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There is a sense of confusion among practitioners on just what can and can't be done to hedge and monetize a low-cost-basis stock without triggering a taxable sale. Investors can still hedge and monetize without concern for triggering a sale, though the task is more difficult than it needs to be. Hedging was fairly straightforward until 1997, when the constructive sale rules (IRC Section 1259) were enacted. The constructive sale rules force owners of low-basis shares to retain some upside *or* downside when hedging. Before these rules a perfect hedge was permissible, before 1997 we recommended a short-against-the-box, others advocated equity swaps, and others deep-in-the money calls (all would now trigger a gain under IRC Section 1259).

Slicing and dicing the payoff possibilities of a stock is best accomplished by using options on those shares. Investors who purchase a put effectively purchase a floor, or minimum price, at which the shares could be sold. If an investor contemplates buying a put and is concerned with triggering gain, the put must be at the money or below the current price. An in-the-money put could be troublesome if 1) it is so deep in the money to assure exercise or 2) the put is coupled with the sale of a call that would not allow enough "upside" potential.

"Enough" possibility for profit *or* loss is the first concept where confusion may exist. The government after passing Section 1259 was to write regulations that would guide investors in this endeavor. It's been over 10 years, and there have been no regulations released. We are in touch with two ex-government employees who wrote regs, but neither's work has seen the light of day.

Historically, we've relied on language in the Committee Reports (commonly called the Blue Book) relating to IRC Section 1259. As chairman of the SIA's Tax Policy Committee I testified to Congress on this issue and thus looked at the Committee Reports very closely. IRC Section 1259 does not tell investors what they can do, only that the potential for profit or loss cannot be so de-minimis to be "abusive." The Committee Reports however discuss what Congress considered an "average" collar. This "average" collar had a put purchased with a strike price equal to 95% of the current market price and a call option sold with a strike price equal to 110% of the current market price of the shares. We've felt that what is "average" can't at the same time be abusive, so this 15% band has been our operating minimum for retained profit or loss. Of course, this 15% band must include the current market price but it could be a 100 put with a 115 call or even an 85 put with a 100 call.

Some confusion persists because the NY State Bar issued a paper where they suggested a 20% band if the government were to write regulations. The members of the NY State Bar are the very same attorneys that advise the derivative dealers, so it is not uncommon to find that many dealers think a 20% band is the law. There is no law—only tealeaves. We still believe a 15% band is sufficient. If a collar is for an extended period of time (more than 5 years) maybe a wider band would be appropriate. We have executed collars with maturities of more than 10 years, and the investor used a band of 50% to be "safe."

This brings us to the Anshutz case currently in Tax Court, where the taxpayer is being told that they created a sale when utilizing Wall Street's favorite hedging/monetization device the pre-paid variable forward contract (PPVF). A PPVF combines a put, a call, and a borrowing all into one piece of paper. The government has consistently "picked at" PPVFs, and with the Anshutz case the gloves have come off. First there was a 1999 Field Service Advice that ruled against a PPVF. An article in *Derivatives Report* observed that "while many practitioners believe that this FSA has reached an incorrect conclusion, investors should take pause before entering into a prepaid forward contract involving appreciated securities."[1]

Next, on March 16, 2001, came Field Service Advice 200111011. This FSA deals with a transaction that occurred in 1995, two years prior to the enactment of the constructive sale rules, in which the FSA found that there was a sale under Common Law. "The IRS concluded that the investor was required to recognize gain upon entering into the transaction. The IRS's rationale was that the benefits and burdens of ownership of the underlying shares had shifted to the purchasers of the instrument. Even though the investor retained the right to vote and receive dividends paid with respect to the stock and had the right to substitute collateral for the underlying shares. "Many advisors felt at the time that if and when the IRS National Office really looked seriously at one of these transactions in a two sided process such as a TAM, the result and the reasoning of the FSA would be repudiated."[2]

As Mr. Maddrey predicted, the two FSAs were contradicted (and overruled) by Revenue Ruling 2003-7. However, an IRS official (Matt Stevens) subsequently threw cold water on the party by commenting that the ruling required a very specific set of facts and circumstances." The ruling emphasized that the shares were pledged to a third-party custodian, with the investor keeping the right to collect dividends, vote the shares, and substitute cash or other shares for the pledged shares. "The IRS was thought to have blessed the tax treatment of VRFCs in Rev. Rul. 2003-7… ."[3]

Technical Advice Memorandum 200341005 reiterated these conclusions (ironically this TAM was issued to the same taxpayer as in a 2006 TAM that turned the world upside-down again). Field Attorney Advice 20042305F confirmed again that a PPVF didn't trigger gain even though the PPVF in this FSA was a seven-year PPVF.

In January of 2006 Wall Street was shocked by TAM200604033. This TAM concludes a PPVF did trigger gain under Common Law not the Constructive Sale rule. The TAM states that the customer was willing to accept certain conditions that, combined, caused the government to call the position a sale under common law because it was "one whole continuous transaction." The client loaned their shares to the dealer to short; the reference price for the PPVF was the dealer's short sale price; the client was obligated to pay all dividends to the dealer and two of the three PPVFs had to be physically settled by delivering shares (they could not be cash-settled). These and other indicia of the contract combined to cause the problem. Although the TAM throws cold water on PPVFs, we are advised that gain can be avoided by executing the hedge avoiding these trouble spots. The case is in Tax Court and should prove illuminating when decided.

We advise the use of simple puts and calls, listed on an exchange (preferably) to put these issues to rest. A loan can then be made against this collared position, usually limited to the amount of money preserved if the put had to be exercised. A collar with a 90% put should support a 90% loan under the recent portfolio margin rules.[4] Before these rules investors were limited as to either what purpose the borrowed funds could be used for or how much money could be borrowed.

Unbundling a PPVF in this manner has many attributes favorable to investors:

1. An AAA rated counterparty in the Options Clearing Corporation.
2. Full transparency of option prices and borrowing costs.
3. Deductible interest expense for those who purchased their shares before 1984.
4. Avoiding all the "bad" facts in TAM200604033.

Let's deal with each of these separately. When a client enters into a PPVF, they are taking on the counterparty risk of the executing dealer. I must admit we had a few very uncomfortable days as Bear Stearns was having its troubles. Luckily, our clients who executed with Bear now have JP Morgan as their counterparty. It didn't have to turn out that way.

The Options Clearing Corporation, an AAA rated entity, guarantees listed options. Listed options also can be closed out with anyone on the floor of the exchange who wants to trade; versus an OTC derivative where you have to "beg your way out of the trade" with your counterparty. This OTC unwinding usually is not difficult but there have been times we have been very disappointed in the dealer's proposed unwind prices. The transparency of listed options is also very user-friendly. Clients can see continuous pricing of their options and will also know the interest rate charged in monetizing.

The straddle rules put into effect in 1984 only apply to positions established after 1984. Since only the hedge will be put on after 1984, we are advised that the straddle rules should not apply to stock purchased before December 31, 1983. There are two major consequences of the straddle rules: 1) under IRC Section 263(G) interest incurred in carrying a straddle is not currently deductible, but must be capitalized into the client's cost basis and 2) any losses on closing any legs of the straddle are deferred until all legs of the straddle are closed.

Clients who purchased shares before 1984 are throwing away a potential current interest expense deduction when utilizing a PPVF. Alternatively, clients with post-84 stock are not losing out using a PPVF as it relates to deducting interest expense. A PPVF automatically builds the interest cost into its price. Unfortunately, for those holding positions until death (and thus the forgiveness of gains through the step-up in basis) there is *never* a benefit from being able to deduct the interest/carrying costs.

The second penalty of the straddle rule relating to the forced deferral of losses when closing losing positions can be quite damaging. Let's assume a client executes a zero-cost collar, selling a call for $8 and buying a put for $8. If at expiration the stock is within the band created by the put and call, both options expire worthless. Although no one is surprised that the $8 realized from the call sale is taxable as a short-term gain, many investors are shocked to learn that the $8 cost on the put is not currently deductible. Although the client received no money for the zero-cost collar, they are now to pay tax on an $8 phantom gain.

Investors purchasing shares before 1984 should not worry about this. Investors with post-1984 stock should try to avoid this trap. Here, we suggest the use of an OTC derivative that combines the put and call into one contract. At inception the investor will enter into this one contract and receive no money, but if this combined collar expires worthless there should be no tax to pay.

The last tax issue to contend with is what I'd have to call a "hidden" cost of hedging a dividend—paying stock. Most investors are aware that to qualify for the reduced 15% tax on dividends a 61-day holding period is required. What most investors aren't aware of is that every record date is tested for a proper 61-day holding period. The holding of a put (whether outright or built into a PPVF or zero-cost contract) destroys the dividend-holding period. The confusion persists because investors receive 1099 statements stating that the dividend is qualified. This 1099 is only telling investors that the dividend comes out of earnings and profits and could possibly be available to the lower 15% rate. The broker is not responsible for policing this; the investor is to make their own determination of whether the 15% tax rate should apply beyond the information on the 1099 form.

A hedging/monetization strategy that could allow for both interest expense deductions for post-1984 stock and a re-qualification of the dividend is borrowing through a non-recourse loan (NRL). Traditionally used in real estate, an NRL is a loan where the borrower can walk away from the loan leaving the lender with only the collateral left with the lender and no recourse to "chase" the borrower for any shortfall (unlike a traditional margin loan). We are advised that although the ability to walk away is in itself a measure of protection, it does not affect the holding period of the stock nor cause a straddle. Therefore, for those with post-1984 stock, or those holding high dividend paying shares, the NRL should be ideal. Here caution should be exercised; there have been NRL lenders that disposed of the client's shares. Take care that the lender holds the hedged shares and does not pledge them or lend them, which would make the dividend received not a true dividend available for the 15% tax but instead an in-lieu payment from the borrower of the shares that should be taxed at 35%.

Investors wishing to replicate PPVF economics would not only borrow through an NRL but could also sell a call conforming to how much upside they wished to keep. These calls should be "qualified" covered calls (QCCs). QCCs are calls that are for terms of no less than 30 days nor can they have a term of more than 33 months.[5] The calls must be out-of-the-money with calls exceeding 12 months having an ever-escalating definition of what is in the money.[6] A call with a strike price of 105 would be allowed on a 100 stock if the call matured within 12 months, the same 105 call would cause a problem if the call matured more than 12 months from when written. We have an online tool at http://www.twenty-first. com/qcc/price.htm to help investors determine what call can be sold without "blowing" the dividend holding period.

Although it seems daunting, hedging and monetization can still be safely executed without negative tax concerns if investors are careful to avoid the traps that are possible in such an endeavor. Investors executing PPVFs should not lend their shares to the counterparty, unless the Anschutz case (related to TAM200604033) is decided favorably (as many expect). Investors who purchased their shares before 1984 should use options and borrowing to preserve current interest deductions (now that the limits on borrowing have been lifted). Those with shares purchased after December 31, 1983, should be aware of the straddle rules and use one-contract collars when creating a zero-cost collar. Those post-1983 investors wishing to monetize should explore the use of a non-recourse loan to preserve current interest deductibility. Investors wishing to hedge and monetize high dividend paying shares should also explore an NRL in order to preserve the 15% tax on dividends.

It's not how we did it in the last century but it can be done.

ENDNOTES

[1]Robert Gordon and Mark Fichtenbaum, "Practitioners Are Concerned About Proposed Regulations on Exempt Qualified Covered Call Options, Interest and Expense Capitalization," *Derivatives Report*, Warren, Gorham & Lamont, January 2001.

[2]Jeffrey Maddrey, "Respect for Form: Securities Loans and Hedged Positions in Fungible Stock," Pricewaterhouse-Coopers LLP, February 22, 2007.

[3]Jeffrey L. Rubinger, "Taxation of Variable Prepaid Forward Contracts Uncertain (Once Again) in Light of Recent TAM," *Journal of Taxation*, May 2006.

[4]Effective August 1, 2008, the portfolio margin pilot program in NASD Rule 2520(g) and Incorporated NYSE Rule 431(g) became permanent.

[5]Regulations issued April 26, 2002.

[6]The American Jobs Creation Act of 2004.