

By Robert N. Gordon & Kirk Hoopingarner

The Estate Collar

Volatile markets call for clever solutions so that, after a death, estates can profit from upswings—or downswings

It was in the depths of the Great Depression that the alternative valuation mechanism was first put into place. Federal lawmakers realized that forcing an estate to pay taxes on its assets' value the exact day a wealth owner died might mean, when stock values were dropping, that the estate paid too much. After all, the stock wouldn't be sold on that date of death (DOD), but some time later. In 1935, the lawmakers said they had to do something in response to "the hardships that were experienced after 1929 when market values decreased very materially between the period from the date of death and the date of distributions to the beneficiaries."¹

Today, Internal Revenue Code Section 2032 allows fiduciaries to choose between the value of assets on the date of the wealth owner's death or six months after death. And with the markets volatile once again—soaring and dropping by as much as 800 points in a day—fiduciaries should consider keeping open the option of the alternate valuation date (AVD).

Problem is, fiduciaries might be (rightly) terrified to hold the shares for six more months. They tend to want to sell stock as soon as possible after an owner's death, especially since the shares enjoy a step-up in basis and there are no tax consequences to doing so. After all, what

if a fiduciary deliberately delayed, then the markets went down, down, down?

Sure, electing the AVD would soften the blow of a depreciated portfolio. But it certainly won't totally compensate for a substantial reduction in an estate's value.

So, what's a responsible fiduciary to do?

Consider using what we call "the estate collar": The fiduciary buys a "put" for the value of the stock on the DOD. Then he sells a "call" to completely offset the price of the put. In that way, the stock never sells for less than its value on the DOD. But it could sell for much more—with the heirs paying not the estate tax (which can run to 55 percent including state taxes) but just a capital gains tax (of 15 percent) on the profit.

The Basics

How does that work, exactly?

The put gives a fiduciary the right—but not the obligation—to sell the estate's stock at a predetermined price (the strike price) on a specified date in time, say six months after DOD. Hence, the fiduciary has set the minimum value for the shares' price. Let's say an estate's shares are valued at \$10 million on the DOD.

The fiduciary purchases this put option by paying a premium to Seller X. If, at the end of six months, the stock price does indeed drop below the strike price, let's say it goes down to \$7 million, the fiduciary can exercise the put option and sell the stock at the agreed-upon strike price, \$10 million, to Seller X. Seller X must buy.

The fiduciary elects the AVD and pays estate tax on \$7 million, but actually sells the stock for \$10 million.



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Capital gains are paid on the balance of \$3 million.

If, however, the stock price rises in six months above the strike price, say to \$15 million, the fiduciary is under no obligation to sell the stock at the strike price. The fiduciary sells the stock in the open market for \$15 million but pays estate tax on the DOD valuation of \$10 million. Capital gains must be paid on the difference of \$5 million. What is lost, however, is the premium paid for the put option.

Naturally, though, such a premium can be quite expensive—particularly when the markets are volatile. A six month put on the Standard & Poor’s currently costs about 15 percent, and a put on an individual equity would generally be more expensive.

To pay for the put option, therefore, the fiduciary can simultaneously sell a call option. That call option grants the buyer of the call, Buyer Y, the right to buy shares at a strike price at a certain date in time, say in

six months. Let’s say that the fiduciary will set the strike price at \$12 million. Obviously, Buyer Y hopes that the shares of the stock rise substantially above that strike price in six months. If, indeed, the stock value rises to, say, \$15 million, Buyer Y will buy \$15 million worth of stock for just \$12 million, plus the money he paid for the call. The fiduciary will have sacrificed part of the upside (here, \$3 million of the \$5 million in gains).

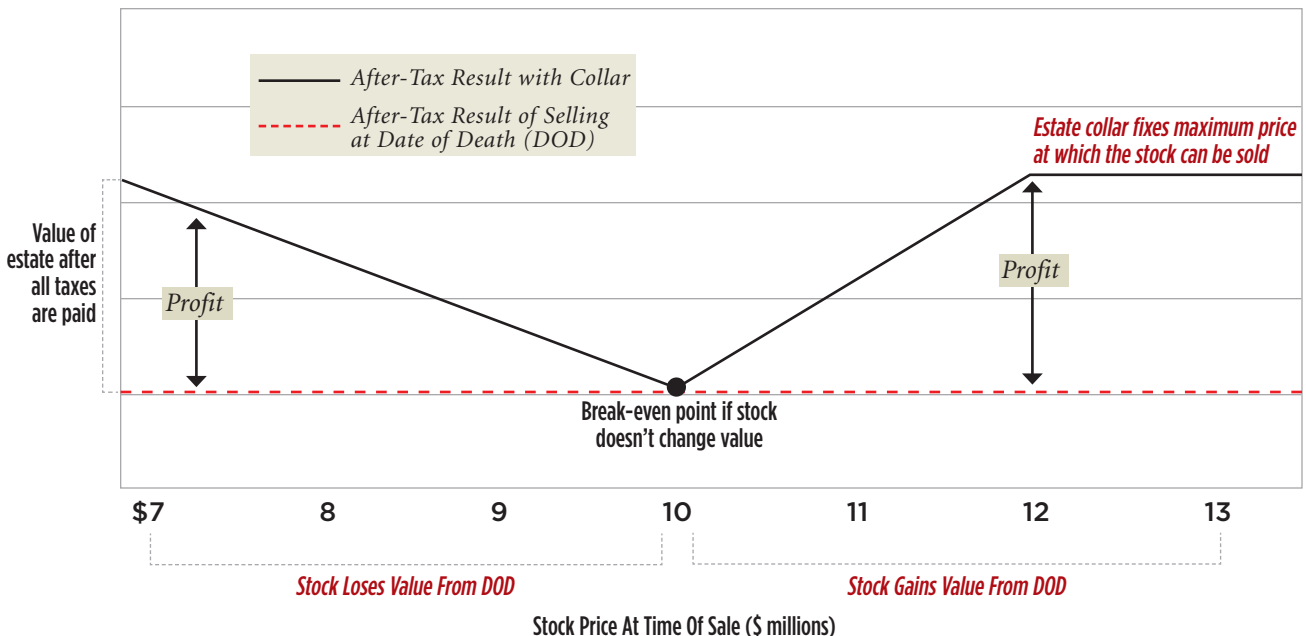
This is called a “zero-cost collar.” The estate’s cost is zero because the cost of the put is completely offset by the cash brought in by the estate selling the call. It’s a “collar” because the fiduciary has fixed both a minimum and maximum value for the shares.

In other words, the fiduciary has created the potential for gain while eliminating the risk of a loss.

Clearly, such an arrangement is consistent with general principles of prudent management. But, of course, this estate collar is only possible if such option

Heads You Win, Tails You Win

Estate collar creates a profit whether the stock gains or loses value from the date of death



Assumptions: Value of stock at DOD is \$10 million.

— Twenty-First Securities Corporation

transactions are allowed under applicable state law and are included in powers given to the fiduciary under the controlling will and trust provisions.

Is It Legal?

The main legal issue in this arrangement, though, is whether the purchase of a put somehow destroys the estate's ability to use the AVD. If a binding contract for the sale, exchange or other disposition of property is entered into, the property generally is considered to be sold, exchanged or otherwise disposed of on the effective date of the contract, unless the contract is not subsequently carried out substantially in accordance with its terms.² So, query: Is the put a binding contract that would result in a valuation of the stock as of the purchase date of the collar?

There are no cases or rulings directly on point. But there are certain rulings and cases that shed some light on the types of transactions considered to be such binding contracts.

In the 1959 case of *Critchfield Estate v. Commissioner*,³ the Tax Court ruled that there was no disposition of a particular asset until the actual date of sale because, while the estate was required to sell the assets, the buyer (namely the surviving spouse) was not required to purchase the asset. In Revenue Ruling 77-180, 1977-1 C.B. 270, the Internal Revenue Service supported the Tax Court's result.

Another case supports the argument that merely purchasing and granting options with respect to securities owned by an estate should not constitute a disposition that accelerates the AVD. In the 1972 case of *Flanders v. United States*,⁴ the Northern District of California ruled that a conservation restriction placed on property after death should not be considered when determining the value of the property on the AVD. The court did not hold that a disposition of the property had occurred when the conservation restriction was granted.

Likewise, it seems reasonable to conclude that a disposition of a security does not occur when the estate enters into a put purchase or collar transaction.

Advisors can gain further protection by purchasing put options that can only be cash-settled. There are two

types of delivery utilized in options. All options trading on public exchanges are physically settled options (that is to say, upon exercise actual shares need to be delivered). Over-the-counter (OTC) options can be contracted to be either physically settled or cash-settled. It seems obvious that the government would have a hard time arguing you had a binding contract to sell when

Choosing the AVD for stocks in an estate's portfolio also means choosing the AVD for all other assets in the estate.

the option is cash-settled and involves no mention of delivering any shares.

As it turns out, though, physically settled options are preferable for the estate collar as heirs inherit the holding period of the deceased. If shares were held long-term before death, any subsequent sale will be taxed at long-term capital gains rates. If the shares declined, a cash-settled option's profits are taxed at short-term gains rates. If the shares are physically delivered, the sale price is the strike price and any gain would be long-term.

After-Tax Payoff Pattern

So what does the after-tax payoff pattern of the estate collar look like? The after-tax profits of the shares are 85 percent of the pre-tax profits and there are after-tax profits as the shares drop through estate tax savings.

Let's go again to our example of the estate with \$10 million in stock on the DOD. (See "Heads You Win, Tails You Win," p. 46.) The fiduciary in charge of the estate purchases put options with a strike price of \$10 million and sells a call option allowing the call buyer to purchase the shares at \$12 million.

Let's say that after six months, the shares are worth only \$7 million. The estate elects the AVD and pays estate tax on \$7 million. But the shares are sold through the put at \$10 million. That means a \$3 million long-term gain. The estate nets a tax savings of \$1.2 million.

That's \$3 million multiplied by 55 percent (the estate tax savings), less \$3 million multiplied by 15 percent (the long-term capital gains tax).

Now, let's look at what happens if the share values rise to \$15 million. Then the estate uses the DOD value and pays estate taxes on \$10 million. The buyer of the call option would exercise his right to buy \$15 million worth of shares at just \$12 million. The estate realizes a \$2 million gain and makes \$1.7 million after taxes.

(There's another possibility to explore: The estate could buy the call option back for \$3 million. But that strategy is a whole other topic.)

One more possibility: if the shares are worth \$10 million after six months, there obviously would be no benefit from either taxes or appreciation. But there'd also presumably be no harm, no foul.

Other Considerations

Of course, nothing in life is ever this simple. Note that, under Section 2032, choosing the AVD for stocks in an estate's portfolio also means choosing the AVD for all other assets in the estate. That's why **fiduciaries should consider using a collar written on an entire portfolio.** Since listed options are on individual shares (or pre-determined indices), this also would dictate the need to execute OTC versus using listed options so that the option can be on the estates portfolio in total.

If publicly traded shares make up all or a substantial majority of the estate, the estate can be sure to save tax dollars as the shares decline. If this is the case, the estate can buy less than one put for every hundred shares, either saving on the upfront cost, or alternatively leaving the estate more upside in the shares.

If the estate holds other assets that appreciated while the protected shares declined, the estate might need to use the DOD anyway. That's why **we would recommend using put options on all the shares that have a strike price equal to the market value of the portfolio at death.** This also is why **fiduciaries should consider using a zero cost structure so that there is no scenario in which the estate could be worse off for having executed the estate collar.**

It's a strategy with a lot of moving parts. But, you have to be nimble when the markets are fluctuating and clients' best interests are at stake. **TE**

Endnotes

1. 79 Congressional Record 14632 (1935).
2. Treasury Regulations Section 20.2032-1(c).
3. *Critchfield Estate v. Commissioner*, 32 T.C. 844 (1959).
4. *Flanders v. United States*, 347 F. Supp. 95 (1972).



Victoriana—Sir John Everett Millais' oil on panel "My First Sermon" sold for US \$100,744 at Sotheby's auction "A Great British Collection: The pictures collected by Sir David and Lady Scott, sold to benefit the Finnis Scott Foundation," held on Nov. 19, 2008, in London. This picture (13 inches by nine inches) is a smaller version of Millais' painting in the Guildhall Art Gallery, London.

