

Equity risk management— hedging and monetization

Customized wealth preservation and liquidity solutions
for your concentrated stock positions



Wealth
Management



A comprehensive wealth preservation approach

Individuals with a significant portion of their net worth tied up in a single stock face unique risks that require specialized strategies.*

These risks include market volatility exposure, poor diversification, and limited liquidity, making it difficult to access funds when needed or protect against value declines. Managing these risks requires a thoughtful approach, such as implementing diversification strategies to reduce concentrated exposure, utilizing hedging techniques to safeguard against downside risk, and exploring various liquidity solutions.

RBC's global expertise and resources can provide our high-net-worth¹ clients with customized solutions tailored to these specific challenges.

These comprehensive wealth preservation plans can not only mitigate risk but also create opportunities for growth and improved financial flexibility, ensuring our clients' wealth is both protected and accessible.

Learn more about these various approaches in the forthcoming pages:

- Navigating concentrated stock positions
- Overview of wealth preservation and monetization strategies
- Hypothetical examples of certain over-the-counter “OTC” hedging and monetization strategies
- Discussion of restricted securities, control securities, and tax considerations

1. Clients must have a minimum of \$5 million in concentrated stock positions and \$50 million of net worth (these requirements subject to change).

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A leading, global financial institution ...

Operating since 1869, Royal Bank of Canada (RBC) is among the largest banks in the world based on market capitalization. With more than 100,000¹ employees around the globe, RBC serves over 19 million¹ clients from offices in the United States, Canada, the UK, Europe, Asia, Australia and every major financial and business center.

...with a focus on U.S. markets

Today, we generate 26%¹ of our global revenue from our businesses in the United States. Our capital markets operations derive more than 53%¹ of its earnings from the U.S. market. RBC's business in the U.S. has grown by 39% over the past five years.²

In the U.S.

7th Largest bank in North America by market cap¹

6th Largest Wealth Management Firm in the U.S. by assets under administration¹

9th Largest investment bank in the U.S. by market share²

Global

2025 Revenue ¹	\$47.4 billion
2025 Net Income After Taxes ¹	\$15.5 billion
Return On Equity ¹	16.3%
Market Capitalization ¹	\$156.6 billion
Credit Ratings ¹	Moody's Aa1 / S&P AA-
Total Assets ¹	\$1,658 billion
5-Year Shareholder Return ^{1,2}	22%
Common Equity Tier 1 Ratio ^{1,2}	13.5%

1. 2025 US Capabilities Brochure

2. Past performance is no guarantee of future results. Investing involves risk, including the loss of principal

By the numbers

1.28 million

clients served
across the U.S.¹

\$772 billion

in assets under
administration for
U.S. clients¹

\$139 billion

in loans outstanding
to U.S. clients¹

26%

of our global revenue
is from our businesses
in the U.S.¹





Mitigating risk: why consider hedging and monetization strategies?

There are a variety of potential benefits associated with hedging and monetizing a concentrated stock position.

Risk management



- Downside protection while still maintaining upside potential

Estate planning



- Can create liquidity for estate taxes
- Establish trusts and other estate planning vehicles

Diversification



- Single stock concentration carries significant risk
- Diversifying into a broad portfolio may lower overall risk and provide return potential in other asset classes

Regulatory restrictions



- Can provide protection during lock-up periods for certain shareholders

Liquidity



- Investors may want to extract liquidity for major purchases, diversification, or lifestyle expenses without selling their shares outright

Emotional

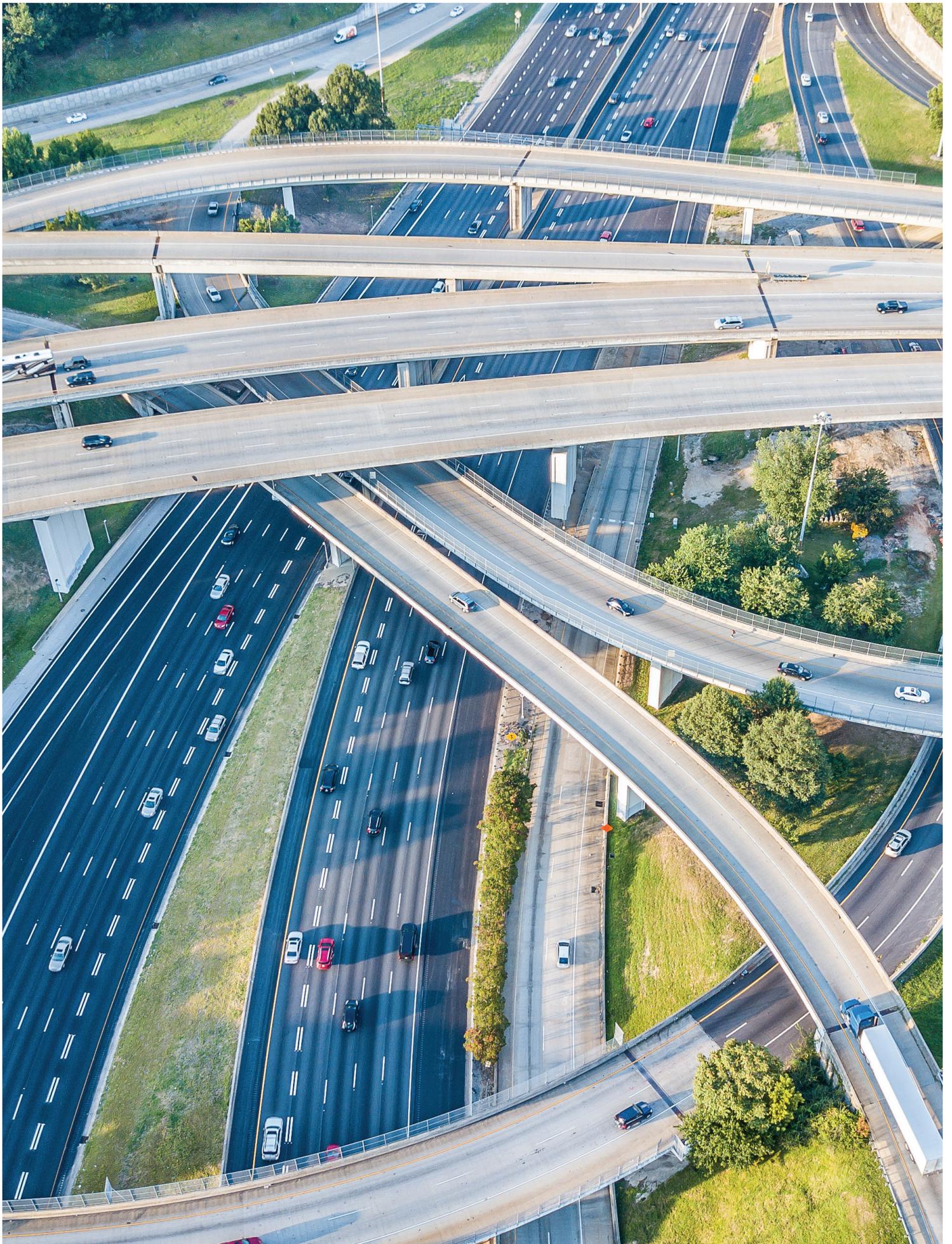


- Allows emotional investors to remain invested while still protecting downside

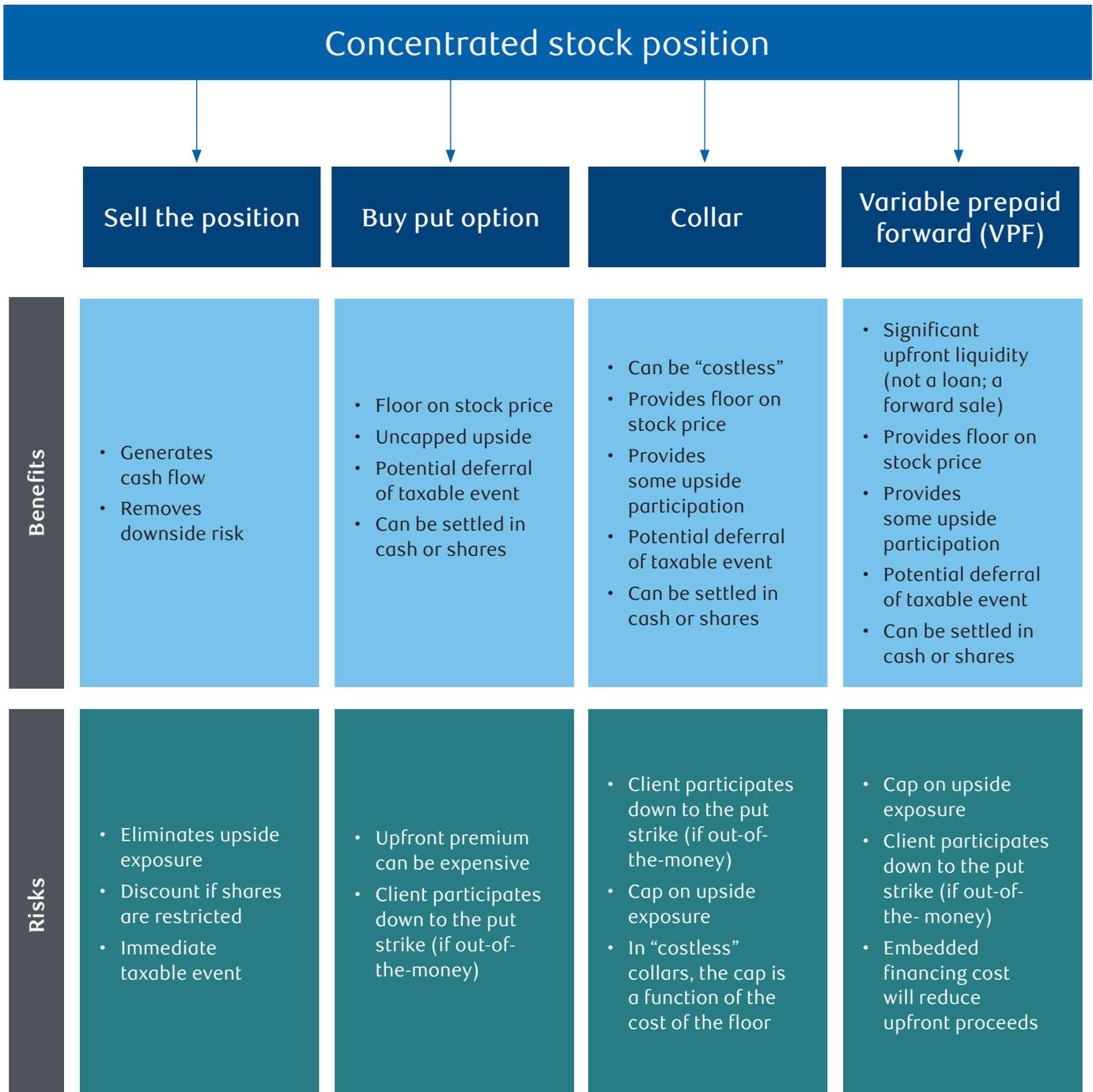
Tax considerations

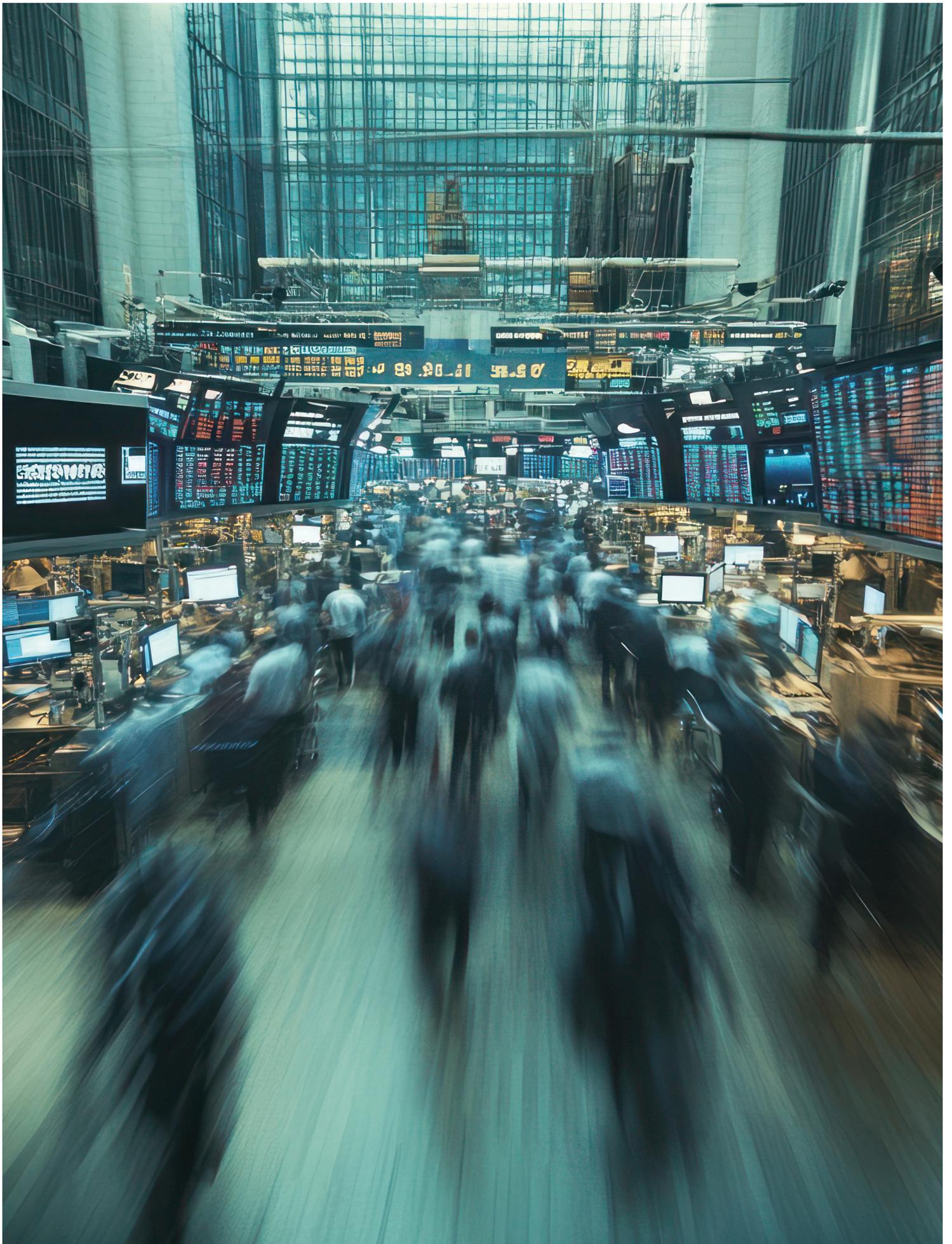


- Certain strategies defer capital gains taxes



The roadmap: wealth preservation and liquidity strategies





Customization vs. standardization: over-the-counter (OTC) and listed options

OTC options can provide clients with a highly customized solution that otherwise might not be possible through the listed options market.

	OTC options	Listed options
Type of transaction	Negotiated contract between RBC and concentrated shareholder	Trades executed on regulated, centralized exchanges
Customization	All terms such as strike price, expiration date, size, etc. are customizable	The Options Clearing Corporation (OCC) along with the exchanges, determines contract size and strike prices
Underlier universe	Single stocks, ETFs, indexes and customized portfolios (baskets)	Limited to single stocks, ETFs and indexes
Counterparty risk	Client and bank assume each others' credit risk; collateral agreements are necessary in certain transactions	The Option Clearing Corporation (OCC) is the the central counterparty for all listed options in the U.S.
Governance	Governed by International Swaps & Derivatives Association (ISDA) Master Agreement, which aim to reduce counterparty risk by providing standardized documentation and terminology for all parties involved	The SEC is the primary regulator of the securities industry which includes listed options.
Access	Typically accessible to institutional and sophisticated investors	Accessible to the general public and all types of investors
Timing	Since OTC transactions are customized and negotiated contracts, timing to execution depends on numerous factors including type of shares held, the status of the shareholder and size of the position	Can be executed during regular market hours
Settlement	Can be cash or physical delivery, as agreed by the parties	Usually standardized, with cash settlement for indices and physical delivery for stocks
Contract size	Can be tailored to the needs of the contracting parties	The Options Clearing Corporation (OCC) along with the exchanges, determines contract size and strike prices
Expiration dates	Must be an exchange trading day	Fixed expiration dates (usually the third Friday of the expiration month)
Clearing	No central clearinghouse; each party bears the credit risk	The OCC is the central clearing house for listed options executed on U.S. exchanges

Hedging: buying a put option

Benefits	Risks
Hedge underlying position below the put strike	Upfront premium payment required, which could be expensive
Full upside exposure	Exposure to stock price decline down to put strike
Protection from stock price decline below the put strike	Tax and Risk disclosures*
Retains ownership and dividends	Cost to terminate prior to maturity



Investor rationale

- Retain ownership, receives dividends and has full upside potential
- Wants protection against unforeseen events
- Has cash to spend on upfront premium, can cost 10–25% of notional value, depending on stock and level of protection (put strike)

Put option payoff illustration at maturity



Premium too expensive? Consider a put spread

A put spread cheapens the cost of protection by limiting the client’s maximum hedged amount. For example, a client can partially offset the cost of a \$90 put with the sale of a \$70 put but their maximum hedged amount would be \$20.

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Hedging: buying a put option hypothetical example

- Term = 2 years
- Initial share price = \$100
- Number of shares = 100,000 (\$10,000,000 value)
- Floor price (put strike) = \$90
- Put premium = 15% (\$1,500,000) paid upfront from client to RBC

Hypothetical scenarios at contract maturity*

Stock price at maturity	Final price (stock return)	Value of shares	Value retained net of put premium	Physical settlement	Cash settlement
\$150	\$50 (50%)	\$15,000,000	\$13,500,000	Option expires worthless/ no payments Investor retains 100,000 shares	Option expires worthless/no payments Investor retains 100,000 shares
\$100	\$0 (0%)	\$10,000,000	\$8,500,000	Option expires worthless/ no payments Investor retains 100,000 shares	Option expires worthless/ no payments Investor retains 100,000 shares
\$95	-\$5 (-5%)	\$9,500,000	\$8,000,000	Option expires worthless/ no payments Investor retains 100,000 shares	Option expires worthless/ no payments Investor retains 100,000 shares
\$90	-\$10 (-10%)	\$9,000,000	\$7,500,000	Option expires worthless/ no payments Investor retains 100,000 shares	Option expires worthless/ no payments Investor retains 100,000 shares
\$50	-\$50 (-50%)	\$5,000,000	\$7,500,000	Investor sells 100,000 shares Investor receives \$90 per share	Investor retains 100,000 shares Investor receives \$40 per share
\$0	-\$100 (-100%)	\$0	\$7,500,000	Investor sells 100,000 shares Investor receives \$90 per share	Investor retains 100,000 shares Investor receives \$90 per share

Table above assumes initial price of \$100 and the investor paid a put premium up front.

*This illustration reflects only the settlement of the contract at maturity and does not illustrate the client's return net of the put premium paid upfront or any dividends received. If the stock matures above the put strike, the option expires worthless and the investor loses the premium spent on the option. This information is not based on anyone's personal circumstances, financial goals or individual risk tolerance and is not intended to be used as the sole basis to evaluate, and does not constitute a recommendation with respect to, any investment or other specific course of action. Any long-term return forecast should not be construed as projecting actual returns of your specific investments.

Hedging: zero-cost collar

Benefits	Risks
No upfront cash premium	Capped upside and potential for capped dividends
Hedge underlying position	Exposure to stock price decline down to put strike
Maintain some potential upside exposure	Tax and Risk disclosures*
Protection from decline in stock price below put strike	Cost to terminate prior to maturity
	Must pledge shares as collateral



Investor rationale and implementation

- Generally bullish; wants to retain ownership and receives dividends
- Comfortable with capping upside in return for not paying a premium for protection
- Cost of protection (put option) is fully offset by selling away the upside above the call option strike

Zero-cost collar payoff illustration at maturity



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Hedging: zero-cost collar hypothetical example

- Term = 2 years
- Initial share price = \$100
- Number of shares = 100,000 (\$10,000,000 value)
- Floor price (put strike) = \$90
- Cap price (call strike) = \$120
- Premium paid upfront = \$0 (the purchase of the put option is offset by the sale of the call option)

Hypothetical scenarios at contract maturity*

Stock price at maturity	Final price (stock return)	Value of shares	Value retained	Physical settlement	Cash settlement
\$150	\$50 (50%)	\$15,000,000	\$12,000,000	Investor sells 100,000 shares Investor receives \$120 per share	Investor retains 100,000 shares Investor pays \$30 per share (\$150 stock price - \$120 call strike)
\$120	\$20 (20%)	\$12,000,000	\$12,000,000	Collar expires worthless/ no payments Investor retains 100,000 shares	Collar expires worthless/ no payments Investor retains 100,000 shares
\$110	\$10 (10%)	\$11,000,000	\$11,000,000	Collar expires worthless/ no payments Investor retains 100,000 shares	Collar expires worthless/ no payments Investor retains 100,000 shares
\$100	\$0 (0%)	\$10,000,000	\$10,000,000	Option expires worthless/ no payments Investor retains 100,000 shares	Collar expires worthless/ no payments Investor retains 100,000 shares
\$95	-\$5 (-5%)	\$9,500,000	\$9,500,000	Collar expires worthless/ no payments Investor retains 100,000 shares	Collar expires worthless/ no payments Investor retains 100,000 shares
\$90	-\$10 (-10%)	\$9,000,000	\$9,000,000	Collar expires worthless/ no payments Investor retains 100,000 shares	Collar expires worthless/ no payments Investor retains 100,000 shares
\$50	-\$50 (-50%)	\$5,000,000	\$9,000,000	Investor sells 100,000 shares Investor receives \$90 per share	Investor retains 100,000 shares Investor receives \$40 per share
\$0	-\$100 (-100%)	\$0	\$9,000,000	Investor sells 100,000 shares Investor receives \$90 per share	Investor retains 100,000 shares Investor receives \$90 per share

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Hedging and monetizing: variable prepaid forward (VPF)

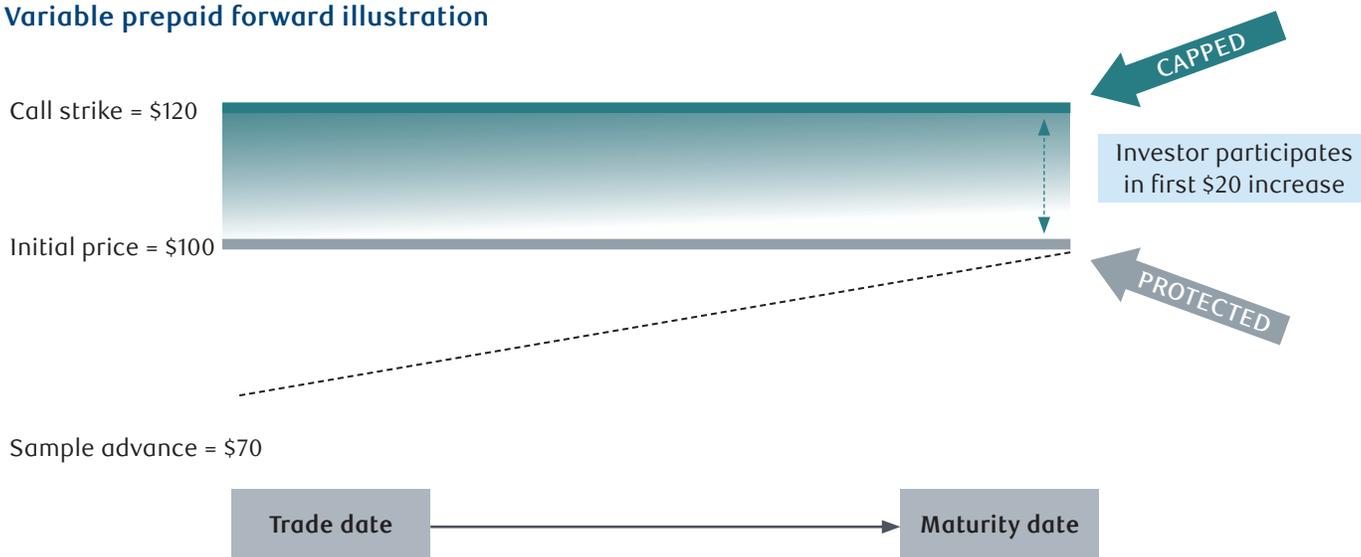
Timeline	Event
Substantial upfront liquidity	Capped upside and potential for capped dividends
Hedge underlying position	Exposure to stock price decline down to put strike
Maintain some potential upside exposure	Must pledge shares as collateral
Protection from decline in stock price below put strike	Tax and Risk disclosures*



Investor rationale and implementation

- Wants substantial upfront liquidity without restrictions on the proceeds (can be invested in marketable securities)
- Wants to defer the sale of shares (typically two to five years), still participates in upside, retains ownership and receives dividends
- Comfortable with capping upside

Variable prepaid forward illustration



How is the advance amount determined?

1. Cost of funds >> present value discount of the lower strike
2. Cost of hedge >> cost of the collar with the specified put and call strikes
3. Dividend yield >> present-value of dividend cash flows are debited

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Hedging and monetizing: variable prepaid forward (VPF) hypothetical example

- Initial share price = \$100
- Number of shares: 100,000 (\$10,000,000 value)
- Cap price (upper limit) = \$120
- Floor price (lower limit) = \$100
- Upfront proceeds = 70% (\$7,000,000)
- Shares delivered =
 - If share price at maturity is below or equal to Floor price: Number of shares x 100%
 - If share price at maturity is strictly between Floor price and Cap price:
Number of shares x (Floor price / Share price at maturity)
 - If share price at maturity is above or equal to Cap price:
Number of shares x [(Share price at maturity – Cap price + Floor price) / Share price at maturity]
- Number of shares investor retains = Number of shares – Shares delivered

Timeline	Event
Trade date	Client receives a discount to the current stock price by agreeing to deliver a variable amount of shares (or cash equivalent) at maturity
During the term	Client generally retains an agreed-upon dividend on the collateral and most VPFs are structured so that RBC effectively receives any dividends exceeding that dividend amount; terms typically are three to five years.
At maturity	Client delivers a variable amount of shares (or cash equivalent) based on the formulas illustrated below

Stock price at maturity	Value of shares	Physical settlement	Cash settlement	# of shares retained (if physical settlement)	Value of retained shares	Upside participation
\$150.00	\$15,000,000	86,667	\$13,000,000	13,333	\$2,000,000	20.0%
\$140.00	\$14,000,000	85,714	\$12,000,000	14,286	\$2,000,000	20.0%
\$130.00	\$13,000,000	84,615	\$11,000,000	15,385	\$2,000,000	20.0%
\$120.00	\$12,000,000	83,333	\$10,000,000	16,667	\$2,000,000	20.0%
\$115.00	\$11,500,000	86,957	\$10,000,000	13,043	\$1,500,000	15.0%
\$110.00	\$11,000,000	90,909	\$10,000,000	9,091	\$1,000,000	10.0%
\$105.00	\$10,500,000	95,238	\$10,000,000	4,762	\$500,000	5.0%
\$100.00	\$10,000,000	100,000	\$10,000,000	0	\$0	0%
\$90.00	\$9,000,000	100,000	\$9,000,000	0	\$0	0%
\$80.00	\$8,000,000	100,000	\$8,000,000	0	\$0	0%
\$70.00	\$7,000,000	100,000	\$7,000,000	0	\$0	0%

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Hedging and monetizing: variable prepaid forward (VPF) hypothetical example (continued)

Examples of the taxable gain or loss recognized upon cash settlement (with respect to the same hypothetical VPF terms above) are outlined below.* Further information regarding the tax consequences of entering into a VPF, including a description of the constructive sale rules, straddle rules and the tax treatment of physical settlement, are included in the Selected Tax Considerations section on page 23.

Some of the assumptions we have made for purposes of these examples are as follows:

- The investor is a U.S. taxpayer
- The investor held 100,000 shares for more than a year at the time of entering into the VPF
- Entering into the VPF does not trigger a “constructive sale” or other deemed sale of the shares for U.S. tax purposes
- The VPF is not materially amended or modified before settlement. (Note that a material modification such as a “roll” of the VPF will typically be taxed as if the existing VPF were cash settled and a new VPF were entered into, with the terms of the new VPF immediately after the roll or other modification being retested for purposes of the “constructive sale” rules.)

Stock price at maturity	Cash settlement		
	Cash delivered	Long-term capital gain (loss)	Short-term capital gain (loss)
\$150	\$13,000,000	(\$6,000,000) deferred	
\$110	\$10,000,000	(\$3,000,000) deferred	
\$80	\$8,000,000	(\$1,000,000) deferred	
\$60	\$6,000,000		\$1,000,000

Any loss on settlement of the VPF will generally be long-term capital loss and such loss may be deferred under the “straddle” rules to the extent of unrealized gains on any appreciated shares of the underlying stock that are held by the investor or capitalized into the basis of retained shares if the investor has made an identified straddle election.

*The tax implications of entering into variable prepaid forward contracts will vary depending on how they are used, the specific terms of the transaction and an investor’s particular circumstances. This example does not purport to provide a comprehensive discussion of all of the income tax consequences that may be relevant. Given the complexity of these financial instruments and the potential for tax regulations to change, it is crucial for taxpayers to seek advice from a qualified tax advisor, who can provide guidance based on the specifics of the transaction and the current tax laws. Neither RBC nor its affiliates provide legal, regulatory, accounting, or tax advice and nothing in these materials should be construed as legal, regulatory, accounting, or tax advice.

A closer look at creating liquidity: variable prepaid forward (VPF) vs. margin loans

VPFs can provide significant advantages to traditional margin loans for those seeking liquidity from their equity portfolio.

	VPF	Margin loan
Proceeds amount	Can be as high as 85–90% of notional value	Maximum of 50% of notional value
Use of proceeds	No restrictions	Restrictions may apply
Servicing during term	None; fully collateralized by the shares	Subject to margin call based on market movements; additional collateral could be required
Interest	None (not a loan)	Yes; typically a floating rate
Ownership and control	Full ownership and control	Full ownership and control
Price cap	Yes; investor has essentially locked in a price and cannot participate above that	No; investor can participate in full upside
Price floor	Yes; investor is protected below the stated floor price	No; client is subject to full downside risk
Dividends	Yes; but typically capped at a pre-determined level	Yes; receives all dividends



Regardless of which option best meets your needs for the short- and long-term, RBC Wealth Management can provide advice and guidance—working with you and your relevant tax and legal professionals.

For more information, reach out to your RBC Wealth Management financial advisor.

An overview of restricted and control securities risks and considerations

Restricted and control securities are two categories of stock that have certain limitations on their sale or transfer. They are typically acquired through private placements or other non-public means while control securities are securities held by an affiliate of a company and in each case are governed by specific regulations.

	Restricted securities
Definition	Restricted securities are generally securities acquired directly or indirectly from the issuer or an affiliate of the issuer through a private transaction or series of private transactions, such as private placements, employee stock benefit plans, or as compensation for professional services.
Regulations	The most common rule governing the sale of restricted securities is Rule 144 under the Securities Act of 1933. Rule 144 provides a safe harbor that allows holders of restricted securities to sell their shares once a minimum holding period is met.
Holding period	The required holding period before restricted securities can be sold under Rule 144 is generally six months for reporting companies (those subject to SEC reporting requirements) provided that the issuer has filed all required periodic Exchange Act reports in the one year preceding the sale and one year for non-reporting companies or reporting companies that have not met such filing obligations.
Legend	Restricted securities typically bear a legend indicating their restricted status. This legend must be removed before the securities can be sold, which usually involves a legal opinion stating that the conditions of Rule 144 have been met.

	Control securities
Definition	Rule 144 can also be relied upon when selling control securities. However, affiliates face additional/different restrictions to prevent potential abuses of insider information (though both restricted and control security resale conditions will apply to a sale if an affiliate is selling restricted securities).
Regulations	Control securities are subject to the same regulations that apply to restricted securities. However, because control persons are considered insiders, they face additional restrictions to prevent potential abuses of insider information.
Reporting requirements	Affiliates must also file Form 144 with the SEC if the sale of control securities exceeds certain thresholds in reliance on Rule 144. This form provides notice of the intent to sell and includes information about the sale.
Volume/manner of sale	Rule 144 requirements (i) dictate the manner of sale for control securities, which generally requires that sales be conducted through a broker in routine brokerage transactions or riskless principal transactions, without any solicitation of orders to buy the securities and (ii) imposes a volume limitation that limits the number of control securities that can be sold in any three-month period.

Both restricted and control securities are subject to complex regulations designed to prevent market manipulation and protect investors. Anyone dealing with these types of securities should be familiar with the rules or seek advice from a legal professional to ensure compliance with all applicable laws and regulations.

An overview of restricted and control securities, continued (Rule 144) risks and considerations

Rule 144 under the Securities Act of 1933 is a regulation set forth by the U.S. Securities and Exchange Commission (SEC) that provides a safe harbor exemption from the registration requirements for the public resale of restricted and control securities. Reliance on Rule 144 requires meeting specific conditions to sell these securities publicly without having to register such sale with the SEC.

Rule 144 provides a way for holders of restricted or control securities to sell their shares in the public market, subject to compliance with its conditions. This is important because it allows for liquidity and the possibility of monetizing investments that were previously locked up due to their restricted nature.

		Rule 144 conditions
Only applies to control securities	Current public information	Adequate current information about the issuing company must be publicly available. This typically means that the company has complied with the periodic reporting requirements of the SEC.
	Trading volume formula	The amount of securities that can be sold during any three-month period is limited. For affiliates, the limit is the greater of 1% of the shares outstanding of the same class being sold or the average weekly trading volume during the four weeks preceding the filing of a notice of sale on Form 144.
	Ordinary brokerage transactions	Sales must be handled as routine trading transactions and brokers may not receive more than a normal commission. Neither the seller nor the broker can solicit orders to buy the securities.
	Filing a notice of proposed sale	For affiliates, when the sale exceeds certain thresholds, Form 144 must be filed with the SEC. This form is a notice of the intent to sell restricted or control securities.
	Manner of sale requirements for affiliates	Affiliates must sell their shares in a manner that does not disrupt the market, such as selling through a broker in ordinary brokerage transactions.

It's important to note that Rule 144 is complex and the conditions for selling restricted or control securities can change. Therefore, individuals and entities looking to sell such securities in reliance on the Rule should consult with legal professionals who are well-versed in securities law to ensure they are in full compliance with the Rule's requirements.

Selected tax considerations

Over-the-Counter (OTC) options transactions, such as puts, collars and variable prepaid forward contracts, can have various tax implications depending on how they are used, the specific terms of the transaction and an investor's particular circumstances. Below is a general summary of some of the material income tax issues that could impact an investor. This summary does not purport to provide a comprehensive discussion of all U.S. federal income tax consequences that may be relevant and does not address any state, estate, local, foreign or other tax consequences of a transaction. Given the complexity of these financial instruments and the potential for tax regulations, rulings and other guidance to change, it is crucial for taxpayers to seek advice from a qualified tax advisor, who can provide guidance based on the specifics of the transaction and the current tax laws. Neither RBC nor its affiliates provide legal, regulatory, accounting, or tax advice and nothing in these materials should be construed as legal, regulatory, accounting or tax advice.

As discussed further below, some tax considerations related to the hedging and monetization strategies discussed above are:

- **Potential Deferral of Income/Gain** – option premium or a prepayment on a variable prepaid forward (“VPF”) may not be taxable as income or gain when cash is received.
- **Constructive Sale Rules** – certain hedging transactions may trigger gain recognition on the hedged position if too economically similar to a short sale, short total return swap or short forward (where the price and amount of property to be delivered are substantially fixed).
- **Other Deemed Sale Risks** – a VPF may trigger upfront gain recognition in certain circumstances, including where there is no right of the investor to cash settle the contract, rather than deliver the underlying shares, or if the other party has the right to borrow the underlying shares from the investor.
- **Retesting on a Material Modification, Including a Roll** – a hedging transaction may need to be retested when modified (including rolls) to determine whether a constructive sale or other deemed sale of the referenced shares has occurred as a result of the modification.
- **Straddle Rules** – The straddle rules could have adverse tax consequences including:
 - An investor that has not already held the shares for more than a year when entering into a tax straddle will generally not get long-term capital gains when selling the stock.
 - If an investor has held the shares for more than a year when entering into the tax straddle, any loss on the hedging transaction generally will be long-term capital loss.
 - Any losses on cash settlement of the hedging transaction will generally be deferred while there is still unrecognized gain on the referenced stock.
 - Physical settlement of a loss straddle position will generally be taxed as if the position had been cash settled and the shares delivered sold for their fair market value, potentially resulting in higher taxable gains in the year of settlement if the loss on the deemed cash settlement is deferred.
 - Investors should consult a tax advisor as to whether to make certain identification elections.
- **Taxation of Dividends** – dividends received on hedged stock will generally not be eligible for the lower tax rates on “qualified dividends.”

Constructive sale considerations

Under the “constructive sale” rules in the Internal Revenue Code, an investor who enters a hedging transaction that reduces risk with respect to the investor's appreciated stock position may be treated as having constructively sold their stock for U.S. federal income tax purposes. Specifically, a constructive sale may arise if the investor enters into, with respect to the appreciated stock, a short sale, an offsetting notional principal contract or a forward contract that requires the delivery of a substantially fixed amount of stock for a substantially fixed price. In addition, other hedging

transactions, such as put options or collars, may be treated as constructive sales if they have “substantially the same effect” as the transactions listed in the preceding sentence.

Although the Internal Revenue Service (the “IRS”) has provided limited guidance on the definition of a constructive sale, the prevailing market view is that a hedging transaction in the form of a put, collar or VPF contract does not give rise to a constructive sale provided that, under the terms of the contract, the taxpayer retains sufficient upside and/or downside exposure to the underlying stock. In the case of collars or VPFs, the taxpayer’s retained exposure depends on, among other things, the put and/or call strike prices embedded in the terms of the contract.

A separate body of case law holds that an investor may have a deemed sale of their stock position if, as a result of entering into a hedging transaction, they have not retained sufficient elements of ownership with respect to the position. While these authorities depend on the particular facts and circumstances, the IRS has ruled in the context of a VPF that the investor’s ability (both as a contractual matter and as an economic matter) to elect to cash settle the contract, rather than deliver the underlying shares, helped support the conclusion that the investor retained ownership of the shares for tax purposes. In addition, one court case addressed the collateral arrangements associated with a VPF contract, holding that the forward counterparty’s right to borrow the pledged shares resulted in a taxable disposition by the investor of those shares.

Prospective investors should be aware that, assuming there is no disposition of the stock for tax purposes upon entry into the hedging transaction, a delivery of stock to settle the contract would nonetheless be a taxable event with respect to the stock delivered. Additionally, modifications to a contract throughout the term of the contract may result in a taxable event with respect to the contract and may require retesting of whether a “constructive sale” has occurred, as described above.

Straddle considerations

The U.S. federal income tax “straddle” rules are likely to apply to an investor who enters into a hedging transaction such as a put, collar or VPF contract with respect to actively traded stock, and these rules can have, among other things, consequences for the investor’s holding period in the stock as well as the timing of recognition of loss, if any, on the hedging transaction.

Very generally, a straddle is defined as offsetting positions with respect to actively traded property such as stock. Because the value of the put, collar or VPF contract varies inversely with the stock hedged by the contract, such a contract and the related stock are likely to constitute a straddle.

One consequence of straddle treatment is that, unless the investor has a long-term holding period in their stock prior to entry into the hedging transaction, the holding period of the stock will be reset to zero and will not grow as long as the stock is a position in a straddle for tax purposes. Accordingly, an investor who has held a stock position for less than a year and one day prior to entering into a corresponding hedging transaction and disposes of the stock at a gain after termination of the hedge will recognize short-term capital gain (which is taxed at the higher rates applicable to ordinary income) unless the investor waits to dispose of the stock until more than a year after the termination of the hedging transaction. Additionally, if the investor has a long-term holding period in their stock prior to entry into the hedging transaction, any loss on the hedging transaction will be treated as long-term capital loss (to the extent it is not deferred as discussed below), irrespective of how long the investor held its position in the hedging transaction.

A second consequence of straddle treatment is that the investor’s ability to recognize losses on a straddle position is limited. As a result, if the investor cash-settles a put, collar or VPF contract, any loss that would otherwise be recognized on the contract may be deferred as long as the investor continues to hold any stock that constituted a straddle with the put, collar or VPF contract.

Straddle treatment can also limit the ability of an investor to deduct interest expense on a loan or other debt obligation incurred to purchase or carry a position in the straddle.

Depending on the investor’s circumstances, it may be advantageous for an investor to make an “identified straddle” election with respect to the hedging transaction and the underlying stock. Positions in an “identified straddle” are generally not treated as straddle positions with respect to other positions held by the investor, which may be desirable for an investor who only hedges a portion of their stock holdings. In order to properly make an identified straddle election, a straddle must be clearly identified on the investor’s records by the close of the day on which the hedging transaction is entered into. Because the straddle rules are extremely complex, the investor should consult their tax advisor about whether to make such an election.

Physical settlement

The U.S. tax consequences relating to the physical settlement of a VPF can be complex and lead to potentially adverse tax consequences depending on the investor's particular circumstances. In particular, in certain situations physical settlement of a loss straddle position may be taxed as if the position had been cash settled and the shares delivered sold for their fair market value, potentially resulting in higher taxable gains in the year of settlement and a deferral of the offsetting loss. Investors may want to speak to their tax advisors about making an identified straddle election, as described above, to mitigate this risk.

Dividends

In general, dividend income recognized by an individual investor with respect to stock positions meeting certain requirements may be "qualified dividend income" that is subject to tax at U.S. federal tax rates applicable to long-term capital gain, which are lower than ordinary income tax rates. However, entering into a hedging transaction such as a put, collar or VPF may cause dividends paid on the hedged stock position to be ineligible for "qualified dividend" treatment and therefore be subject to tax at ordinary income tax rates.

The discussion above represents a general summary and is not a complete discussion of all U.S. federal income tax rules that may be relevant to an investor who enters into a put, collar or VPF contract. Moreover, the tax rules that apply to these transactions are highly complex. Therefore, an investor should seek professional tax advice before entering into any hedging transaction with respect to an appreciated stock position.

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