Deliver to: Brent Shumate

The "Daily Plan-It™"

SHUMATE BROKERAGE CORP.

Volume 8, Issue 11 **6/1/2006**

Popular Hedging Approach at Risk

If your clientele includes wealthy executives and/or entrepreneurs who use a popular hedging strategy known as "prepaid variable forward," it may be time to put them on red alert. The IRS issued a technical advice memorandum earlier this year that paves the way for potential audits for people using this technique.

Prepaid Variable Forward

This strategy, used by top-level executives, makes use of derivatives to protect hefty stock positions from sudden drops in the market. In return for giving their shares to a financial institution in the future—typically two to five years—investors get an upfront payment now from between 75 to 90 percent of the stock's value. This protects them from any drop in the stock's price, but still enables them to participate if the stock rises. In addition, capital gains taxes can be deferred to a later date.

Senior executives who have large positions in their companies often use this technique to diversify their holdings.

The Short Side of Share-Lending

Once the financial institution receives these shares, they often use them to hedge their positions by selling some of the shares short. Shares used for shorting are generally borrowed from the security lending market. However, companies who handle prepaid variable forward sales often borrow shares to short from the same investor. This process is called "share-lending."

Earlier this year, the IRS issued a technical advice memorandum stating that once an investor gives up shares for share-lending, they are no longer owners of these shares, and therefore, owe capital gains taxes immediately, rather than in the future. This could create a sudden, and unwanted, tax hit that could trigger back taxes, interest, and possibly an audit for users of this strategy.

Avoiding a Tax Trap

The good news is that not all prepaid variable forward deals will be subject to IRS scrutiny—just ones that engage in share-lending. However, these transactions may have already involved billions of dollars. Therefore, it's important to alert your clients to be cautious about lending shares to a financial institution if they want to protect themselves from a potentially severe tax hit and unwanted audit.

If your clients have engaged in this strategy, they should consult their tax professional immediately to make sure that they are not at risk for the IRS' fine-tooth comb. Although the memorandum can't be used as a precedent because it related only to one investor, it could set the tone for future scrutiny of comparable transactions.

Shumate Brokerage Corp.

1918 West Cass Street
Tampa, FL 33606-1232
800.330.8582
813.254.7681
Fax ~ 813.251.8049

www.ShumateBrokerage.com

Email ~ Brent@ShumateBrokerage.com

Marketing
competitively priced term, whole life, universal life and annuities.
Profitable handling
of your most difficult impaired risk life cases.
Multiple companies
for you to select from.

Serving Florida Insurance Professionals since 1957!

© 2006 SHUMATE BROKERAGE CORP., Phone: 813-254-7681. All rights reserved.
No portion of this newsletter may be reused in any way without prior express written consent.