MORE TAX CONSIDERATIONS FOR MAXIMIZING INVESTMENT RETURNS

By Clark M. Blackman II and Ellen J. Boling

Understanding the tax consequences of selling your investment holdings is a necessary first step in making wise investment decisions and requires a clear idea of what you'll end up with when you walk away from the table.

In our final article on the tax consequences of various investments you currently own or may be considering, we delve into the world of stock options, mutual funds, and stock received due to splits, dividends, and mergers.

OPTIONS

There are several kinds of stock options, and we will focus on two: marketable stock options and employer stock options.

Marketable options are either "puts" or "calls," and you can either be the purchaser or the seller ("writer") of these options. [For the specifics of how puts and calls work, please see the article "Maximizing Returns, Part 2: Tax Considerations for Investing" in the June 1999 *AAII Journal*.]

In contrast, employer stock options are granted to employees (or sometimes even non-employee directors) of a company. These options cannot be bought or sold on the market, although some employer stock option plans allow the employee to transfer/gift the options to another person or entity, such as a trust.

EQUITY COLLARS

A zero-cost equity collar is a strategic application of marketable put and call options around a stock that has appreciated substantially. The effect of the collar is to limit the downside loss potential should the stock price fall, without realizing capital gains on the current appreciation.

A put is an option that gives the put owner the right to sell a set number of shares within a certain time frame at a specified price; a call is an option that gives the call owner the right to buy a set number of shares within a certain time frame at a specified price. The equity collar strategy involves the simultaneous sale of a call option and purchase of a put option.

Here's an example that illustrates the mechanics of an equity collar: Let's assume that you own an appreciated stock position with a fair market value of $50. You sell a call with a "strike" price (the price at which the buyer may purchase your stock) of $55. At the same time, you purchase a put with a strike price (the price at which you may sell the stock) of $45. The put limits your losses to 10% of the stock's price by ensuring you will receive no less than $45 for selling the stock. On the other hand, the call limits your upside potential; if the stock price rises above the $55 strike price, you must sell your stock for $55. To be sure there can be no exercise prior to the expiration date, "European-style" options are used. A European-style option has only one exercise date, which is the last day of the contract. These options may be bought and sold through any broker.

The cost of purchasing or the proceeds from selling either a put or call option is referred to as a premium. In our example, you sell a call and receive a premium that is structured to be equal to or higher than the corresponding

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premium you must pay for purchasing the put. This "zero-cost" equity collar protects your gain and limits your risk to the extent of the range set by the call and put strike prices.

However, you will still face some risk in applying this strategy. For one, you have exposure for the first 10% of losses if the stock's price drops. You also have a risk of "opportunity lost" if the stock price increases beyond the call option's strike price ($55 in our example). If the stock price has risen above the strike price on the date of expiration of the option, you must turn over that difference to the purchaser. This may require selling some of the stock involved in the collar and paying the necessary capital gains tax.

In our example, assume that the stock price is $60 per share on the date the option expires. When the option holder exercises his purchase right, he would pay you $55 for an asset worth $60. The $5 profit you owe the option holder is usually paid in cash. However, if you don't have the cash available, you may be forced to sell stock, which could generate a taxable gain.

There are other advantages to employing this strategy. Because the terms of the option contracts are usually at least one year in duration and the stock holdings therefore are stabilized, you are generally able to borrow substantially more than 50% (in certain situations up to 95%) of the value of the stock position by using the collared position as collateral. This procedure is known as monetizing—it allows you to use the loan proceeds to diversify a single stock position into a broader market position while postponing the taxes you would pay if you sold the stock and reinvested the proceeds to achieve the same diversification goal.

Additionally, because the equity collar allows you to hedge your equity position without selling the stock, you maintain your voting rights in that stock.

While the equity collar can limit your losses and postpone recognition of gains on an appreciated position, you must structure the collar appropriately and consider the "deemed sales" rules. Essentially, the deemed sales rules state that if the equity collar is too tight, a sale of the collared stock will be "deemed" to have taken place. To avoid this situation, a 20% spread (preferably 10% over and 10% under the market price) between the put and call strike prices is considered safe. However, for time horizons in excess of five years, the spread would need to be increased.

While there is no tax paid on creation of the collar, there are tax implications with respect to terminating the collar, whether or not the stock is sold.

There are three possible outcomes to an equity collar:

- The call option is exercised by the purchaser, and the stock is transferred or cash is tendered;
- The put option is exercised by you, and the stock is transferred; or
- Neither the call nor the put option is exercised and both options expire worthless.

If the call option is exercised, the gross proceeds from selling the call option are treated as short-term gain. Gain on the sale of the stock is taxed as long-term capital gain if it was held for one year or longer *prior* to creating your collar. Your put option would then expire unexercised. The amount paid for the put option constitutes a capital loss, and is characterized as long-term or short-term depending on the holding period as determined by §1234(a) of the Internal Revenue Code. If you do not tender stock on the call exercise but instead pay cash, the loss on the put becomes a basis adjustment on the remaining stock shares.

If you exercise the put option, the call option you sold would then expire. The gross proceeds from selling the call option are again treated as short-term gain. Gain on the sale of the stock is taxed as long-term capital gain (see above paragraph). The amount paid for the put option becomes part of the basis of the stock sold and reduces the amount of the long-term gain recognized.

If both options expire worthless, the gross proceeds from selling the call option are treated as short-term gain, and the amount paid by you for the put option results in a basis adjustment to the stock pursuant to the straddle rules. Straddle rules attempt to prevent you from using various tax-motivated transactions to defer income or to convert short-term capital gain into long-term capital gain. [For further detail on the "straddle" rules, you should consult your tax advisor.]

EMPLOYEE STOCK OPTIONS

Stock options are increasingly becoming an integral part of employers' compensation packages. Companies grant options to employees to reward them for their performance and allow them to share in the future growth and success of the company. Employee stock options come in two basic forms: the non-qualified stock option (NSO) and the incentive stock option (ISO). Non-qualified stock options are so named because they do not meet all the requirements of the Internal Revenue Code (IRC) to be qualified as incentive stock options.

Generally, you will not incur tax on "grant" (receipt) of a non-qualified stock option. When the option is exercised, you will recognize income equal to the fair market value of the stock received, *at the first time it is not subject to substantial risk of forfeiture,* over the amount paid for such stock. This is often referred to as the "bargain element" or profit in the stock on that date. Stock is considered subject to substantial risk of forfeiture if your rights to full enjoyment of the stock are conditioned upon the future performance of substantial

services.

Alternatively, if the stock is subject to substantial risk of forfeiture on the date of the exercise, you may elect to receive treatment under IRC §83(b), but this is a fairly rare circumstance. This enables you to elect to recognize income at the time of the exercise equal to the fair market value of the stock received (*without regard to substantial risk of forfeiture*) over the amount paid for such stock. When the stock is subsequently sold, you are afforded capital gain tax treatment on the gain (also assuming you hold the stock as a capital asset for a sufficient period of time, which is one year under 1999 law).

When the stock is sold, the taxable income from the sale will be subject to capital gain treatment. The holding period for which you have held the stock begins as of the option exercise date. Your basis in the stock is the price paid for the stock (exercise price) plus any amounts previously included in income.

With an incentive stock option, you do not recognize ordinary income at the date of grant or the date of exercise. If, after exercise, you sell the stock after having satisfied a holding period of one year from date of exercise *and* two years from date of grant, you will recognize long-term capital gain or loss in the amount of the difference between the sales price and your exercise price.

Although you do not recognize ordinary income at the date of exercise, you must adjust your alternative minimum taxable income calculation by the difference between the fair market value of the stock at the date of exercise and the exercise price (assuming the stock is not restricted). The alternative minimum tax basis of the stock is adjusted for this amount.

Table 1 summarizes the tax rules for employee stock options.

TABLE 1. TAXATION OF EMPLOYEE STOCK OPTIONS

Date	Non-Qualified Stock Options	Incentive Stock Options
Date of Grant	No tax impact	No tax impact
Date of Exercise	Difference between fair market value of stock and exercise cost is taxed as ordinary income and reported on Form 1040	Difference between fair market value of stock and exercise cost is reported as a preference item for alternative minimum tax purposes on Form 6251
Date of Sale	Difference between fair market value of stock and basis is taxed as capital gain; basis is equal to exercise cost plus amount recognized as ordinary income at date of exercise	Difference between fair market value of stock and basis is taxed as capital gain; basis is equal to exercise cost at date of exercise

MUTUAL FUNDS

Mutual funds must periodically distribute dividends, interest, and capital gains to their shareholders. You must pay tax on these distributions. Because of these distributions, you must give special consideration to the timing of your investment in a mutual fund.

When a distribution is made, the net asset value (NAV) of the fund decreases by an equal amount. Suppose the NAV of your fund XYZ is $20 per share on December 20. On December 21, the fund makes a distribution of $2 per share, and as a result, the NAV decreases by a like amount to $18 per share. Since you received the $2, you still have $20 of asset value, but now $2 is subject to tax. The $2 is taxable even if you reinvest it in that fund. One small consolation is that the reinvested amount becomes an increase to your tax basis in the fund (i.e., reduces your capital gain in the future when you sell the fund shares).

Mutual funds commonly make distributions toward the end of the year. Investors must be wary of this distribution date. Generally, you should not invest in a mutual fund shortly before its distribution date, because a portion of your investment will be immediately returned to you with an accompanying tax liability.

Most mutual funds should be able to give you a good idea of when their year-end distributions will take place, so calling the fund company prior to investing can be a wise move.

SPLITS, DIVIDENDS, & MERGERS

One of these days when you're reviewing your brokerage account statement, you might find that you have more or less shares of a particular stock than you recall from the previous month's statement. You might even find yourself owning shares of a company you swear you never purchased. If so, it is likely that your company has undergone a stock split, reverse split, stock dividend, or merger. Be aware that such events will alter your basis *per share* and as a result, the capital gain or loss you recognize should you subsequently sell less than 100% of your holdings in that stock.

In the case of a stock split, you end up with more shares than you previously had, but no change to your *total* basis occurs. However, the per-share basis value will change. For example, if you purchased 100 shares of a stock for $5 per share, your basis is $500. If the stock splits 2-for-1, you will now have two shares for each one share you previously held, thus doubling your shares to 200. Your total basis remains at $500, but your basis per

share is now $2.50 ($500 divided by 200 shares). When you sell the shares, $2.50 is the per-share basis amount you should use to calculate your capital gain or loss. The acquisition date for the new 100 shares is the same as for the original 100 shares.

As you can probably surmise, a reverse split is the opposite of a normal split in that it results in fewer shares being held. In our previous example, if the 100 shares you own split 1-for-2, you will have one share for every two shares you previously held, thus halving your shares to 50. Again, your total basis remains at $500, but your basis per share is now $10 ($500 divided by 50 shares).

A stock dividend is a dividend paid in stock instead of cash. Its effect on basis is similar to that of a stock split. For example, assume you purchased 100 shares of a stock for $5 each, so that your total basis is $500. If a company declares a stock dividend of 10%, you will receive additional shares equal to 10% of the number of shares you already own. In this case you will receive 10 additional shares (100 shares multiplied by 10%). Your total basis remains at $500, but your basis per share is now $4.55 ($500 divided by 110 shares).

Finally, when two companies merge, you may wind up owning an entirely new stock. For example, assume you owned 100 shares of Company X with a basis of $500 before the merger. The merger requires you to exchange your Company X shares for Company Y shares. After the merger, you now own 75.4 shares of Company Y. Your total basis remains at $500, but your per-share basis has changed. Before the merger it was $5 per share ($500 divided by 100 shares); after the merger it has become $6.63 per share ($500 divided by 75.4 shares).

One caveat you should note with mergers is that the new company may decide to cash you out of any partial shares you own after the merger. You might receive a payment to compensate you for the sale of your partial shares. In our example, Company Y may decide to pay you for the 0.4 share. In this case, your basis of the 0.4 share sold would be $2.65 (0.4 shares multiplied by $6.63 per share). In this case, your taxable gain is the difference between the amount you were paid for the fractional share and $2.65. Your remaining shares continue to have a basis of $6.63 per share for a total basis in your holdings of $497.25.

A BASIS FOR DECISIONS

Understanding the tax consequences of selling your investment holdings is a necessary first step in making wise investment decisions.

Knowing "when to hold 'em and when to fold 'em" requires a clear idea of what you'll end up with when you walk away from the table. ✦