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

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Date: DEC 2 2 2000

Contact Person:

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Identification Number:

Telephone Number:

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Employer Identification Number:

Legend

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B =
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Dear Sir or Madam:

This is in reply to your request for rulings with respect to the federal income tax consequences of the pledge by A to B of an option to purchase A's common stock (the "Option"), and subsequent transfer to, and exercise by, an unrelated section 501(c)(3) organization, under sections 170, 511, 4940, 4941 and 4942 of the Internal Revenue Code of 1986.

## FACTS

A is a for-profit corporation. A's common stock is publicly held and listed on the National Association of Securities Dealers Automatic Quotation ("NASDAQ") Stock Exchange. A is the common parent of an affiliated group of corporations filing consolidated federal income tax returns. A, together with its affiliates including joint ventures, operates hospitals and related health care entities.

B is a Delaware non-stock, non-profit corporation that is exempt from federal income tax under section 501 (a) of the Code and is an organization described in section 501 (c)(3) of the Code. The Service has recognized B as a private foundation as defined in section 509(a) of the Code. A is a "substantial contributor" to B and as such is a "disqualified person" with respect to B pursuant to section 4946(a) of the Code.

B makes gifts to charitable organizations selected by its directors. It is anticipated that the majority of the gifts will be made to charitable organizations that are located in the communities in which A's hospitals are located and that are dedicated to improving those communities and to fostering community activities.

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As of September 24, 1999, A pledged the Option to B which provides B with an option to purchase 50,000 shares of A's common stock at a par value of X per share (the "Common Stock") at an option price of Y per share, representing the closing price of a share of Common Stock on the NASDAQ Stock Exchange on the date the pledge was made. The Option is subject to the condition that A and B receive the rulings requested.

The Option is exercisable in whole or in part at any time and from time to time during the period commencing on the date when the last of the rulings from the Service is received and ending on September 24, 2009. B 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(s) may not transfer or assign the Option or any portion thereof without the written consent of A.

It is expected that B will transfer the Option to one or more unrelated charitable organizations and that the unrelated charitable organization transferee(s) will pay to B 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. These terms will be negotiated at arm's-length. It is further expected that the unrelated charitable organization transferee(s) will thereafter exercise the Option before its expiration.

The business purpose of the pledge of the Option is to further the charitable purposes of B and other charitable organizations.

## Rulings Requested

The following are the requested rulings:

1. The pledge of the Option by A to B does not constitute an act of self-dealing between a private foundation and a disqualified person 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 B and a disqualified person under section 4941 of the Code.

3. After a transfer of the Option by B to an unrelated charitable organization, A will be entitled to a charitable contribution deduction under section 170 of the Code upon the exercise of the Option in an amount equal to the difference between the exercise price and the fair market value of the Common Stock on the date of exercise, subject to the limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2) of the Code.

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

5. B'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 B's net investment income under section 4940 of the Code.

6. Gain on B'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.

## LAW AND ANALYSIS

**1. The pledge of the Option by A to B does not constitute an act of self-dealing between a private foundation and a disqualified person under the provisions of section 4941 of the Code.**

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." However, Section 53.4941(d)-2(c)(3) of the Income Tax Regulations exempts the pledge of the Option by providing that (emphasis added):

> *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.*

The pledge of the Option was given, without any consideration, to further the charitable purposes of B and other unrelated charitable organizations. Therefore, the pledge of the Option by A to B does not constitute self-dealing.

**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 B and a disqualified person under section 4941 of the Code.**

The transferee of the Option must be an unrelated charitable organization described in sections 170(c)(2) and 501(c)(3) of the Code. For purposes of section 4941 of the Code, the term "disqualified person" does not "include any organization which is described in section 501(c)(3) of the Code." Section 53.4946-1(a)(8) of the regulations. The term "self-dealing" does not "include a transaction between a private foundation and a disqualified person where the disqualified person's status arises only as a result of the transaction." Section 53.4941(d)-1(a) of

the regulations. The transferee unrelated charity will not be controlled by B as control is defined in Section 53.4941(d)- I (b)(5) of the regulations.

Therefore, the exercise of the Option by the unrelated charitable organization transferee will not constitute an act of self-dealing between A and B.

**3. After a transfer of the Option by B to an unrelated charitable organization, A will be entitled to a charitable contribution deduction under section 170 of the Code upon the exercise of the Option in an amount equal to the difference between the exercise price and the fair market value of the Common Stock on the date of exercise, subject to the limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2) of the Code.**

Section 170(a) of the Code provides, subject to certain limitations, a deduction for contributions and gifts to or for the use of organizations described in section 170(c) of the Code, payment of which is made within the taxable year. Section1.170A-I(a) of the regulations provides a deduction for any charitable contribution "actually paid during the taxable year . . . irrespective of the date on which the contribution is pledged." Rev. Rul. 68-174, 1968-1 C.B. 81, concludes that a debenture, bond or a promissory note issued and delivered by the obligor to a charitable organization represents a mere promise to pay at a future date and is not a "payment" for purposes of deducting a contribution under section 170 of the Code. Section 170(b)(2) of the Code provides that the total deduction allowed a corporation cannot exceed ten percent (10%) of the corporation's taxable income computed without regard to certain deductions.

Section 1.170A- I (c) of the regulations provides that if a "contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution." The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

Rev. Rul. 75-348, 1975-2 C.B.75, holds that a corporation that pledges to sell shares of common stock at a specified price to an educational organization is entitled to a charitable contribution deduction in the taxable year the pledge is exercised for the excess of the fair market value of the shares on the date of the exercise over the exercise price and no gain will be recognized when the pledge is exercised. Rev. Rul. 82-197,1982-1 C.B. 72, concludes that an individual who grants an option on real property to a charitable organization is allowed a charitable deduction for the year in which the organization exercises the option in the amount of the excess of the fair market value of the property on the date the option was exercised over the exercise price.

Accordingly, A will be entitled to a deduction in an amount equal to the difference between the exercise price and the fair market value of the Common Stock subject to the Option on the date of the exercise of the Option, subject to the limitations of section 170(b)(2) of the Code.

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

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 (5%) of the "aggregate fair market value of all assets of the foundation" other than specifically excluded assets. Section 53.4942a-2(c)(2)(iv) of the regulations provides 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.

Accordingly, the Option is excludable from the assets taken into account in computing the amount of the minimum investment return of B for purposes of determining the tax on failure to distribute income under section 4942 of the Code.

**5. B'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 B's net investment income under section 4940 of the Code.**

Section 4940(a) of the Code imposes a 2% tax on the net investment income of tax exempt private foundations. Net investment income is gross investment income and capital gains less attributable expenses. Section 4940(c)(1) of the Code. For this purpose, capital gains includes only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents and royalties, and property used for the production of unrelated business income under section 511 of the Code (unless the gain was taxed under such section). Section 4940(c)(4)(A) of the Code. Section 53.4940-1(f)(1) of the regulations provides, among other things, that property will be treated as held for investment purposes, even if immediately disposed of, if it is property of a type which generally produces interest, dividends, rents, royalties or capital gains through appreciation.

In Zemurry Foundation v. United States, 755 F.2d 404 (5th Cir. 1985), the Fifth Circuit held that gain from the sale of timberland was not subject to the tax imposed on net investment income under section 4940 of the Code. It held that the regulation could not subject to the tax capital gains derived from the property of the type that generally produced income through appreciation and not from interest, dividends, rents or royalties. Stock options are not property susceptible to use to produce interest, dividends, rents or royalties.

Accordingly, B'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 B's net investment income under section 4940 of the Code.

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

Section 511 (a) of the Code imposes a tax on unrelated business taxable income earned by section 501(c)(3) organizations. Under section 512(a)(1) of the Code, the term "unrelated business taxable income" means gross income derived from any unrelated trade or business regularly carried on by it, less directly connected deductions, as modified by section 512(b) of the Code. An "unrelated trade or business" is, among other things, the conduct of a business which is not substantially related (aside from the need to raise money or make profit) to the organization's exempt purpose. Section 512(b)(5) of the Code provides that all gains or losses from the sale, exchange or other disposition of property are excluded from the computation of unrelated business taxable income other than property that is (A) stock in trade or inventory or (B) held for sale to customers in the ordinary course of a trade or business. B will not hold the Option either as stock in trade, inventory or for sale in the ordinary course of business; thus the gain on the sale of the Option will be excluded from the computation of unrelated business taxable income.

Accordingly, gain on B's sale of the Option to unrelated organizations described in section 501(c)(3) of the Code will not be subject to the tax on unrelated business taxable income imposed by section 511(a)(1) of the Code.

## RULINGS

Therefore, we rule has follows:

1. The pledge of the Option by A to B does not constitute an act of self-dealing between a private foundation and a disqualified person 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 B and a disqualified person under section 4941 of the Code.

3. After a transfer of the Option by B to an unrelated charitable organization, A will be entitled to a charitable contribution deduction under section 170 of the Code upon the exercise of the Option in an amount equal to the difference between the exercise price and the fair market value of the Common Stock on the date of exercise, subject to the limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2) of the Code.

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

5. B'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 B's net investment income under section 4940 of the Code.

6. Gain on B'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.

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

The rulings in this letter only apply the specifically indicated sections of the Code and regulations to the facts that you have represented. In this letter, we do not rule on the applicability of any other sections of the Code and regulations to your case.

Because this letter could help resolve any future questions about your income tax responsibility, please keep a copy of this ruling in your permanent records.

Sincerely yours,

Marvin Friedlander
Chief, Exempt Organizations
Technical Branch 1