Internal Revenue Service

Department of the Treasury

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Refer Reply To:
CC:FIP: /PLR-168302-02
Date:

March 25, 2003

LEGEND

Taxpayer =
Parent =
State =
Date 1 =

Dear :

This is in reply to a letter dated December 12, 2002, and subsequent correspondence, submitted by your authorized representative, requesting a ruling that the transfer of a customer's short sale position from its current broker to Taxpayer, in the manner described below, does not constitute "entering into" a short sale by the customer under § 1.6045-1(a)(9) of the Income Tax Regulations.

FACTS

Taxpayer, a State corporation, uses an accrual method of accounting and uses a fiscal year ending Date 1 as its taxable year. Taxpayer is a U.S. regulated securities broker-dealer that carries out a full-service securities business, including executing and settling trades for customers.

The Transaction

A potential customer of Taxpayer (Customer) holds long and short positions in a prime brokerage account with an unrelated securities broker-dealer (Broker). Customer's short positions are the result of short sales entered into by Customer. Customer would like to transfer its brokerage account, consisting of both long and short positions, to Taxpayer.

The short sales entered into by Customer were effectuated through Broker. Customer directed Broker to sell securities that Customer did not own for Customer's account. Typically, Broker, acting in a principal capacity, obtained the securities sold in the short sale transactions by borrowing the securities from a third party lender. Customer's account then shows a "short position" in securities sold, as well as the cash proceeds of the short sale. Customer also has an obligation to deliver the same amount and kind of securities sold short to Broker.

As a condition for the transfer of Customer's short positions to Taxpayer and the release of the collateral that supports Customer's obligation to Broker, Broker requires Taxpayer, on behalf of Customer, to deliver the appropriate amount and kind of securities to Broker to fulfill Customer's obligation to Broker created by the short sales. Taxpayer typically obtains the securities to deliver to Broker by borrowing from a securities lender. Taxpayer is not acting as Customer's agent when it borrows the securities. Customer does not own the borrowed securities that Taxpayer delivers to Broker on Customer's behalf and has no tax basis in those securities.

LAW AND ANALYSIS

Section 1.1233-1(a)(1) provides that, for income tax purposes, a short sale is not deemed to be consummated until delivery of property to close the short sale. Pursuant to § 1.1233-1(a)(4), if the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

Case law suggests that if a short seller delivers shares that it has borrowed from a second lender to satisfy its obligation under a short sale, the short seller will not realize gain or loss on the short sale until it delivers shares to satisfy his obligation to the second lender. The short sale is not closed by the delivery of the borrowed stock. See H.S.Richardson v. Commissioner, 42 B.T.A. 830, 844 (1940). In general, a short sale is closed by the delivery of stock that has previously been purchased by the short seller or stock that is purchased by the short seller for the purpose of closing the short sale. See Farr v. Commissioner, 33 B.T.A. 557, 559 (1935). Furthermore, courts have held that where a taxpayer satisfies his obligation under a call option using borrowed stock, it is proper to consider the option remaining open until stock is acquired to cover the borrowing. See Reinach v. Commissioner, 373 F.2d. 900, 903 (2nd Cir. 1967).

If a taxpayer were treated as closing a short sale by the delivery of borrowed securities, the normal method of determining gain or loss on a short sale would not be possible. In determining gain or loss on a short sale, the short sale price is matched against the basis of the stock used to close the transaction. See Bingham v. Commissioner, 27 B.T.A. 186, 190 (1932); Farr, 33 B.T.A. at 562. A short seller that delivers borrowed securities is unable to determine gain or loss in this manner because the short seller has no basis in the borrowed securities.

Section 6045(a) of the Internal Revenue Code provides generally that brokers must file information returns regarding transactions they execute for customers. The returns must report the transaction's gross proceeds and such other information as the

Service may specify in forms or regulations. Section 1.6045-1(a)(9) provides in effect that "entering into" a short sale is one of the events that generates information reporting obligations under § 6045.

For the reasons described above, the delivery of the borrowed stock should not be regarded as the closing of a short sale and "entering into" a new short sale. Accordingly, the transfer of the brokerage account does not invoke the rules in § 1.6045-1 regarding reporting of short sales.

CONCLUSION

The provisions in § 1.6045-1 requiring information reporting upon the “entering into” of a short sale create no obligations for Taxpayer regarding the transfer described above.

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 representatives.

Sincerely yours,

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PATRICK E. WHITE
Senior Counsel, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosures:
Copy of this letter
Section 6110 Copy

cc: