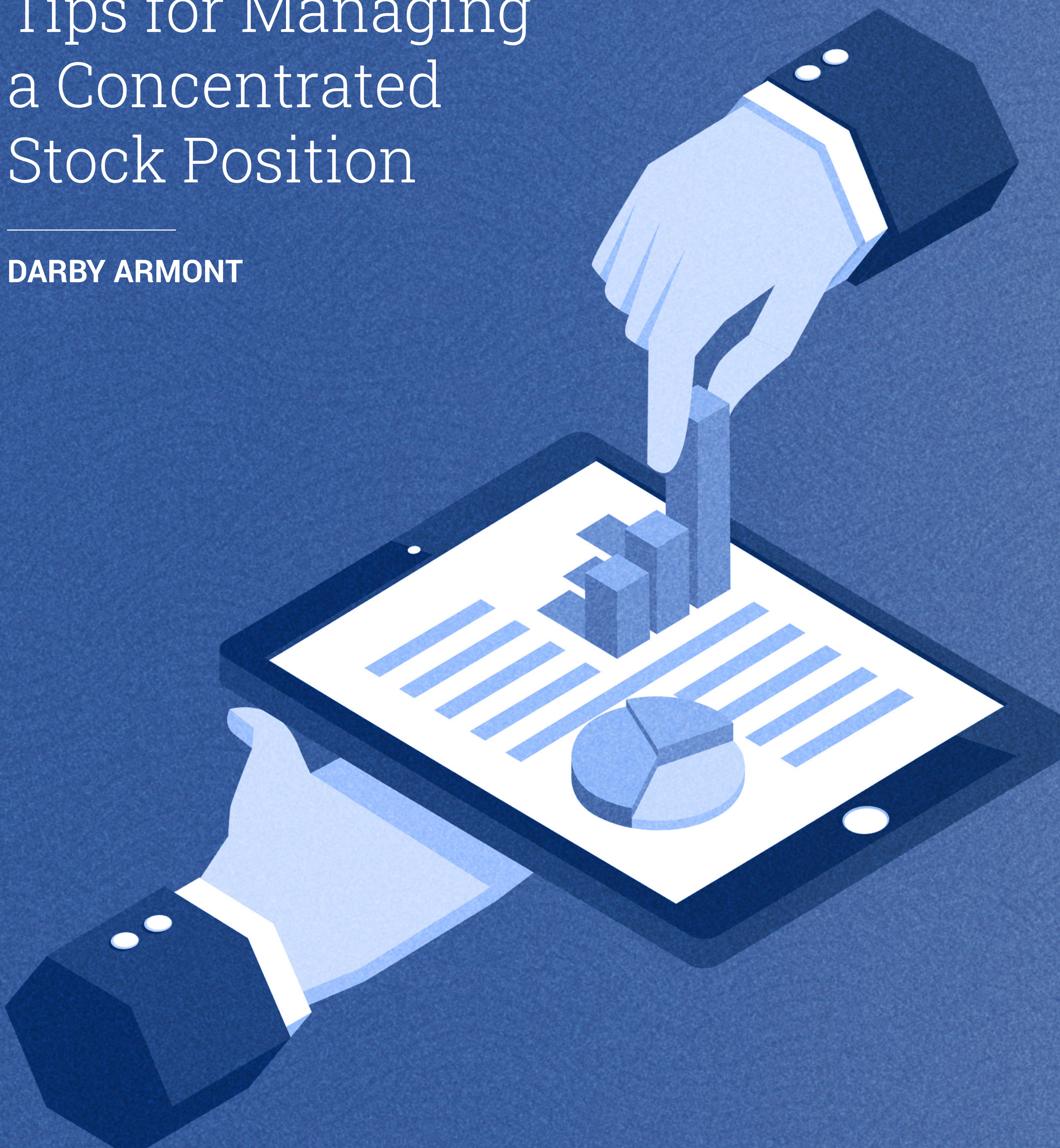
ON COURSE

Tips for Managing a Concentrated Stock Position

DARBY ARMONT



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Tips for Managing a Concentrated Stock Position

DARBY ARMONT

Executive Vice President

RICHARD P. SLAUGHTER ASSOCIATES, INC.

> **There are many reasons a person may find themselves in possession of a large holding of a single stock.** Perhaps you inherited the stock from a parent. Maybe the company you work for has given you restricted stock and options over the years and the value has increased significantly. Or the 1,000 shares of Netflix you purchased in 2005 on a whim are now worth more than your house.

Whatever the reason, having a single stock that represents a significant amount of your net worth (5% or more) can potentially create risk in your financial plan. Sudden volatility in the stock price just at the point you need to start using those funds can significantly alter your success rate. Or perhaps the stock has underperformed the market over the last several years, resulting in a lower return than what is required in your financial plan.

Clients often hesitate to sell these concentrated positions, either due to the tax consequences or for sentimental reasons. If your mom or dad worked for a company for many years and left you all the stock they accumulated over their lifetime, it may be challenging to let go of those shares knowing how much financial security they provided over the years. In this case, we often recommend that a client requests a stock certificate for a token amount of shares, typically 10 or 100 depending on the share price, and frame it as a memento of their loved one.

When there are significant tax consequences to selling shares, many options are available to manage risk and improve diversification, including:

Sell restricted shares of stock as soon as they vest.

If you have a large number of shares from your employer, you may not want to sell older shares that have accumulated over the years. But when a restricted stock unit (RSU) vests, you have to pay ordinary income taxes on the value of the shares received. At that moment, there is no capital gain or loss on the stock. The cost basis is equivalent to the value you had to recognize for tax purposes. This is a good time to sell shares if you are trying to reduce your holding without additional taxes.

Give shares to charity.

If you have a long-term capital gain in the shares, you can gift them directly to a charity or a Donor Advised Fund. Your charitable deduction is the equivalent of the market value of the shares at the time of the donation. See our August Insight article on a special tax plan for 401(k) concentrated stock positions for more information on gifting appreciated stock.

Use options strategies to manage risk or potentially improve returns while you wait.

If you're waiting to sell appreciated stocks until a specific time (for example, you're retiring next year and will be in a lower tax bracket), options can be a great tool. Collar strategies limit the upside return but also protect on the downside. Covered calls allow you to pocket a premium in return for being willing to sell the stock at a specified higher price in the future. These are complex strategies, and we strongly recommend using professional guidance before venturing down such paths.

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Opportunity Zone investments.

These were created in the Tax Cuts and Jobs Act (TCJA) of 2017 and allow preferential tax treatment for making real estate investments in economically distressed communities. If you take the proceeds from the sale of appreciated stock and invest them in a Qualified Opportunity Zone fund or property, you're allowed to defer your capital gains to a later date, receive a 10% increase in your cost basis, and enjoy tax-free growth on the O.Z. investment itself. There are many rules, deadlines, and requirements to make this strategy work, so we encourage clients to seek professional tax advice on the particulars of their situation.

Exchange Funds.

These are pooled assets where investors with different concentrated positions exchange their stock into this fund and receive shares of the pooled portfolio. For example, someone with Home Depot stock would contribute her shares to the fund. Someone else with Microsoft would put his shares in, and so on. In turn, they would all get pro-rata shares in the partnership.

Exchange Funds are constructed to provide instant diversification, with returns targeted towards broad market stock indexes. At the end of seven years, you receive shares of all the different individual stocks with your original basis split among all the investments. This makes it easier to continue to diversify the portfolio over time.

Just sell it now.

There are many tax proposals on the table, including some that would increase the capital gains rate significantly depending on a taxpayer's overall income. The details of these proposals are still being worked out, including whether to make this rule retroactive to an earlier date in 2021. If rates do indeed increase, it may be wise to realize gains at today's lower rates.

Parting with concentrated stock positions can be difficult for many reasons. We encourage you to work with your financial planner and tax professional to find the best solution for your situation.

Richard P. Slaughter™ Associates

Darby Armont, MBA, CFA, CFP®
Executive Vice President

Richard P. Slaughter Associates, Inc.
13809 Research Boulevard, Suite 905
Austin, TX 78750
Tel. 512-918-0000

invest@slaughterinvest.com
slaughterinvest.com