

IRS LETTER RULINGS

Letter Ruling Alert

A New Twist in Donations of Stock Options By Disqualified Persons

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In PLR 200141018 (July 5, 2001), the IRS has confirmed that a taxable corporation will be entitled to a charitable contribution deduction under section 170 for its pledge of a stock option to a private foundation. Unlike previous rulings addressing donations of such option pledges, the IRS has determined that a corporation will also be entitled to a charitable contribution deduction if, pursuant to the option agreement, the foundation elects to receive shares of the corporation's stock in exchange for the cancellation of the option. (For PLR 200141018, see p. 420.)

Facts

The ruling was requested by a taxable corporation seeking a charitable contribution deduction under section 170 for its pledge to a private foundation of an option to purchase a specified number of shares of the corporation's common stock at a fixed price determined by the corporation's board of directors on the pledge date, pursuant to the terms of an option agreement. The option agreement provides for the transfer or assignment of the option or any portion thereof to one or more "permitted transferees," which are unrelated charitable organizations described in sections 170(c)(2) and 501(c)(3). A permitted transferee takes the option subject to the restriction that it may not transfer or assign the option or any part of the option without the written consent of the corporation. The permitted transferee may exercise the option in whole or in part by way of written notice and payment of the exercise price to the corporation. The shares transferred to the permitted transferee may be subject to restrictions.

The option agreement between the corporation and the foundation also provides for a novel cashless "net exercise" procedure in which the foundation or permitted transferee may agree to cancel the option in exchange for shares of common stock equal to the value of the option at the time, in lieu of purchasing a block at the option price. The number of shares of common stock issued by the corporation in exchange for the private foundation's or permitted transferee's cancellation of the option is based on a formula that is specified in the option agreement, but not described in the ruling.

The foundation expects to make use of the option in two parts. First, it plans to cancel a portion of the option in exchange for shares of the corporation's common stock using the net exercise procedure. Second, the foundation plans to transfer the remaining portion of the option to an unrelated

charity, in exchange for a payment from the unrelated charity equal to the difference between the fair market value of the common stock on the date of the option transfer and the option exercise price, less an agreed upon discount. These terms will be negotiated at arm's length.

IRS Legal Analysis

In analyzing this particular option with its unusual net exercise procedure, the IRS first reviewed its previous treatment of stock option pledges to charities. Under section 170, a charitable contribution may be in the form of money or other property. In Rev. Rul. 75-348, 1975-2 C.B. 75, the IRS held that a corporation was entitled to a charitable contribution deduction for its transfer of a pledge to an educational organization of an option to purchase shares of its common stock at a specified price. Similarly, in Rev. Rul. 82-197, 1982-2 C.B. 72, the IRS held that an individual who grants a charitable organization an option to purchase real property is entitled to a charitable contribution deduction. In both rulings, the corporate or individual taxpayer granting the option was entitled to a charitable contribution deduction in the taxable year that the option was exercised, for the excess of the fair market value of the property on the date of exercise over the option's exercise price.

Applying the reasoning of Rev. Rul. 75-348 and Rev. Rul. 82-197 to the transactions in question, the IRS ruled that if the option is exercised by a permitted transferee by payment of the exercise price for shares of common stock, the corporation will be treated as making a deductible charitable contribution in the year that the option is exercised. The corporation's charitable contribution deduction will equal the excess of the fair market value of the shares on the date of exercise over the option price. The IRS went on to rule that if either the private foundation or a permitted transferee uses the net exercise procedure and cancels the option in exchange for shares equal to the option's value, the corporation will be treated as making a deductible charitable contribution in the year that the stock is transferred to the foundation or the charity. The IRS again grounded this result in the reasoning of Rev. Rul. 75-348 and Rev. Rul. 82-197. In this instance, the amount of the charitable contribution deduction will be the fair market value of the shares that are "paid" to the foundation or the permitted transferee. The IRS noted that if the stock transferred by the corporation to the foundation or permitted transferee is restricted, this may materially affect

the fair market value of the stock and consequently, the value of the corporation's deduction.

Commentary

Valuation

This ruling confirms that taxable corporations that make pledges of transferable stock options to a private foundation will be entitled to a charitable contribution deduction, subject to the limits of section 170(b)(2), in the year in which the option is exercised. In previous rulings, the common stock subject to the option was actively traded on an exchange and presented no difficulty in valuation.

Unlike previous rulings, however, this ruling does not specify whether the common stock that is subject to the option is publicly traded stock or stock of a closely held corporation, only that the fair market value of the stock will be determined by the corporation's board of directors at the time the pledge is made. Because the value of stock of closely held corporations cannot be readily determined by reference to an established market and is affected by several factors — including restrictive agreements, market factors, and discounts for minority interests and lack of marketability — when making a pledge of an option on its stock, a closely held corporation must establish a reliable valuation procedure. Accordingly, if the stock discussed in this ruling is not publicly traded, it will be necessary to value the stock to determine the value of the option: (1) on the pledge date; (2) when shares are issued in exchange for cancellation of the option under the net exercise procedure; (3) when the option is sold by the foundation to a permitted transferee; and (4) upon exercise of the option by a permitted transferee.

Net Exercise Procedure

The stock option pledge in this ruling is structured differently than option pledges described in previous rulings because here the foundation can use the net exercise procedure. The net exercise provision is significant primarily because of the self-dealing issues it raises, which the IRS explored in a previous ruling concerning the same transaction, PLR 200111051 (December 19, 2000 (*Doc 2001-7691 (6 original pages); 2001 TNT 53-59*)). This ruling indicates that the donor corporation involved in this transaction is a substantial contributor to the foundation and, as such, a disqualified person. The fact that the IRS has not revisited its legal analysis of the self-dealing implications of the net exercise procedure in this ruling bears reviewing here.

In previous rulings, the IRS found no self-dealing when the foundation transferred the stock option to an unrelated charity that in turn, exercised it. (See PLR 200112065 (*Doc 2001-8515 (7 original pages); 2001 TNT 58-63*); PLR 9234031.) In these rulings, it is stated that the foundation itself will not exercise the option to purchase shares from the corporation because such an exercise would be a sale or exchange with a disqualified person, and therefore an act of self-dealing. Here, the foundation can itself use the net exercise procedure, so that a transaction occurs directly between the foundation and the corporation, which is a disqualified person. The IRS ruled that this transaction did not constitute

self-dealing. This conclusion is somewhat surprising because the arrangement certainly resembles a sale or exchange between a disqualified person and the foundation. The corporation remits shares in exchange for the foundation's cancellation of its stock option, which is a marketable asset in the hands of the foundation. (The ruling notes that the foundation can sell the option to another charity.)

Nevertheless, the IRS determined that because the pledge of the stock option was given gratuitously to the foundation to further the charitable purposes of the foundation (and other charitable organizations), the substitution of common stock in satisfaction of the pledge option before the due date would not result in a "sale or exchange" of property between the corporation and the foundation that would give rise to an act of self-dealing. By focusing on the fact that no *cash* was exchanged between the donor corporation and recipient foundation, the IRS seemingly overlooked that the corporation was nevertheless transferring an asset that had value and could be sold to an unrelated party or exchanged for shares with an ascertainable value.

It is clear, based on previous rulings, that the foundation may not exercise the option directly by purchasing shares for the net exercise price without engaging in a self-dealing transaction. However, the foundation may choose to transfer the option or a portion of the option to an unrelated charitable organization in exchange for cash, or choose to use the net exercise procedure itself to obtain shares of the corporation. If the shares have declined in value or are significantly discounted because of restrictions, the foundation may find it difficult to sell the option. This is where the net exercise procedure is an attractive alternative because it enables the foundation to receive value directly from the corporation, which is a disqualified person, without paying cash for shares or having to seek a buyer for the option. The net exercise procedure ensures the corporation that it will receive a deduction for its charitable contribution. If the shares issued to the foundation ultimately lose all value, the foundation has not suffered any real loss. If the shares increase in value in the future, the foundation will have the opportunity to sell them by transferring them to an unrelated charitable organization.

