Estate and Financial Planning Aspects of Managing the Risk of a Highly Appreciated Stock

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One of the estate planning advisor's most professionally challenging problems arises from a client's happy situation: the dramatically appreciated asset that represents a substantial portion of the client's net worth. This problem has become more noticeable in recent years with the dramatic advances of the stock market. Whether the client is a corporate insider, or merely someone who shrewdly invested early in "the next big thing," the circumstances, while enviable, also spell risk. The estate planning risk is that concentration in a single asset may limit flexibility in utilizing various techniques. Additionally, selling the asset will precipitate an income tax on the capital gain, resulting in a loss of wealth. The financial planning risk is that continuing to hold the stock amounts to a substantial bet that the asset is actually worth its current price, and that it will not ultimately decline or under perform in the future. What should the professional adviser recommend in these cases? When does the risk of holding the stock outweigh the tax cost of selling? This article examines these issues.

Risk Can Lower Return

Various studies have found that it is precarious to hold much of one's wealth in a single security.[1] By definition, the average stock in the market earned the same annual return as did the stock market as a whole from 1970 through 1995. Nevertheless, these studies also found that the *volatility* of the average stock's return was far greater than that of the general market. The studies found that the standard deviation of returns for the average stock was roughly 30%, versus a standard deviation of 15-18% for a well-diversified *basket* of stocks over the same period.

The Longer You Live The Riskier

Beyond the volatility inherent in a single stock, other factors also affect its risk, notably, the investor's life expectancy. The longer the time horizon, the more likely it is that any given stock, rather than a diversified portfolio, will underperform the market.

Other factors that also affect risk include the following:

! *What has been the volatility of the stock in the past*?

! *How is the stock priced relative to the market at the time of sale*? An investor who carries more than a relatively modest portion of one's wealth

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in a single stock creates undue risk of underperforming the market, or in extreme cases, losing some of the past gains.

Reining In The Single-Stock Risk

Understanding the risk of a concentrated investment position is the first step. The second step is the challenge of diversifying, or otherwise managing the risk. Several common solutions exist:

- Sell the asset, pay the resulting capital gains tax, and diversify the remainder;
- Hold the asset until death to allow the recipients to receive an adjustment in the basis of the asset;
- Give the asset away;
- Donate the asset to a qualified charity;
- Sell the asset "short-against-the-box."

Outright Sale. The most obvious alternative is to sell some or all of the position, pay the resulting capital gains tax, and reinvest the proceeds in a diversified portfolio.

Using a long term perspective, however, the cost of selling may be far less than investors perceive. With a five-year investment horizon, the cost drops to 7% amortized annually. Over 10 or 20 years, the annualized cost is just 2-3%.

Step-Up In Basis. Instead of selling, some investors, particularly elderly ones, may choose to hold an asset until death.

Gifting the Asset. If passing an asset to an heir will incur estate taxes, gifting might seem to offer clear tax advantages. When the owner gives the asset away, the recipient assumes the donor's basis, increased only by the amount of gift taxes the donor paid on the asset's net appreciation.

The overall tax burden of gifting, therefore, may well be heavier than simply paying estate tax on the stock.

Without the capital gain tax, however, the disparate effects of estate and gift taxes become dramatic. Gifting the original asset, either through taxable gifts or the annual exclusion, simply transfers the investment risk.

Charitable Donation. Charitable donation can provide a flexible mechanism to transfer an appreciated asset, avoiding capital-gain, and a portion of the gift and estate taxes.

Since a CRT provides regular payments to designated beneficiaries like the donor, either for the lives of the beneficiaries or for a specified period up to 20 years, it is a very popular estate and tax planning tool, often more popular than outright donations.

The CRT's singular disadvantage is the donor's irretrievable loss of the transferred asset.

Two significant new requirements were added to current law by the 1997 legislation to qualify for charitable remainder trust treatment.

Short-Against-the-Box. If an owner, such as an investor with a short life expectancy, decides that the best course is to hold onto an appreciated asset, a tax-planning technique known as "short-against-the-box" could add an important element of protection.

Short-against-the-box works as follows: The investor borrows an equal number of shares of the stock the investor is holding and sells those shares.

Four risks exist in going short-against-the-box. First, if interest rates, or the stock's price, rises the cost of the borrowed stock rises as well. Second, earnings on the funds reinvested in a new portfolio may not be large enough to offset the costs associated with selling short. Third, the original stock might actually outperform the new portfolio. Finally, a corporate transaction, such as a merger, could force an inopportune unwinding of the position, and cause unplanned tax liability.

A fifth, noneconomic, risk to "selling short against the box" is the result of amendments to the Internal Revenue Code made by H.R. 2014, the Taxpayer Relief Act of 1997. The legislation is intended to prevent taxpayers from deferring gain on financial products through the use of equity swaps or "short-against-the-box" transactions.

The section is effective for constructive sales entered into after June 8, 1997. Code section 1014(c), allowing for an adjustment in basis to fair market value as of the date of death, shall not apply to constructive sales.