

ISSUE

Is the income of an exempt organization that is attributable to a short sale of publicly traded stock through a broker treated as unrelated debt-financed income within the meaning of section 514 of the Internal Revenue Code and therefore subject to the unrelated business income tax under section 511?

FACTS

O is an organization exempt from Federal income tax under section 501(a). As part of its investment strategy, O seeks to earn a profit from any decline in the value of corporation A stock, which is publicly traded. On January 2, 19yy, when the value of the stock is \$5x per share, O instructs its broker to sell A stock short. To sell the stock short, O, through its broker, borrows 100 shares of A stock and sells the shares. O's broker retains the \$500x sale proceeds and any income earned on these proceeds as collateral for O's obligation to return 100 shares of A stock. In addition, O puts up additional collateral of \$250x cash from its own (not borrowed) funds.

The broker credits O's account with a "rebate fee," equal to a portion of the income earned on the investment of the collateral. On July 2, 19yy, the value of the stock has declined to \$4x per share, and O instructs its broker to close the short sale by purchasing 100 shares of A stock for \$400x and delivering the stock to the lender. O thus realizes a gain of \$100x, the difference between the \$500x proceeds of the sale of the borrowed stock and the \$400x purchase price of the replacement stock.

LAW

Section 511(a) generally imposes a tax on the "unrelated business taxable income" (UBTI) of organizations otherwise exempt from Federal income tax under section 501(a) and certain other entities.

Section 513 defines the term "unrelated trade or business" as meaning in the case of an organization subject to the tax under section 511, any trade or business that is not substantially related to its exempt purpose, other than through the production of income.

Section 512(a)(1) generally provides that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business, as defined in section 513, regularly carried on by it, less certain deductions and subject to the modifications provided in section 512(b).

Section 512(b)(1) excludes from UBTI all dividends,

interest, payments with respect to certain securities loans, and annuities, and all deductions directly connected with such income.

Section 512(b)(5) excludes from UBTI gains or losses from the sale, exchange, or other disposition of property other than stock in trade or other property of a kind that would properly be included in inventory if on hand at the close of a taxable year, or property held primarily for sale to customers in the ordinary course of trade or business.

Section 512(b)(4) generally provides that notwithstanding the exclusions set out in section 512(b)(1) and (b)(5), UBTI includes certain income, less deductions, derived from "debt-financed property," as defined in section 514.

Section 514(b)(1) defines the term debt-financed property as any property that is held to produce income and with respect to which there is "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)(1) provides that the term acquisition indebtedness means, with respect to any debt-financed property, the unpaid amount of (A) indebtedness incurred by the organization in acquiring or improving the property, (B) indebtedness incurred before the acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement, and (C) indebtedness incurred after the acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of the acquisition or improvement.

ANALYSIS

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 section 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), 1940-1 C.B. 118, 122, the Supreme Court held that although a short sale created an obligation, it did not create indebtedness for purposes of the predecessor of section 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 section 514.

HOLDING

If an exempt organization sells publicly traded stock short

through a broker, then neither the gain or loss attributable to the change in value of the underlying stock nor the rebate fee is income or loss derived from debt-financed property within the meaning of section 514. No inference is intended with respect to a borrowing of property other than publicly traded stock sold short through a broker.

DRAFTING INFORMATION

The principal author of this revenue ruling is Charles Barrett of the Exempt Organizations Division of the Office of the Assistant Commissioner (Employee Plans/Exempt Organizations). For further information regarding this revenue ruling contact Mr. Barrett on (202) 622-8152 (not a toll-free call).