Tax Aware

A Brief Guide to Pricing and Taxation of Variable Prepaid Forwards

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Variable prepaid forward (VPF) contracts have been developed as a solution to hedging the risk of concentrated low-basis stock. Using options pricing theory, we develop a VPF pricing model that helps understand the VPF prepayment amount and the cash flows and tax liabilities upon VPF rolls. We also provide a detailed discussion of the application of tax straddle rules to VPF transactions. We show that, depending on circumstances, a VPF can offer a prepayment exceeding 90% of the value of the stock committed to the contract, with the VPF floor having a major impact on the prepayment amount. We find that, while for some price ranges, rolling a VPF may generate a positive cash flow for the investor, rolling a VPF can be very costly when the stock price declines significantly, which is the very scenario from which the investor seeks protection by entering into the VPF contract in the first place.

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