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Short Sales and CFCs

Short sales are either everyday events or mysterious to most people. By short sales, I do not mean selling a house that is worth less than the mortgage; I mean selling property you do not own.

A short seller usually sells and delivers property it does not own, and therefore, necessarily, has borrowed from the owner. To close out the borrowing, the short seller must buy or again borrow the same or sufficiently similar property and return it to the lender. Because the exact property cannot be returned to the lender, the short sale is limited to fungible property, which is usually readily available on a market; this normally means traded securities. Therefore, for transactional purposes, short selling and securities lending cannot be separated.

Likewise, the income tax law chose to integrate the two transactions early and measure the short seller's gain or loss by its cost in the property returned to the lender. This tax choice obviously makes short selling attractive from the tax viewpoint by delaying taxation to follow payment receipt: the short seller can receive payment for the short sale without any tax liability arising at that point. As a practical matter, the short seller usually is not yet economically better off because it usually is required to deposit most or all of the short sale proceeds as security with the securities lender. In addition, it usually is required to make the lender whole for any interest or dividends it would have received on the lent securities.

Short selling was recently highlighted in a transaction in which a controlled foreign corporation (CFC) bought its parent's publicly traded stock and used the stock as part of the acquisition currency to buy a domestic subsidiary. Aside from the subpart F questions about the transaction, the use of short sales was interesting.

Because of the large percentage of the parent's outstanding stock that had to be obtained, the CFC could not just go into the market and buy it. Instead, it contracted with investment banks for the purchase. The banks

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borrowed the stock from their customers, for whom they held the stock in brokerage accounts, or from other similar brokers.

That meant that the banks sold the parent stock short sale to the CFC of the parent. This was of no particular concern to the CFC, because it obtained fee ownership of the stock—whether its sellers had borrowed it or not. The banks then have several months—perhaps up to a year—to buy the parent's stock in the market and use it to replace the borrowed shares.

This is a standard technique for assembling large quantities of publicly traded stock for some purpose, such as spending it. The technique also approximates a standard corporate stock buyback program, because the banks' future purchases of the stock will have the same effect as purchases the parent likely would have made anyway.

Although the target was a domestic corporation in that situation, the same technique can be used, and is much easier to apply, when the target is a foreign corporation.

For additional information, call Jack Cummings at (919) 862-2302.

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