Internal Revenue Service

Department of the Treasury

Washington, DC 20224

UIL:
511.00-00
512.01-00
4940.02-00
4941.04-00
4942.01-02

Contact Person:

199905038

Telephone Number:

In Reference to: OP:E:EO:T:3

Date:
NOV 12 1998

E.I.N.

LEGEND:

V=

W=

X=

Y=

Dear Sir or Madam:

This is in response to a ruling request dated July 29, 1998, submitted on your behalf by your authorized representatives. You are seeking rulings on the federal income tax consequences of a proposed transaction, as more fully set forth below.

X is a for-profit corporation whose common stock is publicly held and traded. X is the common parent of an affiliated group of corporations filing consolidated federal income tax returns. X, together with its affiliates, maintains its consolidated books and records, and files its consolidated tax returns on the accrual basis with a December 31 taxable year end. Through unrelated mergers, V and W became members of X's affiliated group of corporations.

Y is a non-profit corporation that has been recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and as a private foundation described in section 509(a). X is a "substantial contributor" to Y and as such is a "disqualified person" with respect to Y pursuant to section 4946(a).

Y makes grants in accordance with its charitable purpose and targets, though not exclusively, programs relating to certain areas of health care, children's issues, quality of life, self-sufficiency, culture and arts.

X has recently pledged the Option to Y which provides Y with an option to purchase shares of X common stock at an option price representing the closing price of a share of Common Stock on the date that the pledge of the Option was made.

The Option is exercisable in whole or in part at any time and from time to time during the period specified in the "Stock Option Pledge Agreement". Y may transfer and assign the Option or any portion thereof only to one or more unrelated charitable organizations described in sections 170(c)(2) and 501(c)(3) of the Code. The transferee may not transfer or assign the Option or any portion thereof without the written consent of X.

It is expected that Y will transfer the Option to an unrelated charitable organization and that the unrelated charitable organization transferee will pay to Y a price for the Option equal to the difference between the fair market value of the Common Stock subject to the Option on the date of the transfer and the exercise price of the option, less an agreed upon discount. It is represented that these terms will be negotiated at arms-length. It is further expected that the unrelated charitable organization transferee will thereafter exercise the Option prior to its expiration.

It is further represented that the business purpose of the pledge of the Option is to further the charitable purposes of Y and other charitable organizations.

Section 4941(a) of the Code imposes a tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(B) of the Code provides that the term "self-dealing" includes any "lending of money or other extension of credit between a private foundation and a disqualified person."

Section 53.4941(d)-2(c)(3) of the Foundation and Similar Excise Taxes Regulations provides that the making of a promise, pledge, or similar arrangement to a private foundation by a disqualified person, whether evidenced by an oral or written agreement, a promissory note, or other instrument of

indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit (within the meaning of this paragraph) before the date of maturity.

Section 53.4941(d)-1(b)(1) of the regulations provides that the term "indirect self-dealing" includes any transaction between a disqualified person and an organization "controlled" by a private foundation within the meaning of section 53.4941(d)-1(b)(5).

Section 53.4941(d)-1(b)(5) of the regulations provides that for purposes relative to acts of indirect self-dealing under section 4941(d) of the Code, two basic tests for determining whether an organization is "controlled" by a private foundation. There is control if: (1), the foundation or one of its foundation managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute self-dealing; or, (2) in the case of a transaction between the organization and a disqualified person, if such disqualified person, together with one or more persons who are disqualified persons by reason of such a person's relationship (within the meaning of section 4946(a)(1)(C) through (G)) to such disqualified person, may only by aggregating their votes or positions of authority with that of the private foundation require the organization to engage in such a transaction. The regulation also provides that an organization will be considered to be controlled by a private foundation or by a private foundation and disqualified persons if such persons are able, in fact, to control the organization (even if their aggregate voting power is less than 50 percent of the total voting power of the organization's governing body) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing.

Section 4942 of the Code imposes a tax on the undistributed income of a private foundation. The undistributed income is defined, in part, as the amount by which qualified distributions are less than a "minimum investment return" of five percent of the "aggregate fair market value of all assets of the foundation," other than specifically excluded assets.

Section 53.4942(a)-2(c)(1) of the regulations further explains the computation of the minimum investment return.

Section 53.4942(a)-2(c)(2)(iv) of the regulations state that any pledge to the foundation of money or property (whether or not the pledge may be legally enforced) is not to be included in determining the minimum investment return.

Section 511(a)(1) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c) of the Code.

Section 512(a)(1) of the Code defines unrelated business taxable income as the gross income earned by an organization from an unrelated trade or business which is regularly carried on, less applicable deductions.

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

In Zemurray Foundation v. United States, 755 F.2d 404 (5th Cir. 1985), the court held that gain from the sale of timberland was excluded from the computation of an organization's capital gain net income. The court stated that property that produces capital gain through appreciation is not an independent category of property whose disposition will be taxable and that the regulations, to the extent that they imply it is, are invalid because they exceed the scope of the Code provisions.

Because the pledge of the Option was given, without any consideration, for the purpose of furthering the charitable purposes of Y and other unrelated charitable organizations, the pledge of the Option by X to Y does not constitute an act of self dealing between X and Y. Regs. 53.4941(d)-2(c)(3).

Furthermore, assuming that the transferee unrelated charity will not be controlled by Y (as defined in section 53.4941(d)-1(b)(5) of the regulations), the exercise of the pledged stock option by the unrelated charitable organization will not constitute an act of self-dealing between X and Y.

The transfer of the option by Y to the unrelated charity will not be an act of self-dealing since the cancellation of the enforceable pledge will be for consideration paid by the unrelated charity. The consideration will be an amount equal to

the difference between the fair market value of the stock subject to the option on the date of the transfer less an agreed-upon discount. Also, the transfer will not be an act of self-dealing since the transfer will be to a charitable organization.

The Option will be excluded from the assets taken into account in computing the amount of the minimum investment return of Y for purposes of determining the tax on failure to distribute income under section 4942 of the Code since section 53.4942(a)-2(c)(2) of the regulations provides that pledges of property are not included in computing the minimum investment return.

As concluded in Zemurray Foundation v. U.S., cited above, the tax on capital gain through appreciation applies only to noncharitable assets susceptible to use to produce interest, dividends, rents and royalties. Stock options are not such assets. Accordingly, Y's proceeds from the sale of the Option to an unrelated organization exempt under section 501(c)(3) of the code would be excluded from the computation of Y's net investment income under section 4940 of the Code.

Sale of the options by Foundation will not produce any unrelated business taxable income because the sales come within the exclusion under section 512(b)(5) of the Code. The exceptions to the exclusion do not apply because Y does not resemble a merchant who acquires or produces property to sell to customers.

Based on the information submitted and the representations made therein, we rule as follows:

(1) The pledge of the Option by X to Y does not constitute an act of self-dealing between X and Y under the provisions of section 4941 of the Code.

(2) The exercise of the Option by an unrelated charitable organization to whom the Option will be transferred will not constitute an act of self-dealing between Y and a disqualified person under section 4941 of the Code.

(3) We have referred your third ruling request, which concerned section 170 of the Code, to the office of the Associate Chief Counsel (Domestic), Income Tax and Accounting, for consideration. They will respond directly to you.

(4) The Option will be excluded from the assets taken into account in computing the amount of the minimum investment return of Y for purposes of determining the tax on failure to distribute income under section 4942 of the Code.

(5) Y's proceeds from the sale of the Option to an unrelated organization exempt under section 501(c)(3) of the Code are excluded from the computation of Y's net investment income under section 4940 of the Code.

(6) Gain on Y's sale of the Option to unrelated section 501(c)(3) organizations will not be subject to the tax on unrelated business taxable income imposed by section 511(a)(1) of the Code.

These rulings are directed only to the organization that requested them. Section 6110(j)(3) provides that they may not be used or cited as precedent.

Because these rulings may help resolve any questions regarding your exempt status, you should keep a copy of this ruling letter in your permanent files.

If you have any questions please call the person whose name and telephone number appear in the heading of this letter.

Sincerely,

--

(signed) Kenneth Earnest

~~Edward K. Karcher~~

Acting Chief, Exempt Organizations
Technical Branch 3