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Tax Alert

IRS Affirms Treatment of Short Sales for UBTI Purposes

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Since there are many hedge funds that utilize short selling as part of their investment strategy, it is important for hedge fund investors, including tax exempt organizations, to understand the U.S. tax treatment of these transactions.[1] Fortunately for the exempt investors, the IRS has taken a favorable view of short sales, in guidance that was confirmed recently in a private letter ruling. Specifically, the IRS has affirmed a position taken in a 1995 Revenue Ruling to the effect that a short sale does not generally give rise to "unrelated business taxable income" ("UBTI") with respect to tax-exempt investors. Before considering the ruling itself, it is worthwhile to summarize the key tax issues faced by exempt organizations in hedge fund investments, as well as some of the basics regarding short sale transactions and their treatment for U.S. federal income tax purposes.

It is well known that tax-exempt investors, including universities, foundations, as well as public and private employee pension funds, are among the largest and most influential investors in alternative investment strategies such as private equity and hedge funds. These institutions regularly commit hundreds of millions of dollars to investment funds, and consequently may have significant negotiating power in the structuring of the funds. While there are indications that some of the largest pension funds are slowly allocating some of their capital away from hedge funds,[2] the numbers are still astounding. For example, CalPERS, the nation's largest public employee pension fund, is still reported to have as much as $3 billion invested in hedge funds, even after accounting for a sharp drop this year.[3]

From a U.S. federal income tax perspective, the key issue impacting hedge fund investment by tax exempt organizations is the UBTI rules imposed under Sections 511 through 514 of the Internal Revenue Code of 1986, as amended (the "Code").[4] Organizations exempt from tax under the Code (e.g., under Section 501) are nevertheless subject to tax on their UBTI, which is defined as the gross income derived from an unrelated trade or business, less related deductions (with certain modifications).[5] Tax exempt organizations are subject to tax on UBTI at regular corporate rates, and the incurrence of UBTI also gives rise to a return filing requirement on Form 990-T. [6] Section 512(b) excludes from UBTI numerous categories of passive investment income, such as dividends, interest and gains from the sale of property other than inventory or dealer property. Significantly, however, the use of leverage to acquire property causes even these categories of investment income to constitute UBTI, based on the percentage of the purchase price financed by debt.[7] These "unrelated debt financed income" ("UDFI") rules typically play a prominent role in an exempt organization's evaluation of a hedge fund investment. The use of leverage in a fund often necessitates the use of tax blockers or other UBTI mitigation strategies.[8] Alternatively, an exempt organization may not be UBTI-phobic and may accept the tax costs in light of the investment returns expected (although in the case of a fund that generates only UDFI, as opposed to "active business" UBTI, offshore blocker entities can often preserve the fund's economics while avoiding any material tax cost to the exempt investors).

The UDFI rules are relatively broad in scope and cover situations in which an incurrence of debt and an investment are less than directly related.[9] Furthermore, investments retain a UDFI "taint" for a year following a retirement of the related indebtedness.[10] While the IRS has issued rulings (well known to practitioners in the area) to the effect that income from investments funded by certain lines of credit do not give rise to UDFI, these rulings are very narrow in scope and generally address situations in which the borrowings were intended only to cover short-term liquidity constraints resulting from investor redemptions.[11]

The historical purpose for the enactment of the UDFI rules, although beyond the scope of this article (and not

perfectly clear), can best be described as an effort to prevent tax exempt organizations from "trading" on their exempt status by financing investments with debt to improve their economic returns.[12] Given the complexity of the financial markets and the vast categories of derivatives and structured financial products traded every day, interesting questions arise relating to the proper characterization of certain transactions for UDFI purposes. One example of such a transaction is a short sale of a security.

In its most basic form, a "short sale" of a security occurs when an investor sells a security he does not currently own (via a borrowing) and later purchases the security ("covering the short") in order to repay the lender. The stock borrower may also be permitted to repay the lender in the form of cash in an amount equal to the then market value of the loaned securities. The short seller will typically deposit the sale proceeds as collateral with the lender until the short is covered. Most securities loans take place in the context of short selling. In exchange for a borrowing fee, brokers lend stock to speculators who then sell the stock short. In addition to returning the borrowed stock at the maturity of the loan, the stock borrower/short seller also is usually required to make "substitute dividend payments" to the stock lender, representing any dividends paid on the borrowed stock. Subject to certain anti-abuse rules, a short sale is treated as an "open transaction" for U.S. tax purposes until it is closed out.[13] The character of the associated income depends on whether the property used to close the short sale is a capital asset in the taxpayer's hands as well as its holding period.[14]

In Rev. Rul. 95-8,[15] the IRS held that gain from the short sale of publicly traded stock through a broker did not result in UDFI. In the ruling, an exempt organization had its broker borrow 100 shares of stock and sell them short, resulting in $500x of sale proceeds. The broker retained the proceeds as collateral. The organization supplemented the collateral with additional (non-borrowed) cash of its own. Under the collateral arrangement, the organization was credited with a "rebate fee" consisting of a portion of the income earned on the collateral.[16] The value of the shorted stock dropped to $400x, at which point the broker closed out the short sale on behalf of the organization. Focusing on the definition of "acquisition indebtedness" under Section 514(c), as well as the Supreme Court's holding in *Deputy v. du Pont*,[17], the IRS held that "although the short sale created an obligation, it did not create indebtedness" for tax purposes.
The IRS has recently reaffirmed this position regarding short sales under the UDFI rules of Section 514. In PLR 201434024 (8/22/14), the IRS addressed a charitable trust that proposed to invest in a number of hedge funds treated as partnerships for U.S. federal income tax purposes. According to the ruling, the funds' investment strategy called for neutrality between long and short positions. The short positions were established using customary stock loans from a broker, which charged the funds a lending fee and required collateral equal to the value of the stock loaned. Furthermore, the cash and securities used as collateral were assets owned by the fund and were not borrowed from outside sources.

The key fact in the ruling appears to be that "in no case in which a fund takes a short position will there be any net borrowing by the fund on its own behalf or on behalf of" the trust. Therefore, in the absence of any leverage outside the short sale itself, the only question was whether the short position itself gave rise to "acquisition indebtedness" for UDFI purposes. Citing Rev. Rul. 95-8 and *DuPont*, the IRS stated that "an indebtedness arises only with respect to the borrowing of money, not the borrowing of property." Since the income from the short sale did not constitute UDFI, the corresponding long positions purchased with such proceeds were also not UDFI.

Tax-exempt hedge fund investors can continue to be assured that hedge funds that engage in short selling similar to that described in the recent ruling will not implicate the UBTI rules, absent other factors.

Endnotes

[1] To be sure, data suggests that due to increasing costs and regulatory limitations, short selling by hedge fund managers has decreased. According to a 2013 Forbes report, "Driving the reduction in hedge fund short trading is the escalating cost of selling stock short in the last few years." Nathan Vardi, *Death of the Hedge Fund Short Seller*, Forbes, Jan. 10, 2013. A key contributor to this increased cost is the more onerous terms associated with borrowing the shorted securities, as described more fully below.
[2] Dan Fitzpatrick, *Calpers Pulls Back from Hedge Funds*, The Wall Street Journal, July 23, 2014.
[3] *Id*.
[4] All section references herein are to the Code. Importantly, while many state institutions take the position that

they are exempt from UBTI as a result of their broad exemption from taxation as state sovereigns under Section 115 of the Code, this article is focused on those organizations that are in fact subject to UBTI.

[5] Section 512(a)(1).

[6] Sections 511(a)(1); Treas. Reg. Section 1.6012-2(e).

[7] Section 514.

[8] Section 512(c) provides that exempt organizations are required to look through partnerships of which they are members for purposes of computing their share of UBTI (regardless of distributions). Because many private investment funds, including hedge funds, are structured as partnerships for tax purposes, the presence of active business and/or leverage in these funds implicates UBTI and UDFI issues for exempt investors. See also Treas. Reg. Section 1.514(c)-1(a)(2), Example 4.

[9] Section 514(c)(1)(A).

[10] Section 514(b)(1).

[11] See, e.g., PLR 200233032 (8/16/02); 200235042 (8/30/02). In these rulings, the facts stipulated that "the Line of Credit will be used exclusively to finance redemptions of Units and not for the purpose of making additional investments."

[12] In connection with the 1969 amendments to the UDFI rules (prior to which the rules applied only to certain lease transactions), the House Ways and Means Committee stated that the goal of preventing unfair business competition by tax exempt organizations "can be achieved by imposing the unrelated business income tax on the income received by the exempt organization in proportion to the debt existing on the income-producing property." *See* H.R. Rep. No. 91-413 at 44-46 (1969).

[13] Treas. Reg. Section 1.1233-1(a).

[14] Treas. Reg. Section 1.1233-1(a)(1), (3).

[15] 1995-1 C.B. 107, 1/03/95.

[16] In common securities lending transactions, this rebate fee can be thought of as a payment of interest by the securities lender to the securities borrower in respect of the cash collateral posted by the securities borrower.

[17] 308 U.S. 488.

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