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## Internal Revenue Code Section 1259: A Legitimate Foundation for Taxing Short Sales Against the Box or a Mere Makeover?

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## NOTES

### INTERNAL REVENUE CODE SECTION 1259: A LEGITIMATE FOUNDATION FOR TAXING SHORT SALES AGAINST THE BOX OR A MERE MAKEOVER?

"[B]ulls make money, bears make money, and hogs get slaughtered."<sup>1</sup> That is the Wall Street gospel on investors who are motivated by greed. Gluttonous investors should heed its advice because Congress, through its enactment of the Taxpayer Relief Act of 1997,<sup>2</sup> has taken aim at the tax benefits once reaped by engaging in short sale against the box transactions.<sup>3</sup> Investors no longer will be able to enter into absolute hedges without recognition of capital gain; rather, they will be forced to recognize capital gain on appreciated financial positions even if those positions are not sold. This latest attack on a specialized application of short selling<sup>4</sup> is merely an extension of a long running disdain for this financial practice.

For centuries, governments have treated short sales with varying degrees of contempt.<sup>5</sup> In the United States, government scrutiny of short selling dates back to World War I,<sup>6</sup> but politicians did not voice their disapproval of short selling until the

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1. Lee A. Sheppard, *Deconstructing Daschle's Constructive Sales Draft*, 70 TAX NOTES 498, 498 (1996).

2. Pub. L. No. 105-34, 111 Stat. 788 (to be codified at scattered sections of I.R.C.).

3. See I.R.C. § 1259 (West Supp. 1997). For another description and interpretation of newly passed section 1259, see William M. Paul, *Constructive Sales Under New Section 1259*, 76 TAX NOTES 1467 (1997).

4. Short selling is a financial strategy under which an investor sells a security he does not own. See *Provost v. United States*, 269 U.S. 443, 450-51 (1926); *DuPont v. Commissioner*, 38 B.T.A. 1317, 1326-27 (1938) (citing *Farr v. Commissioner*, 33 B.T.A. 557, 561 (1935)), *aff'd*, 110 F.2d 641 (3d Cir. 1940).

5. See J. EDWARD MEEKER, SHORT SELLING 106-19 (1932); Jonathan R. Macey et al., *Restrictions On Short Sales: An Analysis of the Uptick Rule and its Role in View of the October 1987 Stock Market Crash*, 74 CORNELL L. REV. 799, 801 (1989).

6. See MEEKER, *supra* note 5, at 122-23.

stock market crashed in 1929. Consider Illinois Representative Adolph Sabath's assessment of short selling activity: "short selling' . . . is the greatest evil that has been permitted or sanctioned by the Government that I know of."<sup>7</sup> Fifty-eight years later, in the wake of the 1987 stock market crash, this critical attitude resurfaced.<sup>8</sup> Joseph Grundfest, then Commissioner of the Securities and Exchange Commission, commented on the possibility of heightened government regulation of short sales: "When you sell short, you are in a sense betting against the team."<sup>9</sup> After the 1929 and 1987 crashes, investors attacked short sales on the grounds that they facilitated the manipulation of securities prices and aggravated market declines.<sup>10</sup>

Recently, critics have renewed calls for intensified regulation of short sales in reaction to the November 16, 1995 initial public offering (IPO) of the Estée Lauder Companies, Inc.<sup>11</sup> Rather than picking at the wound left by years of criticism regarding short selling's alleged "demoralizing" effect, government regulators now are attacking short sales from a different angle. The focus of regulatory watchdogs has shifted to the tax advantages enjoyed by investors using one version of these transactions: short selling against the box.<sup>12</sup>

Although many investors sell short against the box,<sup>13</sup> a vari-

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7. *Short Selling of Securities: Hearing on H.R. 4, H.R. 4604, H.R. 4638, H.R. 4639 Before the House Comm. on the Judiciary*, 72d Cong., pt. 1, at 7 (1932) [hereinafter *1932 Hearing*] (statement of Representative Adolph Sabath).

8. See Macey et al., *supra* note 5, at 799.

9. David A. Vise, *Are Short Sales on the Up & Up?: NYSE Suspects Violations, but Can't Find Them*, WASH. POST, May 8, 1988, at H1 (quoting Joseph Grundfest, Commissioner, Securities and Exchange Commission).

10. See Macey, *supra* note 5, at 799-804. But see *1932 Hearing*, *supra* note 7, at 97 (statement of Richard Whitney, President, New York Stock Exchange) ("If there had been no short selling of securities, I am confident that the stock exchange would have been forced to close many months ago. It was the willingness of people who had sold short at higher levels to buy when prices were breaking that helped to maintain the markets."); MEEKER, *supra* note 5, at 101-02 (stating that short selling stabilizes price movements and therefore benefits the stock market).

11. See Tom Herman, *White House Moves to Curb Techniques to Get Around Capital-Gains Taxes*, WALL ST. J., Jan. 15, 1996, at A2.

12. See *id.* ("The Clinton administration is taking aim at several popular techniques used by investors to defer or even eliminate capital-gains taxes . . . . [T]he legislative initiative would eliminate 'selling short against the box' . . . .").

13. Short selling against the box is a financial practice under which an investor

ant of short selling that can defer or reduce tax liability, Estée Lauder Companies' 1995 IPO served as the impetus for the restructured assault on short sales.<sup>14</sup> Congress responded to the manner and degree to which the Lauders used short selling to effectuate their stock offering by passing tax legislation that treats certain financial transactions as "constructive sales" so long as those transactions function to lock in capital gain or loss with respect to the security involved.<sup>15</sup> The new law, codified as Internal Revenue Code section 1259, treats certain appreciated financial positions as constructive sales and taxes the capital gains on those positions.<sup>16</sup> This Note contends that section 1259 is flawed. Fundamentally, section 1259 does not address directly the true abusive practices involved in the Lauder transaction—the ability to sell short against the box indefinitely without any possibility of being squeezed;<sup>17</sup> the opportunity to obtain the proceeds from the short sale against the box before the

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sells short a security that is already owned. *See id.*

14. *See* William J. Goldberg & Mark T. Watson, *Short Sales Against the Box: An Endangered Income Tax Planning Technique*, 27 TAX ADVISER 345, 345 (1996); David L. Evans et al., *New York Accountants Oppose Short-Against-the-Box-Proposal*, TAX NOTES TODAY 54-112, Mar. 18, 1996, at ¶¶ 24-26, available in WESTLAW, TNT Database; L.G. "Chip" Harter, *Proposed Section 1259: Targeting "Shorts Against the Box" and What Else?*, 37 Tax Mgmt. (BNA) S-121, S-121-22 (May 27, 1996); Rob Marvin, *Practitioners Pleased Administration's New Anti-Deferral Proposal Not Broad-*er, [1996] Daily Tax Rep. (BNA) G-3, G-3 (Jan. 17, 1996); Rob Marvin, *Relief Offered for Financial Instruments Subject to Some Administration Proposals*, [1995] Daily Tax Rep. (BNA) G-3, G-4 (Dec. 12, 1995); Diana B. Henriques & Floyd Norris, *Wealthy, Helped by Wall St., Find New Ways to Escape Tax on Profits*, N.Y. TIMES, Dec. 1, 1996, at A1; Herman, *supra* note 11, at A2; Allan Sloan, *Lauder Family's Stock Maneuvers Could Make a Tax Accountant Blush*, WASH. POST, Nov. 28, 1995, at D3.

15. *See* I.R.C. § 1259 (West Supp. 1997). "Security" as used in this Note refers to publicly traded stock and certain forms of indebtedness. Note that the term "financial instruments" discussed hereafter applies to many types of securities, not only stock. Section 1259, however, targets stocks, debt instruments, and partnership interests only. *See id.*

16. *See id.*

17. The term "squeezed" refers to a scenario in which the short seller is forced to deliver the borrowed securities before desired because the lender makes demand. *See* Telephone Interview with Sarkes Missakian, Vice President of Investments, Prudential Securities Inc. (May 6, 1997) [hereinafter Missakian Interview]. As a result of this squeeze risk, the short seller faces possible losses or limited capital gains on the transaction. *See id.*

transaction is closed;<sup>18</sup> and, finally, the combination of Revenue Ruling 72-478<sup>19</sup> and section 1014 of the Internal Revenue Code ("the Code").<sup>20</sup> Rather, section 1259 creates an inequitable standard that is both contrary to longstanding tax doctrine and detrimental to legitimate investment decisions.

This Note is divided into six parts. The first part explains the principal financial instruments affected by section 1259: short sales against the box and total return equity swaps. The second part traces Estée Lauder Companies' November 16, 1995 IPO and uses that transaction as a case study to flesh out the abuses with which section 1259 should be concerned. The third part outlines the prior tax law as it applied to short sales against the box, highlights the pertinent requirements of section 1259, and discusses section 1259's purpose. The fourth part documents the shortcomings of section 1259. The fifth part suggests alternative proposals that Congress might have considered. Finally, the sixth part offers a paradigm, the *Related Individual—Income With Respect to a Decedent Rule*, that more appropriately addresses and alleviates the abuses that can occur when particular investors sell short against the box.

## THE AFFECTED FINANCIAL INSTRUMENTS

### *Short Sales Against the Box*

To understand short sales against the box, familiarity with the practice of short selling is necessary.<sup>21</sup> "The term *short sale* means any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."<sup>22</sup> At some point in

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18. See *infra* note 34 and accompanying text for an explanation of the term "closed."

19. Rev. Rul. 72-478, 1972-2 C.B. 487.

20. I.R.C. § 1014 (1988 & West Supp. 1997).

21. For a more complete discourse on short selling, see MEEKER, *supra* note 5, and HENRY D. SCHULTZ, BEAR MARKET INVESTMENT STRATEGIES 141-55 (1981).

22. 17 C.F.R. § 240.3b-3 (1997); see also *Provost v. United States*, 269 U.S. 443, 451 (1926) (stating that a short sale occurs when an investor contracts to sell a security that he "does not own or the certificates for which are not within his control so as to be available for delivery at the time when, under the rules of the Exchange, delivery must be made").

the future, the short seller returns the borrowed security to the lender with an identical security purchased in the market.<sup>23</sup> A short sale, therefore, involves three brokers: the selling broker who represents the customer selling short, the buying broker who represents the investor purchasing the security sold short, and the lending broker who represents the account lending the securities to the selling broker.<sup>24</sup>

Mechanically, the selling broker borrows the security from the lending broker and then sells the same security to the buying broker.<sup>25</sup> In exchange for the loan of the security, the lending broker receives full protection from the selling broker in the form of a check equal to the fair market value of the loaned security.<sup>26</sup> The short seller, furthermore, must "mark to the market" whenever the price of the shorted security rises.<sup>27</sup> In other words, the loan of the security must be protected at 100% of its fair market value, meaning that the short seller must make cash deposits with the lending broker to the degree that cash reserves are equal to the market value of the borrowed security.<sup>28</sup> A collateralization system is necessary to ensure that the security will be returned to the accounts from which the security was borrowed when the owners of those accounts demand delivery.<sup>29</sup> A more salient point with respect to this Note is the fact that the *proceeds* from short sales against the box cannot be used by the *average* short seller.<sup>30</sup> Rather, the pro-

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23. See 1997 TAX FACTS 2: ON INVESTMENTS 14 (Deborah A. Miner et al. eds., 1997).

24. See WILLIAM H. RUBIN & ANTHONY J. GAMBARO, FUNDAMENTALS OF MARGIN TRADING 140 (1969). Fewer than three brokers may be used if one of the brokers assumes more than one function. Cf. *id.* (noting that three brokers are involved "in theory").

25. See *id.* At this point, the buying broker is out of the picture. See *id.*

26. See *id.* In the case of a short sale against the box, the borrower deposits the appreciated security, the security in the box, with the lending broker to serve as additional collateral. See John R. Wilson & Patrick A. Jackman, *Using Derivatives to Have Your Cake and Eat It, Too*, 24 COLO. LAW. 2213, 2214 (1995). Typically, the borrower receives interest that is derived from the market value of the security in the box. See *id.* These interest payments continue until the short sale against the box is closed. See *id.*

27. RUBIN & GAMBARO, *supra* note 24, at 161, 164.

28. See *id.* at 161.

29. See Missakian Interview, *supra* note 17.

30. See RUBIN & GAMBARO, *supra* note 24, at 147; Henriques & Norris, *supra*

ceeds are transferred to the lending broker who holds the proceeds in an interest bearing account as collateral for the borrowed shares.<sup>31</sup> Wealthy short sellers with large accounts, however, may obtain the proceeds by taking out a loan from the selling broker<sup>32</sup> for up to ninety-five percent of the value of the security sold short.<sup>33</sup>

In addition to transaction costs and a premium paid to the lender for the right to borrow the security, the short seller must reimburse the lender for all dividends declared to the stockholders of record while the short sale remains open.<sup>34</sup> Such payment is required because the lender transfers only the physical certificate to the short seller, thereby retaining all of his shareholder rights.<sup>35</sup> The short seller does not collect the dividend paid out to the borrowed shares but instead adjusts his financial position to reflect the dividend payment.<sup>36</sup>

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note 14, at A1.

31. See Wilson & Jackman, *supra* note 26, at 2214. The collateral discussed is the same referred to *supra* text accompanying note 29.

32. See Henriques & Norris, *supra* note 14, at A45; Missakian Interview, *supra* note 17.

33. See Daniel Shefter, *Tax Proposals on 'Short Against the Box' and Other Hedging Transactions*, 70 TAX NOTES 581, 584 (1996); Wilson & Jackman, *supra* note 26, at 2214. Consequently, the typical investor who sells short against the box does not receive the equivalent of what he would have received had he closed out his long position. Rather, only wealthy investors with large accounts can get the proceeds by taking out a loan, at extremely favorable rates, that requires interest payments and repayment. See Missakian Interview, *supra* note 17. The assumption that the Lauders *did* receive the proceeds raises another interesting potential abuse of short selling against the box. Although perfectly legal, the fact that the Lauders might have been able to obtain the proceeds distances their activities from those of the average investor, thereby raising questions regarding equitable treatment. See *infra* notes 119-23 and accompanying text.

34. See 1997 TAX FACTS 2: ON INVESTMENTS, *supra* note 23, at 14; RUBIN & GAMBARO, *supra* note 24, at 164-65. The short sale remains open until the short seller returns to the lender a security identical to the one borrowed. See 1997 TAX FACTS 2: ON INVESTMENTS, *supra* note 23, at 14. At that time, the short sale is said to be closed. See *id.*

35. See RUBIN & GAMBARO, *supra* note 24, at 164.

36. See *id.* at 165. In effect, the buying broker has reregistered the purchased security in his customer's name. See *id.* at 164. All dividends declared, thus, are collected by that investor. See *id.* Logically, however, the lender should be reimbursed for the foregone dividends that he would have collected had the loan never occurred. See *id.* at 164-65. As a result, the short seller must adjust his position to compensate the lender. See *id.* at 165. Consider the following example: A short seller bor-

A short sale against the box is mechanically identical to a plain short sale with one important exception. When an investor sells short against the box, he owns the security or a similar marginable security being sold short but elects to borrow the identical security from a third party rather than deliver the security he already owns (i.e., the security in "the box").<sup>37</sup> As a result, the investor creates both a long and a short position in the same security, thereby hedging against any price fluctuations.<sup>38</sup> The investor has removed all of the risk of loss and opportunity for gain associated with the fluctuation in the security's market price.<sup>39</sup> Short selling is motivated by speculation, hedging, and tax planning.<sup>40</sup> The primary incentives to short selling against the box, though, are hedging and tax planning.<sup>41</sup>

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rows 100 XYZ shares with a market value of \$50. While the short remains open, a 100% dividend is declared. The short seller adjusts his or her position accordingly to 200 XYZ shares borrowed, thereby making up for the lost dividend. *See id.*

37. *See* 1997 TAX FACTS 2: ON INVESTMENTS, *supra* note 23, at 14.

38. *See* Shefter, *supra* note 33, at 583.

39. *See* Goldberg & Watson, *supra* note 14, at 345-46; Shefter, *supra* note 33, at 583.

40. *See* RUBIN & GAMBARO, *supra* note 24, at 143. Speculators enter into short sales with the hope that the market will decline. *See id.* This decline will enable them to purchase identical securities at a lower price than the price at which they sold the borrowed securities. *See id.* The spread between the price sold and the price purchased will be the short seller's gain or loss. *See id.* at 144. Investors who engage in a short sale with the intent to hedge usually are long in a similar or identical security. *See* Missakian Interview, *supra* note 17. The hedger hopes to minimize, or in the case of short selling against the box, remove the risk involved in being long in a particular security. *See id.* The tax incentive involved is the central issue of section 1259. *See, e.g.,* Herman, *supra* note 11, at A2. Presently, the tax laws do not acknowledge realization of capital gain or loss on a short sale until the short is closed. *See* I.R.C. § 1233(b) (1994); Treas. Reg. § 1.1233-1(a)(1) (as amended in 1980); *see also* DuPont v. Commissioner, 110 F.2d 641, 642-43 (3d Cir. 1940) (stating that a capital gain or loss is recognized upon closure of a short sale). The investor, therefore, may defer gains or losses to a future date when he or she has offsetting gains or losses or the capital gains rates are more favorable. *See* Missakian Interview, *supra* note 17. Because the typical short seller does not have complete control over the time when the sale will be closed, this motive is misleading. *See id.* In other words a squeeze might occur to force the typical short seller to close the short position. *See id.; cf.* Wilson & Jackman, *supra* note 26, at 2214 (stating that the lending broker has the right to demand that the short sale be closed to protect itself against loss).

41. *See* RUBIN & GAMBARO, *supra* note 24, at 154; Shefter, *supra* note 33, at 583. Speculation is removed as a motive because the short seller is long in an equivalent amount of the borrowed security and thus cannot realize any additional capital gain from the short sale. *See* Missakian Interview, *supra* note 17. For an excellent discus-



For example, assume an investor owns 100 shares of XYZ stock with a cost basis of \$100 per share and a current market value of \$150 per share. Instead of selling the XYZ stock in the market, perhaps motivated by a desire not to create a taxable event, the investor can instruct his broker, the selling broker, to borrow 100 shares of XYZ from a third party, the lending broker, and then sell the borrowed shares short in the market.<sup>42</sup> The \$15,000 in proceeds would then be deposited with the lending broker who, in turn, would place the proceeds in an interest bearing account.<sup>43</sup> Next, the investor, perhaps because he or she wishes to become more liquid, could take out a loan from the selling broker that is valued at no more than \$14,250.<sup>44</sup> At some future date, the short seller will return the borrowed stock, repay the loan, and receive \$5,000 in capital gain, the difference between the value of the shorted stock (\$15,000) and the cost basis of the investor's original shares (\$10,000).<sup>45</sup> Under prior tax law, recognition of the \$5,000 capital gain occurred at this time.<sup>46</sup>

### *Total Return Equity Swaps*

Although referred to as short sales against the box legislation,<sup>47</sup> section 1259 reaches beyond this one financial instrument and also affects certain derivative instruments. Derivatives are financial products that derive their value from the value of some underlying asset.<sup>48</sup> The value of derivatives fluctuates in

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sion of the tax consequences of short sales against the box, see Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 TAXES 783 (1993).

42. At this point, the short seller has hedged his long position.

43. See *supra* text accompanying note 31.

44. Ninety-five percent of the value of the shares sold short—the maximum permissible loan. See *supra* notes 32-33 and accompanying text.

45. See Shefter, *supra* note 33, at 583-84.

46. See *id.*

47. See Office of Pub. Affairs, U.S. Dep't of the Treasury, *Treasury Comments on "Short Against the Box" Proposal*, Treasury News, Jan. 12, 1996, reprinted in Shefter, *supra* note 33, at 587.

48. See Joseph L. Motes III, Comment, *A Primer on the Trade and Regulation of Derivative Instruments*, 49 SMU L. REV. 579, 583 (1996). For more information on the regulatory framework faced by derivative instruments, see Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1 (1996).

reaction to changes in the underlying asset's value.<sup>49</sup> As a result, derivatives are attractive instruments to investors who wish to hedge their risk and to others who want to speculate in the financial markets.<sup>50</sup> The principal type of derivative instrument affected by section 1259 is called a notional principal contract or swap.

"A swap is a [forward] contract between two parties . . . to exchange a series of cash flows over time."<sup>51</sup> The various types of swaps are distinguished by looking at the definitions of periodic cash flows, i.e., whether the payments consist of different rates of return within one currency or different currencies.<sup>52</sup> Items that may be swapped include returns on equity, interest rates, and currencies.<sup>53</sup> Similar to short sales against the box, the motivations to enter into swap arrangements include speculation, hedging, and tax advantages.<sup>54</sup> The swap arrangements affected most by section 1259 are total return equity swaps.<sup>55</sup>

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49. See Motes, *supra* note 48, at 583.

50. See *id.* (citing Saul Hansell & Kevin Muehring, *Why Derivatives Rattle the Regulators*, INSTITUTIONAL INVESTOR, Sept. 1992, at 49, 50). Essentially, a derivative functions as a bet between two parties with respect to the value of some asset that, in turn, is affected by the direction of the market. See *id.*

51. Romano, *supra* note 48; at 46; see Gunter Dufey & Taeyoung Chung, *International Financial Markets: A Survey*, in INTERNATIONAL FINANCE AND INVESTING 3, 25-26 (R.L. Kuhn ed., 1990); Motes, *supra* note 48, at 590. A "forward contract" is an individualized agreement between two parties whereby one party agrees to buy and the other party agrees to sell a particular asset or bundle of assets at some future date. See *id.* at 588. Furthermore, both the price and quantity of the contract are set at the time the contract is made. See *id.* Forward contracts, however, are not to be confused with futures contracts, which are standardized and exchange-traded. See *id.* For more information on this distinction, see RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 636-42 (4th ed. 1991).

52. The former description refers to interest rate swaps and the latter to currency swaps. See Dufey & Chung, *supra* note 51, at 25-26.

53. See Romano, *supra* note 48, at 47-51; Lewis R. Steinberg, *Selected Issues in the Taxation of Swaps, Structured Finance and Other Financial Products*, 1 FLA. TAX REV. 263, 281 (1993); Motes, *supra* note 48, at 590-93.

54. Whether tax considerations continue to be a motivation to participate in equity swaps is debatable given the fact that equity swaps are deemed straddles for tax purposes. See I.R.C. § 1092(d)(3)(B) (1994); Treas. Reg. § 1.1092(d)-2 (1995); Evans et al., *supra* note 14, ¶ 6; Shefter, *supra* note 33, at 584. A "straddle" means "offsetting positions with respect to personal property." I.R.C. § 1092(c)(1).

55. Cf. Shefter, *supra* note 33, at 584 (noting that under the new law total return equity swaps would be deemed constructive sales whereas the new law may not apply to other types of equity swaps).

Total return equity swaps are forward contracts in which one party agrees to trade the total return<sup>56</sup> with respect to a particular security owned by that party for the total return on a different security, equity index, or bundle of securities owned by a second party, typically a broker.<sup>57</sup> Due to the trade, each investor has eliminated his risk of loss and opportunity for gain in the swapped security over the term of the swap arrangement.<sup>58</sup> For example, assume an investor owns 100 shares of XYZ, with a cost basis of \$100 and a fair market value of \$150.<sup>59</sup> In an attempt to hedge against the risk of a decrease in the price of XYZ, and as an alternative to selling the stock outright, the investor can enter into a three year total return equity swap with a broker who holds ABC stock having a cost basis of \$100 and a fair market value of \$120. In exchange for paying the broker the following (1) dividends, if any, declared on XYZ, (2) appreciation, if any, in the value of XYZ over the swap period, and (3) depreciation, if any, in the value of ABC during the term of the swap agreement, the investor shall receive from the broker the following: (1) any dividends declared on ABC, (2) any appreciation in the value of ABC, and (3) any depreciation in the value of XYZ over the same swap period.<sup>60</sup> The investor, for a specified time period, has transferred his economic interest in XYZ to the broker in return for the broker's economic interest in ABC.<sup>61</sup> Under prior tax law, the investor did not realize any

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56. "Total return" refers to dividends and appreciation. *See id.*

57. *See id.* *See generally* Mary L. Harmon & Daniel P. Breen, *The Changing World of Equity Derivatives*, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITION'S SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS, AND RESTRUCTURINGS 1996, at 935, 941 (PLI Tax Law & Practice Course Handbook Series No. J-393, 1996) (defining equity swaps).

58. *See* Shefter, *supra* note 33, at 584. Both the upside and downside potential of the security are eliminated because the investor has swapped the security's returns for the returns of some other security. *See* Missakian Interview, *supra* note 17.

59. Realistically, the amounts involved in this example will be much larger; the small scale, however, provides for a more understandable explanation.

60. *See* Shefter, *supra* note 33, at 584.

61. *See id.* Unlike the stock for stock swap exemplified previously, investors frequently seek to swap out of a single stock for the return on a bundle of stocks deriving their value from a stock index such as Standard & Poor's 500. *See id.* Alternatively, the investor can swap the total return on his or her equity position for a return derived from an index such as the London Interbank Exchange Rate (LIBOR). *See* Richard L. Reinhold, *Tax Issues in Equity Swap Transactions*, 57 TAX NOTES

capital gain or loss as a result of the swap, because the transaction was not viewed as a sale but as an executory contract in which the parties contracted to exchange a series of future cash flows.<sup>62</sup> Tax liability, therefore, was not incurred until the sale of the swapped stock by its owner.

### THE IMPETUS: THE ESTÉE LAUDER COMPANIES' IPO

Estée Lauder Companies' November 16, 1995 IPO<sup>63</sup> served as the driving force behind the enactment of section 1259.<sup>64</sup> Given the huge tax savings involved under prior law<sup>65</sup> and the IPO's apparent violation of the spirit of the tax laws, Congress's response is easy to understand. To illustrate, consider the transactions entered into by Estée Lauder and Ronald Lauder, respectively.<sup>66</sup>

#### *Estée Lauder*

Using a trust entitled the "EL 1994 Trust" as her agent, Estée Lauder borrowed 5.5 million shares of Estée Lauder Companies stock from her son, Leonard.<sup>67</sup> Subsequently, as part of the

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1185, 1186 (1992).

62. See Shefter, *supra* note 33, at 584; Steinberg, *supra* note 53, at 282-84.

63. THE ESTÉE LAUDER COMPANIES INC., PROSPECTUS (1995).

64. See *supra* note 14 and accompanying text. Although somewhat anomalous, the Estée Lauder Companies' IPO is not an isolated distortion of the short sale against the box rules. Consider former U.S. citizen and multi-billionaire Justin Dart who shorted over \$300 million in Salomon Brothers Inc. stock against the box with the likely intention of taking advantage of section 877 of the Code, which eliminates U.S. tax liability for certain positions held open for more than ten years. See I.R.C. § 877(a)(1) (1994); Evans et al., *supra* note 14, ¶¶ 21-23.

65. See Laura Jereski & Laura Bird, *Beauty Secrets: Ronald Lauder's Debts and Estée's Old Age Force a Firm Makeover*, WALL ST. J., Nov. 8, 1995, at A1; Sloan, *supra* note 14, at D3.

66. In both of these transactions, assume the Lauders' cost basis in their long positions equaled zero because they likely paid nothing for the closely held stock. See Sloan, *supra* note 14, at D3. Further assumptions include: (1) the Lauders's placement in the highest local, state, and federal income tax brackets, and (2) the application of generally accepted short against the box mechanics. See *id.* Also note that the description of the Lauders's plan is ex-ante. The current law, discussed below, grandfathers in transactions such as the IPO in order to ensnare those "taxpayers" who had open positions at the time of enactment. See *infra* note 105.

67. See THE ESTÉE LAUDER COMPANIES INC., *supra* note 63, at 53, 55-56; Sloan, *supra* note 14, at D3.

IPO, the Trust sold these shares short against the box to the public at an offering price of \$26 per share.<sup>68</sup> After accounting for brokerage fees equaling \$1.43 per share,<sup>69</sup> Estée received \$24.57 per share,<sup>70</sup> or approximately \$135 million.<sup>71</sup>

Under prior tax law, selling borrowed stock did not generate taxable income because realization did not occur until the short seller returned the borrowed stock to the lender, thereby closing the short sale.<sup>72</sup> Estée, therefore, paid no capital gains taxes on the "income" received in the year the sale was made, but rather, recognition would occur upon completion of the short sale at some future date.<sup>73</sup> The question is whether Estée will return the borrowed shares to Leonard before she died. Consider the following: if Estée dies before closing out the short sale, then her estate could devise the 5.5 million shares held in the box to Leonard.<sup>74</sup> Due to the death loophole found in section 1014 of the Code, Leonard would take the stock at a tax-free stepped-up basis.<sup>75</sup> In turn, Leonard would close out the short sale himself using the devised stock. The result: the cost basis on the stock would be stepped-up to its fair market value on the date of the deviser's death.<sup>76</sup> Consequently, no capital gain would be realized on the stock.

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68. See THE ESTÉE LAUDER COMPANIES INC., *supra* note 63, at 1; Sloan, *supra* note 14, at D3.

69. See THE ESTÉE LAUDER COMPANIES INC., *supra* note 63, at 1.

70. See *id.*; Sloan, *supra* note 14, at D3.

71. See Sloan, *supra* note 14, at D3. Recall that the proceeds from the typical short sale against the box are not received by the short seller directly but are transferred to the lending broker to be held as collateral. See *supra* note 31 and accompanying text. Technically, \$135 million dollars likely was generated in Estée's short account before any of the proceeds reached Estée. See Missakian Interview, *supra* note 17.

72. See I.R.C. § 1233(a) (1994); Doyle v. Commissioner, 286 F.2d 654, 657 (7th Cir. 1961); Bingham v. Commissioner, 27 B.T.A. 186, 189-90 (1932); Rev. Rul. 72-478, 1972-2 C.B. 487; Treas. Reg. § 1.1233-1(a)(1) (as amended in 1980).

73. See Sloan, *supra* note 14, at D3.

74. See *id.*

75. See I.R.C. § 1014(a)(1) (1994). Section 1014 states that "the basis of property in the hands of a person acquiring the property from a decedent . . . shall . . . be (1) the fair market value of the property at the date of the decedent's death." *Id.*

76. See Missakian Interview, *supra* note 17.

*Ronald Lauder*

Like his mother, Ronald used the short against the box loophole to perfection. He first borrowed approximately 8.33 million shares from various family members, including his brother Leonard.<sup>77</sup> Subsequently, he sold that borrowed stock short against the box to the public for \$26 per share for a net total of about \$205 million.<sup>78</sup> Under prior tax law, Ronald, like Estée, would not have paid any tax on the \$205 million until he returned the 8.33 million shares to the lenders.<sup>79</sup>

Additionally, Ronald could have taken advantage of section 1014, i.e., he might have left the short position open for the remainder of his life.<sup>80</sup> In so doing, he would have passed on the shares in the box, at a stepped-up basis, to the specified individual.<sup>81</sup> As with Estée Lauder, the result would have been that no tax would be paid on the capital gain.

## PRESIDENT CLINTON'S RESPONSE: SECTION 1259

On March 19, 1996, President Clinton released his Fiscal Year 1997 Budget Proposal, the supplement to which contained, among other things, a proposal to amend the Internal Revenue Code.<sup>82</sup> As part of the President's plan "to kill 'selling short against the box' and similar strategies to lock in gains while deferring or even eliminating taxes,"<sup>83</sup> Congress recently passed this proposal, and the President signed it into law.<sup>84</sup> The Code,

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77. See THE ESTÉE LAUDER COMPANIES INC., *supra* note 63, at 53, 55; Sloan, *supra* note 14, at D3.

78. See THE ESTÉE LAUDER COMPANIES INC., *supra* note 63, at 1, 53; Sloan, *supra* note 14, at D3. Again, the net amount is adjusted for underwriter fees of \$1.43 per share. See THE ESTÉE LAUDER COMPANIES INC., *supra* note 63, at 1.

79. See *supra* text accompanying note 72.

80. See Sloan, *supra* note 14, at D3.

81. See I.R.C. § 1014(a)(1) (1994).

82. See OFFICE OF MANAGEMENT AND BUDGET, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 1997 36, 39 (1996) [hereinafter BUDGET]; Lee A. Sheppard & Sheryl Stratton, *Proposed Business Tax Changes in Administration's 1997 Budget*, 70 TAX NOTES 1714, 1714 (1996).

83. *Tax Report: A Securities-Industry Group Defends Investor Techniques Under Assault*, WALL ST. J., Feb. 12, 1997, at A1.

84. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001, 111 Stat. 788, 903 (codified at I.R.C. § 1259 (West Supp. 1997)); Office of Fed. Tax Servs., Arthur

as amended, includes section 1259, entitled "Constructive Sales Treatment For Appreciated Financial Positions."<sup>85</sup> Section 1259 is a response to the short sale against the box transaction that the Lauders used as part of Estée Lauder Companies' IPO.<sup>86</sup> Considering the potential tax revenues at stake—countless investors could have used this type of transaction—the Administration's and Congress's concern was warranted.

### *Tax Implications of Short Sales Against the Box*

#### *Prior Law*

Prior tax law did not recognize capital gain or loss until realization occurred.<sup>87</sup> Additionally, a taxpayer did not realize capital gain or loss until a capital asset was sold or exchanged.<sup>88</sup> With respect to open transactions such as short sales against the box, a taxpayer did not realize capital gain or loss until the taxpayer returned the borrowed stock and closed the short position.<sup>89</sup> As a result, taxpayers could lock in capital gain or loss by entering into certain positions while deferring recognition

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Anderson LLP, *The Taxpayer Relief Act of 1997*, 76 TAX NOTES 817, 817 (1997).

85. I.R.C. § 1259.

86. See *supra* note 14 and accompanying text. Note that the administration proposed further that the basis of substantially identical securities be determined on an average cost basis. See DEPARTMENT OF THE TREASURY, 1996 GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 70-71 (1996) [hereinafter TREASURY EXPLANATION]. Although linked strongly to section 1259, the Average Cost Basis Requirement is beyond the scope of this Note. Importantly, however, notice that requiring the taxpayer to use an average cost basis method greatly reduces the incentive to use short sales against the box as a short-term hedge. In other words, prohibiting the investor from selecting the exact securities he or she wishes to deliver and requiring that he or she use an average cost basis defeats the benefit of purchasing securities in the market—with a higher cost basis than the securities in the box—to close out the short position. For further discussion of the Average Cost Basis Requirement, see *id.*

87. See I.R.C. § 1001(a) (1994). Realization occurs when the taxpayer sells or disposes of taxable property. Cf. *id.* § 1001(b) (stating that "[t]he amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received").

88. See *id.* § 1222.

89. See *supra* note 72 and accompanying text. Swaps, options, and many other derivative instruments are open transactions. See generally Wilson & Jackman, *supra* note 26 (discussing the tax implications of swaps, options, and short sales against the box).

until some future date<sup>90</sup> or, in some instances, avoid recognition altogether. As indicated previously, section 1014 can be used to avoid paying, or reduce greatly, taxes on capital gains altogether.<sup>91</sup> When used in conjunction with the prior Code provisions for open transactions, section 1014 created an enticing loophole for investors holding concentrated equity positions.<sup>92</sup> The transaction entered into by the Lauders demonstrates the lure of this combination of tax provisions. Believing “[i]t is inappropriate for taxpayers to be able to dispose of the economic risks and rewards of owning appreciated property without realizing income for tax purposes,”<sup>93</sup> the Administration drafted legislation *ex post facto* to prevent taxpayers from doing what the Lauders did: eliminate risk of loss and opportunity for gain on the stock sold short while being treated for tax purposes as if no disposition occurred.<sup>94</sup> In drafting section 1259, therefore, the Administration focused on investors who had the necessary amount of capital or access to modern financial products to enable them to lock in capital gain forever without any recognition.<sup>95</sup>

### *Section 1259*

In response to these concerns about how the Code applied to certain open positions, the Administration issued a proposal—the precursor to section 1259—that would require taxpayers to “recognize gain . . . upon entering into a constructive sale of any appreciated position in stock, a debt instrument, or a partnership interest.”<sup>96</sup> As enacted, section 1259 creates two provisions: (1) the taxpayer must hold an appreciated financial position and (2) that position must be constructively sold.<sup>97</sup> Section 1259 defines “appreciated financial positions” as “any position

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90. See TREASURY EXPLANATION, *supra* note 86, at 72-73.

91. See I.R.C. § 1014; Sloan, *supra* note 14, at D3; *supra* notes 74-81 and accompanying text.

92. The Lauders possessed a concentrated equity position—their portfolio was concentrated heavily in one particular security.

93. See TREASURY EXPLANATION, *supra* note 86, at 72.

94. See *id.* at 72-73.

95. See *id.* at 72-74.

96. BUDGET, *supra* note 82, at 39; see TREASURY EXPLANATION, *supra* note 86, at 73.

97. See I.R.C. § 1259(a) (West Supp. 1997).



with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value."<sup>98</sup> Section 1259(c)(1) provides that a "constructive sale" of an appreciated financial position occurs when the taxpayer

(A) enters into a short sale of the same or substantially identical property,

(B) enters into an offsetting notional principal contract with respect to the same or substantially identical property,

(C) enters into a futures or forward contract to deliver the same or substantially identical property,

(D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or

(E) to the extent prescribed by the Secretary in regulations, enters into [one] or more other transactions (or acquires [one] or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.<sup>99</sup>

The financial products specifically named in section 1259 include short sales against the box, notional principle contracts, and certain futures and forwards contracts.<sup>100</sup> Section 1259 defines a "forward contract" as "a contract to deliver a substantially fixed amount of property for a substantially fixed price"<sup>101</sup> and an "offsetting notional principal contract" as "an agreement which includes—(A) a requirement to pay . . . all or substantially all of the investment yield (including appreciation) on such property for a specified period, and (B) a right to be reimbursed for . . . all or substantially all of any decline in the value of such property."<sup>102</sup> Section 1259, however, does exempt certain transac-

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98. *Id.* § 1259(b)(1). Note, however, that exclusions are created for straight non-convertible debt and certain other positions that are marked to market under the Code. *See id.* § 1259(b)(2).

99. *Id.* § 1259(c)(1)(A)-(E).

100. *See id.*

101. *Id.* § 1259(d)(1).

102. *Id.* § 1259(d)(2). The total return equity swaps discussed previously clearly fall

tions: If the transactions are closed within thirty days after the end of the taxable year (January 30) and if the taxpayer holds the appreciated position at risk for a sixty day period beginning on the date the open position was closed.<sup>103</sup> Section 1259 applies to constructive sale transactions entered into after June 8, 1997,<sup>104</sup> and for decedents dying after that effective date, a special rule applies.<sup>105</sup>

### CRITICISMS OF SECTION 1259

In critiquing section 1259, the Lauder family's exceptionally abusive application of short selling against the box to the Estée Lauder Companies' IPO must be kept in mind. By remembering the Administration's motivation, several legitimate grounds for attacking section 1259 become more obvious.<sup>106</sup> First, section 1259, rather than resulting in a fair application of the tax laws, will lead to greater inequities between taxpayers. Second, the concept of treating certain property as constructively sold, and hence resulting in income, when in fact no "accessions to wealth, clearly realized, and over which the taxpayer[] [has] complete dominion"<sup>107</sup> have occurred is contrary to long-standing tax policy. Finally, the inflexible nature of section 1259 will limit the benign practices of investors partially controlling the timing when capital gains will be recognized, or using short selling against the box as a hedging tool to protect against short-term risks.

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into this category. See *supra* notes 56-62 and accompanying text.

103. See I.R.C. § 1259(c)(3)(A)(i)-(iii).

104. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001(d)(1), 111 Stat. 788, 907 (to be codified at note to I.R.C. § 1259).

105. See *id.* § 1001(d)(3) (to be codified at note to I.R.C. § 1259). The special rule will treat certain appreciated financial positions as income in respect of a decedent under section 691 of the Code if the following requirements are satisfied: (A) a constructive sale of an appreciated financial position occurred on or before June 8, 1997; (B) the constructive sale transaction remains open, either with respect to the decedent or an individual related to the decedent (i) for at least two years after the transaction is entered into and (ii) for any amount of time during the three year period preceding the decedent's death; and (C) the position is not closed within thirty days after the enactment of section 1259. See I.R.C. § 475 note.

106. The following criticisms do not necessarily apply to the plain vanilla swaps and total return equity swaps discussed *supra* notes 51-62 and accompanying text.

107. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

*Inequitable Results*

Although many might argue to the contrary, the U.S. tax system remains grounded in equity.<sup>108</sup> In addition to raising more revenue, an important motivation behind a progressive, comprehensive tax structure is the creation of a level playing field on which taxpayers pay their fair share of taxes according to their various income levels.<sup>109</sup> Logically then, a system concerned with equality will attempt to create rules and regulations that uphold the goals of fairness and justice. Section 1259 gives short shrift to these equitable interests on three distinct fronts.

First, section 1259 appears to address a glaring inequality in the tax laws: the ability of investors in the top bracket of the tax scheme to defer and, in some instances, avoid capital gains taxes by using certain financial products.<sup>110</sup> The wealthy seemingly have more tax deferral and avoidance tools at their disposal than do the poor. In its present state, however, section 1259 will lead to a system that is slanted even more in favor of wealthy investors. Rather than curtailing the abuses practiced by the Lauders, section 1259 will do more harm than good.

Putting aside the criticisms enumerated above and below, consider the consequences of section 1259 from an equitable front. Broad treatment of short sales against the box and other financial instruments will motivate investment banks to create even more sophisticated financial products<sup>111</sup> that are beyond the

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108. Cf. Marjorie E. Kornhauser, *Equality, Liberty, and a Fair Income Tax*, 23 FORDHAM URB. L.J. 607, 619 (1996) (stating that the current tax system addresses both vertical and horizontal forms of equity). Many people, however, might argue that a progressive tax system is unfair. See *id.* at 607-08 (citing critics' calls for a flat tax or a consumption tax). A progressive system might not be consistent with the literal definition of fairness used by Representative Dick Armey: that a flat tax is fair because "[e]veryone should be treated the same." Dick Armey, *Review Merits of Flat Tax*, WALL ST. J., June 16, 1994, at A16. But in reality, a normative world allows for "many ways people can be treated the same." Kornhauser, *supra*, at 613. In other words, equality is not necessarily a black and white issue but is comprised of several considerations. See *id.* at 612 n.10. A discourse on the ideal tax structure for the United States, however, is beyond the scope of this Note.

109. See Kornhauser, *supra* note 108, at 619 (discussing the goal of vertical equity).

110. See, e.g., *supra* notes 67-81 and accompanying text.

111. See Deborah L. Paul, *Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax*, 3 FLA. TAX REV. 1, 45-46 (1996). Section 1259 "could encourage Wall Street legal specialists to devise new and more sophisticated alterna-

grasp of the Code and the average investor.<sup>112</sup> Although equity swaps already provide fodder for wealthy individuals and institutions, short sales against the box and options are available to all investors.<sup>113</sup> Encouraging the creation of more complex vehicles that require higher commissions<sup>114</sup> and are available only to the wealthy will not produce a more equitable tax system. Instead, the already wide gap between the rich and poor will be broadened.<sup>115</sup>

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tives. 'Creative investment bankers may well devise new strategies.'" Herman, *supra* note 11, at A2 (quoting Robert Willens, Managing Director, Lehman Brothers). Additionally, compare the financial community's response to the strains placed on the capital position of domestic and international banking institutions by the globalization of the capital markets over the last twenty years. See David Barbour et al., *Capital Adequacy Concerns: Basle Supervisors Committee, US and UK*, in ASSET SECURITIZATION: INTERNATIONAL FINANCIAL AND LEGAL PERSPECTIVES 270, 271 (Joseph Jude Norton & Paul R. Spellman eds., 1991). In an attempt to meet these capital strains, substantial innovation has occurred in the form of new financial products, such as asset securitization. See *id.* In turn, regulatory agencies have responded with tighter controls over the new products. See *id.* Predictably, financial institutions have "implement[ed] increasingly broader and more sophisticated forms of securitization techniques in order to comply with or otherwise minimize these more stringent regulatory practices." *Id.* For a thorough description and mechanical explanation of asset securitization, see Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369 (1991).

112. Cf. Tom Herman & Suzanne McGee, *How to Cut Your Capital-Gains Tax Bite*, WALL ST. J., Aug. 7, 1997, at C1 (claiming that "as the new law shuts off some avenues, others now look much more attractive").

113. Cf. Shefter, *supra* note 33, at 584 n.10 (stating that "equity swaps have generally been used less frequently than short against the box transactions by individual taxpayers," most likely because investors need five to ten million dollars in assets other than the security being hedged to participate in an equity swap); see also Henriques & Norris, *supra* note 14, at A1 (discussing a full page advertisement placed in *Barron's* magazine by Bankers Trust that solicited investors interested in entering into equity swaps, but only if the investors had a two million dollar position in a single security).

114. Cf. Henriques & Norris, *supra* note 14, at A1 (stating that instruments such as swaps are highly profitable and already generate handsome, continuous fees).

115. An additional concern regards the risks associated with more sophisticated financial products. Although some might argue that the wealthy would get what they deserve, regulators should be concerned that the instruments might become so complex that investors will not be able to understand the risks involved. Consider the following statement by Robert Citron, former Treasurer of Orange County, California, and the centerpiece of that County's derivatives fiasco: "In retrospect, . . . I was not the sophisticated treasurer I said I was." *Juicy: Orange County*, ECONOMIST, Jan. 21, 1995, at 74. In an era in which derivative instruments already are criticized for their complexity, see U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVA-

Second, in its attempt to tax short sales against the box, section 1259 fails to address the unfair practice of short sellers borrowing shares from related individuals.<sup>116</sup> One of the glaring inequities of the Estée Lauder Companies' IPO was the fact that the Lauders, by borrowing shares from related individuals, put themselves in a position in which they would *never* be squeezed.<sup>117</sup> In other words, there was no risk that the stock would have to be delivered before the borrowers wanted to make delivery. For example, assume that six months after the IPO, a tender offer was made for fifty-one percent of the outstanding shares. Typically, in a situation in which the borrower and lender are not related individuals, the borrower faces the possibility that the lender will wish to tender his or her shares to the bidder. That possibility was unrealistic in the Lauder case because both the personal relationship between the counterparties and the fact that the counterparties possessed controlling interests in the Estée Lauder Companies pressured the related individual not to tender his or her shares. The result was a *perpetual* short sale against the box. Although the Administration sought to tax such a transaction up front,<sup>118</sup> section 1259 does nothing directly to discourage or prevent this inequity.

Finally, section 1259 falls short with respect to the divide between wealthy and middle-income investors: a chasm that is

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TIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM, GAO/GGD-94-133 67 (1994), creating an incentive for investors to delve into more sophisticated products is irresponsible. Cf. William K. Maready, Jr., Comment, *Regulating for Disaster: Federal Attempts to Control the Derivatives Market*, 31 WAKE FOREST L. REV. 885, 887 (1996) (stating that "further regulation in this area . . . is unnecessary and harmful to a business which provides numerous benefits to businesses, investors, and the economy").

116. To correspond with the Code, "related individuals" will be defined here as individuals "in one of the following relationships: (1) husband and wife [or other familial relationships], (2) grantor and fiduciary, (3) grantor and beneficiary, (4) fiduciary and beneficiary, legatee, or heir, (5) decedent and decedent's estate, (6) partner[ship], or (7) member of an affiliated group of corporations." I.R.C. § 1313(c) (1994). For the purpose of curtailing the abuse accomplished by the Lauders, however, this definition shall be expanded to include any parties who, when considered together, constitute a majority shareholder block that controls the voting process in any publicly traded entity.

117. Conceivably, the Lauders *could* be squeezed, but such an action seems unlikely given the Lauders' relationship to the lenders.

118. See Shefter, *supra* note 33, at 583-84.

created by the procedures followed by many Wall Street investment firms. Theoretically, the average investor should be able to enjoy the same tax benefits that the Lauders are experiencing: specifically, a perpetual short sale against the box plus retention of the proceeds from the short against the box transaction. As explained previously, however, "*ordinary investors* are not allowed by their brokers to withdraw the proceeds from their short sales until they have returned the shares they borrowed."<sup>119</sup> Realistically, therefore, the average investor does not have the incentive to keep the transaction open perpetually but uses this technique only to defer taxes temporarily,<sup>120</sup> a practice that is both benign and beneficial to the operation of the capital markets.<sup>121</sup>

Recently, however, Wall Street investment houses began treating their wealthiest clients differently by permitting that clientele to withdraw up to ninety-five percent<sup>122</sup> of the proceeds from short sales immediately "in the form of a very inexpensive loan."<sup>123</sup> Here lies another abuse of shorting against the box: wealthy investors have the ability to lock in their profit on the underlying security, effectively receive that profit in the form of a loan, and delay, or in some cases avoid, taxation on the profit. Section 1259 should rectify, not ignore, this abuse.

### *Contrary to Longstanding Principles of Tax Law*

Further criticisms of section 1259 arise out of the longstanding treatment short sales against the box and other open transactions have received: namely, that *realization* does not occur until a transaction is closed<sup>124</sup> and that the Code should not place undue burdens on taxpayers.<sup>125</sup> Despite attacks on the

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119. Henriques & Norris, *supra* note 14, at A1 (emphasis added); see Missakian Interview, *supra* note 17; *supra* text accompanying notes 30-33.

120. See Henriques & Norris, *supra* note 14, at A1.

121. See *infra* notes 177-81 and accompanying text.

122. See *supra* notes 32-33 and accompanying text.

123. Henriques & Norris, *supra* note 14, at A1; see Missakian Interview, *supra* note 17.

124. See *supra* note 72 and accompanying text.

125. See Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 366 (1988) (stating that "[i]n the American tax system, a person's taxable income for any year is intended to reflect . . . the extent to which Congress believed that the imposition of tax might impose an undue hardship on the taxpayer").

realization requirement,<sup>126</sup> it remains one of the most fundamental components of the tax system.<sup>127</sup> Realization derives from the Supreme Court's holding in *Eisner v. Macomber*<sup>128</sup> that gain must be severed from invested capital.<sup>129</sup> In essence, the point of *Eisner* was that an appreciated position should not result in income under the Sixteenth Amendment<sup>130</sup> unless an event severs the appreciation, i.e., gain, from the underlying capital.<sup>131</sup> Although this standard was not intended to define gross income forever,<sup>132</sup> its impact can be found in *Commissioner v. Glenshaw Glass Co.*,<sup>133</sup> which determined that for gain to be part of taxable gross income it must be an "undeniable accession[] to wealth, *clearly realized*, and over which the taxpayer[] [has] complete dominion."<sup>134</sup> In the words of Justice Blackmun:

It long has been established that gain or loss in the value of property is taken into account for income tax purposes only if and when the gain or loss is "realized," that is, *when it is tied to a realization event*, such as the sale, exchange, or other disposition of the property. Mere variation in value—the routine ups and downs of the marketplace—do not in themselves have income tax consequences. This is fundamental in income tax law.<sup>135</sup>

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126. See I.R.C. § 475 (1994) (requiring a mark-to-market accounting method for dealers in securities); *id.* § 1256 (requiring an end-of-the-year mark-to-market accounting method for contracts consisting of certain financial products).

127. See Loren D. Prescott, Jr., *Cottage Savings Association v. Commissioner: Refining the Concept of Realization*, 60 FORDHAM L. REV. 437, 440-41 (1991) (citing 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 5.2, at 5-17 (2d ed. 1989)).

128. 252 U.S. 189 (1920).

129. See *id.* at 207.

130. The Sixteenth Amendment grants Congress the authority to "lay and collect taxes on incomes, from whatever source derived." U.S. CONST. amend. XVI.

131. See *Bancker v. Commissioner*, 76 F.2d 1, 2 (5th Cir. 1935); Prescott, *supra* note 127, at 439-40.

132. See *Helvering v. Bruun*, 309 U.S. 461, 468-69 (1940) ("It is not necessary to recognition of taxable gain that [the taxpayer] should be able to sever the improvement begetting the gain from his original investment."); *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931) (holding that the taxpayer realized income when it repurchased its own bonds for less than par value).

133. 348 U.S. 426 (1955).

134. *Id.* at 431 (emphasis added).

135. *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 569-70 (1991) (Blackmun,

Realization thus, according to Justice Blackmun, is “fundamental in income tax law.”<sup>136</sup> The majority opinion in *Cottage Savings* seemed to agree with Justice Blackmun: “Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer’s property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer ‘realizes’ the gain or loss.”<sup>137</sup> Even the Code agrees: “The gain from the sale or other disposition of property shall be the excess of the *amount realized therefrom* . . . .”<sup>138</sup> Although not a constitutional requirement but a rule “founded on administrative convenience,”<sup>139</sup> the realization principle requires that the taxpayer engage in a sale or disposition of the ownership of the property in question before gain or loss will be realized.<sup>140</sup> Under the realization-based tax system, therefore, two elements apparently must exist before gain will be realized: (1) a *sale or disposition* must occur (2) of property *owned* by the taxpayer.<sup>141</sup>

### *Sale or Disposition*

Traditionally, recognition of income occurred when the taxpayer realized income, not when the taxpayer received the right to obtain income.<sup>142</sup> The Supreme Court has relaxed this standard, however, to the degree that “realization may occur when the last step is taken by which [the taxpayer] obtains the fruition of the economic gain which has already accrued to him.”<sup>143</sup> Clearly, a short sale against the box cannot be characterized as a sale accompanied by the receipt of money for income

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J., concurring in part and dissenting in part) (emphasis added).

136. *Id.* at 570 (Blackmun, J., concurring in part and dissenting in part).

137. *Id.* at 559.

138. I.R.C. § 1001(a) (1994) (emphasis added).

139. *Helvering v. Horst*, 311 U.S. 112, 116 (1940); see *Wilson & Jackman*, *supra* note 26, at 2216 n.5.

140. See I.R.C. § 1001(b); *Wilson & Jackman*, *supra* note 26, at 2213. This requirement, however, has proved to be met easily under recent legislation. See, e.g., I.R.C. § 475 (requiring a mark-to-market accounting method for dealers in securities); *id.* § 1256 (requiring year-end mark-to-market accounting for any regulated futures contract, foreign currency contract, nonequity option, or dealer equity option).

141. See I.R.C. § 1001(a).

142. See *Horst*, 311 U.S. at 115.

143. *Id.*



tax purposes. Support for this contention lies not only in section 1259's title, which refers to "Constructive Sales,"<sup>144</sup> but also is inherent in the transaction itself—the broker, rather than the taxpayer, retains the proceeds from a short sale against the box.<sup>145</sup> The question then is whether a short sale against the box can be deemed a disposition due to the taxpayer's enjoyment of the benefit of economic gain. Such an event "may occur when [the taxpayer] has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth."<sup>146</sup>

A valid argument can be made that a disposition indeed has occurred: Some taxpayers are able to withdraw loans of up to ninety-five percent of the proceeds garnered from the short sale against the box.<sup>147</sup> Although *some* taxpayers certainly are enjoying the benefits of economic gain in the form of low-interest loans from the broker, such is not the case for all taxpayers entering into short sale against the box positions. As argued previously, not all investors who sell short against the box have the ability to obtain this inexpensive loan.<sup>148</sup> Rather, only certain wealthy investors may do so.<sup>149</sup> Disposition, therefore, has occurred only with respect to certain investors who receive the loan. Section 1259, however, unwisely treats *all* investors as if a recognizing event has taken place.

### *Three Attributes of Tax Ownership*

Typically, tax ownership consists of three attributes: "legal title; possession [of] the right to use the property or to derive current income[]; and the right to subsequent appreciation, as well as the risk of loss."<sup>150</sup> First, when an investor sells short

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144. I.R.C. § 1259 (West Supp. 1997).

145. See Henriques & Norris, *supra* note 14, at A1; Missakian Interview, *supra* note 17; *supra* text accompanying notes 30-33.

146. Horst, 311 U.S. at 116.

147. See *supra* notes 32-33 and accompanying text.

148. See *supra* text accompanying notes 32-33, 119-20.

149. See *supra* text accompanying notes 32-33, 122-23.

150. Wilson & Jackman, *supra* note 26, at 2213; cf. Paul, *supra* note 111, at 9 (citing Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981)) (listing several factors the courts use to determine whether a sale has occurred).

against the box, he or she does not relinquish legal title to the underlying asset even though risk of loss and opportunity for gain might be limited or eliminated.<sup>151</sup> For example, selling a security short against the box has no effect on the investor's voting rights.<sup>152</sup>

Second, a short sale against the box does not affect the seller's right to use the security or derive current income from the security. In other words, an investor who sells XYZ stock short against the box retains control over the stock—he or she still may sell the stock in the market without closing the transaction so long as he or she gives property of equal value to the lending broker as collateral.<sup>153</sup> Additionally, the investor retains the right to current income in the form of any declared dividends.<sup>154</sup>

Last, a case can be made that most investors do retain certain benefits and burdens of ownership when utilizing short sales against the box. Although the stock's value is insulated completely from depreciation and appreciation during the time the position is held open, the average investor still faces several risks. First, average investors can be squeezed, an event that could prevent them from achieving the goal that motivated the transaction.<sup>155</sup> For example, if the investor seeks protection from short-term shocks in the market, then that goal is threatened by forcing the investor to close his or her position before the short-term risks have subsided. Second, investors that enter into short sales against the box to hedge against short-term risks expect to be re-exposed to market risks and opportunities for capital gain at a future date. Such investors, therefore, only eliminate risk of loss and opportunity for gain temporarily. A line should be drawn between this practice and that used by the *Lauders* in which all benefits and burdens were eliminated in perpetuity, including the possibility of being squeezed.<sup>156</sup>

Section 1259 ignores these facts. Furthermore, it comes close to defining income as the sum of consumption and changes in

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151. See Missakian Interview, *supra* note 17.

152. See *id.*

153. See *id.*

154. See *id.*

155. See *id.*

156. See *supra* notes 117-18 and accompanying text.

wealth over a given period of time. In other words, the *Glenshaw Glass* definition of income<sup>157</sup> essentially is abandoned in favor of a Haig-Simons economic definition of income.<sup>158</sup> Consequently, unrealized and realized appreciation will be taxed,<sup>159</sup> a result contrary to established precedent.

### *Undue Hardship and Lack of Liquidity*

In addition to the realization principle, section 1259 violates another historical concern of the Code: liquidity. Congress's concern with liquidity is evident in its treatment of installment sales.<sup>160</sup> Recognizing the fact that the seller in an installment contract will not receive the entire payment for the sale in the current taxable year, Congress granted the seller relief from this liquidity problem by enacting section 453.<sup>161</sup> The investors utilizing short sales against the box suffer from a similar liquidity problem.<sup>162</sup>

Again, consider the average investor who is unable to withdraw the proceeds from a short sale against the box transaction.<sup>163</sup> Such an investor has no identifiable liquid base from which to extract capital to finance his or her tax bill resulting from a constructive sale. True, the argument can be made that investors dealing in publicly traded securities do not have a li-

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157. See *supra* text accompanying note 134.

158. Economic income is defined by Henry Simons as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938). Robert Haig's definition of income was similar: "the money-value of the net accretion to economic power between two points of time." Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in 9 *READINGS IN THE ECONOMICS OF TAXATION* 54, 75 (Richard A. Musgrave & Carl S. Shoup eds., 1959).

159. See Paul, *supra* note 111, at 5-6.

160. Generally, "[t]he term 'installment sale' means a disposition of property where at least [one] payment is to be received after the close of the taxable year in which the disposition occurs." I.R.C. § 453(b)(1) (1994).

161. *Id.* § 453; see JAMES J. FREELAND ET AL., *FUNDAMENTALS OF FEDERAL INCOME TAXATION: CASES AND MATERIALS* 844-45 (9th ed. 1996).

162. But cf. Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 *TAX L. REV.* 571, 594-95 n.94 (1995) (arguing that liquidity should not be a major concern when the taxable transaction involves publicly traded securities).

163. See *supra* text accompanying notes 30-33, 119-21.

quidity problem because a market exists in which they can sell the securities very easily.<sup>164</sup> This argument, however, is circular: If the investor were to take advantage of a liquid market and sell the securities to obtain cash, then no short sale against the box would occur, and no constructive sale issue would ensue.<sup>165</sup> The fact that publicly traded securities have a liquid market does not solve the liquidity problem created when selling short against the box. As Professors Noël Cunningham and Deborah Schenk suggested, “[a]ny proposal that would tax income as it accrues rather than when realized should satisfy the burden of proof with respect to . . . liquidity.”<sup>166</sup> Section 1259 falls short of meeting this burden.<sup>167</sup>

### *Adverse Impact on Legitimate Investment Decisions*

Supporters of section 1259 claim that “[a] short sale against the box is a tax deferral transaction, nothing more.”<sup>168</sup> John Buckley, Minority Tax Counsel to the House Ways and Means Committee, voiced this opinion when he stated: “A senior member asked me why we permit short sales against the box. I couldn’t think of any economic reason for it.”<sup>169</sup>

Although tax deferral is a major, and perhaps primary, concern of investors who sell short against the box, deferral is not as dubious or isolated a motivation as these commentators suggest.<sup>170</sup> Often, investors sell short against the box to hedge an investment without incurring any tax liability until some future

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164. See Schenk, *supra* note 162, at 594-95 n.94.

165. Furthermore, in the case of an investor hedging against short-term risk in a stock with long-term growth potential, such a liquidity argument defeats the goal of the transaction.

166. Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A “Revolutionary” Approach to Ownership*, 47 TAX L. REV. 725, 742-43 (1992).

167. The truth of this statement is highlighted by the fact that the Administration did not address the liquidity problem in its proposed legislation. See *supra* notes 82-84 and accompanying text.

168. Lee A. Sheppard, *Fixes to Ensure that Tax Is Paid on Capital Gains*, 69 TAX NOTES 1165, 1166 (1995).

169. Sheppard, *supra* note 1, at 498 (quoting John Buckley, Minority Tax Council to the House Ways and Means Committee).

170. See *supra* note 41 and accompanying text.

date.<sup>171</sup> For several reasons, investors wish to maintain ownership of their investment and thereby delay realization. On the one hand, a questionable motive such as the possibility of tax avoidance drives some investors with large concentrated equity positions to enter into a short sale against the box transaction.<sup>172</sup> On the other hand, benign reasoning such as deferring gains or losses from one time period to the next<sup>173</sup> or seeking short-term protection for equity positions that have long-term prospects motivates investors to sell short against the box.<sup>174</sup> Read in its entirety, section 1259 prevents deferral.<sup>175</sup> The exception created for certain transactions found in section 1259(c)(3)<sup>176</sup> limits the goal that the exception was intended to achieve: To permit the use of short selling against the box as a short-term hedging technique.<sup>177</sup> The existence of a benign motivation such as hedging requires a more specific treatment of the abusive practices that can be invoked when selling short against the box.

First, granting an investor the ability to maintain some control over the time period in which a capital gain or loss is realized functions as a risk premium to compensate the investor for investing his savings in the capital markets.<sup>178</sup> In other words, flexibility in the tax system is necessary to attract capital investment. Preventing an investor from delaying realization might result in reduced cash flows into the capital markets and thereby increase market volatility. Additionally, giving investors the latitude to choose the period in which they will realize their

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171. See *infra* text accompanying notes 182-86.

172. The Lauder transaction appears to exemplify this motivation—a motivation that should concern the Administration.

173. See Evans et al., *supra* note 14, ¶ 39. The key word here is “defer.” Merely deferring realization should not be an issue because tax liability will result in the future. Rather, the concern should be over perpetual deferral and ultimately tax avoidance under section 1014.

174. See *id.* ¶¶ 17-20.

175. This point should be obvious. Section 1259, by treating short sale against the box and other positions as constructive sales, creates a scheme of current recognition.

176. I.R.C. § 1259(c)(3) (West Supp. 1997).

177. The limits created by the new law are discussed *infra* text accompanying notes 187-95.

178. Cf. Evans et al., *supra* note 14, ¶ 39 (discussing the need for favorable tax provisions to offset the market risk associated with securities investment).

tax liability helps to bridge the gap between ordinary individual investors and institutional investors.<sup>179</sup> Institutional investors generally possess tremendous advantages over individual investors, especially with respect to financial resources and size.<sup>180</sup> Allowing investors to maintain control over the timing of realization levels the playing field slightly because an additional incentive would be created for individuals to enter the capital markets alongside institutions.<sup>181</sup> Section 1259, therefore, would function as a barrier to entry for individuals who do not have comparable capital reserves. Such a result is inequitable and inefficient.

Second, selling short against the box allows investors to protect securities with long-term upside potential from short-term risks.<sup>182</sup> For example, an investor might hold a stock that he believes has great long-term value. The investor also might be concerned that the stock faces a possible fall in value over the short-term.<sup>183</sup> To protect his investment, the investor can sell the stock in question short against the box. By so doing, the position is protected against a short-term drop in value—any loss in the value of the shares owned by the investor is recovered from the short sale.<sup>184</sup> After the investor believes the short-term risk has passed, he then can purchase shares in the market with the proceeds from the short sale and deliver those shares to the lender to close out the transaction.<sup>185</sup> Throughout, the investor keeps the shares in the box, i.e., the long position, without affecting their holding period or basis.<sup>186</sup> Section

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179. *See id.* Institutional investors include mutual funds, pension funds, insurance companies, etc.

180. *See id.*

181. *See id.*

182. *See id.* ¶ 17.

183. Consider a software manufacturer such as Microsoft. Microsoft might have great prospects because of the continued growth of the software industry. At the same time, the value of Microsoft's stock might be threatened in the short-term because a competitor plans to release a new product that will compete directly with software marketed by Microsoft. *See id.*

184. *See id.*

185. *See id.*

186. In other words, short selling against the box can be viewed as latent fuel for capital market appreciation and cushioning for market depreciation because of the fact that the borrowed stock must be repurchased except in abusive cases. *See*

1259(c)(3) recognizes the positive hedging attributes of short selling against the box by creating an exception from constructive sale treatment for certain closed transactions, but the standard used is far too inflexible. The new law will emasculate this hedging strategy even though there is neither a similarity to the Lauder transaction nor a motive to cheat the tax system.<sup>187</sup>

To keep the taxpayer's long position exempt from constructive sale treatment, the new law requires that taxpayers close the short position with respect to the same or substantially identical security no later than January 30th following the taxable year in which the taxpayer entered into the short against the box transaction.<sup>188</sup> Section 1259 also requires that the taxpayer hold the long position at risk<sup>189</sup> for at least sixty days following the date on which the taxpayer closes the short against the box

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Missakian Interview, *supra* note 17.

187. For a further discussion on the mechanics involved in this transaction, see Evans et al., *supra* note 14, ¶ 17. Supporters of section 1259 might argue that other methods are available by which an investor can hedge against short-term risks, namely selling and repurchasing the stock or purchasing a put option. *Cf. id.* ¶ 18 (noting that section 1259 will force taxpayers to purchase put options to eliminate downside risk). Although both of these alternatives protect the investor's short-term position, neither is acceptable. Selling and repurchasing the stock destroys the investor's holding period and affects basis. *Cf. id.* ¶¶ 17-18 (noting that short sales against the box preserve the taxpayer's holding period and basis). As discussed in this Note, the resulting tax liability is not the proper means for addressing the abuses associated with short selling against the box. *See infra* notes 207-32 and accompanying text (providing an alternative approach to these abuses).

188. *See* I.R.C. § 1259(c)(3)(A)(i) (West Supp. 1997). Note that the taxpayer can close the position in one of two ways: Either by delivering the shares already owned or by purchasing shares in the market. *See* 1997 TAX FACTS 2: ON INVESTMENTS, *supra* note 23, at 14. The former option, however, is improbable if the investor is hedging against short-term risk because he will want to maintain the long position. *See* RUBIN & GAMBARO, *supra* note 24, at 154.

189. By requiring that the taxpayer remain at risk during the sixty-day period, the exemption prevents the taxpayer from entering into another short against the box position until after the sixty-day period has expired. Clearly, section 1259 allows the taxpayer to open a second short against the box transaction regarding the same or a substantially identical security during the sixty-day "at risk" period. *See* I.R.C. § 1259(c)(3)(B). By doing so, however, the second transaction must meet the section's requirements, i.e., the second transaction, or the third or fourth, etc., must be closed out within thirty days after the end of the taxable year and must be held at risk for sixty days. *See id.* The eventual impact upon the taxpayer, therefore, is that he must refrain from entering into a short against the box position until after the sixty-day "at risk" period relating to the final transaction ends.

transaction.<sup>190</sup> For example, assume a taxpayer enters into a short against the box transaction on October 30, 1997. Under the new law, the position must be closed by January 30, 1998, to prevent it from being characterized as a constructive sale of the taxpayer's long position. Once the taxpayer closes the short position, e.g., on January 30, 1998, he or she must hold the long position at risk, i.e., without entering into another short against the box, at least until the end of the day on March 31, 1998. On April 1, 1998, the taxpayer could then open another short against the box position using the same security. That position, for purposes of complying with section 1259, need not be closed until January 30, 1999. The taxpayer motivated by short-term hedging, therefore, may hedge his or her long position for no more than thirteen months at a time. Given the fact that such an investment strategy is unrelated to the abusive nature of the Estée Lauder Companies' IPO, this limit placed on the taxpayer's hedging strategy is troubling for two reasons.

First, the exclusion does not provide much relief for investors who discover short-term risks late in the taxable year. For example, consider an investor who determines on November 1, 1997, that a stock in which he or she is long is susceptible to a short-term risk of loss caused by competition in the industry. Previously, the investor could establish a short against the box position that he or she could maintain until the risk passed, whether that time period be two months or two years. Under section 1259, however, the investor, among other things, must close the position no later than January 30 of the taxable year following the year in which the security was purchased.<sup>191</sup> In the hypothetical, the investor must close the short position approximately three months after it was opened. According to the new law, the investor, after holding the long position at risk for sixty days, could re-establish the short against the box.<sup>192</sup> In other words, the investor, after discovering a short-term risk on November 1, 1997, can hedge until January 30, 1998, without suffering adverse tax consequences. After remaining at risk until

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190. See I.R.C. § 1259(c)(3)(A)(ii)-(iii).

191. See *id.* § 1259(c)(3)(A)(i).

192. See *id.* § 1259(c)(3)(A)(ii)-(iii).



April 1, 1998, which the investor clearly will be if the estimated short-term risk continues to exist, the investor can enter into another short against the box position.<sup>193</sup> Certainly, this result is neither overly sympathetic nor helpful to investors facing short-term risks.

Second, section 1259's exclusionary language places too low of a ceiling on the amount of time investors can hedge against short-term risks. Assuming the investor enters into a short against the box position on January 1, the new legislation creates a thirteen month, uninterrupted maximum hedging period.<sup>194</sup> Such a standard is too inflexible to be helpful to investors facing short-term risks of varying length. The problem is that the short-term risk to which the investor's stock is exposed might not pass for six months, twelve months, or twenty-four months. An investor, therefore, who is fortunate enough to establish the hedge at the earliest point of the year, January 1, and whose long position faces an eighteen month short-term risk, will be able to remain short against the box with respect to the stock at risk for only sixteen of the eighteen risk-related months.<sup>195</sup> This limit on the time that investors may hedge, combined with the unpredictability of the date on which the short-term risk will be discovered, makes section 1259 an inflexible and unfocused law considering the abusive practice it supposedly targets.

### SOME ALTERNATIVE SUGGESTIONS

Section 1259 is flawed. Specifically, it fails to correct directly the abuses of short selling against the box. Although section

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193. Note that the hypothetical also applies to investors who discover short-term risks before and after November 1 of the taxable year. The crux of the problem is that short-term risks do not fall conveniently on certain dates. The utility of section 1259(c)(3) would be much higher if the Code could act as a *Farmer's Almanac* and accurately predict that all short-term risks confronting securities would occur on January 1 thereby giving investors thirteen months of uninterrupted hedging bliss. Because such a prediction is not the case, the new law at least should be flexible enough to accommodate for the unpredictability of short-term risks.

194. See I.R.C. § 1259(c)(3)(A)(i).

195. The investor could close his short position on January 30 of the following year, remain at risk for two months, and then establish another short against the box position on April 1 for the final three months of the eighteen-month risk period.

1259 will result in the taxation of capital gains arising from constructive sales, thereby closing the short against the box loophole directly and the interrelation between that loophole and the death loophole indirectly, it does nothing to prohibit short sellers from borrowing securities from related individuals. Section 1259 is, therefore, ineffective.<sup>196</sup> The question remains whether a precise mechanism exists for eliminating abuses without creating an inequitable result that is contrary to longstanding tax doctrine and hostile to legitimate investment decisions.

One option is to take section 1259 one step further and create a complete mark-to-market or accrual tax regime. Under such a system, a Haig-Simons definition of income<sup>197</sup> would be used and realized and unrealized appreciation alike would be taxed. Although a few commentators argue that this type of system would be ideal,<sup>198</sup> others claim that this system is a direction in which the Code should not travel.<sup>199</sup> Similar to section 1259, a mark-to-market or accrual system raises concerns over liquidity.<sup>200</sup> In other words, investors would be taxed on nonliquid, paper gains rather than capital gains that are liquid. As argued previously, the tax system should continue to postpone taxation of gains until realization to prevent taxpayers from being unduly burdened with concerns over liquidity.<sup>201</sup>

Additionally, some commentators, including Treasury officials, suggested the possibility of introducing safe harbors into section 1259 before it was passed into law.<sup>202</sup> The New York State Bar Association also recommended that section 1259 contain a provision giving the regulating body the power to exclude transac-

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196. Apparently, preventing short sellers from borrowing securities from related individuals was never a target of section 1259; rather, Congress focused on preventing multi-year tax deferrals and short against the box transactions that straddled two tax years to defer recognition of capital gains. See Paul, *supra* note 3, at 1474.

197. See *supra* note 158.

198. See Paul, *supra* note 111, at 6.

199. See Evans et al., *supra* note 14, ¶ 4 (stating that section 1259 is a step toward a mark-to-market regime and thus a step in the wrong direction).

200. See Missakian Interview, *supra* note 17.

201. See *supra* notes 160-67 and accompanying text.

202. See Chris McCarter, *Short-Against-The-Box Proposal May Include Safe Harbors*, *Officials Say*, [1996] Daily Tax Rep. (BNA) G-12, G-13 (May 13, 1996); Richard L. Reinhold, *NYSBA Analyzes Short-Against-The-Box Legislation*, TAX NOTES TODAY 46-35, Mar. 6, 1996, pt. III.E.3, at 15-16, available in WESTLAW, TNT Database.

tions that are not abusive.<sup>203</sup> Neither safe harbors nor exclusionary language, however, will correct section 1259's indirect treatment of the abusive nature of short selling against the box while also ensuring that no inequitable result contrary to longstanding tax policy occurs. Although these options each have glimpses of merit, none addresses the abuses typified by the *Lauders* without correspondingly detrimental effects to the capital markets or the economy.

The rule proposed by this Note originated with the following argument by L.G. "Chip" Harter, a partner of Baker & McKenzie in Washington, D.C.: "If there is consensus that the aggressive use of 'short against the box' techniques in estate planning must be curbed, it would be preferable to directly address the issue of stepping up the basis of hedged positions on the death of the holder."<sup>204</sup> Basically, Harter posited that short against the box abuses can be corrected narrowly by not allowing the cost basis of securities to be stepped-up to fair market value upon the death of the short seller "if the [short seller's] risk of ownership had been 'substantially eliminated' for more than one-half of the three-year period immediately preceding the [short seller's] death."<sup>205</sup>

Harter is correct: a proposal must be drafted that corrects narrowly for the abuses that occur when short sales against the box are used as aggressive estate planning devices. Although Harter's proposal presents an appropriate framework upon which to build, the proposal is ineffective because it relies on ambiguous language. Specifically, Harter would disallow a step-up in basis if the risks of owning the stock were "substantially eliminated" for more than one and one-half years of the three-year period prior to the death of the short seller.<sup>206</sup> The problem is that the "substantially eliminated" language is not defined. Such ambiguity only can complicate further a Code that already is far too complex. The next section of this Note presents a narrowly tailored solution to correct for the abuses perfected by the *Lauders*.

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203. See Reinhold, *supra* note 202, pt. I, at 5.

204. Harter, *supra* note 14, at S-127.

205. *Id.*

206. See *id.*

## CONSTRUCTING A NEW PARADIGM

The three principal abuses with which regulators should concern themselves are the following: (1) the unlikelihood that the Lauders could ever be squeezed, i.e., the ability of short sellers to borrow from relatives, especially relatives who control the company that issued the stock sold short against the box; (2) the presumption that the Lauders were able to obtain the proceeds from the short against the box transaction; and (3) the conjunctive use of Revenue Ruling 72-478<sup>207</sup> and section 1014 of the Code.<sup>208</sup> In other words, Congress should have tailored section 1259 narrowly to curtail the aggressive estate planning practice used by the Lauders: the creation of a perpetual short sale against the box.<sup>209</sup> Contrary to the opinion of the Treasury,<sup>210</sup> this goal is achievable.

*The Related Individual-Income with Respect to a Decedent Rule  
Arms' Length Requirement*

Presently, investors may borrow stock from any counterparty for the purpose of effecting a short sale against the box.<sup>211</sup> As a result, these investors face no legitimate threat of being squeezed because of their relationship to the lender.<sup>212</sup> To the contrary, typical investors<sup>213</sup> are exposed to this counterparty

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207. Rev. Rul. 72-478, 1972-2 C.B. 487.

208. I.R.C. § 1014 (1994).

209. See Harter, *supra* note 14, at S-123, S-127. In other words:

While proposed § 1259 has been characterized as a response to the use of "short against the box" transactions in the estate planning context, the proposed legislation amounts to nothing less than a sweeping departure from realization-based tax accounting for most financial instruments. The proposal thus appears to be a keystone in the Treasury's plans to "re-engineer" the taxation of financial instruments rather than a targeted anti-abuse provision.

*Id.* at S-123.

210. See McCarter, *supra* note 202, at G-12 (quoting Treasury official David Weisbach as saying "[t]his is the narrowest approach we could have taken").

211. See *supra* text accompanying note 116.

212. See *supra* text accompanying notes 117-18.

213. Most investors who sell short against the box would seem to fall into this category.

demand risk.<sup>214</sup> Legislation must be crafted in such a manner, therefore, that prevents investors from entering into short sales against the box transactions in which there is no threat of being squeezed by the lender. By so doing, all investors will be placed in a more equitable position with respect to the risks inherent in a short against the box position. Congress can achieve this result in a straight-forward way: Creating a rule that prohibits investors from borrowing securities from related individuals for the purpose of entering into a short sale against the box.

For example, consider the arm's length requirement of section 23B of the Federal Reserve Act<sup>215</sup> that prevents member banks and their affiliates from entering into certain transactions unless they do so "on terms and under circumstances . . . that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies."<sup>216</sup> In other words, a member bank or affiliate cannot engage in transactions more favorable than comparable transactions with nonaffiliate banks. A purpose of this arm's length provision "is to keep companies affiliated with banks or thrifts from using their access to federally insured deposits to compete unfairly with companies not so affiliated."<sup>217</sup>

A similar rule can be incorporated here. Investors may engage in short sale against the box transactions only on terms and under circumstances that are substantially the same or at least as favorable to the short seller and related individual lender as those prevailing at the time for short sale against the box transactions between the short seller and other non-related lenders. Put differently, "[t]ransactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive free-market dealings may not

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214. See *supra* text accompanying notes 117-18.

215. 12 U.S.C. § 371c-1 (1994).

216. 12 U.S.C. § 371c-1(a)(1)(A). A good faith provision also exists for situations in which there are no comparable transactions, see *id.* § 371c-1(a)(1)(B), but that subsection is not relevant here.

217. Lee S. Adams & Bruce Rigelman, *The New Business of Banking: What Banks Can Do Now*, in *THE NEW BUSINESS OF BANKING: WHAT BANKS CAN DO NOW* 361, 363 (PLI Corporate Law & Practice Course Handbook Series No. B-884, 1995).

exist.”<sup>218</sup> Because related individuals probably will never squeeze the short seller, this provision can be stated more succinctly: Investors may not engage in short sale against the box transactions with related individuals.<sup>219</sup> Under such a rule, all investors will be treated equally with respect to counterparty demand risks.

### *Withdrawal of Proceeds*

In recent years, wealthy investors had the opportunity to withdraw the proceeds from short sales against the box transactions in the form of low-interest loans.<sup>220</sup> Presumably, the Lauders opted for this tactic when they sold their shares of Estée Lauder Companies short against the box. This questionable practice constitutes an abuse of the Code’s allowance of short against the box transactions because of its similarity to a sale of the underlying stock. Note, however, that not all investors have the ability to obtain this loan.<sup>221</sup> As a result, a law such as section 1259 ensnares investors who are not abusing the hedging technique because they are not receiving the proceeds of the short sale. Section 1259 penalizes these average, nonabusive investors rather than the atypical investors who, as a result of their acquisition of the proceeds, are sufficiently liquid to absorb the tax liability created under section 1259.

The paradoxical situation created by section 1259 can be rectified by crafting a more narrow rule of law. For example, Congress could fashion a law that levies a tax only on investors who actually receive the proceeds from the transaction. It also could enact legislation that prohibits all investors from obtaining the proceeds from a short sale against the box. Although presenting less of an opportunity to raise revenue, the latter alternative should be preferred over the former because the latter strikes at the heart of the abuse: The ability of particular investors to

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218. RELATED PARTY DISCLOSURES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 57, § 3 (Financial Accounting Standards Bd. ed., 1982).

219. See *supra* note 116 for a proposed definition of related individuals; cf. Evans et al., *supra* note 14, ¶ 25 (supporting a rule that would prohibit short sellers from borrowing shares from related parties).

220. See *supra* notes 122-23 and accompanying text.

221. See *supra* text accompanying notes 30-33.

withdraw proceeds while others cannot.

*Treat Open Positions as Income in Respect of a Decedent*

Finally, the Estée Lauder Companies' IPO demonstrated that short sales against the box can be abusive when used in conjunction with section 1014 of the Code. As stated previously, section 1014 allows for a security to be passed on by way of death at a step-up in basis.<sup>222</sup> The death escape clause, therefore, allows an investor to sell an appreciated stock short against the box, leave the transaction open until he or she dies, and pass on the underlying stock at a step-up in basis—one equal to the stock's fair market value at the time of death.<sup>223</sup> In such a case "no gain would be realized because the basis in the shares delivered [to close the short position] would have been stepped up to fair market value on the death of the shareholders."<sup>224</sup> Such a result clearly is an abuse that was never anticipated by the Code. Section 1259 will prevent this practice because the capital gain will be taxed when the short sale against the box is opened.<sup>225</sup> A narrower correction can be made, however, without the side effects that accompany Congress's solution.

Recall the suggestion made by Chip Harter to disallow a step-up in basis if the risks of ownership of a particular stock were substantially eliminated for more than one and one-half years of the three years prior to the death of the short seller.<sup>226</sup> With the exception of the "substantially eliminated" language, the idea behind this proposal is valid.<sup>227</sup> In other words, if the "substantially eliminated" language were omitted, and other minor alterations were made, then the proposal becomes narrower and corrects for the abuse in a straight-forward manner. For example, Congress could create a rule that requires treatment of proceeds from an open transaction such as a short sale against the box when the proceeds are passed on by way of

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222. See *supra* note 75.

223. See *supra* notes 74-76 and accompanying text.

224. Harter, *supra* note 14, at S-122.

225. See I.R.C. § 1259(a)(1), (c)(1)(A) (West Supp. 1997).

226. See *supra* text accompanying notes 205-06.

227. See *supra* text accompanying note 206.

death as income in respect of a decedent pursuant to section 691 of the Code.<sup>228</sup> In other words, no step-up in basis will occur, and any gains will be included in the gross income of either the estate of the decedent or any person who acquires the right to receive such income from the decedent.<sup>229</sup> Section 1259 takes a step in this direction but falls short because it effectively grants section 691 treatment only to constructive sales that are entered into before June 9, 1997.<sup>230</sup> Specifically, gains on appreciated financial positions will be treated as income in respect of a decedent under section 691 if the following events occur: (1) the decedent dies after June 8, 1997; (2) the decedent entered into a constructive sale prior to that effective date; (3) the constructive sale transaction remains open (a) for at least two years following the date of the transaction and (b) for any amount of time during the three-year period which ends on the date the decedent dies; and (4) the transaction remains open after the thirty-day period beginning on the date of enactment of section 1259.<sup>231</sup> The problem with this approach is its underinclusiveness. Section 691 treatment does not apply to constructive sales occurring after June 8, 1997; rather, taxpayers must close those transactions within thirty days after the end of the taxable year and hold the appreciated position, without reducing risk of loss by entering into offsetting positions, for a sixty-day period beginning on the date on which the taxpayer closes the position to avoid constructive sale treatment and thus recognition of capital gain.<sup>232</sup>

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228. See I.R.C. § 691 (1994). Some commentators have argued that a rule preventing short sellers from borrowing from related individuals would correct for all the abuses contained in the Lauder transaction and thus an additional rule closing the death loophole for short sellers against the box would be unnecessary. See Evans et al., *supra* note 14, ¶ 25. Practically, these commentators might be correct, but theoretically investors still could use the death loophole in conjunction with I.R.C. § 1233, albeit with more difficulty.

229. See I.R.C. § 691(a)(1)(A)-(C).

230. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001(d)(3), 111 Stat. 788, 908 (to be codified at I.R.C. § 1259 note).

231. See *id.*

232. See I.R.C. § 1259(c)(3)(A) (West Supp. 1997).



## CONCLUSION

Regulators have decried short selling, especially in periods of market decline, as a questionable trading practice in need of constant restraint. In the past, however, attempts to regulate short sales focused on their supposed vices.<sup>233</sup> Section 1259 departs from this approach. Congress enacted section 1259 to curb the use of short sales against the box as a means to abuse the tax system by perpetually deferring—avoiding—the payment of taxes on appreciated long positions. Congress, however, has made a law that extends beyond the mere elimination of a taxpayer's ability to use short sales against the box to avoid taxes. Congress thus appears less concerned with the potential abuses of short selling against the box than with taking advantage of populist rhetoric by masking a revenue raiser as an attack on a publicly criticized trading practice. As demonstrated in this Note, such a plan is unwise.

First, rather than leveling the playing field for all taxpayers, section 1259 creates a more inequitable tax system. True, equity may result in the short-run, but the likelihood that more complex financial instruments will be invented to open new tax loopholes will lead to long-term inequity.

Second, section 1259's attempt to recognize realization before a capital asset is disposed of is an affront to longstanding tax doctrine. Although the Code possesses other constructive rules, the creation of yet another such rule is not prudent. To label something constructive is, in effect, an admission that the thing did not occur. More importantly, Supreme Court precedent re-

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233. An obvious example is the uptick rule that was invented after the stock market crash of 1929. See Macey et al., *supra* note 5, at 801. In response to "bear runs," a domino effect where multitudes of investors sell their positions and thereby drive the market down, government regulators created a rule that would prevent short selling from instigating or exacerbating such movements. See *id.* at 802-04. For further discussion on the history of the uptick rule and short selling's role in the crash of 1929, see FRED R. MACAULAY & DAVID DURAND, *SHORT SELLING ON THE NEW YORK STOCK EXCHANGE* vi-vii (1951). The uptick rule stipulates that investors shall be allowed to sell short only if the price at which the short is made is greater than the previously traded price. See 17 C.F.R. § 240.10a-1 (1997); SEC Rule 10a-1, reprinted in *NEW YORK STOCK EXCHANGE GUIDE* ¶ 2440B, Rule 440B, at 3783-86 (1994). Hence, an investor can only sell short on an uptick or zero uptick. See Missakian Interview, *supra* note 17.

garding the occurrence of realization suggests that the Administration's change in recognizing when realization takes place is improper. For these reasons, section 1259 is not a wise provision.

Third, section 1259(c)(3)'s inflexible nature will prevent investors from adequately hedging against short-term risks. Hedging is a benign practice unrelated to the abusive use to which the Lauders put their short sale against the box transactions. As a result, the new law overreaches the abuse with which it should be concerned and places severe limits on a legitimate trading strategy.

This Note demonstrated that the present tax system, as amended by section 1259, is unacceptable. Additionally, alternatives such as an accrual tax system or adding safe harbors to section 1259 are not wise.<sup>234</sup> Rather, legislation that directly addresses the abuses of short selling against the box should be enacted. Instead of reaching through the revenue raising curtain and grasping at shadows—as section 1259 does—the *Related Individual-Income with Respect to A Decedent Rule* proposed in this Note narrowly and properly will correct short sale against the box abuses.

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234. Other alternatives exist, e.g., eliminating the capital gains tax entirely, but similar to the alternatives discussed previously, such a solution does not focus specifically on the abuses in question.