



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

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UIL:4940.00-00, 4941.00-00 8 511 .00-00

Date: JUL 18 2001

Contact Person:

Identification Number:

Telephone Number:  
(202)

**T:EO:B1**

Employer Identification Number:

Legend:

C =  
F =  
G =  
X =

Dear Sir or Madam:

You requested rulings on behalf of C and F involving the federal income tax consequences of the pledge by C to F of an option to purchase C's common stock (Option) and the subsequent transfer to and exercise of the Option by an unrelated section 501(c)(3) organization under sections 170, 511, 4940, and 4941 of the internal Revenue Code of 1986 (Code).

**Facts**

**Parties to the Transactions**

C is a for-profit corporation whose common stock is publicly held and listed on G. C, together with its affiliates operates hospitals and related health care entities.

F is a non-profit corporation exempt from federal income tax under section 501 (c)(3) of the Code and is a private foundation as defined in section 509(a) of the Code. C is a substantial contributor to F and as such is a disqualified person with respect to F pursuant to section 4946(a) of the Code. F makes gifts to charitable organizations selected by its directors. It is anticipated the majority of the gifts will be made to charitable organizations located in the communities in which C's hospitals are located and that are dedicated to improving those communities and to fostering community activities.

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### Description of Transaction

On July 11, 2000, C pledged an Option to F allowing F the right to purchase a certain number of shares of common stock of C (Common Stock) at an option price of \$X per share. 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 July 11, 2010. F may transfer and assign the Option or any portion thereof only to one or more unrelated charitable organizations (Permitted Transferees) described in sections 170(c)(2) and 501 (c)(3) of the Code. The Permitted Transferees may not transfer or assign the Option or any portion thereof without the written consent of C.

The Permitted Transferees will pay to F 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. F states these terms will be negotiated at arm's-length. F further expects the Permitted Transferees will thereafter exercise the Option prior to its expiration.

F states the purpose of the pledge of the Option is to further the charitable purposes of F and other charitable organizations.

### Rulings Requested

1. The pledge of the Option by C to F 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 F and a disqualified person under section 4941 of the Code.
3. We have referred your third ruling request, which concerns section 170 of the Code, to the Office of Associate Chief Counsel (Domestic), Income Tax and Accounting, for consideration. They will respond directly to you.
4. F'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 F's net investment income under section 4940 of the Code.
5. Gain on F'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

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 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 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 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 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 gain from the sale of timberland was excluded from the computation of an organization's capital gain net income. The court stated property that produces capital gain through appreciation is not an

independent category of property whose disposition will be taxable and the regulations, to the extent they imply it is, are invalid because they exceed the scope of the Code provisions.

#### Rationale

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

Assuming the Permitted Transferee will not be controlled by F (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 selfdealing between F and a disqualified person.

As concluded in Zemurray Foundation v. U.S., supra, 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, F's proceeds from the sale of the Option to a Permitted Transferee are excluded from the computation of F's net investment income under section 4940 of the Code.

Gain on the sale of the Option by F 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.

#### Conclusion

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

- (1) The pledge of the Option by C to F 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 F 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) F'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 F's net investment income under section 4940 of the Code.

- (5) Gain on F'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. This ruling does not purport to rule on whether F's ownership of stock options will be excluded from the minimum investment return under section 4942 of the Code.

These rulings are directed only to the organization that requested them. Section 6210(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.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

(signed) **Marvin Friedlander**

Marvin Friedlander  
Manager, Exempt Organizations  
Technical Group 1