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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Date: FEB 20 2003

Contact Person:

Identification Number:

Telephone Number:

T:EO:B2

Employer Identification Number:

LEGEND:

X =
Y =

U.I.L. Nos.
514.00-00
514.06-00
514.07-00

Dear Sir or Madam:

We have considered X's request dated May 24, 2001, as amended by letter dated June 26, 2002, for 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 or create any "acquisition indebtedness" within the meaning of section 514 of the Internal Revenue Code.

FACTS:

X is a charitable organization recognized as exempt under section 501(c)(3) of the Code and as a publicly supported organization described in sections 509(a)(1) and 170(b)(1)(A)(vi). X has invested in one of the Funds of Y.

Y is represented to be a common trust fund described in section 584 of the Code, comprising several investment Funds. The Funds' portfolios generally consist of U.S. and foreign stocks, bonds, and other investment assets (collectively "Securities"). The beneficial interests of a Fund are divided into Units of equal value, representing undivided proportionate interests. X represents that under section 1.584-2(c)(3) of the regulations and Rev. Rul. 98-41, X is treated proportionately as directly conducting the investment activities of the Fund of Y for purposes of computing unrelated business taxable income.

Generally, each Fund is permitted to maintain cash reserves of up to 5% of its assets. Redemptions of units are usually funded out of cash reserves, cash inflows, and funds raised through the sale 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. Market practices determine the length of this settlement period; it is generally three days for U.S. Securities and longer for foreign Securities.

Occasionally the cash required in a Fund to meet redemptions may exceed the cash

reserves plus cash inflows, less funds needed to satisfy a prior commitment to acquire Securities, resulting in a shortfall. To raise cash and cover the net outflows, a Fund may be required to liquidate a large amount of Securities in its portfolio quickly. Depending on market conditions, such large volume sales could result in a lower sales price than sales conducted in a more orderly manner, to the detriment of all participating investors in the Fund.

To finance redemptions and avoid the necessity for large volume sales to eliminate shortfalls, a Line of Credit has been established with a lender on an arm's length basis. Each Fund will be able to borrow up to the lesser of 15% of the Fund's assets or $50 million, with certain other limitations. There will be no joint and several liability among the Funds for the debt of a particular Fund. The Line of Credit will be used exclusively to finance redemptions and not to make additional investments. The Line of Credit will be available only to bridge the period between distributions of cash in redemption of Units and the settlement date for Securities sold to fund the redemption. 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 reserves plus cash inflows less funds needed to satisfy prior commitments. X anticipates the following: that the Line of Credit will be used infrequently; 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); and that the average daily outstanding balance under the Line of Credit will be de minimis compared to the average daily asset value of the borrowing Fund.

LAW:

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt from federal income tax under section 501(a).

Section 512(a)(1) of the Code defines "unrelated business taxable income" (UBTI) generally as gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions directly connected with such business, both computed with the modifications provided in section 512(b).

Section 512(b)(1) of the Code excludes dividends and interest from UBTI.

Section 512(b)(4) of the Code provides that, notwithstanding sections 512(b)(1) and (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).

Section 512(b)(5) of the Code excludes capital gains and losses from UBTI.

Section 513(a) of the Code generally defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or

performance by an organization of the purpose or function constituting the basis for its exemption.

Section 513(c) of the Code provides that "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. An activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Section 514(a)(1) of the Code provides that in computing UBTI under section 512 there shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business a certain percentage of the total gross income derived during the taxable year from or on account of such property held by the organization during such taxable year.

Section 514(b)(1) of the Code generally 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, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).

Section 514(b)(1)(A)(i) of the Code excepts from "debt-financed property" any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, or (ii) any property to which clause (i) does not apply, to the extent that its use is so substantially related.

Section 514(c)(1) of the Code defines "acquisition indebtedness," with respect to any debt-financed property, 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.

Section 1.513-1(b) of the Income Tax Regulations provides that for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or

performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of exempt purposes (other than through the production of income), and is "substantially related" for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services for which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 1.514(c)-1(a)(1) of the regulations provides that whether the incurrence of an indebtedness is reasonably foreseeable depends upon the facts and circumstances of each situation.

In Example (2) of section 1.514(c)-1(a)(2) of the regulations, Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building which Y rents to an insurance company for purposes not described in section 514(b)(1)(A), (B), (C), or (D). The indebtness is “acquisition indebtedness” since such indebtedness, though incurred subsequent to the improvements of the office building, would not have been incurred but for such improvement, and the indebtedness was reasonably foreseeable when, to make such improvement, Y reduced its working capital below the amount necessary to continue current operations.

Rev. Rul. 78-88, 1978-1 C.B. 163, held not subject to tax under section 511 of the Code 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 was 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 income earned from investing the collateral. The Service reasoned in part that although the exempt organization had the obligation to return the collateral, it did not incur this debt for the purpose of making additional investments, but to secure the broker's obligation to deliver identical securities, and the exempt organization was allowed to retain the income from investment of the collateral as compensation for entering into the transaction. Therefore, the income derived from the transaction was not debt-financed income.

ANALYSIS:

The investment activity of the Fund of Y is conducted solely to produce income and therefore yields unrelated business taxable income to X unless an exception applies. Sections 512(b)(1) and (5) of the Code generally except dividends, interest, and capital gains from unrelated business taxable income. However, section 512(b)(4) treats a certain percentage of such income as unrelated business taxable income if it is derived from debt-financed property. Under section 514(b)(1), X's holding in the Fund of Y is debt-financed property if there is an acquisition indebtedness with respect to the Fund at any time during the taxable year.

Thus, the essential question is whether borrowings under the Line of Credit used to finance more orderly redemptions will be acquisition indebtedness under section 514(c)(1). The debt will not be used to acquire or improve any property. Moreover, the "but for" definitions of acquisition indebtedness set forth in sections 514(c)(1)(B) and (C) do not appear applicable--there does not appear any close connection between the debt and the acquisition or improvement of any property. Instead, the debt will be used to obtain a higher price for Securities sold to finance some redemptions, by extending the selling period over several weeks. Under the facts presented, such debt is not acquisition indebtedness of the Fund.

RULING:

Accordingly, we rule 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 to X or create any "acquisition indebtedness" for X within the meaning of section 514 of the Code.

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

This ruling is directed only to X. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Because this letter could help resolve future tax questions, you should keep a copy of this ruling 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.

Sincerely,

(signed) Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2