"Not From Concentrate" -

When There's Too Much Juice in the Portfolio - Part 1

July 2021

SUMMERTIME - "WHEN THE LIVIN' IS EASY"

When I was young, during summertime my mother would often make lemonade for the family dinner by adding water to cans of Minute Maid® frozen concentrated lemonade in a glass jar. It was loaded with sugar and had my two brothers and me bouncing off the walls within minutes of drinking several glassfuls of the stuff.

Sadly, as I have gotten older, the risks of concentrated sugar in my diet have been explained several times over to me by my doctor, wife, and now-grown children.

Concentrated stock positions bring their own kind of sugar rush – when things are going well. But too often the crash comes, and when it does, it comes with a hard lesson of the risks of a concentrated stock position. Over the past two months, we have attended several client meetings where the focus of the conversation was dealing with the risk/reward considerations of the client's single-security concentration. As is nearly always the case, the clients intuitively understood the risks inherent with their current investment strategy, but for various reasons, found it difficult to do anything about it.

REASONS FOR CONCENTRATION

In our experience, individuals have several reasons for holding onto a concentrated stock position. For example, they may have:

- Inherited a large holding
- Exercised options to buy company's stock
- Sold a private business, or founded a company that subsequently went public
- Benefitted from price appreciation or repeated stock splits over the years
- Accumulated restricted or common stock as part of compensation

The amount of stock that indicates a concentrated position is based somewhat on the individual's situation. It depends in part on his/her ability to withstand volatility, level of wealth, desired investment return from the portfolio, and overall asset allocation.

Benjamin Graham, the legendary author of The Intelligent Investor, argued that a diversified portfolio required anywhere from 10 to 30 stocks. If you accept Graham's definition, you might start to consider whether your position is too large once it represents more than 10 percent of the stock portion of your portfolio.

Also remember that if your current income comes from the same company that represents your concentrated stock position - for example, if you hold a large amount of your current employer's stock - you are doubly exposed.

RELUCTANCE TO DIVERSIFY

Just as there are many different reasons for accumulating a concentrated stock position, there are many considerations involved when deciding how to address it. Some of the most common issues we see investors deal with are:

- **Emotional attachments** to a stock. If a person inherits a large position, there is often a reluctance to sell.
- **Fear of "missing out"** - in other words, there is a strong desire to participate in potential future price gains. This can also be a form of emotional attachment to the stock.
- Reluctance to sell because of adverse **tax consequences.** This may become even more of a challenge, based on President Biden's tax policy proposals.
- **Legal constraints** on the ability to sell. When a privately-held company is acquired, its executives and/or shareholders may receive restricted securities (those acquired in private transactions rather than through the public markets). Corporate insiders may be subject to SEC Rule 144, which limits when restricted shares can be sold, and they are usually also subject to legal restrictions on how they trade their company's shares.
- **Company "Black-Out" Periods** Companies may also impose so-called blackout periods during which some employees, particularly officers and directors, are not allowed to sell stock.
- **Practical considerations** In the case of a thinly traded stock, a large sale could overwhelm the market and potentially depress the price.
- **Optics** Particularly for C-suite executives, there can be concerns about the possible perception of market manipulation or insider trading.

RANGE OF STRATEGIES

There are a variety of strategies that are available for the investor's consideration. Other than doing nothing, one or more strategies might provide multiple benefits – in addition to diversification.

DO NOTHING

This is the default strategy for many. The thinking here is, if the stock is part of one's estate, the cost basis may be stepped up after death. That could reduce or eliminate the capital gains tax for heirs. (The value of the stock would be included in determining if an estate tax was due.)

> **Example**: Colin bought a stock for $25 twenty years ago. On the date of his death, it sold for $76 a share. Based on current law, his heirs will use $76 as their cost basis for those shares. At some point later, Colin's heirs decide to sell the stock, which is now trading at $78 a share. They will owe capital gains taxes on the $2 per share difference.

> **Caution**: We have written about this before – under President Biden's "American Families Plan" plan, he has proposed to eliminate this basis step-up for estates of deceased taxpayers who have gains in excess of $1 million ($2.5 million per couple when combined with existing real estate exemptions). Under Biden's proposal, these gains will be taxed, regardless of whether the property is sold by the deceased's heirs, unless the property is donated to charity. (President Biden is also proposing a limited exception for family businesses and family farms as long as they are owned and operated by the family.)

SELLING YOUR SHARES

Selling frees up funds that can be used to purchase other securities that will help diversify a portfolio. Of course, in doing so, you will owe capital gains taxes on the difference between your cost basis and the sale price. If you have a highly appreciated stock, that may be no small consideration.

If you want to continue to participate in any upside potential, you could sell only a portion of your position, or consider selling over time. Although a prolonged bull market has made it difficult to find significant losses in portfolios, sales of concentrated stock positions may be offset by tax-loss harvesting. Generate tax losses when possible and use those losses to offset gains from selling the concentrated position. This strategy is an expansion of the "sales over time" methodology, allowing for an even greater level of sales per year.

ESTABLISH A 10b5-1 FOR COMPANY SHARES

Company executives who want to avoid the perception of insider trading or market manipulation can sell shares over time by using a 10b5-1 plan. Such plans can provide a documented defense against any allegations that trades were made to take advantage of insider knowledge. They must be set up through an independent third party, such as a financial advisor, broker, or trustee, and the decisions about when and how much to sell cannot be based on any material knowledge about the company that is not public.

- A 10b5-1 plan may spell out a **predetermined schedule** for selling shares over time, specifying in advance the dates, prices, and amounts (either a specified number of shares or a specified dollar amount) of each sale.
- It could also set out a **formula**, algorithm, or computerized program for automating the trades.
- It may set up a mechanism that eliminates the investor from any decision-making about the sales. For example, allowing a **third party who has no insider knowledge** to make all selling decisions.

  Example: Laurie is an officer of LML Corp – a publicly traded company. Her daughter will be entering college next fall, and she also plans to buy a second home the following year. Laurie would like to sell some of her LML stock and use the proceeds for both the tuition and home purchase. However, the stock is a volatile one, and Laurie wants to avoid any appearance of impropriety if she sells just before the stock's price plunges. Laurie sets up a 10b5-1 plan that instructs her broker to sell 5,000 of her LML shares on the first day of each quarter over the next 2 years at a price no lower than $40 a share.

EXCHANGING YOUR SHARES

Another diversification possibility is to trade highly appreciated stock for shares of an exchange fund (also known as a Swap Fund) - a private placement limited partnership that pools your shares with those contributed by other investors who may also have concentrated stock positions. Eaton Vance is the largest provider of public stock exchange funds. Other providers include Goldman Sachs, Morgan Stanley, and more.

To qualify as an exchange fund, at least 20% of the partnership portfolio must be in illiquid investments such as real estate. Generally, the rest of the fund will target an index such as the S&P 500.

By contributing to an exchange fund, the investor can achieve instant diversification without immediate tax consequences. If the investor withdraws part or all of the contribution prior to seven years, he or she will receive back the originally contributed stock - at its original tax basis. If the investor makes a withdrawal after seven years, he or she will receive a proportionate share of the basket of stocks--with a basis equal to what was originally contributed. These transactions are not subject to taxation until and unless the shares received are actually sold. When that happens, the investor pays taxes on the difference between the value of the stock contributed and the price received for the exchange-fund shares.

Though it provides no liquidity and typically little or no income during the seven-year holding period, an exchange fund may help minimize taxes while providing greater diversification (though diversification alone does not guarantee a profit or ensure against a loss).

> **Caution**: Be sure to understand the costs included in the exchange fund. There may be a sales load and other fees. Also, you want to ensure that you are not exchanging your shares for a portfolio of low-quality stocks.

MONETIZING THE POSITION

In addition to writing (selling) covered call options, there are strategies that involve generating cash from the stock position – without selling the position:

Prepaid Variable Forward (PVF) Agreements

If you want immediate liquidity, you might be able to use a prepaid variable forward (PVF) agreement. With a PVF, you contract to sell your shares later at a minimum specified price. You typically receive 80 to 90 percent of the shares' value in the form of a payment when the agreement is signed. However, you are not obligated to relinquish ownership of the shares or pay taxes on the sale until the PVF's maturity date, which might be years in the future. In the meantime, your stock is held as collateral.

To diversify the portfolio, you could use the proceeds to purchase other securities. When the expiration date is reached, you must either settle the agreement by making a cash payment, or turn over the appropriate number of shares as payment. (In that case, the number of shares will vary depending on the stock's price at the time of delivery.)

If you turn over the shares, your capital gain or loss will be recognized at that time, and you will owe tax on the difference between your cost basis in those shares and the amount you received when you signed the PVF. If you choose to settle the PVF with cash, you will postpone capital gains taxes on your stock holding. However, any gains or losses from the hedge itself (i.e., the difference between the share price you received upfront and the share price you pay to settle the agreement) are subject to immediate taxation when the PVF is settled.

> **Caution**: Cash settlement may cause a problem known as straddle taxation. Any gains that result from the hedge itself may be taxable at short-term capital gains rates. That could turn a long-term gain on the underlying shares into a short-term gain taxed at higher rates. Also, you may not be able to deduct losses on the hedge until the stock itself is sold.

> **Caution**: Modification of variable prepaid forward contracts can trigger gain realization. Individuals contemplating the modification of any derivative, or entering into an equity derivative transaction implicating the constructive sale rules of IRC Sec. 1259, should proceed with caution, and seek the guidance of tax professionals.

> **Caution**: PVFs must be carefully structured. The IRS has issued a warning that questioned so-called "share lending," which occurs if a financial firm involved in a PVF attempts to hedge the position by, for example, selling the shares short. PVFs must be structured so that is clear that the investor still retains ownership of the shares.

Borrowing Against the Stock to Diversify

If you want to hold onto your stock but need money to build a more diversified portfolio, you could use your stock as collateral to buy other securities on margin.

Typical initial margin requirements specify that you have at least 50 percent of the value of your margin purchases in stock or cash. If you have $50,000 worth of shares, you could use them as collateral to purchase an additional $50,000 worth of securities on margin. You will owe interest on that $50,000, which you are borrowing from the broker, though the interest may be deductible.

Similar to margin, some financial service firms will have relationships with lending institutions that will allow individuals to use their investment accounts as collateral for a loan.

DONATING YOUR SHARES

If your overall planning objectives include philanthropic goals, another possibility for dealing with a concentrated stock position is to donate your shares to charity. This has the potential added benefit of eliminating some or all of your capital gains tax liability on the donated stock. There are many ways to do so. Some methods provide an immediate tax deduction, some offer ongoing income, some enable you to avoid paying capital gains or estate taxes on highly appreciated shares, and some offer a combination of these benefits.

Donate to a Charity

By donating stock directly to a qualified charity rather than selling it and donating the proceeds, you will not only remove it from your taxable estate but avoid paying capital gains taxes. In effect, the donation costs you less because of the tax benefit you receive.

A charity must qualify as a 501(c)(3) nonprofit organization as defined by the IRS in order for you to receive a tax deduction for the donation. Additionally, there are limitations on the amount of your donation that is tax-deductible; the limits are based on a percentage of your adjusted gross income (AGI) and how long you have held the stock.

Donate to a Charitable Lead Trust

The charitable lead trust (CLT) is a trust arrangement under which an annual income from the trust is paid to a qualified charitable organization for a specified period of years, with the principal of the trust passing to noncharitable beneficiaries (often the children or grandchildren of the donor) when the trust terminates. Thus, the lead trust is a technique for making a "temporary gift" of income to a charitable institution and eventually passing the property to individual beneficiaries. You receive no tax deduction for transferring assets to it unless you name yourself the trust's owner (grantor trust), in which case you will pay taxes on the income it generates each year. A charitable lead trust can be an excellent vehicle if you believe your stock has a bright future and want your heirs to benefit from it, but also want to reduce the potential tax liability to your estate.

<u>Donate to a Charitable Remainder Trust</u>

A charitable remainder trust in some ways is the mirror image of the charitable lead trust. You receive an income tax deduction when you make the contribution. Typically, the trust can sell the stock without paying capital gains taxes and reinvest the proceeds to provide an income stream for you as the donor. When the trust is terminated, the designated charity retains the remaining assets.

You can set a payout rate that meets both your financial objectives and your philanthropic goals, and because the principal is not reduced by taxes, the income generated may be greater than if you had sold the asset yourself.

<u>Donate to a Private Foundation</u>

You also can receive an immediate income tax deduction for the market value of your stock by setting up and donating to a private foundation, which then makes grants to qualified 501(c)(3) nonprofit organizations. A Private Foundation is a tax-exempt organization (a trust, corporation, or hybrid) in which a donor creates, funds, and controls for the primary purpose of making grants to charities and/or individuals. A Private Foundation funded during the donor's lifetime can provide philanthropic recognition to the donor and family. Through the management of the foundation, it can instill in the donor's heirs a sense of social awareness and responsibility that might not otherwise be present, while allowing them to be paid for their work on the governing board.

However, the costs of setting up and administering a private foundation can be substantial, so they typically are used for relatively large charitable contributions.

Also, there are legal constraints on contributions in order for it to qualify for a tax deduction. The foundation cannot be involved in so-called self-dealing; for example, family members or their employees cannot borrow money from, buy from, or sell to the foundation. Finally, grants made by a private foundation are public record, so this is not the best choice if you prefer anonymity.

<u>Donate to a Donor-Advised Fund</u>

Similar in some respects to a private foundation, a donor-advised fund offers an easier way for you to make a significant gift to charity over a long period of time. A donor-advised fund enables you to track your own contributions and suggest specific grants and philanthropic causes you would like the money to support. Though the charity is not legally obliged to follow your recommendations, in practice they typically do so (subject to legal constraints, such as making sure the grants go to a 501(c)(3) nonprofit organization).

Unlike a private foundation, your grant recommendations can be made anonymously. Also, the percentage of AGI that you can contribute in any one year and still qualify for a tax deduction is higher than that of a private foundation (though again, you should consult a tax professional who can review your own situation).

CONCLUSION

We have covered a lot of territory in this month's newsletter, and in part two, we will discuss additional strategies that involve hedging the concentrated position.

Dealing with concentrated stock positions can be a challenge – not because there are no options, but because it is a complex task that may involve investment, tax, and legal issues. because it is a complex task that may involve investment, tax, and legal issues. And of course along the way, an investor may have to set aside some of his or her emotional attachment to a stock, and "trust the science."

When dealing with a concentrated stock holding, consider your time frame. Some strategies, such as hedging, might be most suitable in the short term or if you are restricted from selling. Others, such as charitable remainder trusts, may be more cost effective over a longer time period, though your charitable intentions obviously play a role as well. And as always, consult professionals who can help you determine a strategy that is ideally suited for your personal situation.

Please reach out to the team at Pallas Capital Advisors if you have any questions as it applies to your particular situation.

Sincerely,

James Landry, ChFC
Chief Operating Officer, Director of Planning
Pallas Capital Advisors

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