Singer Wealth

Diversify a Concentrated Stock Position Without Paying Capital Gains

Many successful investors find themselves holding a large position in a single stock, often the result of years of stock-based compensation or fortuitous investments in a high-flying stock. While this can lead to tremendous wealth creation, it also brings a major risk: lack of diversification.

During the dotcom craze, many investors saw dramatic gains in their portfolios only to be faced with the dilemma of locking in profits and paying taxes or continuing to take outsized risk. We all know how that ended. The question becomes: how can you reduce risk without selling and triggering large capital gains taxes?

A common solution is the exchange fund. Investors contribute appreciated stock into a partnership that holds many different equities. In return, they receive an interest in a diversified portfolio without realizing gains at the time of contribution. After a set holding period, typically seven years, the investor can redeem for a basket of diversified stocks.

However, traditional exchange funds have notable drawbacks. They're generally illiquid and often require high minimums. Many of them also exclude the most widely held names such as Apple, Microsoft, Amazon, or other "Magnificent 7" stocks, because those positions already dominate the portfolio.

A newer, more flexible solution is Section 351 ETF, which uses Section 351 of the tax code to allow investors to contribute appreciated stock into an ETF structure on a tax-deferred basis. In exchange, they receive shares of a fully liquid, equal-weighted S&P 500 ETF or other similar ETF. This structure can provide instant diversification and daily liquidity, which is a major improvement over traditional exchange funds. Importantly, the contribution of stock to the ETF does not trigger capital gains, allowing investors to diversify without selling.

While the 351 ETF can be a powerful tool, it's not a one-size-fits-all solution. Investors should carefully review the mechanics and potential tax implications with an experienced advisor before proceeding.

For those holding a large, appreciated position, especially in one of the Magnificent 7, a Section 351 ETF may be one of the most elegant ways to achieve true diversification while maintaining liquidity and deferring taxes.

Have you heard about our Vision Quest Process? Watch the video below to learn more!

We are committed to helping you achieve your financial goals. Please feel free to contact us with any questions, comments, or a more in-depth discussion.

Sincerely,
Keith Singer

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