



SINGLE STOCK FAMILY WEALTH...

DiveRsIfyInG THE GOLDEN GOOSE

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Wealthy families face difficult decisions when holding a single stock position in publicly traded or privately held companies. The stock is typically the “Golden Goose” that created their financial success; consequently, they may develop an “emotional hold” that makes it difficult to part with the stock in favor of various diversification strategies.*

This presents a significant risk should something unforeseen occur, causing the stock to fall materially, thus imperiling the family finances and wealth transfer plans. There are some options to consider which may provide financial security in a situation such as this.

I. Hedges

There are several financial instruments that can be used as a hedging strategy for publicly traded stocks. A short list includes Protective Puts, Covered Call Options, Zero-Premium Collars, Prepaid Variable Forward Sales and Exchange Funds. These strategies are highly complex and require the services of experts who routinely advise families on the merits of each strategy.

Primary Benefit of Strategy: Helps family to protect against the risk of loss below an agreed upon price/value. Depending on the tool used, it will cost money in order to gain the downside protection.

Considerations: Alternative investments involve risks that may not be suitable for all investors. These risks include, but are not limited to: the possibility that the investment may not be liquid, principal return and/or interest rate risk, and higher fees may offset any potential gains. Exchange Funds are unregistered securities products not subject to the same regulatory requirements as registered products and are available to qualified investors as defined by the Securities Act of 1933 only. Investors should consider the tax consequences, costs and fees associated with any alternative investments before investing.

II. Charitable Remainder Trust

This strategy involves contributing some of the stock position to a Charitable Trust that sells the stock and avoids capital gain taxes, then reinvests in a diversified portfolio, typically to provide income for the life of the donor (or couple, if married). The donor receives a charitable income tax deduction at the time the contribution is made. This tax deduction can help reduce taxes on the trust income paid to the donors while alive. Once the single stock position is sold, the Trust can invest in a wide variety of investments including, but not limited to, mutual funds, exchange traded funds, certain types of annuities, stocks and bonds.

Primary Benefit of Strategy: The single stock is sold and reinvested without incurring current capital gains taxes. The proceeds can be reinvested in a more diversified fashion to produce predictable income to the donor(s). At the death of the donor(s), the trust corpus is paid to a charity selected by the family (including a family foundation if desired). If replacing the corpus is important, life insurance can be purchased, the cost of which is subsidized by the charitable income tax deduction.

III. Life Insurance

This strategy involves acquiring life insurance on the life of the patriarch and/or matriarch as a way to assure a certain minimum level of wealth will be transferred at death to the next generation. In effect, the family is either liquidating some of the single stock position or using available cash to fund the premiums. The life insurance premiums can be invested conservatively or aggressively depending on the type of contract implemented.

If continued participation in equity markets is desired (even more fully diversified), variable life could be considered. On the other hand, if there's no desire to subject the cash in the life insurance to the ups and downs of the financial markets, non-variable contracts could be utilized.

Primary Benefit of Strategy: If structured properly, the death benefits are paid free of income, gift and estate taxes. The projected after-tax Internal Rate of Return (IRR) should be analyzed relative to the continued hold on the single stock position. The IRR on the death benefit is equivalent to an interest rate (after taxes) at which an amount equal to the illustrated premiums could have been invested outside the policy to arrive at the death benefit of the policy. Depending on the product used, it is not uncommon to see a projected death benefit after-tax IRR in excess of 5% at life expectancy. This compares favorably to the expected after-tax family benefit at life expectancy associated with the single stock position.

Considerations: Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and entails risk, including the possible loss of principal.

IV. Liquidating, Paying Taxes, Reinvesting

It's probably not a stretch to assume that tax rates aren't going to go down anytime soon. With the Bush tax cuts expiring at the end of 2012, all bets are off. It appears likely that capital gain rates will increase along with marginal rates on individuals earning more than \$250,000 per year. Additionally, estate taxes are likely to increase as we see a potential lowering of the lifetime gift and estate exemption from the current \$5 million per individual. The marginal rates will probably increase as well. The likelihood of higher taxes means it may be advisable to sell some of the single stock position.

It is important to understand that anytime a family is contemplating moving wealth to the next generation, a tax trade-off occurs. That is, gifts of assets to family members (or trusts benefiting family members) result in accepting capital gain taxes that will be

due when the benefiting family member liquidates the asset. In return, the gifted asset is outside the estate of mom and dad and, as a result, the estate tax is avoided. You've accepted a capital gain tax in order to avoid the estate tax. Some commentators have suggested that the capital gain tax due by benefiting family members may be a good thing in that it could force them to think twice before selling the asset and incurring tax (particularly in the case of family farms).

Primary Benefit of Strategy: Reinvesting the proceeds establishes a new cost basis. This may be helpful, particularly if one later decides to gift the reinvested portfolio to family members who eventually sell for their own purposes.

Summary

This is a brief summation of options worth considering when it comes to diversifying single stock positions. Advisors should provide families with calculations under various assumptions related to portfolio growth rates and assumed capital gain and estate tax rates before finalizing a gift or sale strategy.

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* Although diversification may help alleviate some concentration risk, it does not ensure a profit or protect against loss in a declining market (reference to first paragraph)