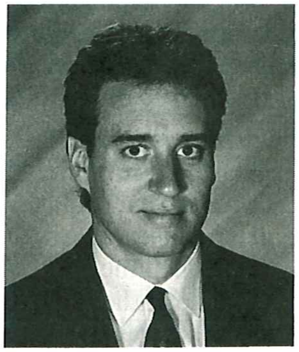
Estate Planning With Short Sales

Christopher P. Bray explores the viability of this technique.



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On November 17, 1995, the Estee Lauder family consummated what may be the most highly publicized capital gain avoidance transaction since the recent wave of expatriation by prominent U.S. taxpayers seeking relief from U.S. income and estate taxes. On that date, the Lauder family shareholders sold almost 15 percent of their cosmetic empire in an initial public offering of The Estee Lauder Companies, Inc.[1] There was nothing particularly unusual about the initial public offering of the tightly held make-up giant. What was unusual was the fact that much of the stock offered was borrowed stock. As such, the selling shareholders may never have to pay taxes on over $330 million of proceeds they received in the offering that might ordinarily have been considered capital gain had the shares sold not been borrowed.[2] That's the power of selling short-against-the-box.

[1] The Estee Lauder Companies, Inc. Prospectus for 15,309,784 Shares of Class A Common Stock, November 16, 1995.

[2] See Sloan, "Lauder Family's Stock Maneuvers Could Make A Tax Accountant Blush," *Washington Post* at D3 (Nov. 28, 1995). See also, Sloan, "Passing The Smell Test," *Newsweek* at 57 (Dec. 4, 1995), and Sheppard, "Fixes to Ensure That Tax Is Paid On Capital Gains," 95 *Tax Notes Today* 236-5.

The Short Sale Against-the-Box

A short sale is a contract for the sale and delivery at a future date of shares of stock or property that the seller does not own or does not want to transfer.[3] Short selling shares of stock involves borrowing the shares of stock (usually from a broker) and then selling the borrowed shares. For income tax purposes, however, the short sale is not closed until delivery of the shares to cover the borrowed shares takes place.[4] A short-against-the-box transaction is simply a short sale of shares of stock that one already owns. Why would one sell short-against-the-box? Typically, an investor sells short-against-the-box to lock in a gain on stock that the investor owns without recognizing the gain for federal income tax purposes. The investor therefore obtains tax savings related to the deferral of capital gain recognition at the expense of interest costs on the borrowed shares sold short for the period in which the transaction remains open.

The Lauder Family Transaction

Until November 17, 1995, The Estee Lauder Companies Inc. (the company) had been a privately held venture since 1946. Leonard Lauder, Estee's older son and the company's chairman and C.E.O., had a reputation for publicly extolling the virtues of private ownership while lamenting the hassles and "headaches" of leading a public company.[5] So why did the Lauder family take the company public? It was done in large measure to alleviate the sobering economic liability facing the company and its shareholders resulting from the impending imposition of federal estate tax on Estee Lauder. In fact, the Lauder family was not bashful in its admission of the primary purpose for the offering. The prospectus is clear: "The principal reasons for the Offerings are to provide the stockholders of the company increased liquidity *for estate planning*. . . ."[6] In addition to the estate planning purpose for the transaction, the offering was structured as a device for Ronald Lauder, Estee's younger son, to transmute his ownership of the company into cash desperately needed to finance his lavish lifestyle and investment appetite.[7]

Although a public offering would provide the desired liquidity solution for the family, the offering created another potential problem—payment of massive capital gain taxes resulting from the exchange of low basis stock for cash. As the transaction unfolded, it became obvious that the family's tax advisors had solved the collateral problem as well in the form of an intrafamily short-sale-against-the-box.

The offering comprised the sale of 15,309,784 of the company's 115,000,000 shares to the public by Estee,[8] Leonard, and Ronald Lauder and the company for over $370 million.[9] Estee sold 5,500,000 shares for $135,135,000, Leonard sold 1,041,667 shares for $25,593,758, Ronald sold 8,333,333 shares for $204,749,992, and the company sold the remaining shares.[10] Immediately before the offering, Estee and Ronald borrowed the shares that they sold, largely from Leonard, and in return gave Leonard a note obligating them to repay the borrowed shares to Leonard on his demand.[11] Estee and Ronald therefore sold the stock short-against-the-box and, as a result, received their sales proceeds *tax free*. Estee and Ronald won't have to recognize capital gain related to the sale until they actually repay the shares they owe to Leonard, thus closing the short sale.[12]

The short sale by Estee, who is 87 years old, will probably not be closed until her estate repays the shares to Leonard. Since company stock owned by Estee at death will take a step up in basis to fair market value, it is conceivable that capital gain won't be recognized when the short sale is closed.[13] If the fair market value of the stock at date of death exceeds the fair market value of the stock on the date of the original short sale, Estee's estate will recognize capital loss.[14] The writers who have generated much of the media attention concerning the transaction speculate that Ronald will leave the short sale open until after his death as well.[15]

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[3] *Provost v. U.S.*, 1 USTC ¶ 153, 269 US 443 (1926).

[4] Reg. § 1.1233-1(a).

[5] See Jereski and Bird, "Ronald Lauder's Debts and Estee's Old Age Force a Firm Makeover," *The Wall Street Journal* at A1 (Nov. 8, 1995).

[6] See supra, note 1, at 9.

[7] See supra, note 5.

[8] Actually, the selling shareholder was a trust created for Estee's benefit called the EL 1994 Trust (see supra note 1, at 56), the trustees of which are Leonard Lauder and Ira Wender, the family's attorney. It is assumed that Estee has retained significant powers over the trust so as to prevent a taxable gift upon her contribution of Company shares to the trust in June, 1994, and to ensure inclusion of trust corpus in her estate at death.

[9] See supra, note 1.

[10] Id.

[11] Id. at 53.

[12] IRC Sec. 1233; and Reg. § 1.1233-1(a).

[13] IRC Sec. 1014(a).

[14] See supra, note 11.

[15] See supra, note 2.

Estate Planning with Short Sales

Now the question becomes, can "ordinary" taxpayers implement the short-sale-against-the-box technique in their estate planning? Maybe. Two situations where taxpayers may be able to avail themselves of this type of planning include a situation where a family held business is anticipating an initial public offering [16] and a situation where a family group shares common ownership of an issue of stock that is already publicly traded. Additionally, there may be two different methods of using a short-sale-against-the box resulting in permanent capital gain avoidance. They include a closing of a short-sale-against-the-box by the estate of the original short seller [17] and the closing of a short-sale-against-the-box by a beneficiary who closes the short sale using shares acquired from the decedent's estate.

Public Offering of Family Held Company. This technique is illustrated in the aforementioned discussion of the Lauder family transaction. The short selling shareholder need only rely on the long-standing authority of Sections 1233 and 1014. Also, there is no need to fret over whether the open short sale may represent income in respect of a decedent under the provisions of Section 691. The Service addressed this issue in Revenue Ruling 73-524, holding that the appropriate basis to use in closing a short sale after death is the stock's fair market value at death [18] rather than the stock's basis before death. [19] Recently, the Service issued another favorable ruling to a taxpayer [20] announcing less ambiguously that, "the excess of the short sale price over the pre-death basis of such shares will not constitute income in respect of a decedent under Section 691."[21]

Common Family Ownership of Publicly Traded Stock. The privilege of exploiting the Internal Revenue Code need not be the sole province of industry for the super wealthy. The short-sale-against-the-box technique could work for a family that may not be standing in line to reap the financial windfall of having a family company go public.

> **Example:** Consider ordinary Senior and Junior who both invested heavily in Cisco Systems, Inc. at its initial public offering price in February, 1990. A sale of Cisco stock purchased in 1990 today would result in a significant capital gain tax liability.[22] If Senior has a liquidity need but doesn't want to be stuck with only after-tax proceeds on the sale of his Cisco stock, he can borrow the Cisco stock from Junior and then sell the borrowed stock for cash without capital gain recognition. If Senior doesn't close the short sale, but rather waits to let his estate close the short sale, then the transaction will most likely result in permanent capital gain tax avoidance.[23]

If the short-sale-against-the-box technique is used in either of these situations, beware of the *Dickman* [24] gift. Remember that an intrafamily short-sale-against-the-box requires borrowing among family members and, as such, the borrowing should be treated as an arms-length transaction to avoid gift tax consequences. An interest element charged at a rate equal to at least the applicable federal rate in accordance with Section 7872 will preclude any attack by the government that the arrangement constituted an indirect gift.[25]

Short Sale by the Estate of the Original Short Seller. Again, the Lauder family transaction is a case in point. As it stands, Estee Lauder owes an obligation to Leonard Lauder to repay 5,500,000 shares of company stock that she sold short for $135,135,000, at $24.57 per share. If the stock had zero basis and had not been sold short, a federal capital gain tax liability of $37,837,800 would have been generated,[26] resulting in net proceeds of only $97,297,200 available for Estee's use. Instead, the short sale provides her with tax-free proceeds of the full $135,135,000. Assume that the company stock has a fair market value of $35 per share at her death and the short sale still remains open. All

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[16] In which case the taxpayers could use the Lauder family transaction as a perfect template in accomplishing the same objectives.

[17] Again, this method is identical to the method that is speculated that Estee Lauder will use to close her short sale.

[18] Or fair market value on the alternate valuation date determined pursuant to Section 2032.

[19] Rev. Rul. 73-524, 1973-2 CB 307.

[20] Who was still apparently uneasy about the prospect of having an open short sale characterized as income in respect of a decedent under Section 691 despite the earlier holding under Rev. Rul. 73-524, 1973-2 CB 307.

[21] CCH IRS LETTER RULINGS REPORT No. 915, Sept. 14, 1994, LTR 9436017 (June 7, 1994).

[22] Cisco Systems, Inc., which currently trades on the NASDAQ, has appreciated substantially from its initial public offering split adjusted share price of less than $1 in 1990 to its current share price of $44. The stock has experienced a 2 for 1 stock split five times since its initial public offering.

[23] Assuming, of course, that the fair market value of Cisco stock at Senior's death is at least equal to, or exceeds, the fair market value of Cisco stock when Senior short sold it.

[24] *Dickman v. Com.*, 84-1 USTC ¶ 9240, 465 US 330 (1984). It was this landmark case that resulted in the enactment of the below-market interest loan provisions of Section 7872.

[25] *Frazee v. Com.*, CCH Dec. 48,192, 98 TC 554, 558 (1992).

[26] The result of $135,135,000 taxed at the top federal capital gains tax rate of 28%. State tax consequences are ignored for this example.

company stock still owned by Estee at death will take a step up in basis from zero to $35 per share pursuant to Section 1014. If her estate uses shares owned at death to repay Leonard and close the short sale, the estate will recognize a capital loss of $57,365,000.[27]

Short Sale by Beneficiary Receiving Shares Sold Short from Decedent. Let's consider Senior and Junior again.

> **Example:** Assume that Junior, rather than Senior, has a liquidity need but doesn't want to recognize capital gain on the sale of Cisco stock to generate cash. This time Junior borrows some Cisco shares from Senior and sells them short-against-the-box, realizing the stock's full fair market value in cash proceeds without the attendant payment of capital gain tax. If the sale remains open until Senior's death and Junior, as beneficiary of Senior's estate, received a distribution of Cisco shares owned by Senior at his death, then Junior could use those shares, with their stepped-up basis, to repay Senior's estate to close the short sale.

And again, the result is permanent capital gain tax avoidance. Only this time Junior, rather than Senior, avoids the gain.

Proposed Legislation

Within less than 60 days of the November 17, 1995 transaction, the Treasury countered the flurry of media attention surrounding the Lauder family's savvy tax planning with a press release of its own. On January 12, 1996, the Treasury proclaimed that a proposal would be offered as part of the ongoing budget negotiations that would be, "aimed at tax-deferral techniques commonly referred to as 'short-against-the-box' transactions."[28] Significantly, the Treasury also announced that the proposal would seek to end the deferral opportunities of short-sales-against-the-box for transactions entered into after January 12, 1996. Just as suspected, the press release and its subject proposal represented the administration's response to "widespread concern" about the well-publicized Lauder family transaction.[29]

On March 19, 1996, the Clinton Administration's Revenue Reconciliation Act of 1996 was released as part of its 1997 budget proposal. The Act provides for a new Section 1259 containing the loophole closing provisions, as the Treasury promised.[30] The provisions call for recognition of gain, but not loss, when entering into a "constructive sale" which would occur when a taxpayer, "enters into one or more positions with respect to the same or substantially identical property which, for some period, substantially eliminate both risk of loss and opportunity for gain on the appreciated financial position."[31] Consequently, selling short-against-the-box would be a taxable transaction with regard to positions with realized gains. The proposal would apply to constructive sales entered into after the date of the proposal's enactment and constructive sales entered into after January 12, 1996, and before the date of enactment that are not closed within 30 days of enactment.[32]

Additionally, the proposal would reach retroactively to the Lauder family transaction by taxing the closing of short-sales-against-the-box after death as income in respect of a decedent. Couched in a "special rule," the proposal treats constructive sales entered into at any time prior to the date of enactment and remaining open at death as property constituting the right to receive income in respect of a decedent under Section 691 if the decedent dies after enactment.[33]

Conclusion

Whether or not the proposed legislation will be enacted in its present form remains to be seen. Practitioners should keep in mind that this is not the only case of proposed legislation as an overreaction to heightened media attention regarding a perceived loophole for the rich. In February 1995, the Clinton Administration released a proposal to treat surrender of U.S. citizenship as a taxable event. The proposal was introduced within three months of the publication of an article appearing in *Forbes* magazine that profiled the recent phenomenon of ultra-wealthy U.S. citizens expatriating to tax haven jurisdictions in order to avoid

[27] See supra, note 11. Representing the difference between the tax basis of 5,500,000 shares of Company stock used by the estate to close the short sale ($35 × 5,500,000 = $192,500,000) and the short sales price of 5,500,000 shares of Company stock ($24.57 × 5,500,000 = $135,135,000).

[28] U.S. Treasury Department Press Release, January 12, 1996, 96 *Tax Day*, Item #C.1, CCH.

[29] See Herman, "White House Moves To Curb Techniques To Get Around Capital-Gains Taxes," *The Wall Street Journal* at A3 (Jan. 15, 1996).

[30] See Revenue Reconciliation Act of 1996, 104th Cong., 2d Sess., § 9512.

[31] Id.

[32] Id.

[33] Id.

U.S. income and estate taxes.[34] The original proposal has been subject to various changes and is also competing for enactment with less stringent Republican proposals to curb tax motivated expatriation. It is doubtful that the mere existence of the proposals has stopped the practice of expatriation since their introduction.[35]

Considering the current political climate, the statutory future of the administration's short-sale-against-the-box proposal is uncertain at best. Unlike the proposed anti-expatriation legislation, the short-sale-against-the-box proposal does not yet enjoy bipartisan support. In fact, GOP leaders have already renounced the March 19 budget package as "politically motivated"[36] and a "budget busting attempt to buy votes for his (Clinton's) presidential election."[37] Furthermore, Republican leaders William Archer (Texas), Chairman of the House Ways and Means Committee and Bill Roth (Delaware), Chairman of the Senate Finance Committee have issued assurances that, in the event the proposal is approved by either Committee, the effective date of the proposal would not be retroactive.[38] These assurances seem to give the green light to taxpayers considering a short-sale-against-the-box transaction.

Despite the proposal, taxpayers can enjoy the same tax planning benefits as the Lauder family using the short-sale-against-the-box under current law and it appears that the Archer-Roth statement provides a window of opportunity to those taxpayers who wish to engage in such a transaction, at least up until the time the proposal, if ever, becomes a reality. In this respect, current planning using a short-sale-against-the-box should be looked upon as a viable technique, but practitioners advising taxpayers who are contemplating use of the technique need to make sure their clients are fully aware of the current proposal to collapse the transaction.

Bankruptcy and Receivership

A married couple's tax liability for two tax years was dischargeable in bankruptcy because the taxes were assessed more than 240 days before the filing of the bankruptcy petition and no tolling provision applied, the Sixth Circuit has held. *G.E. Aberl*, 96-2 USTC ¶ 50,151 (CA-6). The couple submitted an offer in compromise to the IRS before the formal assessment of tax, but the IRS rejected it. However, the offer in compromise did not trigger the applicable tolling provision of the Bankruptcy Code because, the court ruled, the provision clearly applied only to offers in compromise made after the assessment of tax.

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[34] Lenzner and Mao, "The New Refugees," 154-12 *Forbes* 131 (Nov. 21, 1994).

[35] Multi-billionaire Justin Dart was among the over 300 U.S. citizens estimated by *Forbes* to have expatriated since 1993 to escape U.S. taxation. Ironically, Mr. Dart also executed a short-sale-against-the-box of over $300 million of Salomon Brothers stock prior to his departure. If he closes the transaction as a foreign citizen (and satisfies the requirements of Section 877, the current anti-expatriation statute) he will not pay U.S. tax on the sale (see "New York Accountant's Oppose Short-Sale-Against-The-Box Proposal," 96 TNT 54-112). Apparently, U.S. politicians perceived Mr. Dart's act of expatriation as the more egregious scheme deserving of immediate legislative action, ignoring the possible abuse of the short-sale-against-the-box until the Lauder transaction.

[36] See Glenn, "Senate Budget Panel Criticizes Tax Cuts in Clinton Budget," 96 TNT 57-2.

[37] See "Full Text: Livingston Release Slams Clinton Budget," 96 TNT 56-50.

[38] See Herman, "Lawmakers Lift Tax Cloud on Financings," *The Wall Street Journal* at A3 (Apr. 1, 1996).