

Unrelated income; income from lending securities. Income derived by an exempt organization from the temporary transfer of securities to a brokerage house to cover short sales of the brokerage house in exchange for collateral of equal value, which is held by the organization pursuant to a contract requiring the brokerage house to pay the organization an amount equivalent to the dividend or interest income that would have been earned by the securities plus either a premium based on a percentage of the value of the securities or income earned from investing the collateral, is not subject to tax under section 511 of the Code.

Advice has been requested whether income derived by an exempt organization from the transaction described below is subject to tax under section 511 of the Internal Revenue Code of 1954.

The organization is exempt from taxation under section 501(a) of the Code. Pursuant to a contract with a brokerage house, the organization delivers securities from its portfolio to the brokerage house for the latter's use in completing short sales or otherwise preventing 'fails.' The brokerage house posts collateral with the organization equal to the value of the securities and adjusts the collateral daily as the market price of the securities fluctuates. The contract provides that at the end of the contract period the brokerage house will deliver to the organization securities which are identical to those transferred. If for any reason the brokerage house fails to deliver identical securities by the date specified in the contract, the organization may retain the collateral.

During the course of this arrangement, the brokerage house pays the organization an amount equal to the dividends or interest which the organization would otherwise have derived from the securities that were transferred. The brokerage house also pays the organization additional compensation for entering into the arrangement. This is accomplished in either of two ways. Under some contracts, the brokerage house pays a predetermined premium computed as a percentage of the value of the securities. Under other contracts, the organization is allowed to invest the collateral posted by the brokerage house and to retain the income.

With certain exceptions, section 511(a) of the Code imposes a tax upon the unrelated business taxable income (as defined in section 512) of organizations exempt from Federal income tax under section 501(a). Section 512(a) defines 'unrelated business taxable income' as the gross income from any 'unrelated trade or business' regularly carried on by the organization as computed in the manner provided in section 512.

The term 'unrelated trade or business' is defined in section 513(a) of the Code as any trade or business the conduct of which

is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its exempt functions.

Section 514(a) of the Code provides generally that all or part of the income earned on debt-financed property shall be treated as an item of gross income derived from unrelated trade or business. Section 514(b) defines the term 'debt-financed property' to mean any property held to produce income and with respect to which there is an acquisition indebtedness. Section 514(c) defines the terms 'acquisition indebtedness' to include, with respect to any debt-financed property, the indebtedness incurred before the acquisition of such property if such indebtedness would not have been incurred but for such acquisition.

Section 512(b)(5) of the Code, which excludes an organization's capital gains from the unrelated business income tax computation, was amended in 1976 to also exclude the gain derived by an organization in connection with its investment activities from the lapse of put and call options granted with respect to securities owned by the organization. Pub. L. 94-396, 94th Cong., 2d Sess. (1976) (1976-2 C.B. 531). The report of the Senate Committee on Finance indicates that Congress thought it inappropriate for the income from these lapsed options to be taxed as unrelated business income merely because it would be characterized as ordinary income under section 1234. The committee report states that '(t)axing such income is inconsistent with the generally tax-free treatment accorded to exempt organizations' income from investment activities.' Further, in making it clear that the exclusion provided by the amendment to section 512(b)(5) was not to apply when an organization held options or the underlying securities as inventory or for sale to customers in the ordinary course of a trade or business, the committee report reasoned that 'such activities go beyond the concept of production of investment income that is intended to be exempted.' S. Rep. No. 94-1172, 94th Cong., 2d Sess. 3, 4 (1976) (1973-2 C.B. 531).

This legislative history of section 512(b)(5) of the Code indicates that Congress does not intend for ordinary or routine investment activities of a section 501(a) organization in connection with its securities portfolio to be treated as the conduct of a trade or business for purposes of section 513. The transaction described above is considered to be such an investment activity where the securities transferred by the organization were neither inventory nor held by the organization for sale to customers in the ordinary course of a trade or business.

Thus, the income derived by a section 501(a) organization from the transaction described above is not income from unrelated trade or business.

Moreover, when an organization is allowed to retain the income from the investment of the collateral posted by the broker, the income is not unrelated debt-financed income under section 514 of the Code. Although the organization has the obligation to return the collateral, it has not incurred indebtedness for the purpose of making additional investments. Rather, the collateral is posted to secure the broker's obligation to deliver identical securities, and the organization is allowed to retain the income from investment of the collateral as compensation for entering into the transaction.

Accordingly, the income derived by an organization described in section 501(a) from the transaction described above is not subject to tax under section 511 of the Code.