Wealth Design
Financial Engineering

Diversifying Appreciated Stock Holdings

Many sophisticated investors holding highly appreciated, publicly-traded stock have previously used Prepaid Variable Forwards (PVFs) to hedge, monetize and defer taxes on their positions. The primary reason is because this instrument is not subject to the 50% initial margin requirement of Reg T, meaning there are no limitations on the amount of proceeds that can be used to re-invest in publicly-traded stocks, which is what most investors wish to do with the proceeds in order to diversify.

However, PVFs are being closely scrutinized by the IRS. In each of 2006, 2007 and 2008 the IRS issued memorandums stating that the use of a PVF triggers a "taxable event". The 2007 memorandum directed IRS agents to search for and then audit investors who executed PVF transactions. The 2008 memorandum concluded that a PVF might be a "tax shelter" subject to a host of penalties. As a result, even though most tax advisors believe a properly structured PVF should pass muster under current tax law, there is hesitancy amongst sophisticated investors, especially fiduciaries, to use PVFs due to the real or perceived tax risk and heightened IRS audit risk.

Wealth Design has sourced a new technique that addresses the concerns surrounding PVFs. The key ingredient to this strategy is the innovative and expert application of the new portfolio margining rules.

This new technique is not subject to the 50% initial margin requirement of Reg T. That is, there is no limitation on the amount of the proceeds that can be used to re-invest in publicly-traded stocks. The investor is free to do anything it wants with the monetization proceeds, which can be as high as 97% of the value of the stock that is being hedged, a higher loan-to-value ratio than is possible with a PVF.

Depending upon the specifics of the stock being hedged, this strategy can actually produce a superior tax result versus a PVF. And there can be a number of non-tax advantages, including a dramatic reduction in counter-party credit risk, which in the current environment can be especially important to investors.

In sum, this cutting edge hedging solution achieves attractive results, but in a way that eliminates the tax risk and heightened audit risk associated with PVFs. The bottom line is that if an investor would like to diversify out of a concentrated holding, there is now a safe and economically attractive solution.

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