CONCENTRATED POSITIONS
Know the Nuances

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Concentrated positions are a bittersweet proposition. Often times, they have been the source of great financial benefits. As the concentration grows over time, there are real risks that develop and tend to increase overall investment risk in your portfolio. However, there are ways to address this risk.

Each of the options we are explaining below has a layer of complication to them, are quite different from each other and may not relate to your case at all if you have concentrated wealth but it's helpful to know what they all mean. You may have a desire to hold a position to avoid a large tax bill and want to reduce downside risk (**Equity Collar).** If you lean toward charitable contributions you could do outright gifting of shares or a more robust possibility - a **Donor Advised Fund**. Lastly, you could just do an **outright sale.** Any one or all of these could be a possibility for you. If you have a concentrated position and want to talk about, please feel free to call me at your convenience.

What Is an Equity Collar?

An equity collar is a hedging technique designed to protect a stock from downside price risk at little to no out-of-pocket cost to the shareholder. Here's how it works: the shareholder purchases protective put options on the shares he or she owns while simultaneously selling covered call options on those same shares. The protective put places a price "floor" on the shares, while the call creates an upward "ceiling." The options are typically purchased and sold so that the strike price is "out of the money" in relation to the current price of the collared shares. The sale of the call option contracts results in the collection of a premium, which is then used to offset the premium costs associated with the purchase of the put options. Thus, these hedging transactions are often referred to as "zero-premium" or "cashless" collars.

Example: Mr. Stevens owns a large, highly appreciated position in CBA, Inc. It is June, the end of CBA's quarter, and Mr. Stevens is concerned that there may be short-term pressure on the share price. On the other hand, he believes that CBA's long-term prospects remain very strong. Because he'd realize a large taxable gain if he sold them, Mr. Stevens would like to structure a zero-premium collar for his CBA shares, which currently trade at $50 per share, for the next three months.

CBA September $55 call contracts trade at $2 each, and CBA September $45 put contracts also trade at $2 each. Mr. Stevens sells the calls and receives a $2 premium per contract while simultaneously purchasing the puts at $2 per contract. The premiums he receives for the calls offset the cost of the protective puts, resulting in a no-cost hedge. During the term of the collar, $45 represents the protective floor at which Mr. Stevens can sell his stock regardless of how low the price drops; $55 represents the ceiling up to which Mr. Stevens may participate in appreciation of the shares. If the stock trades above $55, the shares may be called away regardless of how high the actual price is.

Points to Consider:

As a protective hedge, an equity collar is best suited for shareholders with significant gains in their shares who feel that, while the price of the stock may be neutral or slightly bearish in the short term, the stock's long-term outlook remains bullish. Many shareholders also use collared shares as collateral to obtain loans, as lending institutions are more likely to lend larger amounts against protected assets.

An equity collar can be very effective in protecting the value of a concentrated position, but it must be structured properly to achieve a zero-cost outcome. It may become necessary to purchase back the call option at a higher premium to avoid having the shares called away and unintended tax results. Consult a financial advisor to learn more about this strategy and whether it may be appropriate for you.

Please note that options are not appropriate for all investors. Typically, commissions are charged for options transactions. Transaction costs may be significant in multi-leg option strategies, including collars, as they involve multiple commission charges. Please contact us for a copy of the Options Disclosure Document.

What Is a Donor-Advised Fund?

A donor-advised fund, or DAF, is an account held through a sponsoring public charity for accepting charitable gifts. Once a gift has been made, the donor becomes a grant advisor to the DAF. As a grant advisor, he or she can make nonbinding recommendations that the sponsoring charity direct grants from the DAF to other public charities. Gifts to a DAF may qualify for a charitable income tax deduction that equals the fair market value of the gifted cash or property in the year in which the gifts are made. The total deductibility of gifts in any given year is subject to the same limitations as gifts made outright to a public charity—currently, 60 percent of the donor's adjusted gross income (AGI) for cash gifts and 30 percent of AGI for long-term capital gain property. If the full deduction cannot be taken in the year of the gift because of AGI limitations, the donor may carry forward the unused deduction for five years.

Benefits of Funding a DAF with Concentrated Stock

Funding a DAF with appreciated concentrated stock can provide the following benefits:

- On the date of contribution, the donor receives an income tax deduction equal to the shares' fair market value.
- Once contributed, the shares can be sold without incurring capital gains tax.
- The donor has a pool of charitable funds that can be directed to support various charitable organizations.
- DAFs are typically easier and less expensive to establish and maintain than other concentrated stock strategies.
- Donors may have the funds professionally managed by their financial advisor.
- Donors can designate successor grant advisors who can continue recommending grants to the DAF after their passing.

Example: DAF*

Mr. Smith owns a large, highly appreciated position in ABC Corp. He typically makes annual gifts to various charities and would like to create a DAF funded with $100,000 of ABC stock that has a cost basis of $20,000. Upon funding the DAF, Mr. Smith can receive a $100,000 charitable income tax deduction. The shares will then be sold—without incurring capital gains tax—and allocated into a diverse portfolio by Mr. Smith's financial advisor. Rather than write personal checks to various charities he typically supports, Mr. Smith can now make grant recommendations to the DAF in support of the same charities.

Considerations

For owners of concentrated positions who have charitable intent, a DAF can be an excellent way to sell appreciated shares and help fund a charitable legacy in a more tax-efficient manner.

*This is a hypothetical example and is for illustrative purposes only. No specific investments were used in this example. Actual results will vary. There can be no assurance of positive performance from the portfolio.

Outright Sale of a Concentrated Stock Position

Most owners of concentrated positions understand the risks inherent in continuing to hold their shares. A significant drop in the price of the issue has the potential to inflict irreparable harm on a portfolio. One potential solution to the problem is to sell the stock. But many owners are wary of the tax implications of implementing this simple strategy and are therefore hesitant to take action. Sometimes, however, the simplest option can produce the best result. To determine whether an outright sale is an appropriate solution for reducing risk, let's review the benefits and downside considerations associated with such action.

Benefits of Outright Sale

- The risk associated with the position is immediately removed from the owner's portfolio.
- The owner now has available cash to allocate to a diversified portfolio—one that is more appropriate for their risk tolerance and financial goals.
- For most taxpayers, long-term capital gain tax rates are still historically low at 15 percent. If the owner is in this 15 percent bracket, selling the position now may make their tax bill more manageable than it could be in the future, if rates were to rise.

Downside Considerations Associated with Outright Sale

- Although long-term tax rates may be at historic lows, the sale of low-basis shares can significantly increase the owner's taxable income.
- A very large capital gain may subject the owner to the alternative minimum tax.
- The owner will no longer participate in the appreciation of the sold shares.
- If the owner were to hold the shares until their death, the heirs would inherit the position with a step-up in tax basis to the fair market value on the date of the owner's death.
- The sale of a significant number of shares on a public exchange could lead to a decrease in the price of the security.
- If the owner's income exceeds the taxable income thresholds ($445,850 individual and $501,600 married filing jointly), the owner will be subject to the higher 20 percent long-term capital gain rate.
- If the owner's modified adjusted gross income exceeds the thresholds ($200,000 individual and$250,000 married filing jointly), the owner's capital gains will be subject to an additional 3.8 percent Medicare surtax on investment income.

All information is for the tax year 2021. This material has been provided for general informational purposes only and does not constitute either tax or legal advice. Although we go to great lengths to make sure our information is accurate and useful, we recommend you consult a tax preparer, professional tax advisor, or lawyer.

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