

**Internal Revenue Service**

Department of the Treasury

Number: **200217039**  
Release Date: 4/26/2002  
Index Number: 1259.00-00

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Date:  
January 24, 2002

**LEGEND**

Taxpayer =  
Trustee =  
Broker =  
Stock =  
State A =  
Date 1 =  
Date 2 =  
X =  
Y =  
Date 3 =  
Z =  
Amount 1 =  
Amount 2 =

Dear :

This is in reply to a letter dated August 17, 2001, and subsequent correspondence, submitted by your authorized representative, requesting a ruling that certain identified short sales with respect to Stock will continue to fall within the exception to section 1259 of the Internal Revenue Code provided in section 1001(d)(2) of the Taxpayer Relief Act of 1997 (Public Law 105-34).

**FACTS**

Trustee is a banking corporation chartered under the laws of State A that engages in the banking, trust, and related financial services businesses. In its capacity as trustee, Trustee manages the assets of Taxpayer on behalf of Taxpayer's beneficiaries. As part of its fiduciary duty, Trustee has sought to protect Taxpayer's assets by, among other things, diversifying Taxpayer's investments. In order to help achieve diversification, Trustee executed short against the box transactions with respect to Stock held by Taxpayer.

Between Date 1 and Date 2, Trustee caused Taxpayer to execute X separate short sales in respect of Y shares of Stock (the Short Sales). Due to a split of Stock on Date 3, the aggregate number of shorted shares is Z. These transactions were short against the box transactions because Taxpayer also owned Y shares of Stock at the

time it entered into the Short Sales. Taxpayer represents that before the close of the 30-day period beginning on August 5, 1997, it clearly identified the Y shares of Stock and the Short Sales in its books and records as offsetting positions. Taxpayer continues to hold the Y shares of Stock and has not delivered shares to close the Short Sales.

In order to effect the Short Sales, Taxpayer established a securities trading account (Margin Account) with Broker so that Taxpayer could execute purchases and sales of securities through Broker and borrow cash on margin from the Broker. Broker charges interest in respect of any borrowing in the Margin Account.

Broker, acting at the direction and on behalf of Taxpayer, entered into a series of securities lending agreements with third parties (the Lenders) for the total Y shares of Stock. Cash collateral in an amount equal to the current fair market value of the borrowed shares had to be posted with the Lenders. On behalf of Taxpayer, Broker posted the required cash collateral with the Lenders. Broker received the Lender's Rebate on the collateral posted and then credited Taxpayer with the Rebate less an amount retained by Broker as a fee. (Taxpayer was also required to post with Broker the same number of shares as were sold short.)

After the shares were transferred from the securities lender to Broker, Broker sold the shares in the capital markets and deposited the short sale proceeds in the Margin Account. If at any time the Lenders require more collateral, Broker must post the collateral on behalf of Taxpayer. If, at the time the collateral is posted, the amount of required collateral is more than the cash in the Margin Account, the difference is deemed a loan from Broker to Taxpayer. As noted above, Broker charges interest on such loans.

Broker proposes to change the interest rate on the Margin Account borrowings as well as the fee Broker retains from the Lender's Rebate. Broker has proposed to fix the interest charged on margin borrowings at the federal funds rate less Amount 1 basis points and to pass along the Lender's Rebate based on the federal funds rate less Amount 2 basis points.

## **LAW AND ANALYSIS**

Section 1001(d)(2) of the Taxpayer Relief Act of 1997 (the effective date provision) provides an exception to section 1259 for sales of positions, etc. held before June 9, 1997 if, before June 9, 1997, the taxpayer entered into any transaction which is a constructive sale of any appreciated financial position, and before the close of the 30-day period beginning on August 5, 1997 such transaction and position are clearly identified in the taxpayer's records as offsetting. The exception ceases to apply as of the date such transaction is closed or the taxpayer ceases to hold the position. The legislative history of section 1259 explains that the effective date provision prevents any identified transaction or position from being taken into account in determining whether a

constructive sale after June 8, 1997 has occurred. S. REP. NO. 949, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 122 (1997), H. R. REP. NO. 2014, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 438 (1997).

Section 1.1233-1(a) of the Income Tax Regulations provides that a short sale is not deemed to be consummated until delivery of property to close the short sale.

Taxpayer represents that it identified both the Y shares of Stock and the Short Sales as offsetting positions as of the date indicated in the effective date provision. At this time, Taxpayer still holds the Y shares of Stock and has not delivered shares to close the Short Sales.

Because Taxpayer has not closed the Short Sales and continues to hold the Y shares of Stock, the Short Sales and the Y shares of Stock still fall within the effective date provision of section 1259. The changes to the interest rate charged on the Margin Account and the fee retained by the Broker will not cause either the Y shares of Stock or the Short Sales to be taken into account in determining whether a constructive sale has occurred under section 1259.

## **CONCLUSION**

Based on the facts submitted and representations made by Taxpayer, the Short Sales will continue to fall within the exception to section 1259 provided in section 1001(d)(2) of the Taxpayer Relief Act of 1997.

Except as specifically ruled upon, no opinion is expressed as to the federal tax treatment of the above transaction.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's authorized representative.

Sincerely yours,  
PATRICK E. WHITE  
Assistant to the Chief, Branch 1  
Office of Associate Chief Counsel  
(Financial Institutions & Products)

Enclosures:

Copy of this letter  
Section 6110 Copy