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# ESTABLISHING A SHORT AGAINST THE BOX NOT SUBJECT TO THE CONSTRUCTIVE SALE RULES THROUGH MERGER ARBITRAGE

Prior to the Taxpayer Relief Act of 1997 (TRA '97) investors used a strategy known as the "short against the box" to hedge & monetize appreciated securities without triggering a capital gains tax. The short against the box is the cheapest and most efficient strategy to hedge & monetize appreciated securities and is the "paradigm" against which all other hedging & monetization strategies are compared.

Here's how it worked. The investor simply established a short position in the same stock it currently owned. Since the investor was simultaneously long and short the same stock, any future change in the stock's price had no impact on the investor's economic position. Because the stock was completely hedged, the investor earned a money market rate of return on the value of the entire position. The investor could borrow up to 99% of the value of the stock, with the loan proceeds typically invested in a diversified portfolio of securities. The "all in" cost of this borrowing was extremely low because the interest income earned on the hedged position greatly offset the cost of the margin loan. Finally, because the long and short positions were deemed separate for income tax purposes, the capital gains tax was indefinitely deferred and eventually eliminated because the shares qualified for a stepped-up basis upon the owner's death.

Put more simply, by using the short against the box it was possible to economically dispose of appreciated stock without triggering taxable gain.

Under the constructive sale rules of TRA '97, an investor is deemed to have made a "constructive sale" (e.g., a taxable sale) of an appreciated stock if the investor enters into a short sale of the same or "substantially identical" property. For instance, it is no longer possible for an investor owning shares of XYZ Corp. to simply establish a short position in XYZ Corp. as this will be a constructive sale.

## Establishing A Short Against The Box Through Merger Arbitrage:

However, assume that ABC Corp. has announced the tax-free, stock for stock acquisition of XYZ Corp. What should the tax result be if a holder of XYZ Corp. shares establishes a short position in ABC Corp. shares at a time when considerable deal risk exists (e.g., before regulatory approvals have been obtained and prior to shareholder votes) and the merger is ultimately consummated? Under these facts, the investor should not be deemed to have entered into a short sale of "substantially identical" property and the constructive sale rules should not apply.

Upon the closing of the ABC/XYZ merger (with ABC Corp. acquiring XYZ Corp.), long and short positions in XYZ Corp. are automatically converted into long and short positions, respectively, in ABC Corp. Thus, if the investor began with a long position in XYZ Corp. and established a short position in ABC Corp., the result is a short against the box position in ABC Corp. shares.

## What Are The Economics Of Merger Arbitrage?

Upon the announcement of a stock for stock merger but while contingencies remain, the target's stock will typically trade at a discount to the value to be received in the deal. If the deal is consummated, the spread is eliminated. Therefore, investors and arbitrageurs most often buy stock of the target and establish a short position in the stock of the acquirer in order to capture the deal spread.

In our example, if an owner of XYZ shares establishes a short position in ABC shares, the investor will typically earn a profit if the deal closes and the result will be a short against the box position in ABC Corp. stock. If the deal collapses, the investor will likely suffer a loss.

The “reverse” arbitrage is also possible. Owners of ABC Corp. shares could establish a short position in XYZ Corp. shares. In this case, if the deal collapses the investor will typically earn a profit. If the deal is consummated the investor will likely suffer a loss; however the result is once again a short against the box position in ABC Corp stock.

The economics of merger arbitrage can be quite complex, especially when alternative bidders enter the fray. Before entering into a merger arbitrage transaction, investors are encouraged to seek the counsel of their investment and tax advisors.

### What Is Accomplished By Establishing A Short Against The Box In This Manner?

The resulting short against the box should not be subject to the constructive sale rules and the capital gains tax is indefinitely deferred. The position would ideally be kept open until the death of the investor at which time the shares should obtain a stepped-up basis. During this period the investor’s stock position will be perfectly hedged and he or she will have access up to 99% of the value of the position in cash with absolutely no limitations on the use of proceeds. The cost of borrow will be extremely low because the income generated by the hedged stock position will greatly offset the cost of the margin loan.

### Why Is A Short Against The Box Superior To A Prepaid Variable Forward?

A short against the box is much more cost efficient than a prepaid variable forward for two reasons. First, no derivative dealer is involved, so a layer of fees is eliminated. Second, because the constructive sale rules should not apply, no collar-like economics need to be built into the transaction.

### Role of Intelligent Edge:

The principals of Intelligent Edge have arranged the execution of billions of dollars of short against the box transactions, including those established through merger arbitrage.

Prior to execution we will model the potential economics of a transaction using our proprietary analytical tools so the investor and his or her advisors completely understand the risk/reward profile. Our relationships with multiple clearing firms should insure that the arbitrage is implemented in the most efficient manner possible.

Once the deal closes and a short against the box position has been established, Intelligent Edge’s role is to oversee the position. At that point the objective becomes twofold: 1) maximize the amount of cash the investor can access; and 2) minimize carrying costs so the investor can keep the short against the box open for a long-term period. Besides delivering carrying costs at a level that can be significantly lower than the broker/dealer community in general, in most instances we enable investors to borrow up to 99% of the value of the stock (95% is normally the maximum with most broker-dealers) and we are willing to partially “cap” increases in carrying costs that are caused by an increased stock price.

### Conclusion:

Through merger arbitrage, it is possible to back into a short against the box that should not be subject to the constructive sale rules.

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