps with embedded options. Based on your answers and personal goals, you can use any of these tools to create the economics of either a zero-cost collar or an income-producing collar.

Stock Acquisition Date Matters

The first issue to consider is the acquisition date of your stock.

Stock Acquired In 1984 Or Later: Straddle Rules And Monetization

If you acquired the stock after January 1, 1984, your hedge will be subject to the straddle rules. Under these cumbersome IRS rules, there are two areas of concern. In a straddle, if you hedge stock with a collar, you cannot deduct the losses realized on any leg of the collar until all positions are closed. An options position is closed when it is exercised, allowed to expire, or offset with an opposite transaction. For example, if you sold a call on CaliforniaSolar, you could close that sale by purchasing a call with the same strike price and date.

However, any gains realized from closing a leg of the hedge must be recognized immediately. To mitigate this potential "whipsaw effect," we suggested that you employ a one-contract collar that includes the put and the call. With this structure, any gains are automatically netted against the costs -- before taxes.

Straddle rules also affect borrowing (i.e., monetization). Suppose that you want to take some money out of your position now. You know that if you sell your stock, you must pay capital gains tax. So you might prefer to monetize, or borrow against, your stock in addition to protecting your gains through hedging.

Monetization does not produce a capital gains tax. However, it does create interest expense. Under the terms of the most recent *proposed* IRS regulations (which reflect the government's recent rulings), if you use collared shares as the exclusive collateral for a loan, the interest on the loan would be capitalized. However, should you be able to post other liquid securities as collateral, then you could currently deduct the interest expense against your portfolio income (e.g., interest and dividends).

If you use the borrowed money to purchase new securities, you should be able to post those securities as collateral. This technique, by itself, would allow you to currently deduct up to 50% of the interest expense.

For example, suppose you have $1 million of the fictitious CaliforniaSolar that you collared. You borrow against this position and reinvest in $1 million worth of other securities. Therefore, you have a total of $2 million in securities in your account. You can currently deduct 50% of the interest expense -- the 50% that traces back to the other securities. The 50% that traces to the CaliforniaSolar would have to be capitalized.

Stock Acquired Before 1984: No Straddle Problems

If you acquired your stock before January 1, 1984, then it will *not* be subject to the straddle rules. In this case, the ideal hedge might well be a swap -- if you are eligible to participate in one. A swap is a contractual agreement under which two parties exchange payments based on the performance of a security.

The big advantage of swaps is that if your stock should gain value, then a swap would produce a more favorable after-tax result than either a variable forward or options. Unfortunately, before you can participate in a swap, you must meet the eligibility requirements. In general, you need to have "gross" balance sheet assets of $10 million to qualify as a swap participant. In addition, most dealers require that a swap involve a minimum of $3 million notional value (i.e., the value of the assets upon which the swap payments are made). For more information about swaps, investors should see our website at www.twenty-first.com.

If you don't meet the requirements for a swap, you can still use either an options-based collar or a variable forward to hedge your position. With these techniques, however, any losses will be capital.

> **Alert:** On February 25, 2004, the US Treasury proposed regulations that would make swaps less attractive. The regulations would force swap investors to change the tax-accounting method for their swaps, requiring them to recognize income or expense during a swap's term rather than using the "wait and see" approach. Treasury staff would like the change to apply to swaps that are already open.

Borrowing With A Hedge

When you borrow against your position, you need to consider not only taxes but also economics.

You can monetize with either a zero-cost collar or an income-producing collar, which is discussed in Part 1. However, the combination of monetization and a zero-cost collar is expensive. Remember, the zero-cost collar produces no income. So if you combined the zero-cost collar with monetization, you would obtain no cash to compensate for the monetization interest expense. We would advise you not to adopt this combination unless you are extremely bullish about the future of the stock or the use of the money you borrow.

The combination of monetization and an income-producing collar is more conservative. You can use the cash from the income-producing collar to help offset the monetization interest expense. Thus, the combination of monetization and an income-producing collar may be the most cautious way to manage your low-basis stock.

To provide investors with an overview of hedging alternatives, Twenty-First Securities maintains an interactive "hedging low-basis stock decision tree" at www.twenty-first.com. For a more detailed overview of these topics, readers may wish to consult Chapter 5 of *Wall Street Secrets For Tax-Efficient Investing,* by Robert Gordon, with Jan Rosen. The book is available at most bookstores and on www.amazon.com.

Next Article

In our next article, we will discuss variable forwards and how to develop a hedging strategy.

Nothing in this article constitutes investment or tax advice or a solicitation to engage in a particular transaction.

> ***Editor's Note:*** *Options involve risk and are not suitable for all investors. Before engaging in an options transaction, you must review the options disclosure document Characteristics And Risks Of Standardized Options.*
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> *Regardless of the type of hedge, many companies prohibit executives and employees from using them because they eliminate the full downside risks and upside potential of stock ownership. You no longer feel the same impact as public shareholders do from drops in your company's stock price and no longer experience the financial motivations to drive the stock price as high as possible.*

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