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Washington, DC 20224

Third Party Communication: None  
Date of Communication: Not Applicable

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PLR-124503-03

Date:  
April 20, 2005

LEGEND:

Corporation =

Foundation =

State1 =

State2 =

Dear

This letter responds to a ruling request jointly submitted by Corporation and the Foundation by a letter dated April 4, 2003, as supplemented by letters dated September 29, 2003; May 27, 2004; September 9, 2004; and April 11, 2005. Corporation and the Foundation requested identical letter rulings on the issues listed below. Corporation and the Foundation have executed Forms 8821, Tax Information Authorizations, allowing each to receive the other's confidential tax information related to the joint ruling request. Both Corporation and the Foundation have the same authorized representatives.

Previously, Corporation and the Foundation jointly submitted a ruling request based on an earlier version of the draft stock option pledge agreement. The Foundation received PLR 200312004 (December 3, 2002). This ruling letter is based on a later version of the draft stock option pledge agreement and encompasses the factual scenarios arising under PLR 200312004. This letter, as of its effective date, supercedes PLR 200312004.

## ISSUES

1. Whether the pledge of the options by Corporation constitutes an act of self-dealing between the Foundation and a disqualified person under the provisions of section 4941 of the Internal Revenue Code.
2. Whether the exercise of the options by the Foundation pursuant to the Net Exercise procedure will constitute an act of self-dealing between the Foundation and a disqualified person under section 4941 of the Code.
3. Whether the exercise of the options by an unrelated charity will constitute an act of self-dealing between the Foundation and a disqualified person under section 4941 of the Code.
4. Whether any proceeds that the Foundation receives upon the transfer of options to the unrelated charities will be excluded from the computation of the Foundation's net investment income under section 4940 of the Code.
5. Whether the gain on the Foundation's exercise of the options through the Net Exercise procedure or sale of the options to an unrelated charity will not be subject to tax on unrelated business taxable income imposed by section 511(a) of the Code.
- 6.a. If the Foundation transfers the options to an unrelated charitable organization and that charitable organization engages in a cash exercise of the options, whether Corporation will be entitled to a charitable contribution deduction under section 170 of the Code upon the exercise of the options by the unrelated charitable organization, and whether such deduction will be for an amount equal to the difference between the exercise price and the fair market value of the Corporation Stock transferred upon the exercise (plus cash distributed in lieu of a fractional share), subject to the flush language of section 170(c)(2) concerning requirements for use of contributions made by corporations and subject to the limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2).
- 6.b. If the Foundation engages in a Net Exercise of the options, whether Corporation will be entitled to a charitable contribution deduction at the time of the Net Exercise, and whether such deduction will be for an amount equal to the fair market value of the Corporation Stock transferred to the Foundation upon the Net Exercise (plus cash

distributed in lieu of a fractional share), subject to the flush language of section 170(c)(2) concerning requirements for use of contributions made by corporations and subject to the limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2).

6.c. If the Foundation transfers the options to an unrelated charitable organization and that charitable organization engages in a Net Exercise of the options, whether Corporation will be entitled to a charitable contribution deduction at the time of the Net Exercise, and whether such deduction will be for an amount equal to the fair market value of the Corporation Stock transferred to the charitable organization upon the Net Exercise (plus cash distributed in lieu of a fractional share), subject to the flush language of section 170(c)(2) concerning requirements for use of contributions made by corporations and subject to the limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2).

## FACTS

Corporation is a for-profit, State1 corporation. Its publicly held stock is listed on the New York Stock Exchange. It is the common parent of an affiliated group of corporations filing consolidated federal income tax returns.

The Foundation was established as a State2 trust pursuant to a declaration of trust to provide a vehicle for Corporation's charitable giving. Pursuant to a letter ruling issued by the IRS, the Foundation is recognized as exempt from tax under section 501(c)(3) and is a private foundation within the meaning of section 509(a).

The Foundation was organized for the purpose of making distributions to or for the use of organizations described in sections 170(c)(1) and/or (2).

Corporation is a substantial contributor to the Foundation and, as such, is a disqualified person with respect to the Foundation within the meaning of section 4946(a). Each of the Foundation's trustees is an officer of Corporation.

Corporation proposes to pledge to the Foundation stock options for the purchase of shares of common stock of Corporation (Corporation Stock), pursuant to a stock option pledge agreement. Corporation will not receive any consideration for its pledge of the options. The business purpose of the pledge of the options is to further the charitable purposes of the Foundation and other charitable organizations.

The options will be exercisable at a price specified in the stock option pledge agreement. The exercise price may be equal to or greater than or less than the closing price of Corporation Stock on the New York Stock Exchange on the date that the option pledge agreement between Corporation and the Foundation is executed. The option pledge agreement may provide for a cap on the maximum value that may be realized

upon exercise of the option regardless of how high the trading price of Corporation Stock rises.

The options may be exercisable, in whole or in part, at any time and from time to time beginning on a date specified in the option pledge agreement (which may be the date the option pledge agreement is executed or a later date) and ending on a specified date, or the options may be exercisable only on one date as specified in the option pledge agreement. The option pledge agreement may provide that the options will automatically be exercised if Corporation Stock reaches a certain trading price.

The Foundation will not directly exercise the options because payment of the purchase price to Corporation could constitute self-dealing within the meaning of section 4941. Instead, it is anticipated that the Foundation will either transfer the options to an unrelated charitable organization or engage in a net exercise with Corporation through a procedure more fully described below.

Under the option pledge agreement, the Foundation will have the power to transfer the options or any portion thereof to one or more unrelated charitable organizations (i) described in sections 170(c)(2) and 501(c)(3) and (ii) that are not private foundations under section 509(a) or organizations described in section 509(a)(4). The option agreement will define an "unrelated charitable organization" as a charitable organization that is (i) not controlled by the Foundation and (ii) not controlled by any person or entity that is a disqualified person, as defined in section 4946(a), with respect to the Foundation.

Generally, the options will be exercisable in whole or in part and, depending on the terms of the option, may be exercisable from time to time, by a written notice of exercise delivered to Corporation. Upon the exercise of the options, the certificate or certificates for shares of Corporation Stock as to which the options will have been exercised, or other evidence of ownership, will be delivered to the person or persons exercising the options or to such other party as the exercising person may designate.

In addition, the option pledge agreement will provide a cash-less exercise ("Net Exercise") procedure, in which the holder of the options makes no cash payment to Corporation. The Foundation will have this power, and an unrelated charitable organization to which the options are transferred may have this power. Under the Net Exercise procedure, the holder would elect to receive shares of Corporation Stock equal to the net value of the options being exercised on the date of exercise (subject to a cap on the maximum value that may be received if the option pledge agreement includes such a provision). The net value of the options is calculated by subtracting the exercise price for the number of options being exercised from the value of the shares that the holder would have received upon a direct exercise (which would reflect the cap amount if the option pledge agreement includes such a provision). If the holder were to elect the Net Exercise procedure, the holder would notify Corporation of the number of options being exercised, along with written notice of its election to use the Net Exercise

procedure, and Corporation would issue to the holder the number of shares of Corporation Stock computed using the formula specified in the option pledge agreement.

Whenever any of the calculations would result in the delivery of a fractional share upon exercise, the number of shares to be delivered shall be rounded down to the nearest whole number and in lieu of a fractional share Corporation shall make a cash payment equal to the value thereof based on fair market value.

There are two ways that the Foundation will be able to obtain value from the option pledge from Corporation. It will either (i) use the Net Exercise procedure to effect a transfer of Corporation Stock from Corporation in satisfaction of its pledge obligation or (ii) transfer the options to one or more unrelated charities. The Foundation may transfer the options to an unrelated charity for consideration, which may be a price negotiated at arm's length less an agreed-upon discount. The fair market value of the option would be affected by the terms in the option pledge agreement. Alternatively, the Foundation might choose to transfer options to an unrelated charity without consideration. The unrelated charity would be expected to exercise the options prior to their expiration.

Corporation will comply with the record keeping and return requirements of section 1.170A-13 to the extent applicable.

## LAW AND ANALYSIS – ISSUES 1-5

### Law

Section 4941(d)(1)(8) 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, 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 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.

### Analysis

Because the pledge of the option was given, without any consideration, for the purpose of furthering the charitable purposes of the Foundation and other unrelated charitable organizations, the pledge of the stock options by Corporation to the Foundation does not constitute an act of self-dealing between Corporation and the Foundation. Section 53.4941(d)-2(c)(3) of the regulations.

Such pledges are not extensions of credit pursuant to section 53.4941(d)-2(c)(3) of the regulations. Corporation pledged the stock options and will satisfy the options with

common stock equal in value to the pledged options. Because the pledged stock options were given gratuitously, the substitution of common stock in satisfaction of the pledged stock options before the expiration date will not result in a self-dealing "sale or exchange" of property between Corporation and the Foundation. Thus, the Foundation's use of the Net Exercise provisions to collect Corporation's pledge obligation will not result in a self-dealing "sale or exchange" of property between Corporation and the Foundation.

The transfer of the option by the Foundation to an unrelated charity will not be an act of self-dealing since the cancellation of the enforceable pledge will be for consideration paid by a non-disqualified person or an entity not controlled by a disqualified person. The consideration will be an amount negotiated at arm's length - 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 or the Black-Scholes value of the option.

Since a representation has been made that the unrelated charity will not be controlled by the Foundation (as defined in section 53.4941(d)-1(b)(5) of the regulations), the exercise of the stock option by the unrelated charity will not constitute an act of self-dealing between the Foundation and a disqualified person.

As concluded in *Zemurray Foundation v. United States*, cited above, the tax on capital gain through appreciation applies only to non-charitable assets susceptible to use to produce interest, dividends, rents and royalties. Stock options are not such assets. Accordingly, the Foundation's proceeds from the sale of the stock options to an unrelated charity would be excluded from the computation of the Foundation's net investment income under section 4940 of the Code.

Because the Foundation will not hold the stock options either as stock in trade, inventory or for sale in the ordinary course of business, the gain on the sale of the stock options will be excluded from the computation of unrelated business taxable income under section 512 of the Code.

Gain on the sale of the stock options by the Foundation to an unrelated charity will not produce any unrelated business taxable income because the sale comes within the exclusion under section 512(b)(5) of the Code. The exceptions to the exclusion do not apply because the Foundation does not resemble a merchant who acquires or produces property to sell to customers. Furthermore, the Foundation's receipt of common stock pursuant to the Net Exercise of the stock options is simply the collection of a pledge obligation that will not create unrelated business income under section 512 of the Code.

CONCLUSIONS – ISSUES 1-5

1. The pledge of the options by Corporation will not constitute an act of self-dealing between the Foundation and a disqualified person under the provisions of section 4941 of the Code.
2. The exercise of the options by the Foundation pursuant to the Net Exercise procedure will not constitute an act of self-dealing between the Foundation and a disqualified person under section 4941 of the Code.
3. The exercise of the options by an unrelated charity will not constitute an act of self-dealing between the Foundation and a disqualified person under section 4941 of the Code.
4. Any proceeds that the Foundation receives upon the transfer of options to an unrelated charity will be excluded from the computation of the Foundation's net investment income under section 4940 of the Code.
5. Gain on the Foundation's exercise of the options through the Net Exercise procedure or sale of the stock options to an unrelated charity will not be subject to tax on unrelated business taxable income imposed by section 511(a) of the Code.

This letter does not address the treatment of the Foundation's ownership of stock options in the minimum investment return under section 4942 of the Code.

#### LAW AND ANALYSIS – ISSUE 6

Section 170(a)(1) of the Code provides the general rule that, subject to certain limitations, there shall be allowed as a deduction any charitable contribution (as defined in section 170(c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary. See also section 1.170A-1 of the Income Tax Regulations.

Section 1.170A-1(a) provides that any charitable contribution, as defined in section 170(c), actually paid during the taxable year is allowable as a deduction in computing taxable income irrespective of the method of accounting employed or of the date on which the contribution is pledged. See also section 1.461-1(a)(2)(iii)(B). However, charitable contributions by corporations may under certain circumstances be deductible even though not paid during the taxable year, as provided in section 170(a)(2) and section 1.170A-11(b).

Section 1.170A-1(b) provides that ordinarily a contribution is made at the time delivery is effected.

Section 1.170A-1(c)(1) provides that if a charitable 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 reduced as provided in section 170(e)(1) and section



1.170A-4(a), or section 170(e)(3) and section 1.170A-4A(c). Section 1.170A-1(c)(2) provides that 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 relevant facts.

Rev. Rul. 68-174, 1968-1 C.B. 81, provides that a debenture bond or a promissory note issued and delivered by the obligor to a charitable organization described in section 170(c) represents a mere promise to pay at some future date and is not a payment for purposes of deducting a contribution under section 170. Cf. Rev. Rul. 78-38, 1978-1 C.B. 67.

Rev. Rul. 75-348, 1975-2 C.B. 75, holds that a corporation that pledges to sell shares of its common stock at a specified price to a charitable organization described in section 170(c) is entitled to a charitable contribution deduction in the taxable year in which the pledge is exercised. The amount of the contribution is the excess of the fair market value of the shares on the date the pledge is exercised over the exercise price. Also, because of the provisions of section 1032, no gain will be recognized by the corporation as a result of the exercise of the pledge agreement.

Rev. Rul. 82-197, 1982-2 C.B. 72, concludes that an individual who grants an option on real property to a charitable organization described in section 170(c)(2) is allowed a charitable contribution deduction for the year in which the organization exercises the option. The amount of the contribution is the excess of the fair market value of the property on the date the option is exercised over the exercise price.

## CONCLUSION – ISSUE 6

6.a. If the Foundation transfers the options to an unrelated charitable organization and that charitable organization engages in a cash exercise of the options, Corporation will be entitled to a charitable contribution deduction under section 170 of the Code only upon the exercise of the options by the unrelated charitable organization, and such deduction will be for an amount equal to the difference between the exercise price and the fair market value of the Corporation Stock transferred upon the exercise (plus cash distributed in lieu of a fractional share), subject to the flush language of section 170(c)(2) concerning requirements for use of contributions made by corporations and subject to the limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2).

6.b. If the Foundation engages in a Net Exercise of the options, Corporation will be entitled to a charitable contribution deduction only at the time of the Net Exercise, and such deduction will be for an amount equal to the fair market value of the Corporation Stock transferred to the Foundation upon the Net Exercise (plus cash distributed in lieu of a fractional share), subject to the flush language of section 170(c)(2) concerning requirements for use of contributions made by corporations and subject to the

limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2).

6.c. If the Foundation transfers the options to an unrelated charitable organization and that charitable organization engages in a Net Exercise of the options, Corporation will be entitled to a charitable contribution deduction only at the time of the Net Exercise, and such deduction will be for an amount equal to the fair market value of the Corporation Stock transferred to the charitable organization upon the Net Exercise (plus cash distributed in lieu of a fractional share), subject to the flush language of section 170(c)(2) concerning requirements for use of contributions made by corporations and subject to the limitations on the amount of a charitable contribution deduction of a corporation under section 170(b)(2).

If the stock that Corporation transfers is subject to restrictions, that may materially affect the fair market value of the stock. Compare section 1.170A-13(c)(7)(xi)(C)(1).

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

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the organization requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Copies of this letter are being sent to your authorized representatives in accordance with the Power of Attorney on file with this office, as modified by the submission dated April 11, 2005.

Sincerely,

Christopher F. Kane  
Chief, Branch 3  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

Enclosures:

Copy of this letter  
Copy for section 6110 purposes

cc: