Selling and hedging strategies for concentrated stock positions

A concentrated stock position is defined as any single holding that makes up 10% or more of an individual's overall investments. Maybe you inherited a large holding, exercised options to buy your company's stock or sold a private business. Perhaps you hold restricted stock, or have benefited from repeated splits over the years. Whatever the circumstance, having a large position in a single stock carries its own risks and challenges. Even if the stock has done well, it may be wise to diversify and shift your strategy to meet new financial goals and mitigate risks.

Selling or hedging are the two main strategies used to offset a concentrated stock position.

Option 1: Sell your shares

Selling a major holding frees funds that can be used to successfully diversify your portfolio. However, if you have a low cost basis, capital gains taxes are of potential concern. You will also want to avoid any perception of market manipulation or insider trading. Selling shares over time can help you manage the tax bite in any one year, while still participating in future growth.

The tax consequences below are only one concern when thinking about selling. Legal constraints may also dictate your ability to sell, including contractual obligations like lock-up agreements. There are practical considerations as well, like the possibility that a large sale could overwhelm the market for a thinly traded stock.

The most recent 2017 tax law updates include the following limitations:

0% rate

applies to net long-term capital gains up to $77,200 for joint filers and $38,600 for single filers

15% rate

applies to net long-term capital gains over the amount subject to the 0% rate up to $479,000 for joint filers and $425,800 for single filers

20% rate

applies to adjusted net long-term capital gains over $479,000 for joint filers and $425,800 for single filers

Note: If your adjusted gross income exceeds $200,000 (or $250,000 for married couples filing jointly), your net investment income will be subject to an additional 3.8% Medicare contribution tax. In contrast to previous years, these rates are not scheduled to expire at a certain date. This increased certainty should simplify planning.

Use a 10b5-1 plan.

If you hold restricted shares, a 10b5-1 plan, which spells out a predetermined schedule for selling shares over time, may serve as an ideal selling strategy. These written plans specify in advance the dates, prices and amounts of each sale. They also comply with SEC Rule 144, which governs the sale of restricted stock and was designed to prevent insider trading. A 10b5-1 plan demonstrates that any selling decisions were made prior to gaining insider knowledge that could influence specific transactions. Beware that terminating the plan or selling too much too quickly could raise questions about the plan's legitimacy.

Sell privately.

You might also be able to avoid some of the restrictions on how much and when you can sell by selling shares privately rather than on the public market. However, you would likely have to sell at less than the market value, and you would still face capital gains taxes.

Option 2: Hedge your position

Simply put, hedging is defined as protecting yourself in the case of an unforeseen event. There are various forms of hedging to consider in the context of concentrated stock positions, many of which can help you protect yourself in the short term against the risk of a substantial drop in price. There are multiple ways to manage that risk by using options, but bear in mind they're not appropriate for all investors.

Buy a protective put option.

Doing so essentially puts a floor under the value of your shares by giving you the right to sell your shares at a predetermined price. Buying put options that can be exercised at a price below your stock's current market value can help limit potential losses on the underlying equity, while allowing you to still participate in any potential appreciation. However, you lose money on the option itself if the stock's price remains above the put's strike price.

Sell covered calls.

Selling covered calls with a strike price above the market price can provide additional income from your holdings, which could help offset potential losses if the stock's price drops. However, the call limits the extent to which you can benefit from any price appreciation. And if the share price reaches the call's strike price, you would have to be prepared to meet that call.

Consider a collar.

This hedging approach involves buying protective puts and selling call options whose premiums offset the cost of buying the puts. As with a covered call, the upside appreciation for your holding is then limited to the call's strike price. If that price is reached before the collar's expiration date, you may not only lose the premium you paid for the put, but may also face capital gains tax on any shares you sold.
You must be careful about closing one side of the collar while the other side of the trade remains outstanding. For example, if you exercised the put, but the shares you sell are later called away prior to the call's expiration date, you could be left with an uncovered call. This has the potential of loss if you're forced to repurchase the shares at a higher price to fulfill the call.

Also, the prices set for a collar must not violate the rules against a so-called constructive sale. A strategy that eliminates all risks is effectively a sale and thus subject to capital gains taxes. The strike prices of a collar should not be too close to your stock's market price.

Options involve risk and are not suitable for all investors. It is possible to lose the entire amount paid for the option in a relatively short time period. Prior to buying or selling an option, a person must receive a copy of "Characteristics and Risks of Standardized Options." Copies of this document can be obtained from your financial professional and are also available via the Options Clearing Corporation website.

Monetize the position.

If immediate liquidity is your goal, you may be able to monetize your position using a prepaid variable forward (PVF) agreement. With a PVF, you contract to sell your shares later at a minimum specified price. You receive most of the payment for those shares—typically 80%-90% of their value—when the agreement is signed. You're not obligated to turn over the shares or pay taxes on the sale until the PVF's maturity date, which may be years in the future. Once that date comes, you must either settle the agreement by making a cash payment, or turn over the appropriate number of shares, which will vary depending on the stock's price at that time. In the meantime, your stock is held as collateral, and you can use the upfront payment to buy other securities that can diversify your portfolio. Additionally, a PVF still allows you to benefit from price appreciation during that time, though there may be a cap on that amount.

PVF agreements are complicated, and the IRS warns that special care must be taken when using them. Consulting a tax professional before considering a PVF is highly recommended.

Exchange your shares.

If diversification is your goal, you may want to consider an exchange fund, a private investment vehicle which offers tax free diversification to investors with highly appreciated low basis stock. You basically swap your shares for units of a diversified fund providing broad equity market exposure, thereby reducing your risk, but without the immediate tax consequences of a sale. Generally, the fund provides no or little yield, so need for income is one factor to consider. This strategy is be suited for long-term wealth transfer planning as you must remain in the fund for seven years to fully benefit from the tax free exchange.

Donate shares to a Charitable Trust.

If income is your goal rather than growth, you may consider transferring shares to a trust. If you have a highly appreciated stock, consider donating it to a charitable remainder trust (CRT). With a CRT, you receive a tax deduction when you make the contribution, and the trust can typically sell the stock without paying capital gains taxes, allowing it to then reinvest the proceeds to provide an income stream for you as the donor. When the trust is terminated, the charity retains the remaining assets. You can set a payout rate of 5% or more that meets both your financial objectives and philanthropic giving goals. Note that the donation is irrevocable.

Another trust donation option is a charitable lead trust (CLT), which in many ways is a mirror image of the CRTs described above. However, with a CLT, your chosen charitable organization receives the income stream for a specified time, while the remainder is provided to your beneficiaries.

There are costs associated with creating and maintaining trusts. With a CLT, you receive no tax deduction for transferring assets unless you name yourself the trust's owner, in which case you will pay taxes on the annual income.

Another philanthropic option is donating directly to a charity or private foundation and taking a tax deduction.

Timing is perhaps one of the most important considerations when dealing with a large stock holding. Hedging, and some of the strategies within, may be most suitable in the short term or if you're facing selling restrictions. Other strategies like contributing your shares to an exchange fund or donating to a trust may be more suitable and cost-effective over a longer time period, although your charitable intentions play an important role.

Managing a concentrated stock position is a complex task that involves investment, tax and legal issues. The right financial professional can help you navigate the maze.

For more information, please contact your Key Private Bank Advisor.

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