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

U.I.L.: 4941.04-00

Date: DEC 19 2000

Contact Person:

ID Number:

Telephone Number:

E:EO:R:3

Employer Identification Number:

LEGEND:

X=

Y=

Dear Sir or Madam:

This is in response to a ruling request dated July 17, 2000, and supplemented December 12, 2000. Both the original ruling request and the supplemental information were 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, which is not itself engaged in an active trade or business. X is a majority member of a limited liability company that does engage in the active conduct of a trade or business. X is a "substantial contributor" to Y and as such is a "disqualified person" with respect to Y pursuant to section 4946(a) of the Internal Revenue Code.

Y is a non-profit corporation that has been recognized as exempt from federal income tax under section 501(c)(3) of the Code and as a private foundation described in section 509(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 to Y an option to purchase shares of X Common Stock at an option price representing the fair market value of the common Stock as determined by X's Board of Directors on the date X pledged the Option.

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 (a "Permitted Transferee"). You have represented that an "unrelated charitable organization" means a charitable organization that is; (1) not controlled by Y , and (2) is not controlled by

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any person or entity that is a disqualified person, as defined in Code section 4946(a), with respect to Y. A Permitted Transferee may not transfer or assign the Option or any portion thereof without the written consent of X.

Generally, the Option is exercisable in whole or in part and from time to time by a written notice of exercise delivered to X. Payment of the purchase price of any shares with respect to which the Option will be exercised generally will be by certified or bank cashier's or teller's check, or wire transfer, and will be delivered with the notice of exercise. Upon exercise of the Option, the certificate or certificates for shares of Common Stock as to which the Option was exercised will be registered in the name of the person or persons exercising the Option.

In addition, the Option Agreement provides a cashless exercise procedure (a "Net Exercise"), in which no consideration is paid to X by the holder of the Option. Under the Net Exercise Procedure, Y may elect to receive all or some of the Option shares of Common Stock equal to the value of the amount of the Option being exercised on the date of the exercise. If Y were to elect the Net Exercise procedure, Y would notify X of the amount of the Option being exercised, along with written notice of Y's election to utilize the Net Exercise procedure, and X would issue to Y the number of shares of the Common Stock computed using the formula specified in the Stock Option Pledge Agreement.

It is expected that Y will collect the Option pledge in two parts. With respect to a portion of the Option, Y will utilize the Net Exercise procedures to effect a transfer of Common Stock from X in satisfaction of its pledge obligation. For the second portion, it would be expected that Y will transfer the Option to an unrelated Permitted Transferee and that the Permitted 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 Permitted Transferee will thereafter exercise the Option prior to its expiration. The relative size of each of the separately exercised Options will depend on several factors including whether there is a public market for X's stock and whether X's stock issued pursuant to the exercise of the Option would be restricted stock under state and federal securities

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, 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 4946 (a)(1) of the Code defines "disqualified person" for purposes of Chapter 42.

Section 53.4946-1(a)(8) of the regulations provides that for purposes of section 4941 only, the term "disqualified person" shall not include any organization which is described in section 501(c)(3) (other than an organization described in section 509(a)(4)).

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).

X's pledge of the Option to Y was entirely gratuitous and unsupported by consideration. Such pledges are not extensions of credit pursuant to section 53.4941(d)-2(c)(3) of the regulations. X pledged the Option and will satisfy the Option with Common Stock equal in value to the pledged Option. Because the pledged Option was given gratuitously, the substitution of Common Stock in satisfaction of the pledged Option before the due date will not result in a self-dealing "sale or exchange" of property between Y and X. Thus, Y's use of the Net Exercise provisions to collect X's pledge obligation will not result in a self-dealing "sale or exchange" of property between Y and X.

The transfer of the option by Y to a Permitted Transferee 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 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.

Since you have represented that the Permitted Transferee 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 Permitted Transferee will not constitute an act of self-dealing between Y and a disqualified person.

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 non-charitable 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 a Permitted Transferee would be excluded from the computation of Y's net investment income under section 4940 of the Code.

Because Y will not hold the Option either as stock in trade, inventory or for sale in the ordinary course of business, the gain on the sale of the Option will be excluded from the computation of unrelated business taxable income.

Gain on the sale of the Option by Y to a Permitted Transferee 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 Y does not resemble a merchant who acquires or produces property to sell to customers. Furthermore, Y's receipt of Common Stock pursuant to the Net Exercise of the Option is simply the collection of a pledge obligation that will not create unrelated business income under section 512 of the code.

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 a private foundation and a disqualified person under the provisions of section 4941 of the Code.

(2) The exercise of the Option by Y pursuant to the Net Exercise procedures will not constitute an act of self-dealing between Y and a disqualified person under section 4941 0f the Code.

(3) 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.

(4) We have referred your fourth 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.

(5) 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.

(6) Y's receipt of Common Stock pursuant to the Net Exercise procedures will be excluded from the computation of Y's net investment income under section 4940 of the Code.

(7) 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.

(8) Y's receipt of Common Stock pursuant to the Net Exercise procedures will not be subject to the tax on unrelated business taxable income imposed by section 511(a)(1) of the Code.

(9) 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 based on the understanding that there will be no material changes in the facts upon which they are based.

These rulings do not purport to rule under any other Chapter 42 provision or any other provisions of the Code

These rulings are directed only to the organization that requested them. Section 6110(k)(3) of the Internal Revenue Code provides that they may not be used or cited by others as precedent.

Please keep a copy of this ruling letter in your permanent records.

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3