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

200235042

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

MAY 21 2002

Uniform Issue List: 514.00-00

T:EP:RA:T3

Attention:

Legend:

Company A =

Bank B =

Trust M =

Trust N =

State P =

Dear

This is reply to your request for a ruling submitted by your authorized representative dated December 1, 2000 that certain borrowings under a line of credit by funds organized under Trust M and Trust N for the purpose of facilitating redemptions do not give rise to unrelated debt financed income or create any "acquisition indebtedness" within the meaning of Section 514 of the Internal Revenue Code (the "Code"). The request was supplemented by correspondence dated May 25, 2001.

Trust M is a group trust described in Rev. Rul. 81-100, 1981-1 C.B. 326, established by Company A under State P law pursuant to a Plan and Declaration of Trust dated *******, **** and amended and restated as of ********** (as amended, the "Trust M Declaration of Trust").

Trust N was established exclusively to pool the assets of (i) employee stock bonus, pension, profit-sharing or other employee benefit plans that meet the requirements of Section 401 (a) of the Code and are exempt from tax under Section 501(a) of the Code and (ii) governmental pension plans, the assets of which may be invested in a group trust as provided in Section 401(a)(24) of the Code. There are currently separate portfolios organized under the Trust M Declaration of Trust (along with funds that may be organized in the future under the Trust M Declaration of Trust, (the "Trust M Funds")). Each Fund is invested and administered as a single investment portfolio.

Company A serves as the trustee to Trust M, Trust N and the Funds (in its capacity as trustee, the "Trustee"). Although the Trustee is authorized by the Trust M Declaration of Trust and the Trust N Declaration of Trust to invest on behalf of the Funds in a broad range of assets, the Funds' portfolios generally consist of U.S. and non-U.S. stocks, securities and other investment assets (collectively, "Securities"). The beneficial interests of each Fund are divided into and represented by units of participation ("Units"). Each Unit of a Fund is of equal value to every other Unit of the Fund and represents an undivided proportionate interest in all assets and liabilities of the Fund.

Under the Trust M Declaration of Trust, the Trustee is required to value the assets of each Fund as of such dates as the Trustee may designate, but not less frequently than once during each period of three months (the "Valuation Date"). It has been the business practice of the Trustee, however, to designate Valuation Dates not less frequently than the close of business each month, and the Trustee expects to continue this practice. In addition, with respect to certain Funds, it has been the business practice of the Trustee to designate each business day as a Valuation Date, and the Trustee expects to continue this practice. A participant in a Fund (a "Participant") has the right to redeem all or a portion of its Units on thirty days' notice to the Trustee prior to a Valuation Date, which notice period may be waived by the Trustee at its discretion. It has been the business practice of the Trustee to waive this notice requirement, and instead require only ten business days of notice for those Funds that have monthly Valuation Dates, and the Trustee expects to continue this practice. Although Funds with daily Valuation Dates have only recently been established, the Trustee expects to require only one business day of notice for those Funds.

Generally, each Fund is permitted to maintain cash reserves of up to 5% of its assets (the "Cash Reserves") and redemptions are usually funded out of the Cash Reserves, cash inflows and funds raised through sales of Securities. When Securities are sold to finance a redemption, there is generally a lag between the date that the Securities are sold and the date that a Fund receives payment in connection with the sale. Overall market practices determine the length of this settlement period. Sales of domestic Securities generally require a settlement period of three days after the date the trade is executed. Sales of non-U.S. Securities generally have settlement periods longer than three days.

With respect to each Fund, occasionally the cash required to meet redemptions may exceed the aggregate cash inflows plus the Cash Reserves less any funds needed to satisfy prior commitments to acquire Securities, resulting in a shortfall. In addition, in order to cover the net outflows, a Fund may be required to liquidate the Securities in its portfolio quickly in order to satisfy its immediate cash needs. Depending on overall market conditions, such

large volume sales could result in a lower price than sales conducted in a more orderly manner, to the detriment of all Participants in the Fund.

In order to finance redemptions and to avoid the necessity for large volume sales to eliminate shortfalls, a line of credit (the "Line of Credit") has been established with Bank B. Under the Line of Credit, subject to certain other limitations, each eligible Fund will be able to borrow up to the lesser of (1) 15% of the total assets in the Fund (10% for certain biotechnology, high yield, emerging markets equities and emerging markets debt Funds) or (2) $50 million. Various diversification requirements will apply that may also limit the ability of certain Funds to draw upon the Line of Credit. There will be no joint and several liability among the Funds. Thus, if one Fund were to borrow under the Line of Credit, Bank B would have recourse only to that Fund and would not be able to look to the assets of any other Fund when seeking repayment on a borrowing.

The Line of Credit will be used exclusively to finance redemptions of Units and not for the purpose of making additional investments. The Line of Credit will be available to a Fund only to bridge the period between the date on which the Fund distributes cash in redemption of Units and the settlement date for Securities sold to fund the redemption. It is anticipated that the Line of Credit will be used infrequently and that borrowings will be outstanding only long enough to permit the orderly disposition of Securities, normally not exceeding 20 days, except in the case of international markets where settlement periods may be longer. Under the Line of Credit, a loan cannot be outstanding for more than 30 days. A Fund will borrow only when its cash needs to fund redemptions exceed its cash inflows plus Cash Reserves less any funds needed to satisfy prior commitments to acquire Securities. Moreover, it is anticipated that the average daily outstanding balance under the Line of Credit will be de minimis as compared with the average daily asset value of any borrowing Fund. The terms of the line of credit established, including the interest rate and any fees, were negotiated on an arm's length basis.

Based on the foregoing, you request a ruling that borrowings by a Fund under the Line of Credit for the purpose of facilitating redemptions of Units do not give rise to unrelated debt financed income, nor create any "acquisition indebtedness " within the meaning of Section 514 of the Code for Trust M.

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)(1) defines "unrelated business taxable income" as the gross income derived by an exempt organization from any "unrelated trade or business" regularly carried on by the organization less the allowable deductions directly connected therewith.

In the case of a trust described in section 401(a), which is exempt from tax under section 501(a), the term "unrelated trade or business" is defined in section 513(b) of the Code as any trade or business that the trust regularly carries on.

Section 514(a) of the Code provides generally that income earned by a tax-exempt organization on its debt-financed property less allowable deductions shall be treated, for purposes of section 512, as income derived from unrelated trade or business. Section 514(b)(1) defines the term "debt-financed property" to mean 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. Debt-financed property does not include property to the extent the use of such property is substantially related to the exercise or performance by the organization of its tax-exempt purpose or function. See section 514(b)(1)(A). Section 514(c)(1) defines the term "acquisition indebtedness" to mean, with respect to any debt-financed property, the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property, the indebtedness incurred before the acquisition or improvement of such property, if such indebtedness would not have been incurred but for such acquisition, and 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. Under section 514(c)(4), acquisition indebtedness does not include indebtedness the incurrence of which is inherent in the performance or exercise of the organization's exempt purpose or function.

Revenue Ruling 78-88, 1978-1 C.B. 163 concerns the applicability of sections 512 and 514 to a securities lending program engaged in by an exempt organization. There the organization, which was exempt under section 501(a), transferred for temporary periods securities from its investment portfolios to a brokerage house in order to permit the brokerage house to cover short sales. In exchange, as additional compensation for the securities loaned, the organization received cash equal to the value of the securities as "collateral," which it had the right to invest and to retain the income therefrom, but which it was required to repay on the return of the securities. The ruling holds that the lending program does not give rise to unrelated business income because "Congress did not intend for ordinary and 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 the purposes of section 513." Further, it holds that the organization would not have debt-financed income under section 514 as a result of the lending program because the organization had not "incurred indebtedness for the purpose of making additional investments," although it had clearly incurred debt because it had the interim right to invest and retain the income from the cash received as "collateral" and the ultimate obligation to repay such cash.

In this case, a Fund will borrow under the Line of Credit in order to raise case needed to fund redemptions in the event that net outflows exceed net inflows, plus cash reserves less any funds needed to satisfy prior commitments to acquire securities. The transitory indebtedness incurred in connection with scheduled program investments qualifies within the holding of Revenue Ruling 78-88 as one of the "ordinary and routine investment activities . . . in connection with [an exempt organization's] securities portfolio." The Fund's temporary payment obligations are not debts incurred for the purpose of making and carrying additional investments to which debt-financed property provisions apply. They are incurred solely for convenience and will be outstanding only long enough to bridge the period between the redemption date and the settlement date, and do not constitute "acquisition indebtedness" within the meaning of section 514.

Accordingly we conclude that borrowings by a Fund under the Line of Credit for the purpose of facilitating redemptions of Units do not give rise to unrelated debt financed income, nor create any "acquisition indebtedness " within the meaning of Section 514 of the Code for Trust M.

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

If you have any questions concerning this ruling, please contact (ID) at (not a toll free number).

A copy of this letter has been sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Technical Branch Group 3
Tax Exempt and Government Entities Division

CC: