MANAGING A CONCENTRATED STOCK POSITION WITH A VARIABLE PREPAID FORWARD CONTRACT

Owners of concentrated stock positions may be well aware of the need to diversify their holdings; however, because of the income tax liability that could result, many are reluctant to do so. Given the tax consequences of reducing a concentrated position, how can you efficiently pare down your risk? If you'd like to monetize a concentrated position while also deferring taxes, it may be worth your while to explore a variable prepaid forward contract (VPFC).

What is a VPFC?

A VPFC is an agreement between the concentrated shareholder and a third party (typically a brokerage firm or investment bank), under which the shareholder agrees to sell his or her shares at a minimum specified price at some point in the future. The VPFC sets a "floor" and a "ceiling" on the stock price during the term of the agreement, providing the shareholder with limited downside risk but also limited opportunity for price appreciation. When the agreement is executed, the third party presents the shareholder with a cash payment, which may represent up to 90 percent of the position's current fair market value.

During the term of the VPFC, the stock is held as collateral and the shareholder may use the cash payment for any purpose, including creating a diversified investment portfolio. The shareholder is not required to pay any capital gains tax on the payment until the VPFC term ends. At that time, the shareholder may deliver cash or shares to settle the VPFC. The number of shares to be delivered depends on the share price on the date of delivery.

If the share price has increased over the term of the VPFC, fewer shares will need to be delivered to settle the agreement. If the share price has fallen below the protected floor price, the shareholder will deliver all shares pledged as collateral when the VPFC was initially executed. Upon delivering the shares, the shareholder recognizes capital gains tax on the difference between the cost of the delivered shares and the payment received when the VPFC was initially executed.

An example: Ms. Street owns a significant concentrated stock position in DEF, Inc. Although she acknowledges the risk of holding such a large portion of her personal wealth in a single position, she's concerned about the tax liability associated with selling the shares and reallocating. Ms. Street's advisor suggests using a VPFC, and she decides to move forward with $1 million of her DEF shares, which are currently trading at $50 per share.

Ms. Street enters into a two-year VPFC, with a floor of $45 and a ceiling of $55. Once the VPFC is executed, she receives a cash payment of $900,000, which her advisor allocates among holdings in a diversified portfolio. At the end of the term, the stock has appreciated to the ceiling price of $55, and Ms. Street delivers an equivalent number of shares to settle the up-front payment (plus interest and fees). Because the stock has appreciated, she needs to deliver fewer shares to settle the VPFC and can retain the rest. (If the stock had fallen to $40 per share, however, Ms. Street would need to deliver all of the shares originally pledged and would retain the original up-front payment.) Upon settlement of the VPFC, she pays capital gains tax on the difference between her cost basis in the shares and the payment amount.

Points to consider

A VPFC can be a flexible solution for dealing with concentrated stock positions, allowing for monetization, risk management, and tax deferral, as well as permitting the shareholder to retain the dividend and voting rights over the shares. But keep in mind that this is a very complex strategy. It's important to fully understand how VPFCs work before executing an agreement. Be sure to consult your financial and tax advisors if you are considering this strategy.

Commonwealth Financial Network® does not offer legal or tax advice. You should consult a legal or tax professional regarding your individual situation.

1275 Ben Sawyer Boulevard | Mt. Pleasant, SC 29464 | Phone: 843.884.9898 | Fax: 843.884.8798 | www.cummingswealth.com

Securities and advisory services offered through Commonwealth Financial Network,® Member FINRA/SIPC, a Registered Investment Adviser.

Rev 02/15