



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Dear \_\_\_\_\_ :

This is in response to your letter dated April 2, 2014, in which you requested certain rulings with respect to I.R.C. § 514.

**Background:**

You represent that you are a qualifying charitable remainder unitrust under §§ 664(d)(2) and 664(d)(3). You propose to invest in a number of funds that will be treated as partnerships for tax purposes. You have represented that none of the partners or brokers will be disqualified persons as to you. The main activity of these funds will consist of investing in stocks. These funds seek to maintain a neutral trading position as between short and long positions at all times in order to minimize risks.

To facilitate your short positions, the funds will direct a broker to sell stock that the funds do not own at the current price to a buyer in the future. At the time that the short sale is settled the funds must borrow stocks from the broker. The broker then provides those stocks to the buyer at the agreed price creating an obligation by the funds toward the broker for the amount of securities loaned by the broker. The funds' creating income or loss is based on the difference between the price at the time of the short sale and the price at the time the sale is settled. The broker often also charges a lending fee for this transaction as well.

In addition to the short position of the funds, the funds will also use the cash proceeds from the short sales to purchase long positions in other stocks. Furthermore, the funds are required to hold cash in reserve to leverage other positions. These cash reserves may be required by law or by the broker depending on the positions taken by the funds.

When a fund takes a long position in a security it will acquire actual ownership of the security and it will not borrow money from any other party to purchase long positions in securities. When a fund takes a short position in a security, it will do so by entering into a short sale with respect to the security. Such short sales will be effected by borrowing the securities from a broker or other third party and collateralizing a fund's obligation to return such securities by depositing cash and securities of equal value of the securities borrowed. Funds securities trades will be

executed through an unrelated third party, which will act as custodian of the securities. The cash and securities used as collateral for such obligations will be assets owned by the fund and in no case will such cash or securities be borrowed from outside sources. Thus, 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 you. The amount of the collateral deposited by a fund will equal at least 100 percent of the amount of its obligations under existing short sale contracts. The value of any securities placed on deposit as well as the amount of the fund's obligations under its short sale contracts will be redetermined on a daily basis, and the fund will maintain sufficient reserves of cash or cash equivalents to meet requirements for any additional deposits which may be required under applicable margin regulations.

A fund's deposit of cash or securities will ensure the broker, and the parties with whom the broker deals in connection with the short sale transaction that the fund will be capable of performing its obligations under its short sale contracts. While cash or securities are on deposit with the broker, the fund will be entitled to receive any earnings which accrue thereon. Similarly, the fund will be required to deliver, upon completion of a short sale, any earnings which accrue during the term of the contract.

**Rulings Requested:**

1. The borrowing of stocks by a fund in entering into short positions will not result in "acquisition indebtedness" as defined in § 514(c) so that none of the distributive share of a fund's income or gain which is derived from the fund's trading activities, to the extent attributable to the foregoing transactions, will be treated as "debt-financed property" as defined in § 514(b).
2. The purchase of long positions in stocks in accounts at one or more affiliates of a broker using, in whole or in part, cash proceeds from short sales made through a fund's accounts at one or more affiliates of that same broker will not result in "acquisition indebtedness" as defined in § 514(c) so that none of the distributive share of a fund's income or gain which is derived from the fund's trading activities, to the extent attributable to the foregoing transactions, will be treated as "debt-financed property" as defined in § 514(b).
3. The use of long positions in stocks, including some or all of those purchased with short sale proceeds, as collateral to secure the performance by a fund of its obligations to deliver stock to the broker to cover its open short positions will not result in "acquisition indebtedness" as defined in § 514(c) so that none of the distributive share of a fund's income or gain which is derived from the fund's trading activities, to the extent attributable to the foregoing transactions, will be treated as "debt-financed property" as defined in § 514(b).

**Law:**

I.R.C. § 512(a)(1) provides that the term "unrelated business taxable income" means the gross income derived by an organization from an unrelated trade or business (as defined in § 513) regularly carried on by it, less the deductions allowed for expenses directly connected with the carrying on of such trade or business.

I.R.C. § 512(b)(1) excludes all dividends, interest, payments with respect to securities loans (as defined in subsection (a)(5)), amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income from the computation of unrelated business income.

I.R.C. § 512(b)(4) provides that Notwithstanding paragraph (1), (2), (3), or (5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

I.R.C. § 512(b)(5) excludes the gains or losses from the sale of property not held as inventory.

I.R.C. § 512(c)(1) provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

I.R.C. § 514(a) provides that a portion of the income produced from debt-financed property shall be included in unrelated business income in relation to the proportion of the overall value of the property constituting "acquisition indebtedness."

I.R.C. § 514(b) defines "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year.

I.R.C. § 514(c) defines "acquisition indebtedness" as the unpaid amount of--

- (A) the indebtedness incurred by the organization in acquiring or improving such property;
- (B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and
- (C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

I.R.C. § 664(c) provides that a charitable remainder unitrust, for any taxable year, is not subject to any tax imposed by this subtitle, unless the trust, for the year, has UBTI (within the meaning of § 512).

I.R.C. § 664(d)(2) defines the term "charitable remainder unitrust" to include a trust--

- (A) from which a fixed percentage (which is not less than 5 percent) of the net fair

market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in § 170(c), and

(C) following the termination of the payments described in subparagraph A, the remainder interest in the trust is to be transferred to, or for the use of, an organization described in §170(c) or is to be retained by the trust for such a use.

Revenue Ruling 95-8, 1995-4 I.R.B. 29, provides that income attributable to a short sale can be income derived from debt-financed property only if the short seller incurs acquisition indebtedness within the meaning of § 514 with respect to the property on which the short seller realizes that income. In Deputy v. du Pont, 308 U.S. 488, 497-98 (1940), the Supreme Court held that although a short sale created an obligation, it did not create indebtedness for purposes of the predecessor of § 163. Therefore, neither the \$100x gain realized by O on the short sale attributable to the decline in value of A stock from \$5x to \$4x nor income derived from the proceeds of the short sale, such as the rebate fee earned by O, is income from debt-financed property within the meaning of § 514.

#### **Analysis:**

Since you represent that you are a charitable remainder unitrust, you are governed by § 664(c). This section subjects you to taxation on income that qualifies as UBTI as defined by § 512. Section 512(b)(4) provides that, notwithstanding paragraphs (b)(1), (2), (3), or (5) of § 512, in the case of debt-financed property certain items gross income and deductions shall be included in the computation of unrelated business taxable income. Section 514(b) defines "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year (or during the 12 months preceding disposition in the case of property disposed of during the taxable year). Section 514(c) defines "acquisition indebtedness" as the unpaid amount of the indebtedness incurred by the organization in acquiring the property and, in certain cases, indebtedness incurred before or after the acquisition.

In accordance with § 512(c)(1), a charitable remainder unitrust, which is a partner in a partnership, is required to count as UBTI its share of the partnership's gross income from unrelated trade or business. In making this calculation the modifications under § 512(b) are applicable, as well as the rules set forth in § 514 pertaining to unrelated debt-financed income. Thus, in this case, your share of interest, dividends, or gains from the sale of property attributable to your participation as a partner in the funds would generally be excluded from the computation of unrelated business taxable income, unless such amounts are derived from debt-financed property.

Accordingly, dividends on your stock holdings earned while the stock is pledged as collateral

would be excluded from the computation of unrelated business taxable income under § 512(b)(1), and income received by you from the sale or exchange of your securities would also be excluded from the computation of unrelated business taxable income under § 512(b)(5). However, the modifications contained in § 512(b) are not available where such amounts are derived from debt-financed property. Section 512(b)(4).

In Rev. Rul. 95-8, supra, we ruled that a short sale does not create an indebtedness for purposes of § 514 because it constitutes the borrowing of property rather than money. Rev. Rul. 95-8, supra, relies on Deputy v. du Pont, 308 U.S. 488, in which the Supreme Court held that a borrowing of property does not give rise to "indebtedness." The taxpayer borrowed stock and argued that payments made to the lender constituted interest. The court held that although the taxpayer had an obligation to the lender, such obligation was not an "indebtedness," because an indebtedness arises only with respect to the borrowing of money, not the borrowing of property.

Based on the information presented, we believe that none of the obligations that will be incurred through the funds pursuant to the transactions described above will result in acquisition indebtedness under § 514(c)(1). Like the income received by the organization described in Rev. Rul. 95-8, supra, your income which is attributable to a sale of publicly traded stock through a broker will not be income derived from debt-financed property under § 514 since the borrowing of the securities used in the short sale does not constitute acquisition indebtedness. See also, Deputy v. du Pont, 308 U.S. at 497-98. Since the income from the short sale will not constitute debt-financed property, the long positions purchased using the cash proceeds from those sales will also not be considered debt-financed property. Therefore, given that no long-position stocks, cash reserves, or short-sale stocks will be purchased using borrowed funds, the income received by you from your participation in the funds will not constitute income from unrelated debt-financed property under § 514.

**Rulings:**

1. The borrowing of stocks by a fund in entering into short positions will not result in "acquisition indebtedness" as defined in § 514(c) so that none of the distributive share of a fund's income or gain which is derived from the fund's trading activities, to the extent attributable to the foregoing transactions, will be treated as "debt-financed property" as defined in § 514(b).
2. The purchase of long positions in stocks in accounts at one or more affiliates of a broker using, in whole or in part, cash proceeds from short sales made through a fund's accounts at one or more affiliates of that same broker will not result in "acquisition indebtedness" as defined in § 514(c) so that none of the distributive share of a fund's income or gain which is derived from the fund's trading activities, to the extent attributable to the foregoing transactions, will be treated as "debt-financed property" as defined in § 514(b).

3. The use of long positions in stocks, including some or all of those purchased with short sale proceeds, as collateral to secure the performance by a fund of its obligations to deliver stock to the broker to cover its open short positions will not result in "acquisition indebtedness" as defined in § 514(c) so that none of the distributive share of a fund's income or gain which is derived from the fund's trading activities, to the extent attributable to the foregoing transactions, will be treated as "debt-financed property" as defined in § 514(b).

This ruling will be made available for public inspection under § 6110 after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Specifically, this ruling does not reach any conclusion as to the qualifying distribution status of your proposed transfer under § 4942(g)(3). Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael Seto  
Manager,  
EO Technical

Enclosure  
Notice 437