Investors with appreciated securities often wish to hedge their positions. Sometimes the goal is simply to protect gains and try to gather additional profits, while, in other cases, the investor will also wish to gain access to cash without currently paying tax.

Section 1259 of the Internal Revenue Code sets forth conditions in which investors will be treated as having constructively sold an “appreciated financial position” by virtue of having hedged away too much of the potential for gain or loss on the position. Under the constructive sale rules, a hedging strategy must retain some potential for profit or loss; otherwise, the strategy may trigger a taxable event. While the constructive sale rules rendered certain hedging tools obsolete, other strategies remain viable.

Protecting Gains

The simplest hedging strategy involves buying a put against a long stock position. A put gives the investor the right to sell a stock at a given price; for example, an at-the-money put gives the investor the right to sell the stock at its current market price. The effect is to create a floor at that price. At the same time, the investor’s potential upside for future profit on the stock is unlimited. Unfortunately, as of this writing, at-the-money put options typically cost 10-12% annually. This cost makes them prohibitively expensive as a long-term hedging strategy.

Collars are a more cost-efficient way to protect stock gains. An options-based collar involves buying a put and simultaneously selling a call. (A call is the opposite of a put. It gives the call buyer the right to purchase a given stock at a given price). The put creates a floor under the current price of the stock. The call creates a cap over the current price.

Investors commonly use two types of collars: zero-cost (or cashless) collars and income-producing collars. Zero-cost collars are the best strategy for a bullish investor who believes that the underlying stock will continue to gain value. These collars involve the purchase of a put and sale of a call, with the strike price of the call set to generate exactly enough cash to pay for the put. The strategy allows the investor to costlessly hedge while still maintaining potential for profit in the position.
Income-producing collars represent a more conservative approach. They involve the purchase of a put and sale of a call with the call strike price set relatively close to the current price of the underlying stock. This lower strike price generates cash in excess of that required to pay for the put. However, it also “gives away” more potential for profit in the collared stock. For many investors, this drawback will be more than balanced by the receipt of immediate cash, the “bird in the hand” theory.
Monetization

An investor with a substantial holding in one position can often monetize, or borrow against, the position to raise capital. One advantage of monetization over an outright sale is that monetization does not produce a capital gains tax. However, monetization does create interest expense, which should be currently deductible like any other investment expense.

It is possible for investors with zero-cost collars to monetize against their underlying positions. However, the combination of the two strategies is relatively expensive because the zero-cost collar produces no income to compensate for the monetization interest expense. For this reason, investors should not adopt this approach unless they are extremely bullish about the future of the underlying security.

The combination of monetization and an income-producing collar represents a more appealing approach because the income-producing collar produces cash to help offset the monetization interest expense. So while monetization with a zero-cost collar may demand an extremely bullish stance, the combination of monetization and an income-producing collar may well represent the most cautious approach to the management of low-basis positions.

Special Considerations for Stock Acquired After 1983

If an investor hedges shares that were acquired during or after 1984, those shares may be deemed to be part of a straddle. As a result, if the collared shares are used as collateral for a loan, the interest would be capitalized. However, if an investor has other liquid securities to post as collateral, it would still be possible to deduct the interest expense. As an example, suppose an investor with $100 of hedged shares were to borrow and re-invest in $100 of securities and leave only these positions in the account. In that case, 50% of the interest expense would be currently deductible while the remaining 50% would need to be capitalized.

If an investor has no other collateral and does not acquire other collateral while a monetization strategy is in effect, then the proposed regulations would create a “level playing field” for options-based collars and a prepaid variable forward. However, if the investor does have other collateral or stands a chance of acquiring other collateral while the monetization is in effect, then an options-based collar would still be the most tax-efficient tool to combine with a borrowing. For this reason, Twenty-First Securities would recommend options-based collars for all investors with post-1983 securities who are considering monetization.

The above discussion of legal and tax issues is provided only as general information, and should not be relied on as up-to-date, definitive, or particularized legal or tax advice. Persons contemplating options trading should consult their tax advisors before making a final decision with respect to such trading.

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