
Financial Transactions

ROBERT GORDON*

Recent Developments Involving Hedges, Collars, and Microsoft Dividends

Seven-Year Hedge Approved in Field Attorney Advice

The Internal Revenue Service has issued a Field Attorney Advice holding that a seven-year prepaid forward is not a constructive sale. Prior to the issuance of FAA20042305F,¹ some investment professionals believed that if a collar or prepaid forward contract extended more than five years, it might constitute a constructive sale; the thinking was that collars with terms under five years were not “abusive” but those with longer terms might be. The Advice should assuage those concerns.

It should also be noted that the advice quoted extensively from a committee report that referenced a collar with a 15% spread as being a

* Robert Gordon is the CEO of Twenty-First Securities and a member of the editorial advisory board of this Journal.

¹ The Field Attorney Advisories can be accessed at www.irs.gov/pub/irs-lafa/042305f.pdf or from the IRS Electronic Reading Room page under “Non-precedential Rulings & Advice: Legal Advice Issued by Field Attorneys,” at www.irs.gov/foia/article/0,,id=110353,00.htm.

typical collar.² Some hedging advisors feel more comfortable with the 20% spread suggested by the New York State Bar Association for future prospective regulations (regulations that were never issued).

Unfortunately, the Field Attorney Advice redacted the specific spread of the seven year hedge. It is generally assumed that longer hedges probably need wider collars. The author feels comfortable with executing ten year hedges with 50 point spreads between the put and call strike prices.

The Effect of Using Borrowed Stock To Close Collars□

A private letter ruling has confirmed the tax treatment to investors who close out collars with borrowed stock. The implications of the ruling would be beneficial to a corporation that has on a very profitable hedge.

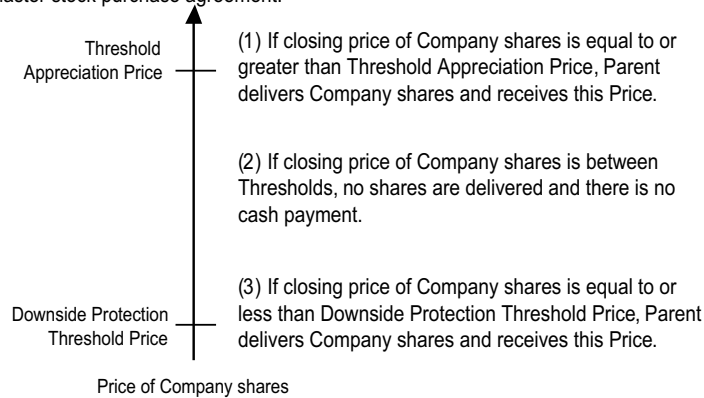
PLR 200440005³ verifies that when an investor employs borrowed stock to close a hedge, it does not trigger recognition of a capital gain on the hedge, nor does it trigger a constructive sale on the hedge. But it does trigger a constructive sale on the stock that was hedged. As a result, the investor must recognize capital gain on that stock. That gain would equal the difference between the stock’s fair market value the day the hedge is closed and the stock’s cost basis. The transaction described in the ruling is diagrammed in Figure 1.

² H. Rep. 105-148 (Revenue Reconciliation Act of 1997).

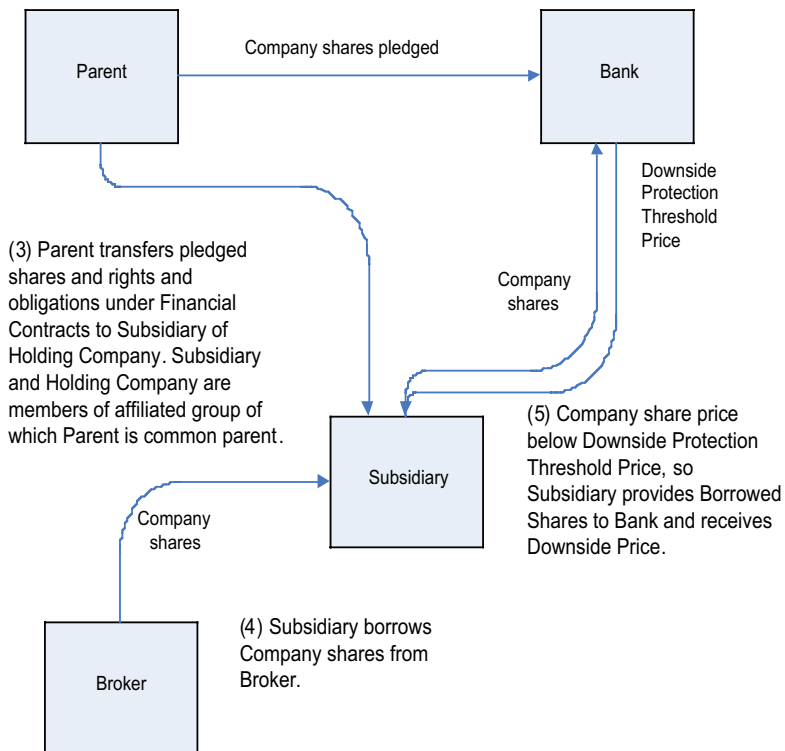
³ June 10, 2004 (released October 1, 2004).

Figure 1: Collar Transaction of PLR 200440005

(1) Parent enters into Financial Contracts with Bank to sell shares of Company stock that Parent holds. Financial Contracts governed by single master stock purchase agreement.



(2) Parent pledges Company shares to Bank to secure obligations, retaining voting rights and right to receive quarterly dividends. Bank could not sell pledged shares unless Parent was in default. Parent could obtain release of pledged shares by substituting cash or other securities.



Example. An investor has a zero basis in DotTech stock. At the time the hedge was entered into, the stock had a value of \$100 and the investor bought an at-the-money put struck at \$100. As the hedge is terminating, the stock is only worth \$20.

If the investor closes the hedge with borrowed stock, it will recognize only \$20 in gain on that stock. It will have approximately \$80 in unrecognized gain that will remain unrecognized until the position is closed.

Conversely, if the investor had closed the hedge for cash, it would have recognized a gain of approximately \$80, and it would be left holding \$20 of stock unhedged. If it closed the hedge by delivering its own stock, it would have recognized a gain of approximately \$100, and it would be left with no stock.

If the hedged stock has dropped by less than 50%, the investor's best approach is usually to accept cash; however if the hedge is worth more than the stock, delivering borrowed shares causes a smaller immediate tax liability. The deferred gain would be short-term gain, which would make this strategy unappealing to almost all individual taxpayers.

No-Action Letter Says Insiders Can Collar Options

An SEC no-action letter indicates that insiders can hedge their unexercised employee stock options with collars on company stock even though they do not own the stock. Section 16(c) of the Securities Exchange Act of 1934 prohibits insid-

ers from shorting company stock or establishing similar positions with options on company stock unless they "own" the stock. In a May 18, 2004 letter to Credit Suisse First Boston,⁴ the SEC confirms that an executive with fully vested options and no shares can hedge company stock with a collar.

The collar in the non-action letter was structured so that the executive could not benefit from a fall in the price of the underlying stock. To ensure this, the executive also granted a put to the dealer at the employee option's exercise price. The collared employee options were substantially in-the-money, the collar did not produce income, and the employee posted collateral equal to the options' exercise price.

Microsoft Dividend: Opportunity or Not?

On July 20, 2004, Microsoft declared a \$3 dividend. Whether this dividend presents an opportunity for savvy investors to convert short-term capital gains taxed at 35% into dividend income taxed at only 15% (10.5% for corporations) will depend a great deal on the price investors pay for Microsoft—or on Microsoft's fair market value the day before it goes ex-dividend.

The mechanics of dividend capture are fairly straightforward: Investors purchase stock while it is "pregnant" a large dividend, hold the stock for at least 61 days (46 days

⁴ On the SEC website at www.sec.gov/divisions/corpfin/cf-noaction/csfb031804.htm.

for a corporation), wait until they are entitled to collect the dividend, and then sell the stock. Once the stock passes its ex-dividend date, its price usually drops by approximately the dividend amount, so the investor may realize a capital loss on the stock.

One major challenge to tax-efficient dividend capture stems from the “extraordinary dividend” rules. If a dividend equals or exceeds 10% of the investor’s basis in the stock, it is usually deemed an “extraordinary dividend” and individual stockholders must treat any loss realized on the underlying stock (up to the dividend amount) as long-term capital loss—regardless of how long they actually hold the stock. □ (Conversely, stockholders can elect to determine a dividend’s status based on the stock’s fair market value the day before it goes ex-dividend.)

Therefore, investors with short-term gains who wish to capture Microsoft’s dividend should first see whether the stock price is high enough so that its dividend is not extraordinary. If the dividend *is* extraordinary, then a dividend capture strategy would not be tax-efficient for corporations under most circumstances, but it might still be viable for individuals if they have *no* long-term gains—only short-term gains. For individuals, any long-term loss first offsets long-term gains. But if an individual has no long-term gains, then the long-term loss offsets short-term gain *dollar for dollar*. So if a dividend is extraordinary and an individual stockholder’s other investments have produced only short-term capital gain, that individual can use the “long-term”

loss on the stock to offset that short-term gain.

Microsoft stock is trading at around \$30. In addition to this special \$3 dividend, Microsoft stockholders may also receive an \$.08 regular dividend. So in order for the \$3.08 of dividends not to be extraordinary, a Microsoft stockholder must have a cost basis in excess of \$30.80 per share (or Microsoft’s fair market value the day before the ex-dividend date must exceed \$30.80). The record date for the \$3 dividend is November 17, 2004. Although a Microsoft dividend capture strategy can be executed at any time, investors wishing to participate for the minimum holding period would not purchase Microsoft before September 15th; indeed, any days before that won’t count towards the holding period necessary to qualify for the 15% dividend tax. If individual investors wish to receive qualified dividends and also be able to dispose of their stock and recognize a capital loss in the current year, they must purchase Microsoft by October 29th. If investors wish to hedge Microsoft during the required holding period, they should not employ Microsoft puts because puts will destroy the holding period. However, they may be able to hedge with a competing stock or index (unless Microsoft constitutes more than 70% of the index).

Dividend capture strategies involve several technical parameters, but they also offer significant rewards to investors with short-term gains. If the investor’s Microsoft cost basis remains below \$30.80, then dividend capture should offer

significant after-tax returns only to individual investors who hold short-term gains exclusively. If the investor purchases Microsoft above the \$30.80 threshold, then the strategy

could create significant after-tax returns for both corporate investors with capital gains and individual investors with both long-term and short-term capital gains.

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