

Protecting Appreciation in Taxable Investment Securities and Portfolios with Hedging Strategies

A Complete Thought Process for Investment Advisors and Trustees

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Hedge—A conservative strategy used to limit investment loss by effecting a transaction that offsets an existing position.¹

Despite the price declines of many U.S. stocks over the last few years, many individuals and trusts have highly appreciated securities in their taxable portfolios due to the strong rise in stock valuations over the last 20 years.² These stocks may be a large percentage of the overall portfolio (concentrated positions) or low percentage holdings worth large amounts.

While this level of appreciation is wonderful for the owners or trust beneficiaries, it needs to be carefully monitored and protected. For investment advisors and trustees that have full, discretionary management power over taxable portfolios, the exact nature of the duty to protect appreciated securities and portfolios is unclear but bound to be a growing point of interest, contention, and litigation,³ given the level of appreciation for many investment portfolios.

There are a variety of factors to consider with the issues of diversification and preservation of appreciated securities. Consequently, the duty to diversify and preserve or hedge against declines in asset values is almost always a facts-and-circumstances evaluation on a case-by-case basis. Yet there is a growing school of thought that investment advisors and trustees may now have a duty to understand the use of applicable hedging techniques.⁴ Once hedging techniques are understood, they can be

rationally discarded or implemented so as to achieve the most appropriate mix of risk and return for clients and trust beneficiaries.

The purpose of this article is to explain the primary hedging strategies which are the most straightforward and conservative, and provide situational uses, within the context of the professional duties of the investment advisor and trustee. As part of the analysis, a review of the tax aspects of hedging strategies is very important because tax savings are one of the primary benefits of hedging strategies.

PROTECTING APPRECIATED SECURITIES MAY REQUIRE QUICK DECISIONS

In most situations, protecting portfolio appreciation can be accomplished in a measured and well-reasoned process after a thorough examination of all relevant facts. Yet more recently, large declines in value are occurring without adequate time to fully unpack the reliable information and sort through the rumors and untruths, while awaiting the release of the true facts. While non-taxable accounts can sell without concern over taxes, clients with highly appreciated positions may be well served by hedging strategies which permit time to evaluate, and possibly hold with no gain, or sell at a later date.

Three companies are good representations of the rapid declines in value that occur without fully knowing whether the declines are justified: Cendant, Tyco, and Enron.

Cendant

In the case of Cendant, what started as a substantial stock decline over the company's own investigation into accounting irregularities at a business unit acquired by merger, turned into a full SEC inquiry, revelations of massive fraud, and a significant, sustained stock decline. Yet during the company's internal investigation, the stock recovered 45% of its initial loss. This recovery provided an opportunity to hedge against further losses until all the facts were in, at which point the stock declined 80% from its pre-accounting problem level.

Tyco International

In Tyco's case, it has two very similar periods of time during which confusion reigned supreme during large fluctuations in stock price. In 2000, Tyco dropped significantly over alleged accounting and financial reporting violations. The stock dropped sharply. The SEC investigated and found no major financial reporting concerns. The stock fully recovered. A sale of an appreciated Tyco holding during the downturn would have been unwise, from a pure return standpoint. During 2002, similar concerns have been raised again about Tyco's accounting and possible financial impropriety (personal and corporate) by senior management. The stock has declined by more than 80% without any clarity on whether the concerns have any validity in fact.

Enron

Enron needs no introduction. From the time of the CEO's resignation in August 2001 to disclosure of large, unexpected losses in October 2001, the stock still had substantial value. Many individuals still had very large positions with low cost basis. Again, hedging strategies could have been a suitable risk management device during this period of uncertainty, although the sell decision proved to be the right decision in hindsight.⁵ Regardless of the decision to sell or to hedge, the decision had to be made fairly quickly. In the end, those investors and fiduciaries that did nothing to sell or hedge lost big on Enron. One prominent family that has a family member on the Enron board and would know more accurate information than any outsider stands to lose hundreds of millions or more from the Enron collapse.⁶

In all three cases, time did not permit a measured analysis before large losses occurred. To sell the position

early on may have triggered substantial capital gains without knowing whether the concerns were justified.

ANALYSIS OF HEDGING STRATEGIES TO MITIGATE EXCESS RISK

This article addresses the rationale for considering hedging strategies to reduce undesired risk for taxable portfolios, including trusts. When the facts and circumstances lead to the decision of protecting appreciation and minimizing risk, the advisor and/or fiduciary should look beyond the straightforward sale decision and ask whether other hedging strategies should be considered. Our purpose in this article is to allow that question to be analyzed effectively, with a clear presentation of the applicable situations, tax and non-tax issues, and potential outcomes that should be considered.

THE DUTY TO DIVERSIFY AND HEDGE AGAINST DECLINES IN VALUE

While the duty to diversify and hedge appreciated or concentrated holdings is not the focus of this article, it is worth noting that investment advisors and trustees that have discretionary authority are subject to standards of conduct on these issues. The prudent investor rule, which was birthed from the Restatement (Third) of Trusts, contains clear mandates to diversify trust holdings unless other countervailing factors outweigh the benefits of diversification.⁷ It is a rebuttable presumption that diversification of trust assets is more prudent than holding concentrated positions, whether the assets be stocks, bonds, real estate, tangible personal property, or private held corporate interests. Many states have adopted similar statutes to the Restatement and its position on diversification and prudent investing.

While the prudent investor rule and its variations are specifically designed for trust situations, there is little doubt that the same analysis and standards are worthy of attention by investment advisors that are serving individual investors, whether or not a fiduciary relationship exists. In an important opinion involving a private investor (not a trust), an independent investment advisor/trust company, and a concentrated position in one appreciated security, the Plaintiff-investor based his claim of damages on many of the same standards contained in the prudent investor rule.

In the Levy case,⁸ the Plaintiff received stock in Corning, Inc. through a stock merger with his privately owned company. The Corning stock represented \$8 mil-

lion in value but was restricted from sale for one year. The Plaintiff claims that on several occasions he made it very clear to the Defendant, an investment advisor and trust company, that he desired for his Corning stock to be protected from a decline in value during the restriction period, if possible. The Plaintiff later learned from another investment firm that hedging the restricted stock was possible and the Plaintiff implemented a hedging strategy (using a combination of put options and call options to provide a floor and ceiling value on the stock) with another investment firm, but only after suffering losses in Corning stock prior to the time the new hedge was placed into effect. The Plaintiff alleged that the Defendant failed to provide any such services and suggested that hedging the downside risk of the restricted stock was not possible. The case settled prior to trial.

Not only is the duty to diversify a necessary standard to evaluate, there is a growing persuasion that in making the diversification decision all reasonable methods of diversification should be considered. Given the widespread use of hedging techniques by pension plans, corporations, corporate executives, and mutual funds, the use of put options, short sales, collars, and other hedges is no longer unusual. The duty to use such techniques is dependent on the situation presented, but the failure to consider such techniques is a dangerous position for any investment advisor or trustee. As fiduciary expert George Crawford says:

This tool [hedging strategies] is now so widely used that it should be in every fiduciary's tool kit, even if used only carefully and sparingly. Like any other tool, it can be used, or misused.⁹

There does need to be better information about practical hedging tools or else most investment advisors and trustees will not even consider the tools, no matter how useful they may be. Most investment advisors and trustees have a working knowledge of some hedging strategies in a conceptual sense, but do not have a complete framework for evaluating all reasonable uses of hedging that can lead to actual implementation of appreciation protection techniques. This framework must be pre-established and able to be pulled of the shelf and applied in quick order as in the case of Cendant, Tyco, and Enron, or in the case of developing economic or political turmoil. While many large investment firms will be pleased to provide hedging counsel for large positions (\$3 to \$5 million at a minimum with significant costs), many advisors have clients under that asset size.

The legal analysis of whether a duty to diversify and/or hedge appreciated securities is an important threshold legal question which is outside the scope of our analysis. However, that legal question would also seem to be dependent on knowing the tax and economic consequences of the methods of diversifying, not just an academic explanation of hedging techniques in a vacuum.¹⁰ The purpose of this article is to harness the complexity of certain hedging techniques, including tax issues, into usable form so that the legal duty to diversify and/or hedge can be prudently evaluated. In doing so, we suggest that a few basic hedging techniques are most likely all that is needed to cover most of the undesired risk.

THE SIMPLE SALE COMPARED TO HEDGING STRATEGIES

We fully expect that in most situations a sale is the best decision when it is necessary to further diversify a security or asset class. Offsetting capital gains with capital losses helps make the sell decision the preferred method of protecting appreciation. But over time, the unrealized gains in an equity portfolio should be much larger than the available unrealized losses.¹¹ While this is an excellent result for most clients and their investment advisors or trustees, it can be a difficult situation for investment advisors or trustees that inherit highly appreciated securities and portfolios from new clients. Often these gains are in stocks not recommended or followed by the trustee or investment advisor. In these cases, it is important to have an array of choices available to protect gains in various situations, unless an automatic sale is required for all securities not on a firm's approved stock list.¹²

Many state laws, uniform trust investment acts, and national regulatory agencies have concluded that hedging strategies are neither inherently prudent nor imprudent.¹³ Unfortunately, the use of hedging strategies for private investment portfolios and trusts is often neglected due to their perception as complex, risky assets. We wish to present an accurate view of hedging strategies and their possible use for taxable private portfolios. Many individuals such as David McCourt (see "Use of Hedging Strategies by Other Parties" below) can thank hedges for saving a substantial portion of their net worth.

BASIC OVERVIEW OF HEDGING STRATEGIES

There are as many hedging strategies possible as the creative mind can structure.¹⁴ Therein lies the legitimate concern that hedging strategies can be misused. Furthermore, advisors and fiduciaries might fear that their reputation could be tarnished by merely suggesting the consideration of a hedging strategy. Yet, once the basic strategies are understood, clients can be educated about their ability to minimize risk, not add risk, in appropriate situations. At their core, defensive hedging strategies transfer the risk of a price decline to another party. Given that appreciation rates for equities the last 20 years have been well above long-term averages, it would seem that clients and their advisors would be open to the concept of transferring price decline risk to others, if the strategies, including costs,¹⁵ are appropriate.

The Short Sale

A short sale strategy involves selling stock borrowed from a third party. Then after the stock declines in value, the stock is purchased on the open market at a lower price than the initial sales price. The purchased stock is returned to the third party and the difference between the initial sales price and subsequent purchase price is taxable profit to the short seller.

The short sale can involve stock of a company currently owned in the portfolio. This technique offers perfect correlation because there is a direct offset to declines in the stock and increase in the short sale technique. Often called “short against the box,” this hedging technique is fairly straightforward, but has negative tax implications (discussed later in the article) and is therefore no longer an effective hedging strategy.

Alternatively, the short sale can involve stock of a company in the same industry which has a close, but not perfect correlation to the stock which is being protected. An example of this technique might be a client or trust which owns a very significant holding in SBC Communications and sells short a similar amount of Verizon or BellSouth, all three being U.S. local telephone companies with growing wireless businesses. Yet any time that correlation is not absolute, the hedging strategy can go awry. It is impossible to hedge perfectly against fraud or massive liability which is specific to one company.

More recently, exchange-traded index and sector funds have been introduced which permit certain baskets

of stocks to be sold short. This can provide a more broadly diversified correlation, such as selling short the S&P Health Care sector to hedge against a large Merck position, or selling short a communications sector index to hedge against a large SBC position.

The Put Option

The purchase of a put option permits investors to limit the downside risk of a stock while retaining the opportunity for stock appreciation.¹⁶ A put option permits the purchaser of the put option to sell a certain number of shares at a pre-determined price (the “strike price”) within a pre-determined time frame. The primary advantages of a put option are:

- The investor retains the appreciation potential on the optioned stock.
- The investor’s maximum loss on the put option is the amount paid for the put option.
- No capital gains tax is triggered on the stock if the transaction is structured properly.

As with short sales, put options can be purchased on the stock which needs protecting (for direct price movement correlation), or can be purchased against a similar stock or index with fairly close correlation. Exhibit 1 illustrates how stock combined with a put option (solid line) can protect the stock from a decline of more than 5% while permitting full appreciation, whereas the stock alone (dashed line) has full downside and upside potential.

EXHIBIT 1
Put Purchased Against Stock

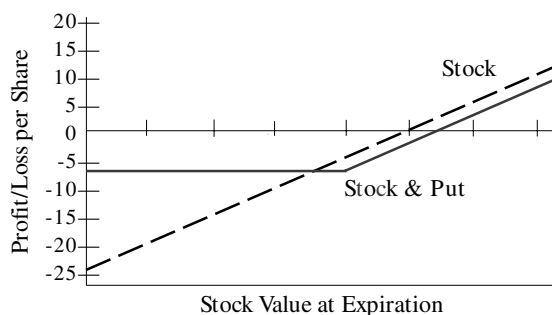
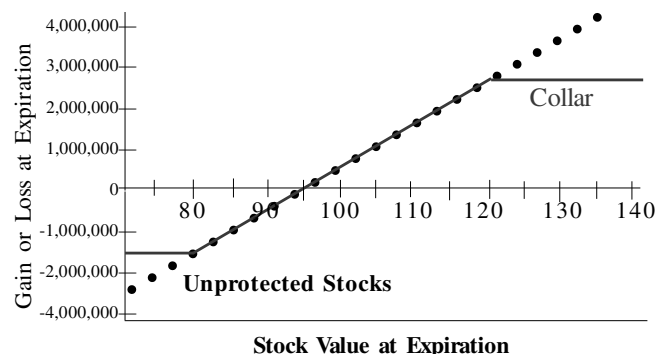


EXHIBIT 2

Protective Collar Using Equity Options



The Collar

A collar involves the purchase of a put option to protect against stock price declines combined with the sale of a call option. As described previously, the put option is structured to limit a price decline according to pre-negotiated terms for a cost, or a premium. By selling a call option, the investor sells to a third party the right to purchase the optioned stock according to pre-negotiated terms, usually with a corresponding expiration date to the put option. The investor gives up the stock appreciation above a certain price but receives a premium in return, which can offset the cost of purchasing the put option. If the premium received from selling the call option completely covers the cost of the put option the net cost of the entire hedge is zero, otherwise called a “cashless” or “zero cost” collar.

As shown in Exhibit 2, the collar (solid line) shows a floating value for the hedged stock, with a limit on the upside and downside even though the unprotected stock price (indicated by the dotted line) can proceed higher or lower than the collar limits.

Collars can be placed on the appreciated stock for exact correlation, but there are some tax issues to consider with collars. The tax issues applicable to collars, and other basic hedge techniques, are discussed later in this article.

SITUATIONS THAT LEND THEMSELVES TO USING HEDGING STRATEGIES TO REDUCE RISK

The key question is why not simply sell a security rather than use a hedge strategy to protect the appreciation of a security or overall portfolio? While there are

many reasons to consider the use of hedging strategies, the primary ones include:

- A client (which may be an individual or a private trust) is uncomfortable with a large percentage of value in a single stock but does not wish to sell and trigger capital gains taxes at the present time.
- A client has a large holding that is facing a potentially substantial decline, but that likelihood is not certain. The holding may continue to appreciate. Time is needed to make a good decision. A hedge may provide time with no adverse tax consequence.
- A client may own a large position in a stock which has trading restrictions due to IPO lock-up provisions, or trading restrictions imposed by the government and/or the company due to insider status or other factors.
- An individual with a short life expectancy due to advanced age or illness may wish to protect against a decrease in stock or equity portfolio value, but does not wish to sell when the appreciated positions would receive a step-up in basis at death.
- An individual may be in need of liquidity for a new home purchase or income but does not wish to trigger capital gains taxes. By entering into a hedge strategy, the minimum value of the appreciated position can be fixed, providing an asset that can serve as collateral for loans.
- A client has significant over-ownership in a certain industry sector comprised of all highly appreciated holdings.
- A trust faces large alimony payments or fixed settlements to a surviving ex-spouse of a deceased grantor for a long period of time and may wish to fix the value of a certain portion of trust assets.
- A trust is required to hold real estate for a beneficiary to live in but the real estate expenses have become larger than anticipated over time, requiring the equity portion of the trust to become a very important source of funds to support the real estate.
- A trust may have common beneficiaries with another trust which holds valuable, but currently illiquid property. Rather than have the illiquid trust sell assets at depressed prices, the two trusts may enter into a lending arrangement on arm's-length terms. Yet the lending trust may need to preserve equity values to honor other trust distribution requirements it may have to its own beneficiaries.

- The trust values may have appreciated so strongly over the past several years that it may be wise to hedge against a downturn in values. Yet the trust may be a marital trust receiving a step-up in basis upon the death of the spousal beneficiary who has a short life expectancy.¹⁷ Or the trustees may simply be looking for more tax-efficient ways to protect against a perceived risk of short-term equity declines (i.e., a one- to two-year bear market).

REASONS HEDGING STRATEGIES ARE NOT CONSIDERED AS A RISK MANAGEMENT TOOL

It is our assumption that many advisors to clients and trusts with taxable portfolios do not consider hedging strategies for several reasons. There is the required time commitment, the complexity of the issue, and the fear of what other people, including the client or other advisors, might think of the advisor that recommends consideration of hedging strategies (i.e., reputation risk).¹⁸ However, ignorance and inaccurate perceptions (which themselves are often based on ignorance) should not be the reason to decline examining a legitimate risk management tool. The primary purpose of this article is to allow advisors to make informed decisions on hedging strategies as a risk management tool. After all, giving in to ignorant fear about hedging rather than evaluating their usefulness on the merits is not in the best interest of the client and is not the course an independent, critically thinking advisor should take.

Even if hedging strategies are given some consideration, there are several reasons why they may not receive serious consideration as a valid risk management tool:

Management of Positions

If there is only one hedging strategy in a portfolio, the oversight of that position is manageable. However, if multiple hedge positions are required to adequately manage the risk (which is quite unlikely), management of these positions becomes dramatically more complex. Tracking option strike dates, strike prices, tax dates, and tax issues could become so time consuming and fraught with execution risk that the benefits of a hedge strategy could become outweighed by the potential costs (both hard dollar costs and soft dollar costs, such as time and anxiety). It is doubtful that multiple hedges would be used for a client or trust, so management of hedged positions should not be overwhelming.

Complexity of Tax Issues

One could argue that complexity is in the eye of the beholder, but most knowledgeable advisors would agree that hedging strategies involve complex tax issues. Hedges are an uncommon occurrence and therefore not a focus for most investment advisors or trustees whose primary duty is to achieve the highest investment performance consistent with the risk required to be undertaken. In many larger firms (such as Merrill Lynch, Goldman Sachs, PaineWebber, and Morgan Stanley), there are hedging specialists who can be called upon to provide highly customized advice, with a full understanding of tax issues. Therefore, the relationship manager of the client need only know when to spot the risk management issue, and then call in the specialists for customized assistance with hedging. However, large firms normally consult and engage in cases where the security or portfolio amount to be protected is in excess of several million dollars.

Liability Concerns

Obviously, no well-run investment firm or trust company should allow its professionals to implement sophisticated hedging strategies that they are not qualified to implement or monitor. For this reason, most firms will shy away from being actively involved in hedge-based risk management techniques. The firm should, however, be able to identify situations where hedges might be useful, yet final recommendations and implementation can be left to attorneys, accountants, and highly specialized experts. An equally important concern should be failure to identify and discuss with clients concerns about protecting appreciated positions in a way which satisfies the client's tolerance for risk.

As Enron has shown, time is often not a friend in protecting large gains in securities or overall portfolios. Therefore, firms that can have a good working knowledge and ability to implement quickly a hedge-based risk management strategy, if appropriate, without causing large tax consequences, may be providing an extremely valuable service to the client.

Other Reasons Hedging Strategies Are Not Considered

There are several other reasons why hedging strategies might not be considered as a viable risk management tool in protecting appreciated securities or portfolios. The

underlying trust document might restrict the use of options and short selling. The investment guidelines of a corporate trustee might prohibit certain hedging strategies. The client might not be sophisticated enough to make an informed decision if presented with a hedging strategy. Professional advisors might balk at any consideration of a hedging strategy due to their complexity, perceived risk, or the professional stigma which might result from recommending hedging strategies (i.e., reputation risk).¹⁹ Yet the client is best served if given the opportunity to decline suitable hedging strategies, rather than never having such opportunities presented.²⁰

THE DUTY TO UNDERSTAND AND CONSIDER HEDGING STRATEGIES

Hedging strategies are merely tools for managing risk; for protecting value, and for balancing assets against liabilities and future cash flows. Achieving realistic returns for clients without taking on undue risk is at the heart of what an investment advisor's or fiduciary's role is for clients. Yet failure to understand and consider various risk management strategies, including hedging, can be evidence that the investment advisor or fiduciary is failing in their role of managing risk.

An Indiana Court of Appeals case highlights the duty to consider hedging strategies. In this case, findings of breach of fiduciary duty against the Board of Directors of a commercial grain co-op were entered due to the Board's failure to consider hedging strategies to contain price risk. While the Board can normally rely on the business judgment rule (a less stringent standard than a fiduciary duty), the Court found that the business judgment rule applies only if the Directors "attain knowledge of the basic fundamentals of hedging..."²¹

If the business judgment rule cannot be relied upon without the defendants informing themselves of the material information necessary to make a business decision, it seems to be logical to assume that fiduciaries (who have a stricter standard) could be held to the same standard of informed decision making. In making the transition from *Brane* to the duty of investment advisors and fiduciaries with regard to hedging strategies, Randall H. Borkus summarizes the analysis well: "The importance of the *Brane* case is that the fiduciaries breached their duty to hedge when they failed to be reasonably informed about commonly used risk management strategies that were regularly implemented in the grain co-op business."²² "Moreover, the key to determining whether a breach has

occurred, regardless of the business sector, is whether fiduciaries have fulfilled their duty to be informed about available hedging and risk management strategies. This duty also includes a duty to delegate the hedging decision to knowledgeable individuals who can implement appropriate risk management strategies."²³

A complete lack of understanding or failure to even consider hedging strategies, when they may in fact be worthy of consideration, is fairly good evidence that the investment advisor or fiduciary is not carefully monitoring risk. Whether that rises to a breach of duty depends upon the facts of the case and the applicable law, and is beyond the scope of this article.

USE OF HEDGING STRATEGIES BY OTHER PARTIES

When considering a new investment idea, comfort can often be taken from other sophisticated businesses or individuals that have implemented the same idea with excellent results. We have selected two investors (one corporation and one individual) that have used hedging strategies to effectively manage risk. In both cases, the hedging strategies have achieved dramatic results. Both investors have a completely different future because of the tremendous wealth protection achieved by their hedging strategies.

Liberty Media

Liberty Media is run by legendary cable pioneer John Malone, who built up TCI Cable which was then sold to AT&T in 1998. Liberty Media is an independent, publicly traded company that, among other operations, owns nearly \$25 billion of marketable securities in other companies such as AOL, News Corp., Sprint PCS (through affiliates), Motorola, Viacom, Cendant, and several others. When Liberty Media determines that a publicly traded investment is not a strategic asset to the company, it has a history of hedging or protecting the value of the security with minimal tax impact. This hedged security can then be used as collateral to finance core business initiatives.

As of February 2002, Liberty Media hedged the marketable securities of nine companies. The hedges were accomplished with collars, with the downside protection paid for by forgoing potential upside appreciation. Exhibit 3 illustrates how Liberty Media has used options as a tax-efficient risk management tool, protecting nearly \$6.5 billion in value that would have been lost without the hedge.

EXHIBIT 3

Securities Hedged by Liberty Media

Hedged Company Stock	Percent Hedged (2)	Current Price (3)	Weighted Avg. Floor/Shr.	Weighted Avg. Ceiling/Shr.
AOL	34%	\$23.70	\$48	\$104
News Corp.	5%	22.40	38	81
Sprint PCS	87%	10.99	32	45
Motorola	100%	11.93	25	40
Viacom Class B	100%	37.46	54	54
Cendant	100%	15.35	19	33
Priceline	7%	4.08	37	92
GM Hughes (1)	100%	14.52	27	54
XM Satellite (1)	100%	11.59	29	51

(1) Shares held by LSAT LLC, which is owned 90% by Liberty Media.

(2) Includes costless collars, put spread collars, senior exchangeable debentures, and variable share forwards as outlined in Liberty Media's press release dated November 13, 2001.

(3) As of February 5, 2002.

Every single hedge utilized by Liberty Media has resulted in substantial protection of value. Each stock is trading below the hedge floor while there is significant potential for appreciation before the stock values reach the ceiling. Our current calculations indicate the following savings in corporate value by entering into the hedging strategies.

Value of Current Holdings with Hedging Strategies \$19.0 Billion
 Value of Current Holdings without Hedging Strategies (12.5 Billion)
 Value Protected by Hedging Strategies \$ 6.5 Billion

These savings produced by Liberty Media's hedging strategies have been instrumental in permitting the company to pursue its business plan. Liberty admits it takes a substantial commitment of professional resources (i.e., intelligent financial and legal advisors) to adequately plan and carry out its strategies, but the results have been well worth it.

David McCourt—MFS WorldCom

In 1996, MFS was acquired by WorldCom in a \$12 billion all-stock, tax-free merger. David McCourt, who is now CEO of RCN, a publicly traded cable/telephone company, was a large investor in MFS and sat on the MFS Board of Directors. Prior to hedging his stock in the new

MFS WorldCom, his 812,000 shares were valued at roughly \$25 million. McCourt was acquainted with the management of WorldCom but did not know them well enough to place a substantial portion of his net worth at risk depending on their success in running WorldCom. As a previously cited investment company president has put it in facing the same situation, "today we have all our eggs in one basket, but we own the basket; if we take your stock, we'd still be all in one basket, but you'd own the basket, and that's an enormous difference!"²⁴

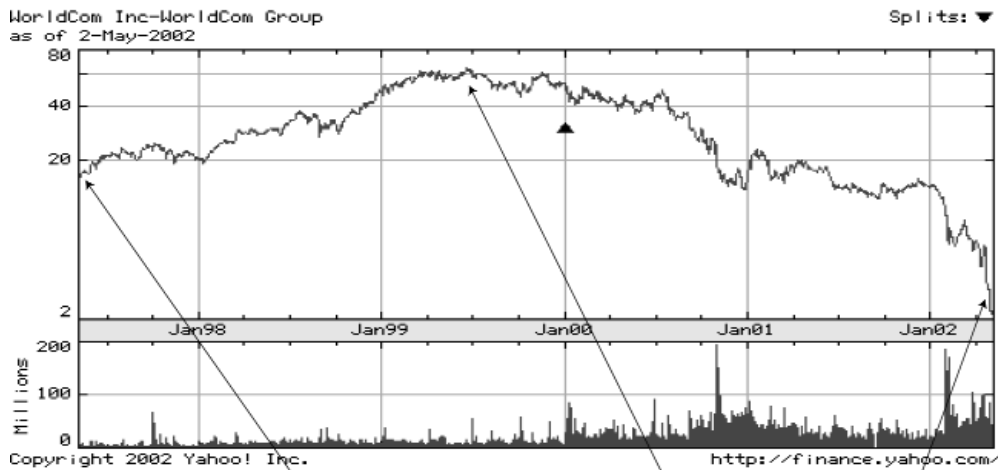
McCourt had a similar view. "I wanted to protect my holding because when you sell something for stock, and you don't know the people, it's a smart way to management the investment."²⁵

McCourt protected his \$25 million position in MFS WorldCom buy entering into a "cashless collar." McCourt sold call options which obligated him to sell his 812,308 shares at \$64 per share, giving up any appreciation above that price for a period of five years from the option date of June 19, 1997. McCourt used the funds received from that transaction to purchase put options which gave him the right to sell his shares at \$28 per share, protecting himself from a decline in the share price below \$28 for a period of five years.

Therefore, McCourt's investment could fluctuate between \$28 and \$64 per share for five years, but no more or less. Put another way, his \$25 million in MFS World-

EXHIBIT 4

Five-Year Price History of WorldCom Stock



Date of Collar: June 19, 1997
Share Price: \$20.50 (\$31 if adjusted for 3 for 2 split)

300% Appreciation as of July 1999

90% decline as of June 2002

Com could fluctuate between \$22.75 million and \$52 million in value. He guaranteed the protection of 91% of his \$25 million investment while reserving the right to achieve just over 100% appreciation on his investment, but no more, for a five year period. Exhibit 4 shows how WorldCom appreciated nearly 300% after the collar strategy was implemented. As of June 2002 the stock declined so that it was worth only 10% of the original \$25 million in value as compared to the floor of the collar which was 91% of the original \$25 million in value. The hedge worked wonderfully for Mr. McCourt as evidenced by the dramatic decline in WorldCom stock the last few years.

Value of WorldCom Stock with Hedge	\$22.5 Million
Value of WorldCom Stock without Hedge	<u>2.5 Million</u>
Value Protected by Hedging Strategy	<u>\$20.0 Million</u>

In a bit of irony, McCourt went on to say that if he had known WorldCom management at the time of his hedge as well as he knew them a few months later, he would never have used options to protect his investment. Lucky for McCourt, he did not know them well and placed the hedge. While WorldCom stock had a very strong perfor-

mance up through 1999, making the option hedge look like a very unwise decision, the stock declined in 2000, 2001, and more so in 2002, making his hedge quite valuable.²⁶ In this case, as in the case of the Enron board member who has lost billions in family value, intimate knowledge of the business and management was of no benefit.

While both Liberty Media and David McCourt successfully protected the value of their stock holdings, those cases are symbolic of many clients or trusts that hold highly appreciated securities due to above-average stock appreciation or mergers. While Liberty's stock holdings are large in dollar amount, no one holding represented a majority of company value. They simply were large holdings that needed to be protected because the risk of loss would prevent Liberty Media from achieving its business goals. Conversely, McCourt's position in MFS WorldCom was a concentrated holding which likely represented a majority of McCourt's net worth. However, just because an appreciated holding does not represent a majority of value does not mean it is not worth hedging or protecting. It simply depends on the client's ability to accept long-term declines in value in relation to the client's anticipated goals and cash flow or liquidity needs in the future.

TAX ANALYSIS OF HEDGING STRATEGIES

Taxes are a key factor in evaluating how to most efficiently minimize risk in taxable portfolios. With a sale, the tax liability is easily calculated, using appropriate short-term and long-term capital gains rates, both state and federal, offset by other available capital losses. With hedging strategies the transaction costs, especially taxes, are less quantifiable because the final selling prices are not known since the final transaction price is not fixed. Therefore, for an advisor or fiduciary to properly understand and evaluate hedging strategies, taxes are a primary, if not threshold issue, and different scenarios and assumptions must be planned for as to final values.

For hedging strategies, there are two primary rules which govern taxation, the constructive sale rules and the straddle rules. The constructive sale rule governs whether initiation of the hedge is construed to be a sale of the hedged security and therefore a taxable event. The straddle rules govern the tax aspects of closing the hedge, including such issues as tolling or freezing capital gain holding periods, and capitalizing carrying costs of the hedge strategy. For most hedging strategies, the primary goal is to avoid the constructive sale treatment and the associated up-front tax recognition. If the negative aspects of the straddle rules can also be avoided, then the hedging strategy can be a much more tax-efficient strategy.

Constructive Sale Rules

The 1997 Tax Reform Act provides that certain transactions which attempt to neutralize gain and loss in a current stock holding are “constructive sales” which are a taxable event if entered into after June 8, 1997.²⁷ A constructive sale is a transaction in which the owner of an appreciated security enters into one of the following three transactions:

- a short sale of the same or substantially identical property
- an offsetting contract with respect to the same or substantially identical property
- a futures or forward contract to deliver the same or substantially identical property.²⁸

The term “substantially identical” is normally considered to be securities issued by the same issuer which are commercially identical in all major aspects including dividend provisions. Normally, securities issued by two differ-

ent issuers are not considered “substantially identical” unless, for example, the companies are merging and are days away from a merged close and the common stock of each company is trading as the same security.²⁹ Correlated pricing by the market is the key test for “substantially identical.”³⁰

Initiating a put option purchase is not a constructive sale. A put option which gives the put holder the right to sell stock at a pre-determined price and time should not be a constructive sale, even if the put option is for the same stock already owned by the put holder. Although final regulations have not been issued to clarify what is and is not a constructive sale, the committee report for the applicable 1997 Tax Reform Act code provisions provides some guidance. The committee report suggests that strategies that trigger constructive sale treatment are those that eliminate nearly all gain and loss.³¹ Because a put option only reduces some, but not all, of the loss, and reduces none of the gain, it should not be classified as a constructive sale. If the purchased put option is “deep in the money,” then the purchase of the put option could be a constructive sale or taxable event because such a put option is close to being a proxy for the stock itself.³²

A client can purchase a put option on appreciated stock without triggering a constructive sale. This hedging strategy is straightforward. The put option cost will depend on the terms of the put option, but a collar strategy could help offset the cost of the put purchase.

A short sale on stocks or indexes not otherwise owned is not a constructive sale. A short sale of a stock or stock index which is not otherwise owned by a client or trust is not a constructive sale because the shorted stock is not substantially identical. Therefore, selling short Verizon (which is not otherwise owned by the client) to hedge against a decline in a highly appreciated position in SBC Communications is not a constructive sale resulting in tax even though the stocks are in similar businesses. This is beneficial for avoiding the constructive sale rules, but a disadvantage in that the hedge may not work due to the lack of complete correlation.

Selling short a stock or stock index which is already owned is a constructive sale (except for a few limited exceptions for short-term short sales) which triggers tax. Therefore, selling short the same stock which needs to be hedged against is not a tax prudent hedging strategy.

The short sale of identical stock makes little sense as a hedge since it would be a constructive sale. The short sale of similar, but not identical stock, would not be a constructive sale, but does not offer perfect correlation. This strategy would seem to be less effective than the purchase of a put

EXHIBIT 5

Put Option Hedge Strategies—Constructive Sale Rules

Transaction Type	Example	Constructive Sale?
Put Option Purchased for Stock or Index Not Otherwise Owned	Purchase a Put Option on Verizon to Protect Against Decline in Large SBC Holding	No
Put Option Purchased for Stock or Index Already Owned	Purchase a Put Option on SBC to Protect Against Decline in Large SBC Holding	No

EXHIBIT 6

Short Sale Hedge Strategies—Constructive Sale Rules

Transaction Type	Example	Constructive Sale?
Sell Short a Stock or Index Not Otherwise Owned	Sell Short Verizon to Protect Against Decline in Large SBC Holding	No
Sell Short a Stock or Index Already Owned	Sell Short SBC to Protect Against Decline in Large SBC Holding	Yes

option on the appreciated stock which offers perfect correlation and with no constructive sale. However, put options are less flexible as to their time horizon whereas shorted stock of a similar but not identical stock can permit long-term hedging without the put option time constraints.

Initiating a non-abusive collar should not be a constructive sale or taxable event. A collar which provides for some loss and some gain should not be considered a constructive sale unless it comes too close to freezing the value of the stock within a relatively tight range (an “abusive collar”). Collars are not likely to be considered abusive if the term of the transaction is three years or less and the differ-

ence between the floor and ceiling price of the collar is at least 20%.³³ The congressional committee report seems to suggest that collars that are not abusive will be grandfathered under the final regulations.³⁴ The Internal Revenue Service has not issued final regulations covering constructive sales, so any hedge which attempts to control both gain and loss, like a collar, must be evaluated with caution.

There are other exemptions from the constructive sale rule, such as short-term hedges relating to shorting the same stock, but for most situations the put option, the short sale against a similar but different stock or index, and the collar are the most often used hedging techniques.

Straddle Rules

When an investor owns an appreciated security and seeks to protect the value of that security with a hedge, avoidance of the constructive sales rules is the threshold tax issue. The second tax issue is whether the hedge is a straddle. For most hedging strategies, the primary goal is to avoid constructive sale treatment and the associated requirement to recognize gain if a constructive sale is deemed to have occurred (even if an actual sale has not occurred). If a hedge is a straddle, numerous tax implications arise with respect to closing out the hedge, as discussed later in this article. The tax impact of a straddle is usually much less onerous than a

constructive sale, but the straddle rules are nonetheless a very important tax factor with hedges.

Straddles defined. A straddle is defined by the Internal Revenue Code as “offsetting positions with respect to personal property.”³⁵ A straddle can be viewed as a teeter-totter. The original stock is on one side and the offsetting position is stock or some other security on the other side. Offsetting positions generally include any transaction which is intended to substantially limit risk of loss to one position.³⁶ Therefore, if a client shorts a stock or buys a put option, that position goes on the other side of the teeter-totter. The next issue is whether the new security

EXHIBIT 7 Various Hedge Strategies—Tax Implications

Transaction Type	Example	Straddle?/ Constructive Sale?
Sell Short a <i>Substantially Similar</i> Stock Not Otherwise Owned	Sell Short Verizon Stock to Protect Against Decline in Large SBC Holding	No/No
Sell Short a Stock Already Owned	Sell Short SBC to Protect Against Decline in Large SBC Holding	Yes/Yes
Purchase a Put Option on <i>Substantially Similar</i> Stock Not Otherwise Owned	Purchase a Put Option on Verizon to Protect Against Decline in Large SBC Holding	Yes/No
Purchase a Put Option on Stock Already Owned	Purchase a Put Option on SBC to Protect Against Decline in Large SBC Holding	Yes/No
Non-Abusive Collar on Stock Already Owned (i.e., Collar does not hold value in very tight range)	Purchase Put Option and Sell Call Option on SBC to Limit Value to a Range	Yes/No

is intended to offset the risk of a decline in the value of the original stock, and if so, it is likely a straddle unless it fits into an exception.

In evaluating if the offsetting positions meet the facts and circumstances test of “intent to substantially limit risk of loss,” the Internal Revenue Code provides several tests which, if met, result in a rebuttable presumption that a straddle exists.³⁷ These rebuttable presumptions assume a straddle if the hedge involves the same security as the protected security, even if in substantially different form.³⁸ These tests also presume a straddle if the hedge is sold or marketed as an offsetting position (regardless of the name used).³⁹ But, as part of these tests, there is a requirement that there be an inverse relationship in valuation changes between the offsetting positions.⁴⁰ The net effect of these rules is that nearly any attempted hedge is likely to fall within the targeted scope of the straddle rules.

To summarize the basic straddle rules:⁴¹

- A straddle occurs when an investor owns stock and then enters into an offsetting position such as:
 - An option on such stock or substantially identical stock.
 - A position with respect to substantially similar or related property (not including stock). Property is substantially similar or related to stock when the fair market value of the offsetting positions primarily reflect the performance of:
 - A single firm, or
 - The same industry, or
 - The same economic factors such as interest rates, commodity prices, or foreign currency rates (by way of illustration and not limitation).
 - Furthermore, changes in fair market value of the offsetting positions are reasonably expected to move inversely, whether as a fraction or multiple of each other.

In other words, if appreciated stock is on one side of the teeter-totter, then a put option on the same stock or substantially similar stock on the other side of the teeter-totter is a straddle.

- A straddle does not appear to exist with an offsetting position in substantially similar stock.⁴² This is similar to what former Enron CEO Skilling did when he sold short AES in August 2001 while owning Enron stock.⁴³

- Very importantly, stock acquired prior to January 1, 1984, is not subject to the straddle rules.⁴⁴ Assuming most of the highest gain stocks in a portfolio are long-term holdings, many positions that may need to be hedged might be pre-1984 stock. For these stocks, puts can be purchased against stock positions with identical correlation and protection, yet without adverse tax implications under either the constructive sale or straddle rules.

There are many other hedge strategies that have straddle implications, including selling short or buying puts on an index fund (either broad based or by sector). These strategies have additional complexity, but can offer higher correlation than hedge strategies on one other stock in the same industry as the appreciated stock.⁴⁵

Straddle rule tax implications on closing the straddle.

If a straddle does exist, the tax implications primarily relate to the closing of the offsetting positions.

- There is a suspension of the capital gain holding periods during the time of the offsets.⁴⁶ Therefore, put options or other similar offsetting positions stay short-term in nature since they are prevented from becoming long-term by the tolling effect of the straddle.
- No current deduction for losses is permitted to the extent of any unrealized gain in the offsetting positions.⁴⁷ Therefore, losses on a straddle are deferred until unrealized gains on the offsetting position are eliminated.
- All carrying charges and interest expense (including margin) during the offset period (net of dividends) are capitalized and added to the basis of the owned stock position. This has the effect of reducing the amount of capital gain when the owned stock position is sold.⁴⁸

ECONOMICS OF PRIMARY HEDGING STRATEGIES

After tax analysis, the basic question is whether the economics merit a hedging strategy considering all relevant taxes (including estate taxes) and the variety of potential price changes for the security or portfolio to be hedged.

Rather than provide detailed guidance on all reasonable economic outcomes of the primary hedging strategies (selling short, put options, and collars), one possible strategy has been highlighted for review; the protective put option on a highly appreciated stock. To fully

unpack both the constructive sale and straddle rules, we have assumed that the stock is long-term capital gain stock, with very low basis, but purchased after January 1, 1984 (so that the straddle rules apply).

Exhibit 8 shows the after-tax economics of two hedging strategies compared to a sale. For this analysis, we assume 20,000 shares of a stock are owned, worth \$57 per share, with no basis. Three return assumptions are used for a four-year period:

- 12% growth per year
- no growth
- 20% decline per year

In each case, we assume a death at the end of the fourth year, with a 50% estate tax. Long-term capital gains taxes are assumed to be 25% (state and federal), and short-term gains and losses are assumed to be 43% (state and federal).

Sale	Hedge #1	Hedge #2
<i>Initial sale of 15,000 shares</i>	<i>Retain 20,000 shares</i>	<i>Retain 20,000 shares</i>
Retain 5,000 shares	Purchase put option on all 20,000 shares for \$52,000 with a strike price of \$45	Children purchase same put option as Hedge #1.

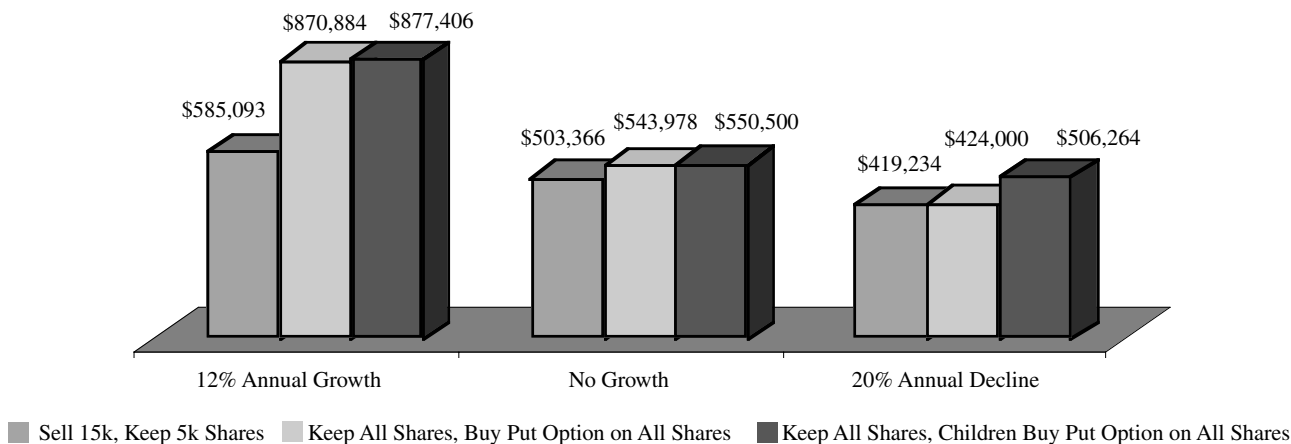
Exhibit 8 shows that in the case of a 20% annual decline, there is little difference between the outright sale and the put option. While the sale triggers capital gains taxes, these taxes reduce the estate and therefore the estate tax. In essence, the capital gains tax of 25% is only 12.5% due to the estate tax savings. Offsetting the capital gains tax for the sale is the interest income earned on the sales proceeds whereas the hedge strategies are still holding the stock and forgoing interest income on the proceeds. Also, if the put option is sold prior to death, all of the gain is subject to tax (not reflected in the chart because of the assumption of holding until death) due to the straddle rules. If the stock was purchased prior to 1984, the straddle rules do not apply and the put option gain can be long-term if held for over one year (with a longer-term option period).

The real value of the put option strategy (Hedges #1 and #2) is if the stock appreciates in value. With the sale strategy, the appreciation is lost unless (and this is an important variable) the proceeds are reinvested in an appreciating asset. If the proceeds of the stock sale are left in cash or decline in value, the result is much poorer than holding the stock and buying a put option.

The primary advantage of the put option in this case is where the future is unknown. If storm clouds on the horizon end up not producing any damage, then the sale proved unwise from a tax and economic standpoint. The put option (depending on the price) can protect the downside and yet permit upside without tax if the outlook brightens.

EXHIBIT 8

Net After-Tax Value of Stock to Family after Four Years (20,000 Original Shares Valued at \$57 Per Share)



One last planning point is the possibility of children or their trusts purchasing put options so that the gain on the put, if the stock declines dramatically, is not part of the estate of the parent (Hedge #2). Mitigating this beneficial shift in appreciation to the children is that the capital gains tax would apply to the closing of the gain since the step-up in basis would not apply to the put option upon sale. The straddle rules would not apply since the options owned by the children are not attributed to the parent under the straddle rules.⁴⁹ However, the capital gains tax is still lower than the 50% estate tax (especially if the put option is held long enough for long-term capital gains status), so the result is still beneficial. This strategy would require just the right set of circumstances and cooperation and careful examination of the straddle attribution rules and other applicable legal issues by legal and tax counsel.

LEGAL AND COMPLIANCE ANALYSIS OF HEDGING STRATEGIES

There are many legal and compliance issues surrounding hedging strategies, especially when dealing with trusts. A most useful discussion of these issues is contained in OCC 96-25, a 1996 bulletin issued by the Office of the Comptroller of the Currency (OCC).⁵⁰ This document summarizes general risk management principles for national bank fiduciary activities, specifically in the area of financial derivatives or hedging strategies. Investment advisors, trustees, and other fiduciaries might find helpful the valuable guidance provided by the OCC, even though the OCC supervises national banks.

Some of the key points raised by OCC 96-25 include:

- It is unsafe and unsound practice to purchase hedges in a fiduciary capacity without a full appreciation of the risks involved.⁵¹
- When hedges are being considered as investments, risk management procedures should be adopted, in the same manner as general risk management procedures that national banks use for non-fiduciary relationships.⁵²
- All risk issues must be addressed, including client risk tolerance, liquidity risk, and reputation risk (i.e., damage to reputation and loss of business due to inadequate management of hedging strategies, or non-use of hedging strategies when appropriate).⁵³
- Before considering hedging strategies, the advisor or trustee must have skilled professionals who can

effectively implement and monitor the strategy, or else retain other highly skilled professionals who can do so.⁵⁴

- The persons responsible for risk monitoring (i.e., developing risk management systems and controls, reporting procedures, and monitoring of risk levels) should be independent from:
 - the investment officer making investment decisions and
 - traders executing the transactions.⁵⁵
- The persons responsible for risk monitoring should perform scenario analysis and stress testing to evaluate the effectiveness and range of possible outcomes from different random scenarios.⁵⁶
- The investment advisor or fiduciary should act in the best interest of the client and comply with applicable investment standards and law, including controlling trust document provisions and state laws.⁵⁷

CONCLUSION

The decision-making process for diversification and risk management of highly appreciated securities and portfolios is becoming more prevalent and more complex. While the sale decision is usually simplest, the alternatives including hedging strategies should be understood for possible use. Hedging strategies can be used to effectively manage risk, with favorable tax treatment.

Investment advisors and trustees should critically evaluate hedging strategies for their clients, not giving in to misperceptions of hedging. In the limited situations where hedging strategies are appropriate, the same diligent attention that is given to evaluation and implementation of hedges must be given to proper management and monitoring of hedges.

ENDNOTES

¹*High-net-worth Investors and Listed Options*, Chicago Board Options Exchange, p. 23.

²The focus of our analysis is taxable portfolios that must carefully factor tax considerations into diversification and sell decisions. Similar lines of thinking can apply to hedges of real estate, closely held businesses, or other non-publicly-traded assets.

³The 1997 New York case of *Levy v. Bessemer* is an example of the fact patterns which are becoming more prevalent (No. 97 Civ. 1785, 1997 U.S. Dist. WL 431079 (S.D.N.Y. July 30, 1997)). More details on this important case are provided later in this article.

⁴Summarizing the key argument found in one of the seminal papers on a fiduciary's duty to hedge. George Crawford, *A Fiduciary Duty to Use Derivatives*, 1 STAN. J.L. BUS & FIN. 307 (1995).

⁵Former Enron CEO Jeff Skilling is reported to have sold short millions of dollars of stock in AES, a competitor to Enron in the energy industry. Skilling may have used this trade to hedge his holdings in Enron under the theory that the stocks were somewhat closely correlated, or he may have simply sold the AES stock short hoping for a good result, unrelated to a hedge of his Enron stock. The stock prices were correlated to an extent, as AES stock plummeted during the same period as Enron plummeted. But AES stock did not decline to zero value, as did Enron. "A spokeswoman for Mr. Skilling confirms that he made the wager: a short sale initiated on Aug. 24 against shares of AES Corp., a big energy producer. A person familiar with the matter puts the trade's value at \$30 million, though Mr. Skilling's spokeswoman says the estimate is 'way out of the ballpark' on the high side." Ken Brown, *Wall Street Journal*, January 15, 2002, p. C2.

⁶The Belfer family sold the family petroleum business to Enron in 1983 in return for stock. Robert A. Belfer was a member of the Enron Board of Directors. The amount of their loss was first reported as up to \$2 billion by the *Wall Street Journal*, December 5, 2001. In a subsequent February 20, 2002, article, the *Wall Street Journal* notes that Mr. Belfer used the collar hedging strategy to protect the value of about one million shares with floor prices of \$55 to \$65 per share nearly a year before the Enron collapse. In all, Belfer hedged nearly 17% of all stock holdings, but still faces losses of nearly \$700 million, according to Mr. Belfer's attorney, as cited in the subsequent article.

⁷RESTATEMENT (THIRD) OF TRUSTS Sec. 227, cmt. g. "The objective of prudent risk management imposes on the trustee a duty to diversify... unless special considerations make it prudent not to diversify in the particular trust situation."

⁸See *Levy v. Bessemer*, supra, p. 3. This case was settled prior to trial, but Defendant's motion to dismiss for Plaintiff's failure to state a claim upon which relief could be granted was denied. In the original complaint by the Plaintiff, claims of negligence, negligent misrepresentation, breach of fiduciary duty, breach of the duty to supervise, breach of contract, and fraud were alleged. The only claim dismissed by the Court was the breach of contract claim.

⁹Supra, note 4, p. 328.

¹⁰The model Prudent Investor Act provides that "the expected tax consequences of investment decisions or strategies" are "among the circumstances that the trustee shall consider in investing and managing trust assets." UNIF. PRUDENT INVESTORS ACT (Nat'l Conf. of Comm'rs on Uniform State Laws, Feb. 1995), Section 2(c) (3).

¹¹"Loss realization is a good horse, but it's a horse you usually can't ride very far for very long." "Tax-Efficient Invest-

ing Is Easier Said Than Done," Robert H. Jeffrey, *The Journal of Wealth Management*, Summer 2001, p. 11. But for a discussion of the merits of harvesting losses frequently, see "The Benefits and Methods of Harvesting Your Losses, and Not Just at Year-End," Robert N. Gordon, and Jan Rosen, *The Journal of Wealth Management*, Fall 2001, pp. 51-60.

¹²It seems odd that a trustee or investment advisor would automatically sell a security, regardless of its investment fundamentals, simply because it does not appear on the approved list. However, this is often the case. Because tax liability incurred upon the sale of highly appreciated securities can dramatically lower long-term portfolio returns, an in-depth analysis of the merits of holding or selling an appreciated security would seem to be the best course of action. However, most investment firms follow an approved model and attempt to liquidate all other securities unless the client objects. Customized investment reviews on specific securities not on the approved list are not customary practice. Yet it seems that providing such a service to clients is at the heart of being an independent investment advisor. "Years ago, when money managers were still called investment advisors... client advisories like this were not uncommon." "Tax-Efficient Investing Is Easier Said Than Done," Robert H. Jeffrey, *The Journal of Wealth Management*, Summer 2001, p. 14.

¹³This concept is also supported by the Foundation for Fiduciary Studies. "No investments are imprudent on their face. It is the way in which they are used, and how decisions as to their use are made, that will be examined to determine whether the prudence standard has been met. Even the most aggressive and unconventional investment can meet that standard if arrived at through a sound process, while the most conservative and traditional one may not measure up if a sound process is lacking." *Prudent Investment Practices Handbook* (2001), p. 3.

¹⁴For a more thorough discussion of various hedging alternatives, including charitable giving solutions, see "Comparing Financial and Charitable Techniques for Disposing of Low Basis Stock," Scott D. Welch, *The Journal of Wealth Management*, Spring 2002, pp. 37-46; "Hedging Low Cost Basis Stock," Robert M. Gordon, AIMR Conference Proceedings: *Investment Counseling for Private Clients III*, March 27-28, 2001, pp. 39-44.

¹⁵Most versions of the prudent investor rule require trust expenses to be reasonable. Hedging strategies usually involve transactions costs much greater than the outright sale. In addition, if the trust retains investment advisors that have high fees, including performance fees, the overall costs of the hedging strategy can become unreasonable, even if a positive benefit is achieved through the hedge.

¹⁶*High-net-worth Investors and Listed Options*, Chicago Board Options Exchange, p. 4.

¹⁷A marital trust is a trust created during the lifetime of an individual or at the death of an individual for a spouse. Under Internal Revenue Code Section 2056, a trust can be established for a taxpayer's spouse, if they are married at the time

of the lifetime creation or at the taxpayer's death. Such a trust is often called a marital trust. Assets of the taxpayer which are properly transferred to a trust meeting the requirement of IRC Sec. 2056 will qualify for the unlimited marital deduction. This means that the assets receive a step-up in basis (in the case of assets transferred at death to such a trust) and are not subject to estate tax at the taxpayer's death. However, upon the death of the spouse, who is the beneficiary of the marital trust, the value of the assets in the marital trust at his or her subsequent death are subject to estate tax in the spouse's estate. The assets in the marital trust receive a second step-up in basis at the surviving spouse's death.

¹⁸See note 19.

¹⁹Reputation risk is a key factor. The OCC identifies reputation risk as a substantial factor in any decision to use hedging strategies for a client. OCC 96-25, p. 3. The same argument can be made of any decision not to consider the use of hedging strategies, if in the client's best interest.

²⁰As Warren Buffett would put it, "... I have ... simple goals in reporting: We want to give you the information that we would wish you to give us if our positions were reversed." Letter to Shareholders of Berkshire Hathaway, March 1, 1999.

²¹*Brane v. Roth*, 590 N.E. 2d 587 (Ind. Ct. App. 1992), at pp. 589-590.

²²"A Trust Fiduciary's Duty to Implement Capital Preservation Strategies Using Financial Derivatives Techniques," Randall H. Borkus, 36 REAL PROP., PROB. & TR.J. 150 (2001).

²³Id. at 151, citing THE GROUP OF THIRTY GLOBAL STUDY GROUP, DERIVATIVES: PRACTICES & PRINCIPLES 1 (1993), recommending that top management obtain an extensive understanding of hedging before agreeing to implement strategies for their use of risk management purposes.

²⁴"Reflections on Portfolio Management After 25 Years," Robert W. Jeffrey, *The Journal of Investing*, 2001.

²⁵"WorldCom Director Uses Exotic Play to Hedge Stake," Elizabeth MacDonald, *Wall Street Journal*, October 15, 1997.

²⁶We are uncertain whether McCourt kept his hedge position in place. The options were originally structured to terminate in July 2002.

²⁷The 1997 Tax Act added IRC Sec. 1259 entitled "Constructive Sales Treatment for Appreciated Financial Positions."

²⁸IRC Sec. 1259 (c).

²⁹Treasury Regulation 1.1233-1. *Substantially identical property*. The term "substantially identical property" is to be applied according to the facts and circumstances in each case. In general, as applied to stocks or securities, the term has the same meaning as the term "substantially identical stock or securities" used in section 1091, relating to wash sales of stocks or securities. ... Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another

corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property. Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property. Similarly, depending on the facts and circumstances, the term may apply to the stocks and securities to be received in a corporate reorganization or recapitalization, traded in on a when issued basis, as compared with the stocks or securities to be exchanged in such reorganization or recapitalization.

³⁰*Taxes and Investing*, Ernst & Young, Sept. 1999, p. 6.

³¹The committee report says "it is intended that transactions that reduce only risk of loss or only opportunity for gain will not be covered (by the constructive sale rule). Thus, for example, it is not intended that a taxpayer who holds an appreciated financial position in stock will be treated as having made a constructive sale when the taxpayer enters into a put option with an exercise price equal to the current market price (an 'at the money' option). Because such an option reduces only the taxpayer's risk of loss and not its opportunity for gain, the above standard will not be met." Committee Report on P.L. 105-34 (Taxpayer Relief Act of 1997).

³²According to the Chicago Board Options Exchange (CBOE), a put option is in the money if the strike price is greater than the market price of the underlying security. If the put option strike price is significantly higher than the market price of the underlying stock, the put option trades somewhat like the stock itself and is considered "deep in the money." Because deep in the money puts correlate much more closely with the price movements of the underlying stock than out of the money puts, there is a risk the deep in the money put is a substantially identical property that triggers a constructive sale. Future regulations may deem a deep in the money put as an abusive hedging transaction which is not grandfathered.

³³These are the views of Deutsche Bank Alex. Brown (DBAB), but DBAB also adds that to avoid arguments of an abusive collar the collar should not be used to hedge a stock with exceptional volatility. However, given the volatility of the entire market the last several years that suggestion may not longer be valid. *Strategies for Concentrated Equity Positions*, Deutsche Bank Alex. Brown, June 1999, p. 18.

³⁴H.R. Conf. Rep. No. 105-220, at 514 (1997).

³⁵IRC Sec. 1092 (c) (1).

³⁶IRC Sec. 1092 (c) (2) (a) states that a taxpayer holds offsetting positions "if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to

personal property by reason of his holding 1 or more other positions ... (whether or not of the same kind).”

³⁷IRC Sec. 1092 (c) (3).

³⁸IRC Sec. 1092 (c) (3) (A) (i) and (ii).

³⁹IRC Sec. 1092 (c) (3) (A) (iv).

⁴⁰IRC Sec. 1092 (c) (3) (A).

⁴¹The straddle rules contain other more detailed provisions involving futures contracts and corporations formed to enter into hedging strategies. IRC Sec. 1092 (d) (3) (B) (i) (III) and (ii).

⁴²“Stock offset by another position (other than an option) in substantially similar or related stock ... does not constitute a straddle.” Joint Committee of Taxation’s General Explanation of the Tax Provisions of the Deficit Reduction Act of 1984 at p. 309.

⁴³See note 5.

⁴⁴IRC Sec. 1092.

⁴⁵See BNA U.S. Income Series Volume 184, *Stock Related Tax Issues*, pp. 108-111.

⁴⁶Treasury Regulation 1.1092(b)-2T(a). Security positions which are long-term prior to the creation of the straddle maintain their long-term nature when the straddle is unwound.

⁴⁷IRC Sec. 1092 (a) (1) (A).

⁴⁸IRC Sec. 263(g).

⁴⁹IRC Sec. 1092 (d) (4) attributes offsetting positions owned by the spouse of the taxpayer or any person who files a consolidated return (within the meaning of section 1051) with the taxpayer as being owned by the taxpayer.

⁵⁰OCC Bulletin 96-25, *Fiduciary Risk Management of Derivatives and Mortgage-backed Securities*, Office of the Comptroller of the Currency, Administrator of National Banks, Douglas E. Harris, Senior Deputy Comptroller for Capital Markets, April 30, 1996.

⁵¹Id. at p. 1.

⁵²See Banking Circular 277 *Risk Management of Financial Derivatives*, October 27, 1993, which applies to risk management in general, but is applicable to risk management for all risk-taking activities in a fiduciary capacity.

⁵³OCC 96-25, pp. 2-3.

⁵⁴Id. at p. 3.

⁵⁵Id. at p. 4.

⁵⁶Id.

⁵⁷Id. at p. 5. An excellent resource on this entire topic is *Investment Management Services, Comptrollers Handbook*, Office of Comptroller of the Currency, August 2001. Also, *Procedural Prudence for Fiduciaries*, Donald B. Trone, William B. Allbright, Philip R. Taylor, 1997.

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