IT'S TEA TIME – "TEXAS TEA" TIME: ADVISING DONORS AND MANAGING GIFTS OF OIL, GAS AND MINERAL INTERESTS

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I. INTRODUCTION

Here in Texas, we have a strong attachment to our mineral interests—when someone offers us a royalty interest, we are not likely to decline. But advisors and directors of charitable organizations do not always understand and welcome a gift of mineral interests, due to the uncertainties of how to manage and dispose of these interests within the fiduciary duties and the charitable goals of the organization.

Recently, there has been a dramatic increase in the use of alternative asset classes to fund an individual's charitable donation.[1] According to industry experts, "Hard economic times and the appeal of maximizing tax benefits are driving the growing popularity of making non-cash donations . . . ."[2] Real property and closely held business interests are at the forefront of this trend, followed by items such as "wine and art collections, furniture, soybeans, timber holdings [and] mineral rights"—particularly with high net wealth individuals.[3] Due to the economic climate, financial advisors have had to recommend that their clients look across their entire balance sheets to find a more nontraditional asset to fund their charitable inclinations.[4] For instance, before the economic troubles of 2008, donors would use appreciated stock for their donations; however, those same donors now would rather hold on to that liquidity and contribute other long-term capital gain assets, such as real estate or closely held stocks.[5] One of the drawbacks to this type of charitable giving strategy is that a donor of illiquid assets usually must pay for a qualified appraisal of the asset, which can be costly for hard-to-value assets.[6] If an asset is too illiquid, or if it has the ability to appreciate dramatically in the near future, the donor may be well advised to either wait to make the gift or make the gift to an intermediary charity and have the net proceeds fund his or her donor

1. Charles Paikert, *How HNW Charitable Giving Is Changing*, REGISTERED REP. SOURCE FOR FINANCIAL ADVISORS (Dec. 21, 2011), http://wealthmanagement.com/data-amp-tools/how-hnw-charitable-giving-changing.

2. *Id.*

3. *Id.*

4. Michelle Lodge, *Five Questions With Bryan Clontz*, ON WALL ST. (Jan. 1, 2012), http://www.onwallstreet.com/ows_issues/2012_1/bryan-clontz-five-questions-2676477-1.html.

5. *Id.*

6. *See id.*

advised fund after it is liquidated.[7] However, charitable organizations also must be aware "when potential donors are simply trying to unload an undesirable asset" that they can no longer handle and just want to give away.[8] For example, individuals in the southern part of the country attempted to donate their horses to charities during the economic downturn of 2008 because they could no longer afford to house and feed them.

A whole mass of questions and uncertainties spring up when approached with a gift of such nature, or when this type of gift is handed over by an administrator of an estate as part of a testamentary disposition.[9] This article addresses these uncertainties, provides strategies for managing these concerns and working with donors, and discusses the most challenging issues presented to charitable organizations when considering the receipt of a unique gift such as mineral interests, including whether to accept the gift, how to value the property, whether to retain or sell the interests, how to dispose of the items if such decision is made, and what income or excise tax consequences may arise from accepting that type of gift.[10]

II. FORMS OF MINERAL INTEREST GIFTS

Donors may approach public charities and private foundations with gifts of oil, gas, and other mineral interests, which may be either wrapped up in an entity or may be transferred along with the surface estate and ancillary items on the surface such as livestock, crops, or farming leases.[11] This article will focus on the acceptance and management of these gifts by private foundations and public charities, and how these organizations can best advise donors when approached with a gift of this type.[12] Because a gift of mineral interests may involve more complexities than receiving a simple royalty check in the mail each month, the article first addresses some common types of interests and concerns a charitable organization may have to analyze when marketing to potential donors.[13]

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7. *See* Paikert, *supra* note 1; Janet Novack, *How to Give Like Mark Zuckerberg,* FORBES MAG. (Dec. 6, 2010), http://www.forbes.com/forbes/2010/1206/investment-guide-charity-fidelity-schwab-give-like-zuckerberg.html.

8. Veronica Dagher, *Keep the Stock, Donate the Beans,* WALL ST. J. (Nov. 28, 2011), http://online.wsj.com/news/articles/SB10001424052970204394804577007992610748490.

9. Joe Hancock, *Black Gold: Gifts of Oil and Gas Interests Made Simple*, OKLA. PLANNED GIVING COUNS. 6 (Sept. 10, 2009), http://www.okpgc.org/uploads/Joe_Hancock_Black_Gold_9-10-09.pdf.

10. *See infra* Parts II–IV.

11. *See* Hancock, *supra* note 9, at 7.

12. *See infra* Part III.A.

13. *See* Hancock, *supra* note 9, at 7.

A. Mineral Interests

The basic question to begin with when dealing with some type of mineral interest is: who owns what interest?[14] The term "minerals" not only refers to oil and gas, but also includes "coal, iron ore, sulphur, and precious metals."[15] However, "[w]ater, sand and gravel, salt, building stone, limestone, and surface shale are not minerals because they belong to the surface owner."[16]

There are two theories related to mineral ownership.[17] The "ownership in place" theory (the majority rule, followed in Texas) states that the landowner owns all substances under his land, including oil and gas.[18] This is qualified by the Rule of Capture: if a neighbor drains the oil and gas from beneath the land (without trespass), the original owner loses those interests.[19] Minerals in place are real property until someone severs and extracts them from the surface, at which time they become personal property and are governed by personal property laws.[20] If a landowner is conveying the surface property, he must expressly state the intent to keep the mineral interests, if so desired.[21] The "non-ownership" theory (the minority rule) states that the surface owner does not own the oil and gas under his land but rather has the exclusive right to capture it by operations on his land—similar to a hunting license.[22] Pursuant to this second theory, the landowner will only own the minerals once he captures them.[23]

"If an individual owns all of the private rights in land including both surface and subsurface rights, he or she is said to own a 'fee interest.'"[24] If the individual only owns the surface estate, he owns a surface interest; if the individual only owns the mineral interest, he has a mineral interest or mineral estate.[25] In Texas, the mineral estate is dominant, meaning the owner of the mineral estate may use the surface estate "in a reasonable manner to exploit, mine, or produce minerals" and may lease the interest to others.[26]

There are a few types of severance that one can use to fractionalize the ownership of these interests: (1) vertical severance, which creates two fee

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14. *See id.*
15. *See id.* at 3.
16. *Id.*
17. JOSEPH SHADE & RONNIE BLACKWELL, PRIMER ON THE TEXAS LAW OF OIL AND GAS 14 (5th ed. 2013).
18. *Id.* at 14.
19. *Id.*
20. *See* Hancock, *supra* note 9, at 4.
21. *Id.*
22. *See* SHADE & BLACKWELL, *supra* note 17, at 15.
23. *See* Hancock, *supra* note 9, at 5.
24. *Id.*
25. *Id.*
26. *Id.*

simple estates with each fee simple estate including a piece of both the surface and minerals; and (2) horizontal severance, which creates two fee simple estates in which one is the surface estate and the other is the mineral estate (i.e. conveying the minerals but retaining the surface).[27] A reservation is a sale of the surface estate but retention of the minerals.[28] A conveyance is the sale of the mineral rights, while keeping the surface estate.[29]

The mineral owner has three main rights: (1) the development right, which is the right to develop the minerals and obligation to pay the costs of development; (2) the right to lease those interests to others, which is referred to as the "executive right"; and (3) the right to economic benefits under the oil and gas lease (i.e. bonus, delay rentals, royalties, etc.).[30] Each of these incidents of mineral ownership is alienable, divisible, and inheritable under Texas law.[31] The executive right holder has a duty of the utmost good faith toward the nonexecutive owner to execute a lease on the same terms and conditions as a reasonably prudent landowner would.[32]

When the owner of a mineral interest enters a lease with an oil and gas company, the lessee (oil and gas company) has a leasehold interest—typically called a working interest or operating interest.[33] "The lessee has the rights to use the surface of the property to obtain the minerals, the right to incur costs of exploration and production of the minerals and retain profits subject to the lessor's retained rights . . . ."[34] In exchange for the lease, the lessor usually receives a royalty interest, initial bonus, delay rentals, and shut-in royalty.[35] The lessor also retains a reverter in the mineral interest, effective upon the expiration of the lease.[36] It is important to understand what constitutes an economic interest in order to understand what may occur when a donor approaches the charity with a gift of mineral interests, which the donor may already have leased.[37] To this end, some of the more common types of economic interests are discussed below.[38]

The term "bonus" is used to define the consideration the landowner (lessor) receives upon execution of an oil and gas lease.[39] Lease bonuses

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27. *See* SHADE & BLACKWELL, *supra* note 17, at 16.
28. *See* Hancock, *supra* note 9, at 5.
29. *Id.*
30. *See* SHADE & BLACKWELL, *supra* note 17, at 17.
31. *Id.*
32. *Id.* at 18.
33. *See* Hancock, *supra* note 9, at 6.
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.* at 7.
38. *See infra* text accompanying notes 41–42; Jeremy R. Pruett, Dustin G. Willey & Michael V. Bourland, Oil and Gas for Estate Planning and Probate Attorneys, Presented to The American College of Trust and Estate Counsel 2013 Meeting (Oct. 24–27, 2013).
39. *See* SHADE & BLACKWELL, *supra* note 17, at 17.

are often thought of as being an amount of money the lessee pays in order to induce the lessor to execute the lease.[40] As a practical matter, the bonus payment gives the lessee the right to enter upon the leased premises and explore for oil and gas, commonly for a period of time—typically between one and five years—from the date of the lease.[41]

A "royalty interest" generally consists of an interest in the underlying oil and gas reserves that is retained when the owner of the land (i.e., lessor) grants to another (e.g., by lease) the right to ascertain whether a commercial quantity of oil and gas exists and, if so, to develop the property and produce this mineral.[42] Stated another way, a royalty is a share of production, or the value or proceeds of production, free of the costs of production, if production occurs.[43] A royalty is usually expressed as a fraction (e.g., 1/5th) and bears no portion of the costs of exploration, development, and production.[44] Accordingly, it is a non-operating mineral interest.[45] A delay rental is a payment to defer development rather than a payment for oil and gas.[46] A shut-in royalty is a royalty payment made during the period a producing well is shut-in (temporarily closed or never connected) for some reason.[47]

The development of oil and gas properties usually begins with a leasing arrangement in which the landowner assigns an interest to an oil and gas operator.[48] The property interest the operator acquires is known as the "operating" mineral interest or "working interest."[49] The working interest is so-called because the working interest owner has the right to work on the leased premises to search, develop, and produce oil and gas.[50] The owner of the working interest bears all costs in connection with finding the oil or gas, as well as those attributable to lifting the oil or gas from the reservoir.[51] The working interest expires upon termination of the lease.[52]

An "overriding royalty" is a royalty that is carved out of the lessee's interest in an oil and gas lease.[53] An overriding royalty will terminate whenever the underlying oil and gas lease terminates.[54] Unlike a royalty interest, which is connected to the ownership of the minerals in the ground,

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40. *Id.* at 27.
41. *Id.*
42. *See* Hancock, *supra* note 9, at 6.
43. *Id.*
44. *Id.*
45. I.R.C. § 614(e)(2) (2012).
46. *See* SHADE & BLACKWELL, *supra* note 17, at 148.
47. *Id.* at 158.
48. *See* Hancock, *supra* note 9, at 4.
49. *See* SHADE & BLACKWELL, *supra* note 17, at 159.
50. *See* Hancock, *supra* note 9, at 6.
51. SHADE & BLACKWELL, *supra* note 17, at 159.
52. Hancock, *supra* note 9, at 6.
53. SHADE & BLACKWELL, *supra* note 17, at 154.
54. *Id*. at 20.

an overriding royalty interest stems from the ownership of a portion of the revenues the oil and gas production generates.[55] The industry often uses overriding royalties to compensate parties that have assisted in creating or structuring a drilling venture, or parties that provided services to the lessee (e.g., landmen, geologists, etc.).[56] Overriding royalties may also be reserved upon an assignment of the lease by a lessee.[57]

A "net profits interest" is a non-operating interest that is usually created when the owner of property grants an oil and gas lease to another party, and provides for a royalty to be paid in the form of a percentage of net profits derived from production.[58] A net profits interest, similar to a royalty interest, is expressed as a percentage of production and is free of the costs of production.[59] However, a net profits interest is different from a royalty interest in that it is payable only if there is a net profit, while a royalty interest is payable even if a net profit is not achieved.[60]

B. Real Estate

Gifts of mineral interests may include a gift of the surface estate, as outlined above.[61] While a simple gift of real property will always require a formal appraisal, donors must consider additional factors when they gift other assets in connection with the land, such as mineral interests.[62] For example, if the gift of minerals does not include the surface estate, does that indicate the donor previously severed them from the surface? Does the donor still own the surface estate? If the donor previously severed a particular interest, will that cause complications for the donor's charitable deduction under the partial interest rules? If the surface estate is part of the gift, are there potential environmental hazards on the land that the recipient should analyze? Are there structures on the property that need valuation? What about the contents of those structures—does the gift include tangible personal property to value and somehow sell or use? The governing board or members of the organization must address these questions to fulfill their fiduciary obligations.

C. Business Interests

Donors of mineral interests often have "wrapped up" their interests in some type of entity, such as a Family Limited Partnership or Limited

55. *Id.* at 19.
56. Hancock, *supra* note 9, at 6.
57. SHADE & BLACKWELL, *supra* note 17, at 20.
58. Hancock, *supra* note 9, at 6.
59. *Id.*
60. *See id.*
61. *Id.* at 9; *see supra* Part II.A.
62. *See* Hancock, *supra* note 9, at 9.

Liability Company.[63] This type of structure allows the donor to establish a framework for managing and maintaining the interests during his lifetime and into the future, and provides the benefit of succession planning. However, when a donor approaches a charitable organization with a gift of closely held business interests—such as a partnership owning mineral interests—these closely held interests can be difficult to value, requiring a formal appraisal.[64] This type of gift may also cause concerns of excise taxes—such as excess business holdings in the case of a private family foundation donee—if disqualified persons (usually the founder and his or her family members) remain involved in the management of the entity, and/or concerns regarding unrelated business income tax, with either a foundation or public charity.

III. COMMON CONCERNS FROM THE DONEE'S PERSPECTIVE

A. Gift Acceptance

If a donor approaches a charitable organization with a gift of an asset such as mineral interests, land, or closely held business interests, the organization should first determine whether it can, and should, accept the gift and, if it does, how this gift fits within the charitable purposes of the organization. The directors and officers must stay true to their fiduciary duties to properly manage and invest charitable assets, and must not allow the organization to become a dumping ground for unwanted assets.[65]

1. Issues

Before accepting a potential gift, the board should consider:

i. Is there liability associated with the asset?
ii. Will accepting and managing the gift cost more than its true value to the organization?
iii. What restrictions have been placed on the gift by the donor?
iv. In what format is the asset owned? (i.e. Is the asset owned outright or within a trust or other entity wrapper? Is this a split ownership or co-tenancy situation, in which partition of the asset is necessary?)

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63. Michael V. Bourland et al., Estate and Income Tax Planning with Mineral Interests, Presented to the Estate Planning & Community Property Law Journal Seminar (Feb. 24, 2012), *available at* http://www.estatelawjournal.org/site/wp-content/uploads/2012/02/9-Michael-Bourland-and-Dustin-Willey-Estate-and-Income-Tax-Planning-With-Mineral-Interests.pdf.

64. *See* James W. Buchanan III, *Valuation and Taxation of Transfers of Oil and Gas Interests to Charities*, 22 REAL PROP. PROB. & TR. J. 561, 566 (1987).

65. *See, e.g.*, Dagher, *supra* note 8.

The organization must determine exactly what is being given before going any further in the process.

2. Gift Acceptance Policy

While neither the Internal Revenue Code (Code) or Form 990 require a gift acceptance policy, the development and regular use of such a policy promotes due diligence and fulfillment of the organization's managers' fiduciary duties, as well as provides guidance on the complex issues presented to the board when a donor approaches with exotic gifts. Any nonprofit organization engaging in fundraising should develop and periodically review the organization's gift acceptance policy. Organizations can use a gift acceptance policy as an internal management tool to reduce the risk of excise taxes for foundations and to provide better results with the IRS when compliance questions arise. The policy may promote mission-related gifts, encourage donors to give, and help the board to consider the organization's capacity to receive unusual gifts or partial interest gifts in advance.[66]

Additionally, the policy may serve to protect the organization from unanticipated liabilities by establishing standards for managing risk associated with certain categories of assets, environmental liabilities, and unmarketable property.[67] It can enhance the relationship between the charity and both prospective and established donors by providing uniform expectations, providing terms to govern restricted gifts and the use of donations if changed circumstances occur, and enhancing the likelihood that restricted gifts will be potentially deductible. The organization can also incorporate these procedures and policies into fundraising appeals and specific donor agreements. Further, the policy can help assure that the organization's staff and board members do not benefit personally from gifts the organization received, which represents a conflict of interest, implicates their duty of loyalty, and possibly constitutes conduct prohibited by the Code and the Treasury regulations.[68]

A good gift acceptance policy addresses the types of property the organization will always accept, will never accept, and what comes in between.[69] As to the middle ground asset classes, the policy should specify who has discretion to make the acceptance decision and the type of approval process the policy requires. The approval process may include

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66. Donald W. Kramer et al., *Advising Nonprofits: Top Ten Policies and Practices for Nonprofit Organizations*, A.L.I. CONTINUING LEGAL EDUC. (March 26, 2013), http://www.ali-cle.org/index.cfm?fuseaction=courses.course&course_code=VCU0324.

67. *See* Kathryn W. Miree, *Understanding and Drafting Nonprofit Gift Acceptance Policies*, DAVIDSON GIFT DESIGN 3 (2003), http://www.giftplanners.com/pdfs/understanding.pdf.

68. *See id.* at 4.

69. *See id.* at 3 (stating that the purpose in most instances is to govern acceptance of gifts).

considerations such as: Does the gift have conditions that unacceptably tie up the use of the property itself?; Will this type of asset tie up the use of other property of the organization, incurring expenses for holding or maintaining the gifted item?; Will the organization accept gifts of real estate and, if so, will the acceptance remain conditioned upon an inspection and evaluation?; and Will acceptance of the gift hinder or promote the overall mission and purpose of the organization? These issues all correspond with the directors' duty of obedience; the directors should carefully weigh these considerations against the best interests of the organization as a whole and its charitable purposes.

The policy should address what classes of assets the organization is willing to accept (i.e. cash, life insurance, securities, etc.) and should also address the types of gifting vehicles the charity is willing to deal with (i.e. estate administration, *inter vivos* trusts, charitable gift annuities, charitable lead trusts, charitable remainder trusts, etc.). The policy should specify whether the organization is open to receiving restricted gifts, what types of restrictions are acceptable, and the organization's plan of action when changing circumstances affect those restrictions. The policy may also address what type of acknowledgements the organization should and must provide to donors.

3. Split Ownership

If the donor owns the item he offers to the charitable donee in conjunction with other individuals or entities, this fact of split ownership can cause issues with the charity's ability to accept and manage the property as part of its asset holdings—whether the co-ownership is concurrent or successive.[70]

Divided ownership occurs frequently with oil and gas interests; in Texas, this is usually encountered in the form of tenancy in common.[71] In a tenancy in common scenario, each co-tenant owns an undivided interest in the whole tract of land and underlying minerals; thus, any co-tenant of oil and gas in place can explore, drill, and produce the minerals, or lease his share of the minerals without obtaining the consent of the other co-tenant(s).[72] This could be a potential concern if the charity receives a gift of minerals with a co-tenant.[73] Any co-tenant who has chosen to develop without the other co-tenants must account to them for their proportionate share of the net profits.[74] The developing co-tenant bears the entire risk of the operations but if the well produces, the developing co-tenant must share

70. *See* I.R.C. § 170(f)(3)(A) (2012).
71. *See* SHADE & BLACKWELL, *supra* note 17, at 18–19.
72. *Id.* at 19.
73. *Id.*
74. *Id.*

the benefits with the nonconsenting co-tenant on a pro rata basis.[75] Thus, the charity should closely monitor any operations on that land and may need to hire a third-party agent to assist with these matters.[76] The nonconsenting co-tenant has the option of ratifying the lease, in which case he would begin receiving his proportionate share of the royalty immediately and avoid the requirement of waiting until payout to claim his share of the net profits.[77] The developing co-tenant can also try to force the nonconsenting co-tenant to pool (through the Texas Railroad Commission), the co-tenants can agree to a joint operating agreement, or either co-tenant may exercise his absolute right to partition.[78]

Further, if the charity is the remainderman of successive ownership of property, the board should be cognizant of the actions of the life tenant; both the life tenant and the remainderman are necessary parties to a lease of the mineral interests.[79] Upon execution of a lease, the tenants must divide the economic benefits of the lease according to the standard allocation of receipts to income or corpus, unless agreed otherwise.[80] For example, the IRS considers delay rentals as income so payment should go to the life tenant, but the IRS considers royalty and bonus as corpus; thus, the life tenant will receive the interest that the invested funds generate, while the remainderman will receive the principal after the life tenant's interest terminates.[81]

Some items are easier to partition than others, and for the charity to be able to effectively use the asset for its exempt purposes, it may need to partition the asset. For example, a university was given a large piece of land with the accompanying mineral interests, but the donor owned it jointly with his cousins. The cousins gifted their interest in the same asset to a local church. The university deemed the surface estate undesirable and sold its interest in the land to a third party, but it retained the mineral rights in the donated property. The church, which received the other partial interest in the same property, did not have the ability or resources to manage the interests themselves, so the university purchased the mineral interests on the remainder of the tract of land from the church. However, a gift of partial ownership in a donated item does not always work out this well and can even cause an organization to have to turn away a gift such as this.[82]

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75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.* at 20.
79. *Id.*
80. *Id.*
81. *Id.*
82. *See infra* Part V.A.

4. Restricted Gifts

The organization must be diligent in analyzing the circumstances surrounding a proposed gift and determining whether the donor placed a restriction on any proposed gift, carefully documenting such restriction. It should not accept restricted gifts that do not further its mission and purposes. The board must be aware that acceptance of a restricted gift will make such a restriction enforceable. Restrictions may come in the form of an express restriction the donor made or from a fundraising event for a specific purpose.

If the organization has determined that it will accept certain restricted gifts then it should include this fact in its gift acceptance policy, as well as what types of restrictions they intend to allow, including endowment gifts. It may be wise for the organization to include, as a part of its governing documents, a catch-all phrase similar to the following: "The Organization shall not accept any gift or grant if the gift or grant contains major conditions which would restrict or violate any of the Organization's charitable, educational [or other nonprofit] purposes or if the gift or grant would require serving a private as opposed to public interest." Further, because a gift designated for a specific individual would not be deductible, the organization may want to include in its gift acceptance policy or gift agreement that the organization will not accept such a gift.[83] The organization should also include in the policy or agreement that any check listing a named individual as the ultimate beneficiary will be accepted on the organization's assumption, binding on the donor, that the donor intended the notation as a nonbinding expression of preference as to the use of the gift. Finally, it may be advisable for the organization to reserve the right to use a restricted gift for another charitable purpose in the event changed circumstances prevent the organization from carrying out the initially intended purpose of the gift.

5. Liability Concerns

a. Mineral Interests

When the donor approaches a charity with a gift of mineral interests, the charity should first determine exactly what type of mineral interest is at stake, so the organization understands its potential liability in making the gift acceptance determination.[84] Once the board fully understands the type of interest the donor is offering to the organization, it must then delve

83. I.R.S. Pub. 526 (Nov. 12, 2013).

84. *See* SHADE & BLACKWELL, *supra* note 17, at 68; *see also supra* Part II.A.

further into considerations regarding that specific interest and the specific property. The organization should address issues such as:

1. Would the size of the asset allow the charity to obtain third party administration/management?[85]
2. Is the charity going to accept producing and/or nonproducing assets? (keeping in mind that an oil and gas asset that is not in production has no associated carrying cost, unlike accepting a gift of solely the surface estate).[86]

Further, the gift planning officer, or director in a similar position, may want to ask the potential donor these questions, and for copies of these documents:

1. Is the mineral currently under lease?
2. How did the donor acquire the mineral interest?
3. What is the donor's understanding of his or her ownership?
4. What exactly does the donor want to gift and what are his or her goals for this gift to the organization?
5. Copies of prior or existing leases.
6. Copies of prior division orders.
7. Copies of prior transfer orders.
8. Check stubs from royalty payments.[87]

If the charity is receiving a working or operating interest, it must take further steps to account for any environmental issues.[88] The owner of an operating or working interest bears the liability for environmental problems and liability related to the surface usage.[89] By adopting a gift acceptance policy that prohibits any type of mineral interest gift other than a royalty interest, the charity can avoid these liabilities.[90] If the charity does accept a gift of a working interest, it should consider adjusting its business structure to provide for the greatest possible liability protection.[91] For example, the organization may establish a wholly-owned subsidiary solely for the purpose of holding these interests. The organization's gift acceptance policy should address all of the above issues, including guidance for the board members on how to approach and resolve liability concerns.[92]

b. Real Estate

If the gift of mineral interests includes the surface estate, the organization may not be able to use or dispose of the property within its

85. Hancock, *supra* note 9, at 7.
86. *Id.*
87. *Id.* at 8.
88. *Id.* at 7.
89. *Id.*
90. *Id.* at 13.
91. *Id.* at 14.
92. *Id.* at 7.

exempt purposes, and the organization may incur expenses associated with holding or using the property, depending on the property's type, size, and location. Further, property with existing improvements may have associated dangers related to the property's condition or environmental liabilities (for example, asbestos contained in existing structures or underground environmental contamination).[93] The organization could become legally responsible for the existing environmental liabilities by merely acquiring the property. Under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), the organization could also be liable for environmental cleanup costs, unless it conducts a sufficient investigation of the proposed gift pursuant to the innocent landowner exception.[94] Thus, the organization should perform due diligence by completing an environmental evaluation and other consultations prior to accepting such gifts.[95] Best practices would suggest that the organization provide guidance to its management through internal policies as to the proper review of such property, including when the organization is to engage outside experts, who will manage the property, how to handle maintenance and insurance costs, and how to address issues regarding latent defects, tax liens, and title issues.

c. Business Interests

Gifts of closely held family business interests may come in many forms, including S corporation stock, partnership interests, or LLC interests, which may present the donee with valuation and liquidity concerns, as well as concerns specific to the type of entity being donated.

Whether the charitable organization is a public charity or private foundation, a contribution of S corporation stock will cause several negative impacts on both the charity and the donor. First, the donor's income tax charitable deduction will likely be less than the appraised stock value. Usually, the donor can deduct the full fair market value of appreciated C corporation stock; however, this is not true with S corporation stock. The donor must reduce his deduction by the share of ordinary income that he would have recognized had he sold the S corporation's assets rather than making the gift.[96]

Second, the charity must pay unrelated business income tax (UBIT) on all of its S corporation income while holding the stock. Unlike with other entity interests, the UBIT calculation includes even the S corporation's passive investment income.[97] Third, the sale of the appreciated S

93. *See* Miree, *supra* note 67, at 7.
94. *Id.*
95. *See id.*
96. *See infra* Part V.C; Treas. Reg. § 1.170A-4 (as amended in 1994).
97. I.R.C. § 512 (2012).

corporation stock will trigger a UBIT liability and the charity's gain will be based on the donor's basis, with adjustments. Thus, a gift of S corporation stock essentially shifts the tax burden upon the stock's sale from the donor to the charity. Because a charity generally pays a higher tax rate on its long-term capital gains than an individual donor, there would likely be less overall income tax if the donor would simply sell the stock, incur the individual long-term capital gains tax, and gift cash from the sale proceeds to the charity. This would also save the donor from the administrative costs of a qualified appraisal. Some sources also opine that if there is a "buyer in the wings" for the entire corporation, the donor and charity may be better off selling the stock first and contributing some of the cash proceeds, rather than donating appreciated S corporation stock before the sale.[98] The buyer of the business will pay the charity for the full value of the shares it holds, but the donor's charitable income tax deduction will be much less because (1) the appraised value of the donated stock usually reflects a discount for minority ownership interests, and (2) the ordinary income component of the S corporation's assets does not allow for a deduction.[99]

Further, private foundations and donor advised funds must attune their organization to the rules and prohibitions regarding excess business holdings when receiving a gift of business interests. Including a reminder regarding these rules within the gift acceptance policy will help to keep this issue at the forefront when discussing a gift of entity interests.

6. Gift Acknowledgments

Finally, including within the gift acceptance policy the circumstances in which the organization should and must provide the donor with a receipt, written acknowledgement, and/or any forms required by the IRS will help with compliance issues, as well as the donor properly substantiating his or her gift for income tax deduction purposes.[100] The donee may also desire to provide donor acceptance agreements upon finalization of the acceptance decision to clarify the donor's intentions of making the gift, provide for flexibility in the organization's use of the contribution over time, and provide a mechanism for nonjudicial modification of the donor's restrictions if changes occur. The agreement may also provide for naming rights, including a variance clause and provisions related to enforcement, and state law choice if any party ever raises litigation over the contribution.

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98. *See, e.g.*, Christopher R. Hoyt, *Planning for Maximum Tax Benefits From Charitable Gifts by Corporations and Their Shareholders (Including Subchapter S Corporations*), A.B.A. (2013), http://meetings.abanet.org/meeting/tax/FALL13/media/scorp-charitable-hoyt-paper.pdf.

99. *See* Christopher R. Hoyt, *Charitable Gifts of Subchapter S Stock: How to Solve the Practical Legal Problems*, PLANNED GIVING DESIGN CENTER (2012), http://www.pgdc.com/pgdc/charitable-gifts-subchapter-s-stock-how-solve-practical-legal-problems.

100. *See infra* Part V.B.

This type of donor agreement can also be useful as a fundraising tool and can encourage donors to make the contribution to the charity.

B. Valuation

Once the board has prudently reviewed the concerns regarding gift acceptance practices, split ownership, gift restrictions, and potential liability of the gifted asset(s), the next issue facing the board will be how to value the item and who will provide for an appraisal if it is necessary, which the parties may address in the Donor Agreement. Proper valuation of the assets is not only extremely important for tax compliance on the part of the donor, but also for the determination by the donee of whether to retain or sell the asset(s) after accepting the gift.[101] Additionally, if the donee determines to retain the asset for an extended period of time, it may need to have the asset valued regularly for purposes of its own records.

Although the valuation piece is generally the obligation of the donor to report to the IRS for purposes of the charitable income tax deduction or the estate tax deduction, the organization receiving the gift does have involvement in determining the value of the donated item, and in some cases must make its own representations to the IRS regarding the value.[102] Part V.B will further discuss substantiation requirements; however, proper valuation of the contributed property should be a concern of both the donee and donor for the purposes stated herein.[103]

Generally, the amount of the deduction for a charitable contribution of noncash property is the fair market value of the property at the time of the contribution, with certain limitations.[104] The IRS defines fair market value as "the price the property would sell for on the open market," i.e., what a willing buyer and willing seller would agree upon, with both having reasonable knowledge of the relevant facts and no requirement to participate in the purchase.[105] The willing buyer and willing seller are hypothetical persons; this is meant to be an objective test that requires analysis of the transaction from the perspective of a seller whose sole goal is to maximize his profit on the sale of his interest.[106] The tax court has held that the more difficult it is to appraise property, the more leeway the court will give before finding a party's position not substantially justified.[107]

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101. *See* Treas. Reg. § 1.170A-13(c) (as amended in 1996).
102. *See* I.R.S. Pub. 561 (Apr. 2007).
103. *See infra* Part V.B.
104. Treas. Reg. § 1.170A-1(c)(1) (as amended in 2008).
105. I.R.S. Pub. 561 (Apr. 2007).
106. *See* Farhad Aghdami & William Mullen, *Valuation Planning*, ST025 A.L.I.-A.B.A. 345 (2011).
107. Fair v. Comm'r, 68 T.C.M. (CCH) 1371 (1994).

Any restrictions on the use of the donated property should be reflected in the fair market value determination.[108] In determining the fair market value of property, all factors affecting value should be considered, including: the cost or selling price of the item, sales of comparable properties, replacement cost, desirability, use, scarcity, and expert opinions.[109] Certain donated items will require an expert opinion as to the value of the item, which the following section will discuss.[110] Usually, the date of contribution is the date the transfer of the property takes place (certain exceptions may apply, such as the grant of an option to a charity or a transfer of stock).[111] In the valuation determination, only the facts known at the time of the gift and those that can be reasonably expected at the time of the gift may be considered.[112]

1. Cost or Selling Price

The cost or selling price of the donated property can be the best indication of its fair market value; however, because of the pace with which market conditions change, this factor may have less weight when the buyer did not purchase the item reasonably close in time to the date of contribution.[113] The cost or selling price is a good indication of the property's value if:

> [i.] the purchase or sale took place close to the valuation date in an open market; [ii.] the transaction was at 'arm's-length'; [iii.] the buyer and seller knew all relevant facts; [iv.] the buyer and seller did not have to act; and [v.] the market did not change between the date of purchase or sale and the valuation date.[114]

The parties will need to consider the terms of the purchase when determining the value if they influenced the price, such as "restrictions, understandings, or covenants limiting the use or disposition of the property."[115] Further, only reasonable increases (or decreases) in value of the donated property should be considered during the value determination, unless the donor can show unusual circumstances.[116] If the sale was "made in a market that was artificially supported or stimulated so as to not be truly

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108. I.R.S. Pub. 561 (Apr. 2007).
109. *Id.*
110. *Id.*; *see infra* Part III.B.1.
111. I.R.S. Pub. 561 (Apr. 2007).
112. *Id.*; Jacobson v. Comm'r, 58 T.C.M. (CCH) 645 (1989) (citing Estate of Spruill v. Comm'r, 88 T.C. 1197, 1233 (1987)).
113. I.R.S. Pub. 561 (Apr. 2007).
114. *Id.*
115. *Id.*
116. *Id.*

representative" of the actual market, the sale price does not indicate the true fair market value.[117] For example, a liquidation sale price usually does not indicate the fair market value.[118]

An arm's-length offer to buy the property that is close in time to the valuation date may also help prove its value if the offeror was truly in a position to complete the purchase.[119] To rely on that offer, there should be proof of the offer and the details of the amount to be paid.[120] Offers to purchase property similar to the donated property can also be helpful in determining value of the contributed property.[121]

2. Sales of Comparable Properties

The sales price of comparable properties can be important in determining the fair market value of the contributed property.[122] However, the weight given to each similar sale depends on: (i) the similarity between the property sold and the donated property; (ii) the proximity in time of the sale and the contribution date; (iii) the circumstances of the sale (whether it was an arm's length transaction with a knowledgeable buyer and seller); and (iv) the market conditions of the sale (was it an unusually inflated or deflated market at the time?).[123] For example, if the donor makes a gift of a rare book to an organization, but it is a third edition in poor condition, a sale of the same book that is a first edition in good condition would not be a proper comparable sale to use as the determining factor of the donated item's fair market value.[124]

3. Replacement Cost

The cost of buying or making property similar to the contributed asset may be considered when determining fair market value, although there must be a reasonable relationship between such replacement cost and the fair market value.[125] The replacement cost of the donated property should also be evaluated by taking the estimated cost to replace that item as new and subtracting "an amount for depreciation due to the physical condition and obsolescence of the donated property."[126]

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117. *Id.*
118. *Id.*
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.*
125. *Id.*
126. *Id.*

4. Expert Opinion

The weight the IRS gives to opinion evidence of a property's fair market value depends on its source and support by experience and facts.[127] Facts must corroborate the opinion or else the IRS may disregard it.[128] When an appraisal is secured to determine the value of items donated, the appraisal report should accompany the income tax return (when required) and include:

> (1) A summary of the appraiser's qualifications. (2) A statement of the value and appraiser's definition of the value he has obtained. (3) The bases upon which the appraisal was made, including any restrictions, understandings, or covenants limiting the use or disposition of the property. (4) The date as of which the property was valued. (5) The signature of the appraiser and the date the appraisal was made.[129]

Ultimately, the burden of supporting the fair market value listed on the income tax return is on the taxpayer.[130] Revenue Procedure 66-49 provides guidelines for an appraisal of noncash property gifted to a charitable organization, for which the IRS requires an appraisal, including unique, tangible personal property, real property, and securities.[131]

Further, considerations regarding "blockage" or "market absorption discount" must be taken into account when contributing a substantial block of generally the same type of property.[132] The tax court has found certain factors relevant to determining the property's value, such as "(1) costs of preparing an inventory and a catalog, (2) marketing expenses, (3) inventory retention and shrinkage, (4) the collection's vast quantity, and (5) the length of time it would take to sell" each piece of the collection.[133] The appraiser must consider "how many of the items would be available for sale at any one time and the length of time necessary to liquidate the entire inventory."[134]

a. Mineral Interests

In order to determine whether the donor's interest is of the size that would require a qualified appraisal to substantiate his or her charitable deduction (i.e. the $5,000 threshold), a general rule of thumb in the oil and

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127. Rev. Proc. 66-49, 1966-2 C.B. 1257.
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. Rimmer v. Comm'r, 69 T.C.M. (CCH) 2620 (1995).
133. *Id.* at 7.
134. *Id.* at 4.

gas industry can be used to generate an estimate of the value of the interest: annual income the interest produced multiplied by four.[135]

Absent an actual sale, the fair market value of oil and gas interests can be difficult to determine.[136] Both non-analytical and analytical methods are available, but the IRS prefers non-analytical methods, which are based on sales comparisons rather than engineering studies.[137] The comparable sales method is based on four basic elements: similar quantity, similar quality, same time period, and same geographic area.[138] The net back method for calculating the market value of gas at the lease, which is used if there are no comparable sales, takes the sales price at some distant location and makes an adjustment for how much it would cost to transport the gas to the respective location.[139] The parties may only use analytical appraisals if they cannot determine the value of the mineral property on the basis of cost or comparative values, and if they cannot reasonably determine the fair market value by any other non-analytical method.[140]

A formal appraisal should be based on estimates of the expected future cash flows, using "factors such as production history and the number of producing wells, discounted to present value."[141] Mineral interests that lack economic value are not good candidates for a charitable deduction.[142] Generally, a donor should seek a geologist or professional petroleum engineer to perform the qualified appraisal; good sources to find such an appraiser include the American Institute of Professional Geologists or the American Institute of Mineral Appraisers.[143]

In valuing a mineral interest property, an engineer's appraisal will determine the present value of future cash flow from that property.[144] Some of the most important factors in the appraisal process of an oil property include: "(a) estimation of volume of oil reserves, (b) production decline rate, (c) price of oil and gas, (d) oilfield operating costs, (e) economic life of the property, and (f) discounted cash flow."[145] An appraisal is usually made by first estimating the recoverable oil, multiplying such estimate "by the current price of oil or gas to determine the expected future gross income," and then estimating the expected life of the property.[146] Next, the expenses to be incurred in the operation of the property over that lifetime are

135. Hancock, *supra* note 9, at 9.

136. *See generally* C.R.K. Moore, *Perspective on the Valuations of Upstream Oil and Gas Interests*, 2 J. WORLD ENERGY L. & BUS., no. 1, 2009, at 24–25.

137. *See* Buchanan, *supra* note 64, at 566.

138. *See id.* at 566–68.

139. *See* 30 C.F.R. § 1206.151 (2012).

140. Treas. Reg. § 1.611-2(d)(2)(i)–(ii) (as amended in 1972).

141. Hancock, *supra* note 9, at 9.

142. *Id.*

143. *Id.* at 10.

144. Buchanan, *supra* note 64, at 569.

145. *Id.*

146. Stanton v. Comm'r, 26 T.C.M. (CCH) 191 (1967).

estimated and deducted from the estimated gross income to calculate "the expected future net operating income over the life of the property."[147] The salvage value that is realized from the equipment on abandonment of the property is then determined and added to that future net operating income. Finally, "the total expected future net income is discounted to arrive at the present value of the future net income to a prospective purchaser," also accounting for the risks involved in mineral properties.[148]

As with oil properties, the initial step in appraising a natural gas property is determining the estimated volume of recoverable gas reserves.[149] However, special considerations must be taken into account when making this determination.[150] If using the volumetric method, the engineer must run tests to determine the nature and amounts of all gases in the reservoir, so he can then provide a better estimate of the volume of reservoir gas.[151] If using the material balance method, the engineer must be cautious when the property is a water drive reservoir, as this method will not be as accurate as others.[152] Finally, if using the rate/time decline curve method, which is used in "a gas field producing at capacity from a non-water drive reservoir," particular issues are raised because reserves can be depleted at different rates according to the demands of the gas producer or consumer.[153] The terms of the contract between the producer and utility company can have a significant impact upon value, value estimates, and future cash flow projections the appraiser makes because such contract may dictate or influence the rate of production of natural gas.[154] Also, the number of other wells and the total reservoir pressures may affect "the rate at which gas from a particular well forces its way into a pipeline."[155]

The IRS has discussed the use of the present value method as an analytical appraisal method of valuing mineral property.[156] Under this method, the essential factors to be considered are:

> (i) The total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed, (ii) The quantity of mineral expected to be recovered during each operating period, (iii) The average quality or grade of the mineral reserves, (iv) The allocation of total expected profit to the processes or operations necessary for preparation of mineral for market, (v) The probable operating life of the deposit in years, (vi) The development cost, (vii) The operating costs, (viii) The total

147. *Id.*
148. *Id.*
149. Buchanan, *supra* note 64, at 574.
150. *See id.*
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.*
155. *Id.* at 574–75.
156. Treas. Reg. § 1.611-2(e) (as amended in 1972).

> expected profit, (ix) The rate at which [that] profit will be obtained, and (x) The rate of interest commensurate with the risk for the particular deposit.[157]

Moreover, these valuation factors can be determined from past operating experience if the mineral property has been sufficiently developed; however, an allowance should be made for "probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of development, production, interest rate, and the selling price of the product marketed during the expected operating life of the mineral deposit."[158]

The valuation factors as to other mineral deposits that have not been sufficiently developed must be deduced from concurrent evidence, such as:

> the general type of the deposit, the characteristics of the [area] in which it occurs, the habit of the mineral deposits, the intensity of mineralization, the oil-gas ratio, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the deposit, and any other evidence tending to establish a reasonable estimate of the [above] factors.[159]

Mineral deposits of different grades, locations, and dates of extraction are to be valued separately.[160] The mineral content of a deposit must be determined according to the "method current in the industry and in the light of the most accurate and reliable information obtainable."[161] The estimate of value of these mineral deposits should include as to both quantity and grade: (i) the ores and minerals in sight, blocked out, developed, or assured; and (ii) probable or prospective ores or minerals (those believed "to exist on the basis of good evidence, although not actually known to occur on the basis of existing development").[162] "The value of each mineral deposit is measured by the expected gross income . . . less the estimated operating cost."[163] That number is then reduced to a present value as of the date the valuation is made, at the interest rate applicable to the risk for the operating life, and further reduced by the value, as of the date of improvements and capital additions, needed to realize profits.[164]

In addition to the above valuation issues and the tax issues noted later, the donee should consider the consequences of accepting a contribution of

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157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.* § 1.611-2(c).
162. *Id.* § 1.611-2(c)(i)–(ii).
163. *Id.* § 1.611-2(e)(4).
164. *Id.* § 1.611-2(e).

certain types of mineral properties.[165] The statutory depletion deduction under Treasury Regulation section 1.611-2 will usually only be available to the charity donee as to unproven oil or gas property at the time of receipt, because it is not available to transferees of proven oil or gas property.[166] This is an important consideration as some types of oil and gas interests in the hands of charitable organizations may generate unrelated business income, giving rise to income tax liability against which the statutory depletion deduction would be useful.[167] Also, if later development of the unproven property is successful, the donor will have shifted production from his or her presumably higher income tax bracket to the charity's "zero" bracket.[168] But, this contribution of unproven property may also mean the donor did not receive an income tax deduction in the year of the contribution that reflected the economic value of the given interest.[169]

b. Real Estate

A detailed appraisal prepared by a professional appraiser should be used to determine the value of any piece of real estate donated to the organization because every piece of real estate is unique.[170] The appraiser should be thoroughly trained in the appraisal methods and processes, and preferably should be knowledgeable of the local area conditions.[171] This type of appraisal will contain: a complete description of the property; physical features, condition, and dimensions; and "the use to which the property is put, zoning and permitted uses, and its potential use for other higher and better uses."[172]

There are three generally accepted methods for valuing real estate: the market approach, the income approach, and the cost approach.[173] The final value determination really should be a comparison and examination of the value based on all approaches and factors.[174] "The assessed value for local real estate tax purposes is not used unless it is regarded as the fair market value, and even then must be confirmed by the other methods [noted above]."[175]

The market data approach (or comparable sales valuation), often used for residential real estate and vacant land, depends on comparable

165. Buchanan, *supra* note 64, at 563.
166. *Id.* at 576.
167. *Id.*
168. *Id.*
169. *Id.*
170. I.R.S. Pub. 561 (Apr. 2007).
171. *Id.*
172. *Id.*
173. Aghdami & Mullen, *supra* note 106, at 350.
174. I.R.S. Pub. 561 (Apr. 2007); Aghdami & Mullen, *supra* note 106, at 351.
175. Aghdami & Mullen, *supra* note 106, at 350.

properties in an active market.[176] Recent sales of comparable, nearby land are often chosen as the best indicator of value.[177] The comparable sales method involves locating physically similar properties that have been sold on the open market in nonforced sales for cash, or cash equivalents, within "a reasonable time of the date for which a value of the subject property" must be valued.[178] The "features of the subject property which are most pertinent to its value are compared to [the] same features on the comparable properties."[179] The value of those features of the comparable properties must then be adjusted to be more closely equivalent to those of the subject property.[180] Only the comparable sales that have the least amount of adjustments, in terms of items or total dollar adjustments, should be considered "comparable" to the donated property.[181]

The income approach (or capitalization method) "analyz[es] the present worth of the income the property generates or is predicted to generate in the future."[182] The calculation of the income to be capitalized and the rate of capitalization are the main elements of this approach.[183] This method is most applicable for valuing apartment buildings, hotels, offices, and other commercial real estate.[184] For example, the tax court in *Estate of Hatchett* determined the income approach to valuation is appropriate when valuing productive farmland.[185] "Clearly, unproductive vacant land cannot be valued using the income approach to valuation because there is no income stream to capitalize."[186]

The cost approach analyzes the cost required to reproduce or replace the property. The theory behind this approach is that an investor would not pay more for a property than he would pay to buy land and build a similar building and improvements.[187] However, this would not be true "if a similar property cannot be created because of location, unusual construction or some other reason."[188] This method alone does not usually result in the fair market value of the property but rather tends to establish the upper limit of value, especially in times of rising costs.[189] When this method is used to value improved property, the land and improvements must be valued

176. Rev. Proc. 79-24, 1979-1 C.B. 565; Aghdami & Mullen, *supra* note 106, at 350.
177. Zable v. Comm'r, 58 T.C.M. (CCH) 1330 (1990).
178. *Id.*
179. *Id.*
180. *Id.*
181. I.R.S. Pub. 561 (Apr. 2007).
182. Aghdami & Mullen, *supra* note 106, at 350.
183. *Id.*
184. *Id.*
185. Estate of Hatchett v. Comm'r, 58 T.C.M. (CCH) 801 (1989).
186. *Id.*
187. *See* I.R.S. Pub. 561 (Apr. 2007); Aghdami & Mullen, *supra* note 106, at 350.
188. I.R.S. Pub. 561 (Apr. 2007).
189. *Id.*; Aghdami & Mullen, *supra* note 106, at 351.

separately.[190] The replacement cost of a building is determined by considering the materials used, the quality of work, and the number of square feet to determine the total cost of labor, material, overhead, and profit.[191] The estimated cost to replace is reduced by an estimated amount of depreciation, including physical deterioration, functional obsolescence (which usually occurs in older buildings with inadequate plumbing or heating, etc.), and economic obsolescence (a decrease in the desirability of the area because of an outside force).[192]

c. Business Interests

"The value of a stock or bond is the [fair market value] of a share or bond on the [proper] valuation date."[193] For example, if the donor delivers a properly endorsed stock certificate to the organization, the date of the contribution is the date of delivery.[194] "If the certificate is mailed and received through the regular mail, it is the date of mailing."[195] If the donor delivers "the certificate to a bank or broker acting as [his] agent or to the issuing corporation or its agent, for transfer into the name of the organization, the date of the contribution is the date the stock is transferred on the books of the corporation."[196]

If an active market exists for the contributed stocks or bonds on a stock exchange, the fair market value of the stocks or bonds is the average price between the highest and lowest quoted selling prices on the valuation date. If no sales occurred on the valuation date, but there were sales within a reasonable time before and after the valuation date, the fair market value will be determined by averaging "the highest and lowest sales prices on the nearest date before and on the nearest date after the valuation date."[197] Those averages are then weighted in inverse order by the respective number of trading days between the selling dates and the valuation date.[198]

If selling prices or bid and asked prices are not available, or if the contribution being made is of a closely held entity, the fair market value should likely be determined through a qualified appraisal, and be based on factors such as:

> The nature and history of the business, especially its recent history; The goodwill of the business; The economic outlook in the particular industry;

190. I.R.S. Pub. 561 (Apr. 2007).
191. *Id.*
192. *Id.*; Aghdami & Mullen, *supra* note 106, at 350.
193. I.R.S. Pub. 561 (Apr. 2007).
194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.*
198. *See id.*

> The company's position in the industry, its competitors, and its management; and The value of [interests of entities] engaged in the same or similar business . . . . For preferred stock, the most important factors are its yield, dividend coverage, and protection of its liquidation preference.[199]

The donor should provide financial information, including copies of reports of examinations of the entity made by accountants, engineers, or other technical experts, close to the valuation date.[200] Classes of stock that cannot be traded publicly due to restrictions imposed by the Securities and Exchange Commission, or by the corporate charter itself, should be discounted appropriately in relation to freely traded securities.[201] Furthermore, stock sold under unusual circumstances, "such as sales of small lots, forced sales, and sales in a restricted market, may not represent the fair market value."[202]

In addition, a lack-of-control or minority discount may be appropriate "when valuing an interest in an entity that does not give the holder of the interest the right to decide when distributions of earnings will be made, when the entity will be liquidated, and other issues that affect the financial benefits of ownership in the entity."[203] A lack-of-marketability discount considers the fact that an owner of an interest in a closely held business will have more difficulty than an owner in a publicly traded entity in finding a willing buyer and, in order to sell the interest, may incur additional legal or accounting fees.[204] The risk of ownership of a closely held business interest increases due to the fact there is no ready market to sell these interests and liquidate in a short period of time.[205]

C. Unrelated Business Income Tax (UBIT)

Tax-exempt organizations, including private foundations and public charities alike, are subject to tax on unrelated business taxable income (UBTI) at the regular corporate (or trust, if applicable) income tax rates, subject to a $1,000.00 exemption; excessive UBTI can even jeopardize the organization's tax-exempt status.[206] Furthermore, some practitioners consider the realization of reportable UBTI as increasing their audit exposure on other activities of the organization.[207]

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199. *Id.*
200. *See id.*
201. *Id.*
202. *Id.*
203. Aghdami & Mullen, *supra* note 106, at 352.
204. *Id.* at 354.
205. *Id.* at 352.
206. I.R.C. §§ 511, 512 (2012).
207. William H. Caudill, Unrelated Business Activities: Strategies for Coping, Presented at the University of Texas School of Law Nonprofits Organizations Institute (Jan. 17, 2014).

UBIT is triggered when the organization has income from an activity that it regularly carries on, for the production of income from the sale of goods or performances of services, and that is not substantially related to the exempt purposes of the organization.[208] Most passive income is not subject to UBIT, but it may be if it is from a controlled entity or from debt-financed property.[209] The policy behind the concept of taxing unrelated business income is to eliminate unfair competition; the unrelated business activities of the nonprofit sector are placed on the same tax basis as the for-profit marketplace with which they compete.[210] Further, when an exempt organization participates in a joint venture with a for-profit entity, that for-profit venture conducts its affairs to produce a profit, not to pursue the charity's exempt purposes. Thus, the functions of an exempt organization are subject to strict scrutiny when engaging in business activities.

If an exempt organization has UBTI over $1,000.00, it must file Form 990-T; if the UBTI is $10,000.00 or less, it must file an abbreviated version of the return. If the organization has unrelated business gross receipts exceeding $5,000,000.00, the entity must use the accrual method of accounting.[211]

UBTI generally occurs in two situations: (1) when the organization has income from an unrelated trade or business, or (2) when the organization has income earned in regards to unrelated debt-financed property (UDFI).[212]

There are three basic prongs to incurring UBIT under the first scenario: (1) the activity must constitute a trade or business, (2) the activity must be regularly carried on by the organization, and (3) the conduct is not substantially related to the exempt functions of the organization.[213] A trade or business is defined by the IRS as an activity that is "carried on for the production of income from the sale of goods or performance of services," such qualification includes whether the activity has a profit motive.[214] In the determination of whether the activity is regularly carried on, the IRS will analyze how frequently the nonexempt activity occurs, comparing the manner of conduct and continuity of the activities to those of their for-profit counterparts.[215] For example, business activities that the organization only engages in periodically are not considered "regularly carried on" (such as

208. *See* Treas. Reg. § 1.513-1(a) (as amended in 1983); *see also* United States v. Am. Bar Endowment, 477 U.S. 105, 110 (1986).

209. Shannon G. Guthrie, Advanced Unrelated Business Income Tax Issues, Presented at the 11th Annual State Bar of Texas Governance of Nonprofit Organizations Course (Aug. 2013).

210. *See id.*; Treas. Reg. § 1.511-1 (as amended in 1971); Nicola Fuentes Toubia & Greg D. Lee, UBIT: Advanced Issues and Practical Applications, Presented at the University of Texas School of Law Nonprofit Organizations Institute (Jan. 2014).

211. *See* Treas. Reg. § 1.448-15(f) (as amended in 2005).

212. *See id.* § 1.513-1(a) (as amended in 1983).

213. *See id.*; I.R.C. § 513(a) (2012).

214. Treas. Reg. § 1.513-1(b).

215. *Id.* § 1.513-1(c).

an annual 10k or bake sale), but if the commercial activity is typically seasonal (such as selling beach chairs during the summer), the IRS may consider the activity regular. The IRS also considers the time spent preparing for the activity in the computation of the organization's time involved in the business activity.[216]

The IRS will determine whether a business is substantially related to the exempt purpose of the organization based on the nature, scope, and motivation for conducting the activity.[217] A business is substantially related only if the causal relationship is such that the activity contributes importantly to the accomplishment of the exempt purposes, which in turn depends on the facts and circumstances of each case.[218]

Specifically, the IRS will consider the size and extent of the activity in relation to the nature and extent of the purported exempt function; consequently, it will find unrelated business income when the organization conducts the activity on a scale larger than reasonably necessary to perform the organization's exempt functions.[219]

> A trade or business not otherwise related does not become substantially related to [the entity's] exempt purpose merely because incidental use is made of the trade or business in order to further the exempt purpose. A trade or business is considered related if operated primarily as an integral part of the [exempt function,] but is considered unrelated if operated in substantially the same manner as a commercial operation.[220]

The more an exempt organization can distinguish its activities from the typical manner in which a commercial for-profit entity would handle those activities, the better chance it has of the activities being found to substantially relate to its exempt purposes. Further, the organization should conduct the activities on a scale no larger than necessary to further the charity's purposes.[221] Sometimes this means narrowing the charity's statement of exempt purposes (rather than having a broad purpose statement that it is to "operate exclusively for charitable, scientific, or educational purposes within the meaning of section 501(c)(3)") so that a direct connection can be made between the purpose and the activity.

For example, in Revenue Ruling 76-37, the organization's business of building and selling homes as part of vocational training of students was held not to be UBTI because students did 70% of the building, so that the homes were products of the exempt function, and the homes were built only

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216. *See id.*
217. *See id.* § 1.513-1(d).
218. *Id.*
219. *Id.*
220. Rev. Rul. 55-676, 1955-2 C.B. 266.
221. *See* Treas. Reg. § 1.513-1(d)(3).

on an as-needed basis for the training program.[222] However, in Revenue Ruling 73-127, the organization operated a grocery store to sell food to residents of an impoverished area at lower prices, provided free grocery delivery services to residents, and job training for unemployed residents.[223] The grocery store was held to incur UBTI to the organization because the store operation was conducted on a larger scale than reasonably necessary to perform the organization's training program and exempt functions—only 4% of the store's earnings were allocated to the training program, the store was operated similarly to for-profit businesses in the area, and operation of the store and conducting the training program were distinct purposes of the organization.[224]

The IRS does allow for certain activities to be exempt from UBTI, as well as some modifications to UBTI that exclude certain income from this calculation.[225] Some exceptions include the convenience exception, the exception for volunteer labor, selling donated merchandise, and bingo games.[226] The volunteer exception allows an activity in which substantially all the work in carrying on such business is performed for the organization without compensation.[227] The convenience exemption allows activity that is carried on primarily for the convenience of the organization's members, students, patients, officers, or employees to be exempt.[228] An example of this is the placement of vending machines on college campuses; although the income activity is unrelated, it is carved out of taxation as UBTI because it exists for the convenience of the students. An activity that consists of selling merchandise donated to the organization (such as a Goodwill store) is an exception to UBTI under the thrift shop exception.[229] Qualified sponsorship payments are also an exception from UBTI, so long as there is no arrangement or expectation that a person or donor will receive substantial return benefit other than the use or acknowledgement of that person's trade or business name or logo.[230] It is irrelevant whether the sponsored activity is related or unrelated to the charity's exempt purposes.[231] Income derived from the distribution of low cost articles (currently having a cost of $10.20 or less) incidental to the solicitation of charitable contributions is exempt, such as a mass mailing of donation

222. Rev. Rul. 76-37, 1976-1 C.B. 148.

223. Rev. Rul. 73-127, 1973-1 C.B. 221.

224. *Id.*

225. I.R.C. §§ 512, 513 (2012).

226. *See Unrelated Business Income Tax Exceptions and Exclusions*, IRS, http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Unrelated-Business-Income-Tax-Exceptions-and-Exclusions (last visited Oct. 19, 2014).

227. *Id.*

228. *Id.*

229. Treas. Reg. § 1.513-2 (as amended in 1975); *see Unrelated Business Income Tax Exceptions and Exclusion*, *supra* note 226.

230. *See* Treas. Reg. § 1.513-4(c) (as amended in 2002).

231. *Id*.

requests along with pens, notepads, or address labels with the charity's name and logo.[232]

Once the gross income from the unrelated trade or business is calculated and reduced by the appropriate deductions, the remaining amount of UBTI may be further reduced by certain modifications contained in Code section 512(b).[233] For example, passive income is not seen as a source of unfair competition with for-profit entities, and thus it is not subject to UBIT.[234] This includes dividends, interest, annuities, royalties, rents from real property, and rents from personal property leased with the real property—so long as the rents from personal property are an incidental amount, such as 10%, of the total rents received or accrued under the lease.[235]

Debt-financed income is defined as income or gain from debt-financed property, which is property held to produce income and with respect to which there is acquisition indebtedness.[236] Acquisition indebtedness can be debt incurred by the exempt organization in acquiring or improving the property (i.e., property the organization purchased with borrowed funds) or it could be incurred before or after the acquisition or improvement of the property, so long as the indebtedness would not have been incurred but for the acquisition or improvement and, in the case of later debt, the fact that the debt would be incurred was foreseeable at the time of acquisition or improvement.[237] Acquisition indebtedness includes new debt as well as debt the organization assumed (such as a mortgage or similar lien).[238] Property is considered "debt-financed" if there was acquisition indebtedness at any time during the taxable year.[239] The property can be real property or tangible or intangible personal property—this may include rental real estate, mineral production property, securities, and leased equipment.[240] The sale of debt-financed property within one year of retirement of the debt will cause UDFI that year.[241]

However, UDFI does not include mortgaged property acquired by gift or bequest, unless the organization, in order to acquire the equity in the property by gift or bequest, assumes and agrees to pay the indebtedness secured by the mortgage, or makes any payment for the equity in the

232. I.R.C. § 513(h) (2012); *see also* Rev. Proc. 2012-41, 2012-45 I.R.B. 539.
233. *See* I.R.C. § 512(b) (2012).
234. *Id.*
235. *Id.*
236. *Id.* § 514.
237. *Id.* § 514(c).
238. *Id.*
239. *Id.* § 514(b).
240. *N. I.R.C. 514—Unrelated Debt Financed Income*, IRS (1986), http://www.irs.gov/pub/irs-tege/eotopicn86.pdf.
241. I.R.C. § 514(b)(1).

property owned by the decedent or the donor.[242] Additionally, if the organization uses the property to perform its exempt function or uses the property in an unrelated trade or business already included in the calculation of UBTI, then the UDFI will not be included in UBTI, thus preventing double taxation.[243] Rental income from real property that is financed with acquisition indebtedness is included in UBTI (even though rental income is usually excluded); however, if the property is being substantially used in a manner that is substantially related to the performance of the organization's exempt functions, then all rental income would be excluded from UBTI.[244] The same causal connection rules that apply to determine when organizations are subject to UBTI also apply to determine whether the property meets the definition of UDFI.[245]

When a tax-exempt organization holds property subject to a mortgage, and the property is not being used for its exempt purposes, its UBIT liability can be avoided during a ten-year grace period following acquisition.[246] The charity must not assume or agree to pay the mortgage, and in the case of a lifetime gift, so long as the mortgage was placed on the property more than five years prior to the gift and the donor held the property for more than five years, the organization can escape UBI taxation.[247]

The primary purpose of a tax-exempt organization must be one or more of its exempt purposes.[248] Stated differently, a single nonexempt purpose, if substantial, is enough to destroy exemption regardless of the number of truly exempt purposes.[249] Thus, the organization should not accept or retain a gift that would cause it to incur substantial UBIT.[250] Where an exempt organization has substantial unrelated business income or activities in comparison to its exempt income or activities, the organization risks loss of exemption.[251] The IRS has ruled that there is no "quantitative limitation" on the amount of unrelated business activities or income; however, the IRS has also said unrelated business activities generally should be less than a substantial portion of the organization's overall activities.[252] Rather than setting out a specific limitation, the IRS considers the percentage of the organization's time spent on unrelated business

242. *See generally id.* § 514 (explaining the exceptions for property acquired that is subject to a mortgage).

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.* § 514(c)(2)(B).

247. *See id.* § 514(c); Martin Hall & Jerry J. McCoy, *Setting the Stage for Charitable Giving*, SS045 A.L.I.-A.B.A. 1 (2009).

248. Better Bus. Bureau of Wash. D.C., Inc. v. United States, 326 U.S. 279, 283 (1945).

249. *Id.*

250. Rev. Rul. 69-179, 1969-1 C.B. 158.

251. *Id.*

252. *Id.*

activities and the percentage of the organization's revenue the unrelated business activities generate.[253] The IRS has ruled that when the organization regularly spends more than 50% of its time and/or regularly derives more than 50% of its annual revenue from unrelated business activities, it risks loss of exemption—as the IRS considers this evidence of a nonexempt purpose being a primary purpose.[254]

For example, in Revenue Ruling 2004-51, a tax-exempt university formed an LLC with a for-profit company to expand its summer seminars beyond the classroom, using interactive video technology and off-campus classrooms.[255] The governance of the LLC was split 50/50 between the exempt and for-profit members; however, the LLC was not allowed to engage in any activity that would jeopardize the university's exempt status.[256] The IRS held that the membership in the LLC did not jeopardize the university's exempt status, in spite of 50/50 ownership and control with the for-profit entity.[257] The IRS found that the university's activities within the LLC were substantially related to its exempt purposes and did not subject the university's distributive share of the joint venture income to UBIT.[258]

The asset classes that tend to subject an organization to the greatest risk of incurring UBIT merely through acceptance of a gift include mineral interests, business entities, and engaging in joint ventures with for-profit entities.

1. Mineral Interests

Section 512(b)(2) excludes all income from royalties, including overriding royalties, and all deductions directly connected with such income from the calculation of UBIT.[259] However, the charity must carefully scrutinize the mineral interest being received in order to determine whether it is truly a "royalty" for Code purposes and excluded from UBIT.[260] The IRS "will look to substance rather than form in determining whether a mineral interest should be classified as a 'royalty interest'" for purposes of UBIT.[261] Royalty interest is the right to share in the production reserved to the property owner for permitting another to drill for oil or gas or extract other types of minerals.[262] "To be a royalty interest, the right to

253. *Id.*
254. *Id.*
255. Rev. Rul. 2004-51, 2004-1 C.B. 974.
256. *Id.*
257. *Id.*
258. *Id.*
259. I.R.C. § 512(b)(2) (2012).
260. Rev. Rul. 69-179, 1969-1 CB 158.
261. I.R.S. Tech. Adv. Mem. 77-41-004 (Jan. 1, 1977).
262. Hancock, *supra* note 9, at 16.

payment must be free of both development and operating costs."[263] If the owner is liable for expenses of operating the property (i.e. a working interest), the interest is not a royalty interest and is subject to UBIT.[264]

Where the holder's interest is a net profits interest, not subject to expenses that exceed gross profits, the holder is not liable for the expenses of development or operations within meaning of Treasury Regulation section 1.512(b)-1(b); thus, this is a royalty interest for purposes of section 512.[265] The IRS, in a general counsel memorandum, agreed "that income from a 'net profits interest' . . . generally constitute[s] royalty income" because, unlike the owner of a working interest, the holder of a net profits interest bears no personal liability for development and operation costs.[266]

A shut-in royalty "is a payment made when a gas well, [although] capable of paying in producing quantities, is shut-in for lack of a market for the gas."[267] Similarly, a delay rental is a payment to the lessee for the deferral of the commencement of drilling operations or production during the primary term of the lease.[268] Each of these are generally treated as royalties for UBIT purposes.[269] "Bonus payments [are] one-time payment[s] received by the royalty interest owner at the time the new mineral lease is executed"; thus, a bonus payment does not meet the basic definition of UBIT because it is not income from an unrelated, regularly carried-on activity of the charity.[270] One transaction may include multiple types of the above interests, so each must be analyzed to determine the effect under the UBIT rules.[271]

2. Business Interests/Joint Ventures

The concerns regarding UBIT should be considered when approached with a gift of partnership interests, such that the organization may not want to accept such a gift. There is no prohibition against a tax-exempt organization entering into a partnership with for-profit entities. As long as the business activity is either related to the charity's exempt purpose, or so long as the activity is insubstantial compared to the charity's other activities, the organization's tax-exempt status should not be jeopardized.[272]

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263. Treas. Reg. § 1.512(b)-1(b) (as amended in 1992); Rev. Rul. 69-179, 1969-1 C.B. 158.

264. Rev. Rul. 69-179, 1969-1 CB 158.

265. I.R.S. Tech. Adv. Mem. 77-41-004 (Jan. 1, 1977).

266. I.R.S. Gen. Couns. Mem. 38,216 (Dec. 28, 1979); *see also* I.R.S. Priv. Ltr. Rul. 2011-42-026 (Oct. 21, 2011).

267. Hancock, *supra* note 9, at 16.

268. *Id.*

269. *See id.*

270. *Id.* at 17.

271. *See generally* I.R.C. § 512 (2012) (stating the special rules for determining different types of interests).

272. Toubia & Lee, *supra* note 210.

Because of the potential interactions of UBIT and excise taxes, private foundations are subject to much more risks than public charities when considering their involvement in a joint venture or acceptance of a gift of business interests.[273] When entering into a partnership with a for-profit entity, the risk of incurring UBIT arises and must be considered; additionally, when entering into a partnership with insiders of the foundation, the risk of excise taxes due to excess benefit holdings must also be analyzed.

The ownership of a disregarded entity by a tax-exempt organization presents unique concerns and challenges. When a charity (public or private foundation) is a member of a partnership, the organization's share of income from the partnership—whether or not distributed to the organization—flows through to it, such that the income retains its character as rent, interest, business, or another type of income.[274] If the partnership conducts a trade or business unrelated to the organization's exempt purposes, the charity must report its share of the business income as UBIT, with the exception of passive income.[275] Thus, the partnership acts as a conduit through which the characteristics of the business activity are imputed to the individual partners. The organization is deemed to be carrying on the trade or business that the partnership is conducting—partnership income that would be subject to UBIT if the tax-exempt investors earned it directly will flow through as such to tax-exempt partners.[276] This "look-through rule" applies whether the organization is a general or limited partner, and whether the entity is a partnership or limited liability company.[277]

When a tax-exempt organization controls a for-profit entity, the UBIT rules are even harsher. In contrast to the usual exception from UBIT of passive income, interest, rent, royalty, and annuity payments received from a controlled organization are UBTI to the exempt organization if those payments would have reduced the unrelated income of the controlled organization.[278] Control in this context means the exempt organization owns, directly or indirectly, more than 50% of the beneficial interests in the entity—constructive ownership rules and attribution rules apply for these purposes.[279] This rule is triggered even if the activity of the controlling organization that generates the income does not represent a trade or

273. Maryam K. Ansari, *Foundations Must Be Wary When Entering Joint Ventures*, 23 TAX'N EXEMPTS 40, 41 (July/Aug. 2011).

274. I.R.C. § 512(c)(1); Treas. Reg. §§ 1.512(c)-1 (as amended in 1960), 1.681(a)-2(a) (as amended in 1962).

275. I.R.C. § 512(c)(1); Treas. Reg. §§ 1.512(c)-1, 1.681(a)-2(a).

276. I.R.C. § 512(c)(1); Treas. Reg. §§ 1.512(c)-1, 1.681(a)-2(a).

277. I.R.S. Priv. Ltr. Rul. 01-47-058 (Nov. 23, 2001).

278. *Id.*

279. I.R.C. § 512(b)(13).

business, or the activity is not regularly carried on.[280] The only income that is excluded from this rule is dividend income because the payments of dividends would not generate a deduction for the controlled subsidiary entity.[281]

Furthermore, the debt-financed income rules can come into play here and cause additional UBTI when the foundation invests in a partnership. Because the partnership acts as a conduit through which its activities are attributed to its partners, if underlying partnership assets are subject to debt, a portion of the partnership income may be UBTI to the organization due to the presence of UDFI. The IRS has ruled that, under Code sections 512 and 514, whether the organization incurred the debt to acquire partnership interests or the partnership itself incurred the debt to acquire property within the partnership, it must be included in calculating the organization's portion of the partnership's income related to that debt-financed property.[282]

Generally, investments made through C corporations avoid UBTI taint so long as the organization only owns stock in them and does not lend it money (but consider the rules regarding controlled entities in section 512(b)(13) and foreign corporations in section 512(b)(17)).[283] The dividends and capital gains received from an exempt organization's investment in a C corporation are not subject to UBIT.[284]

Ownership in an S corporation presents an even bigger UBIT issue than disregarded entities; stock of an S corporation represents an interest in an unrelated trade or business per se.[285] Thus, unlike partnership interests, all items of income, loss, or deduction of the S corporation are taken into account in determining UBTI of the exempt organization, regardless of the actions of the S corporation.[286] This includes passive income and other income that would normally be excluded.[287] Gains and losses on the sale of this stock are also required to be considered as part of the organization's UBTI.[288] Thus, the organization likely may prefer the donor to sell any S corporation stock prior to making the charitable gift, although sometimes this foresight is not possible or practical. In such a case, the directors should have policies in place to deal with this type of asset gift as soon as possible, whether that is through a prohibition on accepting this type of asset in its gift acceptance policy or having a structure in place to receive these types of gifts in order to shield the organization from as much liability as possible.

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280. Caudill, *supra* note 207.
281. I.R.C. § 512(b)(13).
282. I.R.S. Tech. Adv. Mem. 96-51-001 (Dec. 20, 1996).
283. I.R.C. § 512(b)(13), (17).
284. *Id.* § 512(b)(1).
285. *Id.* § 512(e).
286. *See id.* § 512.
287. *Id.*
288. *Id.*

D. Private Foundations: Risk of Incurring Excise Taxes

Private foundations are generally privately funded and controlled organizations that make grants to various charitable causes.[289] Because they are privately controlled, private foundations and their managers are subject to more stringent sanctions and excise taxes than public charities in order to discourage activities resulting in private gain.[290] In contrast, public charities carry on some charitable activity for the benefit of the general public and are either supported by the public, are public by the nature of their activities, or are affiliated with publicly supported charitable organizations.[291] Public charities are subject to intermediate sanction provisions as opposed to the excise tax penalties imposed upon private foundations.[292]

1. Excess Business Holdings

Section 4943 imposes an excise tax on the amount of a private foundation's excess business holdings in a business enterprise.[293] However, a "business enterprise" for these purposes "does not include a functionally related business as defined in section 4942(j)(5)" nor does it include a trade or business that derives at least 95% of its gross income from passive sources.[294] For example, in Private Letter Ruling 201329028, a private foundation owned an interest in an LLC whose sole activity was the operation of an investment hedge fund.[295] Because all of the LLC's income was from passive sources, the IRS did not consider it a business enterprise, and thus, it did not subject the foundation's holdings to taxation under section 4943.[296]

The "functionally related" criterion can be a key exception to this prohibition; it is in a sense similar to the concept of the "substantially related" prong of the UBIT test.[297] Thus, if a business activity is considered substantially related under the UBIT analysis, then this may be helpful to the issue of determining permissible business holdings of the foundation. "Functionally related business" means either: (a) a trade or business that is not an unrelated trade or business, as defined in section 513 (for purposes of UBIT), or (b) an activity that is "carried on within a larger aggregate of

289. Lauren Watson Cesare, *Private Foundations and Public Charities—Termination (§ 507) and Special Rules (§ 508*), in 877 BNA BLOOMBERG ESTATES, GIFTS AND TRUSTS (2d ed.).
290. *Id.*
291. *Id.*
292. Treas. Reg. § 53.4958-1 (as amended in 2009).
293. *Id.* § 54.4943-2(a)(1).
294. *Id.* § 53.4943-10(b)–(c).
295. I.R.S. Priv. Ltr. Rul. 2013-29-028 (July 19, 2013).
296. *Id.*
297. *Compare* Treas. Reg. § 1.513-1 (as amended in 1983), *with* I.R.C. § 512 (2012).

similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the [foundation]" (outside of the need for income or funds).[298] Thus, if a private foundation has business holdings in a business enterprise whose activities are functionally related to the purposes of the foundation, then such holdings will not be excess business holdings and the interests in the functionally related business will likely be considered substantially related, not incurring UBIT under the rules outlined above.[299]

A private foundation created after May 26, 1969, is prohibited from excess business holdings to the extent that it, together with all disqualified persons, owns in the aggregate more than: (i) 20% of the voting stock of an incorporated business enterprise (or corresponding profits interests in non-incorporated business enterprises), or (ii) 35% if the control of the corporation is in at least one person who is not a disqualified person as to the private foundation and the entity conducts a business that is not substantially related to the foundation.[300] A private foundation may not have any ownership interests in an unrelated sole proprietorship, but it is allowed to own a *de minimis* 2% voting stock in a corporation.[301] If all disqualified persons own less than 20% of the voting stock of a corporation, then the foundation can hold any amount of nonvoting stock.[302]

Disqualified persons for the purposes of a private foundation include: (1) foundation managers; (2) substantial contributors, defined as an individual who has contributed an aggregate amount of more than $5,000 or more than 2% of the total contributions for the taxable year; (3) an owner of 20% or more of the control of an organization that is a substantial contributor; (4) a family member of the first three categories of persons, including spouses; and (5) organizations with more than 35% controlled by any of the above.[303]

This 20% threshold can be easily crossed accidentally if the foundation directors are not acutely attuned to the current ownership percentages of the applicable parties, or if the foundation indirectly triggers these rules. However, the foundation may be able to avoid tax under these provisions if it disposes of the investment within ninety days after it knows, or has reason to know, of the violation, so long as it acquired its interest other than by purchase and did not know of the acquisition by other disqualified persons.[304] Further, private equity fund partnership agreements often contain provisions allowing the foundation to opt-out of an investment,

298. Treas. Reg. § 1.513-1.
299. Ansari, *supra* note 273.
300. Treas. Reg. § 53.4943-4 (as amended in 2009).
301. *Id.* § 53.4943-3.
302. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2013-29-028 (July 9, 2013).
303. Treas. Reg. § 53.4946-1 (as amended in 2009).
304. *See id.* § 53.4943-2(a)(1)(ii).

withdraw from the fund, or reduce its commitment to avoid the excise taxes or meet the ninety day disposition period.[305]

The foundation will generally have a five-year period from the date it acquires such excess business holdings to dispose of them.[306] In the case of an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures, the foundation may have an extra five-year period to dispose of the excess business holdings if:

> (A) [T]he foundation establishes that—
>
> (i) diligent efforts to dispose of such holdings have been made within the initial 5-year period, and
>
> (ii) disposition within the initial 5-year period has not been possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of the holdings,
>
> (B)[B]efore the close of the initial 5-year period—
>
> (i) the private foundation submits to the [Treasury] Secretary a plan for disposing of all of the excess business holdings involved in the extension, and
>
> (ii) the private foundation submits [a copy] of the plan described in clause (i) to the Attorney General (or other appropriate State official) having administrative or supervisory authority or responsibility with respect to the foundation's disposition of the excess business holdings involved and submits to the Secretary any response received by the private foundation . . . during [the] 5-year period, and
>
> (C)[T]he Secretary determines that such plan can reasonably be expected to be carried out before the close of the extension period.[307]

The excise taxes applicable to the retention of excess business holdings will include an initial 10% tax on the value of the excess holdings that the private foundation must pay and a second tier tax of an additional 200% of the value of the excess holdings if they are not timely disposed of to someone other than a disqualified person.[308] Thus, the gift of a business interest can be extremely detrimental to a foundation if these rules are not carefully analyzed and applied to the proposed gift.

2. Self-Dealing

Code section 4941 imposes an excise tax on each act of self-dealing, direct or indirect, between a private foundation and a disqualified person.[309]

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305. Caudill, *supra* note 207.
306. Treas. Reg. § 53.4943-6 (as amended in 2009).
307. I.R.C. § 4943(c)(7)(A)–(C) (2012).
308. Treas. Reg. § 53.4943-2.
309. I.R.C. § 4941 (2012).

Acts of self-dealing include: (1) sale, exchange, or lease of property; (2) lending of money or other extension of credit (although a disqualified person may lend to a private foundation if there is no interest or charge to the foundation); (3) furnishing of goods, services, or facilities, unless it is without charge and used solely for charitable purposes; (4) payment of compensation to a disqualified person, unless the services were reasonably necessary to the foundation, for its stated purpose, and the amount paid is reasonable; (5) "the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation"; and (6) an "agreement by a private foundation to make any payment of money or other property to a government official (as defined by section 4946(c)), other than an agreement to employ such individual for a period after the termination of his governmental service if such individual is terminating his government service within a ninety-day period."[310]

Because a substantial contributor is defined as a person whose cumulative contributions exceed the greater of $5,000 or 2% of the total cumulative contributions received by the foundation, over time a donor can easily morph into being a disqualified person.[311] Therefore, foundations should carefully monitor contributions against the threshold because the self-dealing rules take effect on the date the donor's cumulative contributions become substantial.[312]

The IRS will impose the excise tax for an act of self-dealing on both the disqualified person and foundation manager.[313] The first tier assesses a tax of 10% of the amount involved for the taxable year payable by the disqualified person; additionally, if the foundation manager willingly and knowingly participated, the manager must pay an excise tax of 5% of the amount up to a maximum tax of $20,000.[314] Further, if the transaction is not corrected, the IRS will impose a second tier of taxes on both parties: an additional 200% tax to be paid by the disqualified person and an additional 50% tax to be paid by the foundation manager, up to a maximum tax to the manager of $20,000.[315] Thus, the foundation cannot simply engage in self-dealing, pay the tax, and continue self-dealing transactions as its usual method of operations; the prohibited conduct must be undone.

a. No Purchase-Back

If a donor makes an outright gift to his family's private foundation of an asset that is significant to his family, whether it is a limited partnership

310. *Id.*
311. *Id.* § 4943(d)(2)(A).
312. *See id.* § 4943.
313. *See id.* § 4943(d)(2)(C)(ii).
314. *Id.* § 4941.
315. *Id.*

(LP) interest in a family partnership owning ranch land or mineral interests, and the donor is considered a disqualified person to the foundation, he and his family cannot expect to ever own that asset again. If the donor or a member of his family were to attempt to purchase the asset back from the foundation, even for fair market value, the transaction would be self-dealing and would subject the foundation to the above excise taxes.[316] Furthermore, the foundation cannot merely return the asset to the donor or his family.[317] Thus, if a donor-insider is proposing to make a gift to the foundation of a significant personal item, the foundation should suggest that the donor consider making a gift through a charitable lead trust or another gift planning vehicle in which he or the family would receive the asset back at the end of the charitable term, rather than making the gift outright.[318] This can be especially important when a donor approaches the foundation with a gift of mineral interests; the foundation should caution the proposed donor that he or she will not be able to receive those assets back from the foundation if the gift of the mineral interests is made outright. If the donor would like the foundation to only receive the income and benefits from those interests but retain the interests himself, practitioners should direct him toward other methods of charitable giving.[319]

In the case of a testamentary gift (such as a founder's residuary estate being distributed to the family foundation), if the foundation's directors determine that property given to the foundation is not suitable to be owned and held by the foundation, or if the testator's family wants to purchase a certain item back from the foundation, the best solution may be to send that asset back to the testator's family in what would normally be considered a self-dealing transaction, under the estate administration exception to self-dealing.[320] The IRS allows some leeway in allocating or selling assets among the other beneficiaries of the estate or the revocable trust for a certain amount of time.[321] The foundation directors would need to work closely with the estate administrator or trustee, as applicable, to ensure that the transaction meets all of the requirements of the estate administration exception to self-dealing.

The estate administration exception requires: (1) the executor, administrator, or trustee to possess authority to sell the property or reallocate it to another beneficiary, or is required to sell the property by the terms of the testamentary document; (2) a probate court having jurisdiction over the estate to approve the transaction (although it is unclear whether this

316. *Id.*; Treas. Reg. § 53.4943-6(c)(3) (as amended in 2009).

317. JODY BLAZEK, TAX PLANNING AND COMPLIANCE FOR TAX EXEMPT ORGANIZATIONS (John Wiley & Sons, Inc., 4th ed. 2012).

318. *Id.*

319. *See infra* Part IV.

320. Treas. Reg. § 53.4941(d)-1(b)(3) (as amended in 2009).

321. *See id.* § 53.4941(d)-1.

means approval must be granted specifically for such transaction or if the court's acceptance of the final estate accounting is sufficient); (3) the transaction to occur before the estate or trust is terminated; (4) "[t]he estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust)"; and (5) the foundation to receive an interest at least as liquid as the one that was given up for an exempt function asset, or receives an amount of money equal to that required under an option that is binding upon the estate.[322] The foundation must exercise special care in using this exception; when an estate transfers property in satisfaction of a bequest, the estate itself becomes a disqualified person as to the foundation once the amount transferred reaches the requisite amount to cause it to have contributed more than 2% of the total donations the foundation has received.[323] The exception does not shelter payments of excess compensation, loans, or indirect self-dealing that could occur between a company the estate owns and the foundation.[324]

The purchase of stock by a disqualified person from an estate, which would otherwise have been distributed to the foundation for less than its fair market value, will constitute self-dealing.[325] For example, in Private Letter Ruling 9252042, the IRS held that the proposed substitution of art between the decedent's children and the private foundation was an improper exchange of property between a private foundation and a disqualified person under section 4941, and thus an act of self-dealing, even though it would have been beneficial to the foundation.[326] Another example of self-dealing between an estate and a private foundation that is a beneficiary of the estate is *Estate of Reis v. Commissioner*. The IRS held that because the foundation was a beneficiary under the decedent's will, it had a "vested beneficial interest in the property of the Estate."[327] The expectancy interest the foundation had in the estate was treated as an asset of the foundation, and transactions affecting property of the estate were thus treated as affecting assets of the foundation.[328]

Compare the above results to the same fact scenario except the donee is a public charity: As long as the donor/insider purchases the asset back from the public charity (including a donor advised fund) at fair market value, there should be no negative tax consequences to him or the charity

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322. *Id.*; *see* BLAZEK, *supra* note 317.

323. BLAZEK, *supra* note 317.

324. *Id.*

325. Rockefeller v. United States, 572 F. Supp. 9, 12 (D.C. Ark. 1982), *aff'd*, 718 F.2d 290 (8th Cir. 1983), *cert. denied*, 466 U.S. 962 (1984).

326. I.R.S. Priv. Ltr. Rul. 92-52-042 (Dec. 14, 1992); *see also* Estate of Reis v. Comm'r, 87 T.C. 1016 (1986).

327. *Estate of Reis*, 87 T.C. at 1021.

328. *Id.* at 1022.

(there should be no issues of private excess benefit or private inurement when the transaction is completed for fair market value). If the donor is also on the board of the charity, he should recuse himself from the decision of the board and disclose all relevant information regarding the proposed purchase to the other board members.[329] But, the IRS could exert a step-transaction application, in which the IRS collapses the two transactions, to treat the immediate purchase of the assets as a cash gift by the donor to the charity, particularly in the case of a contribution of closely held stock immediately before a redemption of the stock by the issuing entity.[330]

b. Gift of Debt-Encumbered Property

Moreover, a foundation should be careful when accepting a gift that is encumbered with the debt of a disqualified person. Under the self-dealing rules, a transfer of indebted real or personal property to a foundation is considered an impermissible sale or exchange (i.e., self-dealing) if the foundation assumes a mortgage or similar lien that was placed on the property prior to the transfer, or takes the property subject to a mortgage or similar lien that the disqualified person placed on the property within a ten year period ending on the date of the transfer.[331] The term "similar lien" includes deeds of trust and vendors' liens, but does not include any other lien that "is insignificant in relation to the fair market value of the property transferred."[332] In general, the donation by a disqualified person to a private foundation of property subject to an outstanding debt falls within the scope of this prohibition—this is true whether or not the transferor was personally liable on the indebtedness.[333]

The IRS interprets this rule broadly, as evidenced by its finding that a contribution to a foundation by a disqualified person of a life insurance policy subject to a policy loan was an act of self-dealing.[334] The IRS based this finding on the determination that a life insurance policy loan "is sometimes characterized as an advance of the proceeds of the policy," with the loan and interest considered charges against the property, rather than amounts that must be paid to the insurer.[335] The IRS found that the effect of the transfer was basically the same as the transfer of property subject to a lien.[336] The transfer of the policy relieved the donor of the obligation to repay the loan, pay any accrued interest, or suffer continued diminution in

329. *See* I.R.C. § 4946(a)(1)(A) (2012).
330. Hall & McCoy, *supra* note 247.
331. I.R.C. § 4941(d)(2)(A) (2012).
332. Treas. Reg. § 53.4941(d)-2(a)(2) (as amended in 2009).
333. *See* I.R.S. Gen. Couns. Mem. 37,105 at 5–6 (Apr. 29, 1977).
334. Rev. Rul. 80-132, 1980-1 C.B. 255.
335. *Id.* at 2.
336. *Id.*

the value of the policy.[337] "The fact that the insurer would not demand repayment of the loan or payment of interest as it accrues does not mean that the loan is not a 'mortgage or other lien' within the meaning" of the self-dealing rules.[338] Furthermore, the IRS stated that the amount of the outstanding loan of $46X from a policy face value of $100X was "not 'insignificant' in relation to the value of the policy."[339] This holding shows the IRS's position that even in cases in which the private foundation has no duty to pay off the lien and only faces the prospect of a reduction in the value of the transferred asset, that asset transferred is considered "subject to a mortgage or similar lien," if the asset is substantial in value and placed on the property by a disqualified person within the ten-year period.[340] Upon further analysis, the IRS ruled that each premium and interest payment made by the foundation was a jeopardizing investment under Code section 4944.[341]

i. "Insignificant" Liens Exception

The value comparison in the "insignificant" analysis is between the value of the debt on the asset and the value of the asset to which it is attached, not the total value of all assets in the foundation.[342] The IRS has held that the membership interests of an LLC donated to a private foundation did not constitute self-dealing, despite the LLC having liabilities attached to it.[343] In this case, the operating liabilities of the LLC were less than 2% of its fair market value and, therefore, were insignificant and not a similar lien for the purposes of section 4941.[344] Some distinguishing features in that case were (although these reasons were not the basis for the IRS decision, they are worth mentioning): (1) the donors were both directors of the foundation and disqualified persons, but they were not personally responsible for the LLC's liabilities; and (2) the LLC itself was not a disqualified person as to the private foundation because the combined holdings of the disqualified persons in the LLC did not reach the threshold

337. *Id.*
338. *Id.*
339. *Id.*
340. *Id.*
341. Rev. Rul. 80-133, 1980-1 C.B. 258. The foundation retained the policy as an investment and paid annual premiums and interest due on the policy and the loan. *Id.* However, the combined interest and premium payment were of such an amount that, after eight of the ten years remaining on the loan, the foundation would have invested a greater amount in premium and interest than it could have received in insurance proceeds upon the death of the insured. *Id*. The IRS ruled in Private Letter Ruling 8134114, however, that insurance policies are not jeopardy investments where there is no outstanding loan on the policy, the donor surrenders all incidents of ownership, and the donor pays the premiums. I.R.S. Priv. Ltr. Rul. 81-34-114 (May 28, 1981).
342. I.R.S. Tech. Adv. Mem. 91-37-006 (Sept. 13, 1991).
343. I.R.S. Priv. Ltr. Rul. 2010-12-050 (Mar. 26, 2010).
344. *Id.*

35% interest.[345] Therefore, the private foundation was not assuming any indebtedness as a result of the transfer.[346]

In a technical advice memorandum, the National Office advised that the transfer of investment assets to a private foundation was self-dealing where the assets were subject to a note.[347] The note, the National Office concluded, was a "similar lien" under the regulations.[348] The National Office also decided that the note did not qualify for the exception of "insignificant" liens because the face amount of the note was 10.4% of the value of the related asset.[349] Further, each time the foundation repaid a sum on the note (originally payable by the disqualified person), those payments were also considered acts of self-dealing.[350] The note payments by the foundation constituted the use of the foundation's money for the benefit of a disqualified person under section 4941(d)(1)(E).[351]

If a private foundation makes a payment satisfying the legal obligation of a disqualified person, such payment usually constitutes self-dealing within these rules.[352] The transfer of assets to the foundation, on condition that the foundation continues the payment of the donor's liabilities, relieves the donor of the obligation to either repay the loan or pay interest.[353] The relief of such an obligation improperly benefits the disqualified person and, therefore, is considered self-dealing.[354]

3. Required Minimum Distribution

A private non-operating foundation is required to annually pay out or spend in "qualifying distributions," via charitable grants or project expenditures, an amount equal to its prior year's minimum investment return.[355] Private operating foundations are not subject to the excise tax on the failure to distribute income but must meet the separate distribution requirements of the income test, which require the foundation to make qualifying distributions directly for the active conduct of the activities constituting its exempt purpose in an amount equal to 85% or more of the lesser of its adjusted net income or its minimum investment return.[356]

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345. *Id.*
346. *Id.*
347. I.R.S. Tech. Adv. Mem. 91-37-006 (Sept. 13, 1991).
348. *Id.*
349. *Id.*
350. *Id.*
351. *Id.*
352. Treas. Reg. § 53.4941(d)-2(f)(1) (as amended in 2009).
353. *See id.*
354. *Id.* The "insignificant" exception was not available to save the foundation from this result, as explained above. I.R.S. Priv. Ltr. Rul. 2010-12-050 (Mar. 26, 2010).
355. Treas. Reg. § 53.4942(b)-1(a)(ii) (as amended in 1983).
356. I.R.C. § 4942(a) (2012); Treas. Reg. § 53.4942(b)-1(b)(1).

The minimum investment return is calculated as 5% of the fair market value of its investment assets for the preceding year (i.e. noncharitable use assets), less the amount of any debt incurred to acquire that property (i.e. their acquisition indebtedness) and less a 1½% provision for cash reserves: minimum investment return = 5% x (investment assets – debt – cash reserves).[357] This requirement means that an amount equivalent to the foundation's return on its investments must be spent, transferred, or used for charitable purposes.[358] While this requirement does not prohibit a foundation from purchasing, or accepting via a donation, a low-yield investment such as raw land, investing in such a manner would mean the foundation must sell or distribute other assets to meet its payout requirement.[359]

This minimum investment return calculation is based on the foundation's investment assets, other than those that are specifically excluded; thus, it is important to distinguish investment assets from exempt function assets.[360] If the foundation holds an asset as an investment then generally 5% of its value is payable annually for charitable purposes, even if it is not producing any current income.[361] The standard private foundation investment portfolio of stocks, bonds, certificates of deposit, and rental properties usually forms the basis for calculating the distributable amount.[362] If the organization uses the property for both investment and program purposes, its value will be allocated between both uses.[363] Business properties, such as cattle and other fixtures of a working ranch, that have been donated to a foundation and partnership interests are included in the calculation of minimum investment return.[364] This rule is very different from the rules for calculating the excise tax on investment income.[365]

Assets over which the foundation owns no present interest and over which it has no control are usually not included in the calculation of the minimum investment return—nor are these usually included in the financial records or statements of the foundation.[366] Further, assets that are held by and actually used by the foundation in conducting its exempt purposes are excluded, such as administrative offices, furnishings, equipment and supplies used by employees in working on the foundation's charitable purposes; buildings and facilities used directly in its projects; reasonable

357. I.R.C. § 4942(e).
358. *See id.* § 4942(b).
359. *See id.* § 4942(e).
360. *See* Treas. Reg. § 53.4942(a)-2(c)(1) (as amended in 1983).
361. *See id.* § 53.4942(a)-2(c)(5).
362. *See id.* § 53.4942(a)-2(b).
363. BLAZEK, *supra* note 317.
364. Treas. Reg. § 53.4942(a)-2(c).
365. *See* I.R.C. § 4940 (2012).
366. Treas. Reg. § 53.4942(a)-2(c)(2).

cash balances; and program-related investments and functionally related businesses that further the foundation's exempt purposes.[367] A functionally related business is one that is not unrelated; thus, a business run by volunteers and that is substantially related to furthering the foundation's exempt purposes would not be counted as an investment asset for this purpose.[368] However, a long-term leasing of heavy equipment or a parking lot is treated as an unrelated business even if the management is donated, and thus, its value would be included.[369]

Not all contributions or disbursements made by the foundation count toward its minimum distribution requirements for that year. First, the expenditure must be made for charitable purposes (i.e. one or more purposes described in Code section 170(c)(1) or 170(c)(2)(B)).[370] Second, it must be actually paid out, based on the cash method of accounting—the foundation cannot retain any control or earmark the funds for its own restricted purpose; thus, a pledge, gift, or promise to make a gift in the future would not qualify.[371] Qualifying distributions specifically includes: (a) any amount, including reasonable and necessary administrative expenses, paid to accomplish one or more tax-exempt purposes, other than a grant to a controlled organization; (b) "any amount paid to acquire an asset used (or held for use) directly in carrying out" tax-exempt purpose(s); and (c) qualifying set-asides and program-related investments.[372] Depreciation expenses, excise taxes, and investment expenses are excluded.[373] Most qualifying distributions are made in the form of charitable grants paid directly to publicly supported charitable organizations, for general support or for a wide range of specific charitable purposes.[374] Grants to accomplish charitable purposes to any type of exempt or nonexempt organization throughout the world can qualify, if the organization follows the proper procedures.[375] However, before making grants to individuals, the foundation must obtain prior IRS approval; in addition, distributions to noncharities for charitable purposes require the foundation to follow strict expenditure responsibility guidelines to monitor the charitable use of the funds.[376]

These minimum distributions must be made within twelve months after the close of the taxable year to satisfy the requirements for that year,

367. BLAZEK, *supra* note 317, at 307.
368. Rev. Rul. 76-85, 1976-1 C.B. 357.
369. Rev. Rul. 78-144, 1978-1 C.B. 168.
370. I.R.C. § 170(c) (2012).
371. Treas. Reg. § 53.4942(a)-3(a)(3) (as amended in 1986).
372. I.R.C. § 4942(g)(1) (2012).
373. I.R.S. Priv. Ltr. Rul. 98-34-033 (May 27, 1998).
374. BLAZEK, *supra* note 317, at 307–08.
375. *See* Treas. Reg. § 53.4942(a)-3.
376. I.R.C. § 4945 (2012).

or within twenty-four months if the foundation has just been created.[377] Also, the foundation may retroactively satisfy the prior year's requirements with the current year's qualifying distributions.[378] For example, a new $1 million foundation created on January 1, 2014, and adopting a calendar year would be required to pay out $50,000 for charitable purposes by December 31, 2015.[379]

A potential issue with the foundation holding exotic assets, such as land, animals, or mineral interests, is that if this is the primary makeup of the foundation's investment assets then the assets may not supply enough liquidity for the foundation to meet its minimum distribution requirements, and thus, the foundation will be subject to an excise tax on the undistributed amount. Section 4942 imposes an excise tax on the amount of the minimum required distribution of a private foundation that is not distributed before the first day of the second taxable year following the taxable year for which the amount should have been distributed under the Code.[380] If the foundation fails to satisfy its minimum distribution amount, the foundation is assessed a penalty of 30% of the difference between the amount actually distributed and the amount that should have been distributed.[381] An additional penalty of 100% of the undistributed amount is assessed if the original penalty is assessed and the distribution is not timely made.[382] A private operating foundation would not be subject to this tax but instead would be subject to losing its operating status.[383]

In order to avoid this excise tax, the foundation may need to either make distributions in-kind, which is likely inappropriate, or may need to explore options for disposing of the asset to produce cash that can be distributed in qualifying distributions.

4. Jeopardizing Investments

See Part G.4, below, for discussion of these rules.[384]

5. Taxable Expenditures

The IRS will tax private foundations on the amount of expenditures made that are not in furtherance of their exempt purposes.[385] Taxable

377. *Id.* § 4942(a).
378. *Id.* § 4942.
379. BLAZEK, *supra* note 317. This is true unless a set-aside distribution applies. *Id.*
380. *See* I.R.C. § 4942(a).
381. *Id.*
382. *Id.* § 4942(b).
383. *See generally Compliance Guide for 501(c)(3) Private Foundations*, IRS 4–5, http://www.irs.gov/pub/irs-pdf/p4221pf.pdf (last visited Nov. 13, 2014) (providing tax-related information to various types of private foundations).
384. *See infra* Part III.G.4.

expenditures include: (1) carrying on propaganda or otherwise attempting to influence legislation; (2) engaging in political activities to influence the outcome of a specific public election or carrying on a voter registration drive, unless the activities are nonpartisan; and (3) distributions to non-charities, including grants to individuals, unless the distribution is in fact charitable, the IRS has approved it, and the foundation is exercising expenditure responsibility.[386] The expenditure responsibility provision requires the foundation to exert all reasonable efforts and to establish adequate procedures to ensure that the grant is used solely for the purposes made, to obtain full reports from the grantee, and to make full reports regarding the expenditures to the Secretary.[387]

Both the foundation and management will be taxed on these taxable expenditures.[388] The foundation must pay a tax equal to 20% of the taxable expenditure amount.[389] The foundation's manager, who agreed to the expenditure knowing it would be taxable, must pay a tax equal to 5% of the expenditure, up to a tax amount of $5,000, unless such agreement was not willful and was due to reasonable cause.[390] The IRS considers a manager's actions "due to reasonable cause" if he has exercised his responsibility with ordinary business care and prudence, including acting on the advice of counsel after full disclosure of the factual situation.[391] Furthermore, if the foundation does not correct the expenditure within the taxable period, the IRS will impose an additional tax equal to 100% of the amount of the expenditure on the foundation.[392] Also, an additional tax of 50% of the amount of the expenditure will be imposed on a foundation manager who refused to agree to part or all of the correction, with a maximum tax of $10,000.[393]

E. Public Charities: Intermediate Sanctions

1. Excess Benefit Transactions

Public charities are not subject to the private foundation excise taxes but are instead subject to intermediate sanctions for excess benefit transactions involving a disqualified person.[394] Transactions between the public charity and a disqualified person must be made at fair market value;

385. I.R.C. § 4945(a)(1) (2012).
386. *Id.* § 4945(d)(1).
387. *Id.* § 4945(h).
388. *See id.* § 4945(a).
389. *Id.* § 4945(a)(1); Treas. Reg. § 53.4945-1 (as amended in 1986).
390. I.R.C. § 4945(a)(2).
391. Treas. Reg. § 53.4945-1(a)(2)(v).
392. I.R.C. § 4945(b)(1).
393. *Id.* § 4945(b)(2)–(c)(2).
394. *See id.* § 4958(c)(1)(A).

any excess above the value of what the disqualified person gave to the charity, including the provision of services, is excess benefit.[395] The rules apply an excise tax on both the disqualified person and any organizational manager who participated in the transaction that improperly benefited the disqualified person.[396]

A disqualified person under this provision is a person who, at any time during the five-year period before the date of the transaction, was "in a position to exercise substantial influence over the affairs of the organization."[397] That person's family and business, if he or she owns 35% or more of that business, are also disqualified persons.[398] Persons who have substantial influence include presidents, chief executive officers, chief operating officers, treasurers, and persons with a material financial interest in a provider-sponsored organization.[399] Persons who are deemed not to have substantial influence include tax-exempt organizations listed in section 501(c)(3), certain 501(c)(4) organizations, and employees receiving economic benefits of less than a specified amount each taxable year.[400] In other instances, facts and circumstances will govern.[401] Facts and circumstances that tend to show substantial influence include: someone who founded the organization, a person who is a substantial contributor, whether the "person's compensation is primarily based on revenues derived from activities of the organization," whether the person "has or shares authority to control or determine a substantial portion" of the charity's capital expenditures, whether the person has managerial authority or is a key advisor to someone with managerial authority, and whether the person has a controlling interest in an organization that is a disqualified person.[402]

Payments to a disqualified person are rebuttably presumed reasonable and, therefore, not an excess benefit transaction, if: (1) an authorized body of the organization composed of non-conflicted individuals approved the transaction; (2) prior to making the determination of approval, such authorized body obtained and relied upon appropriate comparability data; and (3) such authorized body adequately documented the basis for its determination concurrently with approving the transaction.[403] If all three of these requirements are met, the IRS can only rebut the presumption if it develops sufficient evidence to rebut the value of the data relied upon by the authorized body.[404]

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395. *Id.*
396. *Id.* § 4958(a).
397. *Id.* § 4958(f)(1)(a).
398. *Id.* § 4958(f)(1)(b)–(c).
399. Treas. Reg. § 53.4958-3(c)(2)–(4) (as amended in 2009).
400. *Id.* § 53.4958-3(d)(1)–(3).
401. *Id.* § 53.4958-3(e).
402. *Id.* § 53.4958-3(e)(1)–(2)(vii).
403. *Id.* § 53.4958-6(a)(1)–(3).
404. *Id.* § 53.4958-6(b).

The consequences of an excess benefit transaction involve a two-tier excise tax on the disqualified person, as well as an additional excise tax on an organizational manager who knowingly participates.[405] The disqualified person must pay an excise tax equal to 25% percent of the excess benefit and must return the excess benefit to correct the error.[406] The term "correct" in this context means "undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards."[407] "The organization is not required to rescind the underlying agreement; however, the parties may need to modify an ongoing contract with respect to future payments."[408] Additionally, if the excess benefit transaction is not corrected within the taxable period, the disqualified person must pay another 200% tax of the excess benefit.[409] An organizational manager who participated in the transaction, knowing it was such a transaction, is liable for an excise tax of 10% of the excess benefit, up to $10,000, unless the participation was not willful and was due to reasonable cause.[410] If the organizational manager was also the disqualified person who received the excess benefit, the manager can be subject to both of the excise taxes.[411]

F. Donor Advised Fund: Application of Excise Taxes

A Donor Advised Fund (DAF) may provide a desirable alternative to a donor to make the gift. The Pension Protection Act of 2006 (PPA) extended certain excise tax provisions to DAFs, including the private foundation excess business holdings rules and a more stringent form of the excess benefit transaction prohibition on public charities.[412] DAFs do not have a minimum payout requirement, although that may soon change once the Treasury Department finishes studying the issue.[413] The PPA mandated that the Treasury Department specifically consider the appropriateness of the existing deduction rules for contributions to DAFs, whether DAFs should have distribution requirements, and whether a donor's advisory role

405. I.R.C. § 4958(a) (2012).
406. *Id.* § 4958(a)(1).
407. *Id.* § 4958(f)(6).
408. *Intermediate Sanctions-Excess Benefit Transactions*, IRS (Aug. 28, 2014), http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Intermediate-Sanctions-Excess-Benefit-Transactions.
409. I.R.C. § 4958(b).
410. *Id.* § 4958(a)(2).
411. *Id.*
412. *See generally* David A. Levitt, *Impact Investing Through a Donor-Advised Fund*, 25 TAX'N EXEMPTS 03 (Mar./Apr. 2014) (describing the DAF as a growing vehicle for charitable giving).
413. *See* KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS 1 (Thomson Reuters/WG&L 2014).

in the investment or distribution of donated funds is consistent with the IRS's definition of a completed gift.[414] Co-investments involving a DAF and a donor or donor advisor may raise concerns of improperly benefitting the donor or donor advisor and incurring some of these taxes.[415] However, tax guidance in this area is very limited, as there are no Treasury regulations interpreting the Code provisions imposing these restrictions, making the tax concerns of a sponsoring organization more complex with unclear results.[416]

1. Excess Benefit Transactions

The PPA extended the excess benefit rules of section 4958 to DAFs and made the prohibition harsher in application to DAFs than public charities. Section 4958(c)(2)(B) provides that any grant, loan, compensation, or other similar payment from a DAF to a disqualified person is automatically considered an excess benefit transaction.[417] This would mean that excess benefit transactions include items such as expense reimbursement or compensation in the context of a DAF.[418] For transactions involving a DAF, disqualified persons include donors, donor advisors, their family members (spouse, ancestors, children, descendants, siblings, and their spouses), and certain 35% controlled entities related to them.[419] The full amount of such payment is considered the amount of the excess benefit, not just the difference between the value of economic benefit provided to the disqualified person and the consideration the organization receives, as it is under the general section 4958 rules.[420]

The disqualified person receiving an excess benefit must pay an excise tax of 25% of the excess benefit.[421] Also, the disqualified person must in essence correct the excess benefit by returning the amount of the excess benefits to the sponsoring organization; however, the donor's DAF cannot hold that corrected amount.[422] The IRS may also impose an additional 10% tax on a fund manager who agreed to make the distribution, knowing it would be an excess benefit.[423]

Thus, any DAF investment should avoid a payment or loan to a donor advisor disqualified person. For example, if the donor is the general partner in a limited partnership of which the DAF is an owner, and he receives

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414. *Id.*
415. *See* Levitt, *supra* note 412, at 11.
416. *See id.*
417. I.R.C. § 4958(c)(2)(B) (2012).
418. *Id.* § 4958(c)(2).
419. *Id.* § 4958(f)(1).
420. *Id.* § 4958(a), (c)(2)(B).
421. *Id.* § 4958(a).
422. *Id.* § 4958; Joint Committee on Taxation, *Technical Explanation of H.R.4, the "Pension Protection Act of 2006"*, JOINT COMMITTEE TAX'N 347 (Aug. 3, 2006), www.jct.gov/x-38-06.pdf.
423. I.R.C. § 4958(a)(2).

compensation in his role, the IRS could consider the DAF to be providing compensation to the donor advisor, triggering the excess benefit penalties.[424]

Some sponsoring organizations may want to obtain a certification from donor advisors that the distribution the advisor is recommending will not result in an impermissible benefit to the donor, donor advisor, or related parties.[425] Assuming the fund manager does not have actual knowledge that such distribution will result in an impermissible benefit, then obtaining such certification can potentially enable fund managers to avoid penalties; however, the fund manager should be fully cognizant of the law and how the law may apply to the facts.[426]

In addition to these automatic excess benefit transactions, any other transaction involving a disqualified person and the DAF, or involving an investment advisor and the sponsoring organization, would be subject to the general rules of section 4958. When the transaction involves the sponsoring organization, but not necessarily a DAF, the group of disqualified persons also includes an investment advisor (and related parties or entities) with respect to the sponsoring organization.[427]

> [T]he term "investment advisor" means, with respect to any sponsoring organization, . . . any person (other than an employee of such organization) compensated by such organization for managing the investment of, or providing investment advice with respect to, assets maintained in [DAFs] . . . owned by such organization.[428]

A payment pursuant to a bona fide sale or lease of property is not included within the term "other similar payment" for purposes of the automatic excess benefit rules.[429] Rather, such sale would be subject to the general rules of section 4958.[430] Thus, if a donor to a DAF purchased securities (originally contributed by the donor to the DAF) from the DAF, the purchase is subject to the rules of section 4958 because the donor is a disqualified person to the DAF; however, section 4958 would only cause excise tax if the purchase was made for less than fair market value (for example, if the purchase is made for less than the amount the donor claimed the securities were worth for purposes of his charitable deduction).[431] If the donor purchased the securities directly from the sponsoring organization,

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424. *See* Levitt, *supra* note 412.

425. William Choi, *Donor-Advised Funds: Practical Problems with Equally Practical Solutions*, CV018 A.L.I.-A.B.A. 385, 402 (2013).

426. *Id.*

427. *See* Levitt, *supra* note 412.

428. I.R.C. § 4958 (2012).

429. Joint Committee on Taxation, *supra* note 422, at 347.

430. I.R.C. § 4958(c)(1)(A).

431. *See* Joint Committee on Taxation, *supra* note 422, at 347–48.

rather than from the DAF, the transaction would not even be within the purview of section 4958.[432] However, if a donor is contemplating the purchase back of an asset from the DAF, even at fair market value (preferably using the same appraisal information that is being used for his initial gift), the donor should consider whether a different form of a charitable planning vehicle would be a more viable option than the DAF.[433]

2. Prohibited Insider Benefit

Section 4967 imposes an excise tax on insider benefits if, due to a donor advisor recommendation, the sponsoring organization makes a distribution by which a DAF insider—either the donor, donor advisor, or a related party (i.e. a member of the donor's family) or a 35% controlled entity of them—receives, directly or indirectly, more than an incidental benefit.[434] The legislative history of the PPA provides that there is "more than an incidental benefit" under this section if, as a result of the DAF distribution, a donor or donor advisor receives a benefit that would have reduced a charitable contribution deduction if the donor or donor advisor received the benefit as part of the contribution in a direct donation to the sponsoring organization.[435] For example, if a donor advises a distribution to a public radio station and receives token benefits such as key chains with the station's logo, because the benefits received would not have reduced the donor's charitable contribution deduction had he made the contribution directly, the donor has not received more than an incidental benefit.[436] The DAF insider receiving such benefit as a result of the distribution must pay a tax equal to 125% of such improper benefit; if multiple persons are liable for that distribution, all such persons will be jointly and severally liable.[437] In addition, the fund manager who agreed to the distribution, knowing it would confer an insider benefit, will be assessed a tax equal to 10% of such amount, up to $10,000 per improper distribution.[438] However, if the transaction also incurred a tax under section 4958 as an excess benefit transaction, then this provision will not impose a tax.[439]

3. Taxable Distributions

If a taxable distribution is made from a DAF, a 20% excise tax on the amount of the distribution is imposed on the fund sponsoring organization,

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432. *Id.* at 348.
433. *See infra* Part IV.
434. I.R.C. § 4967(a)(1) (2012).
435. Joint Committee on Taxation, *supra* note 422, at 350.
436. Choi, *supra* note 425, at 398.
437. I.R.C. § 4967(c).
438. *Id.* § 4967(a), (c).
439. *Id.* § 4967(b).

and a 5% tax is imposed on a fund manager who agreed to the distribution knowing it was a taxable distribution.[440] A taxable distribution is any distribution to: (1) to a natural person; or (2) to any other person, if the distribution is not for a charitable purpose or if the sponsoring organization does not exercise expenditure responsibility.[441] Expenditure responsibility is another private foundation concept of section 4945(h), but the IRS has not specifically applied it to DAFs through any guidance.

Distributions are not "taxable" if made to: (1) certain 50% charities (public charities and private operating foundations), other than disqualified supporting organizations; (2) the sponsoring organization of the DAF; and (3) another DAF.[442] Thus, a sponsoring organization can make distributions from a DAF to most public charities and to other types of grantees (other than individuals) so long as it is for a charitable purpose and the organization exercises expenditure responsibility over the grants.[443]

A disqualified supporting organization is a Type III supporting organization that is not functionally integrated and a Type I or Type II supporting organization if the donor (or donor's appointee) and any related parties, directly or indirectly, control a supported organization of the supporting organization.[444] Reliance criteria has been provided to private foundations and sponsoring organizations that sponsor donor advised funds in determining whether a potential grantee is a proper supporting organization, in Revenue Procedure 2011-33.[445]

4. Excess Business Holdings

The PPA also extended the private foundation excess business holdings rules to DAFs.[446] Disqualified persons for this purpose include a donor, donor advisor, his or her family members, and entities that are at least 35% controlled by either.[447] DAFs receiving gifts of interests in a business entity have five years to dispose of the holdings over the permitted amount, with the possibility of having an additional five years if the Treasury Secretary approves.[448]

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440. *Id.* § 4966(a).
441. *Id.* § 4966(c).
442. Levitt, *supra* note 412, at 5.
443. *Id.*
444. Choi, *supra* note 425, at 395.
445. 34 AM. JUR. 2d *Federal Taxation* ¶ 18967.
446. Joint Committee on Taxation, *supra* note 422, at 346.
447. *Id.*
448. *Id.* at 341.

G. Duties of Prudent Investment

In deciding whether to accept, retain, and how to manage a gift of mineral interests, the foundation or charity's directors and officers must comply with their state and federal duties of prudent investment and management of the public's assets, as well as the donor's intent. Directors of these exempt organizations are the keepers of the charity's assets and the guardians of the organization's mission. To exercise prudence means to understand the relationship between potential risk and potential return and to create a balanced portfolio based upon a reasoned investment strategy. In terms of the receipt of a gift of mineral interests, whether it also involves closely held business interests, land, farm animals, or other ancillary assets, the management should address the following questions:

- Does the continued management of these assets provide a proper and prudent investment of the other assets of the organization?
- Does state or federal law require that the organization be more diversified, and thus dictate a sale of some interests held by the organization?
- If the asset will cause the organization to incur UBIT and/or excess business holdings, do these rules of prudent management and investment require the charity to dispose of the tax incurring interests?
- Do the rules of prudent investment require that the organization delegate the management of these assets to a third party?

Whether a specific investment is prudent depends upon how the investment fits within the total portfolio and not necessarily the investment or the level of risk associated with the investment in a vacuum; one must manage risk, not avoid it. The standards of prudent investment and management stem from common law fiduciary duties, state statutes, and federal standards.[449] The organization must consider these standards whether it is contemplating the need to diversify, is thinking about selling the gifted mineral interests, and/or is considering the retention of a third-party agent to manage the interests.

1. State Law Fiduciary Duties

To some extent, state business organization and trust codes codified the common law fiduciary duties.[450] Generally, these duties include the

449. See Darren B Moore, Governing Investments: Navigating the Maze of UPIA, UPMIFA and Jeopardizing Investments, Presented to the SALK Institute 42nd Annual Tax Seminar for Private Foundations (May 2014), for a more in-depth discussion of these standards.

450. *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 22.221 (West 2006).

duties of care, loyalty, and obedience.[451] The duty of care is the duty to stay informed and exercise ordinary care and prudence in managing the organization.[452] Regarding investments, the duty of care is often referred to as the duty of prudence: a decision maker must act in good faith and exercise the degree of care a person of ordinary prudence would exercise in the same or similar circumstances.[453] Directors and officers must make decisions they reasonably believe to be in the best interest of the organization based on the objective facts available to them at the time.[454]

The duty of loyalty requires the decision makers to have undivided loyalty to the organization; they must act for the benefit of the organization and not for their personal benefit, avoiding conflict-of-interest scenarios.[455] While the breach of the duty of loyalty gives rise to a tort claim under state law, it may also implicate federal tax law, typically giving rise to private inurement, self-dealing, and/or excess benefit transactions.[456]

The duty of obedience requires the managers of exempt organizations to remain faithful to and pursue the goals and purposes of the organization.[457] The decision maker should follow the organization's governing documents, applicable laws, and donor restrictions to ensure that the organization satisfies its charitable purposes and fulfills its reporting and regulatory requirements.[458] The duty of obedience demands that the charitable assets are not diverted to noncharitable uses and the investment strategy remains consistent with the organization's mission.[459]

2. UPIA and UPMIFA

The law of prudent investment also appears in the statutory guidance and duties related to the investment and management of the assets of charitable organizations, through the adoption of the Uniform Prudent Investor Act (UPIA) and the Uniform Prudent Management of Institutional Funds Act (UPMIFA).[460] UPIA governs the investment and management of trust assets, including charitable trusts with either individual or institutional

451. Landon v. S&H Mktg. Grp., Inc. 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.).
452. *See id.* at 672–76.
453. Levitt, *supra* note 412, at 6.
454. BUS. ORGS. § 22.221.
455. *See Landon*, 82 S.W.3d at 672.
456. *See id.* at 672–73.
457. *Id.* at 672.
458. *See* Darren B. Moore, Megan A. Cunningham & Michael V. Bourland, *Governance of Nonprofit Organizations*, MOORE THOUGHTS ON NONPROFIT L. 1 (Feb. 1, 2013), http://moorenonprofitlaw.com/wp-content/uploads/2013/06/2013-02-Governance-of-Nonprofit-Organizations.pdf.
459. *Id.*
460. *See, e.g.*, TEX. PROP. CODE ANN. § 116.004 (West 2004).

trustees.[461] A trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule.[462]

In Texas, UPMIFA applies to institutions managing institutional funds or endowment funds to the extent a gift instrument does not provide otherwise. [463] UPMIFA does not apply to program-related assets, defined as assets held by an institution primarily to accomplish a charitable purpose, rather than being held for investment.[464] Institution is defined to include: (1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a government or governmental subdivision, agency or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; and (3) a trust that has both charitable and noncharitable interests, after all noncharitable interests have terminated.[465] Institutional fund means a fund the institution holds exclusively for charitable purposes.[466] However, the term does not include: (1) program related assets; (2) a fund held for an institution by a trustee that is not an institution; or (3) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund.[467] UPMIFA specifically imposes the common law duty of loyalty upon institutional managers and also requires the institution to manage and invest the fund considering the charitable purposes of the institution, those of the fund, and any donor intent as expressed in a gift instrument.[468]

UPMIFA also addresses the investment requirements of endowment funds, with specific presumptions of prudent expenditures in section 163.005 of the Texas Property Code.[469] Under UPMIFA, "endowment fund" means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis.[470] The term does not include assets that an institution designates as an endowment fund for its own use.[471] Terms designating a gift as an endowment, or a direction or authorization in the gift instrument, to "use only 'income', 'interest', 'dividends', or 'rents, issues, or profits', or 'to preserve the principal intact'" will create an endowment fund of permanent duration, unless other language in the gift instrument limits the duration or

461. *Id.* § 116.005.
462. *Id.* § 116.004(b).
463. *Id.* § 163.003(4).
464. *Id.* § 163.003(5)(A)–(C).
465. *See id.* § 163.003(4).
466. *Id.* § 163.003(5).
467. *See id.*
468. *Id.* § 163.004(b).
469. *Id.* § 163.005(a).
470. *Id.* § 163.003(2).
471. *Id.* § 163.003(2).

purpose of the fund.[472] These terms do not otherwise limit the authority of the institution to appropriate the funds for expenditure or accumulation.[473]

There are some differences between UPIA and UPMIFA, but they each rely on a modified version of the traditional prudent investor rule, requiring decision makers to consider the charitable purposes of the organization in making investment decisions, consider economic factors, balance risk and return, and attempt to maximize overall return within the level of risk tolerance acceptable to the charity under its investment policy.[474] Under each statute, each investment is to be evaluated in the context of the trust's or organization's portfolio as a whole, and as a part of an overall investment strategy with risks and return objectives reasonably suited to the trust or fund.[475]

Further, the trustee or manager must diversify the organization's (or trust's) investments, unless the decision maker reasonably determines that, because of special circumstances, the purposes of the trust/fund are better served without diversifying.[476] The decision maker may consider any investment so long as it is consistent with the obligations of prudence under UPIA or UPMIFA, as applicable.[477] However, the trustee/directors must make reasonable efforts to verify facts relevant to the management and investment of the trust/fund.[478] A manager with special skills or expertise will generally be held to a higher standard—the standard of a reasonable person with those same skills and expertise.[479]

The manager of the charitable organization may delegate investment and management functions that a prudent trustee/manager of comparable skills could properly delegate under the circumstances.[480] In choosing to delegate, the decision maker must exercise reasonable care, skill, and caution in selecting the agent and managing the terms of the delegation to be consistent with the terms of the charitable entity, as well as in overseeing the proper compliance with the terms of the delegation by such agent.[481] Because an institution or trust should only incur appropriate and reasonable costs in managing and investing the charitable assets, the management should carefully consider delegating a management function to an outside agent.[482]

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472. *Id.* § 163.005(c).
473. *Id.* § 163.005(c)(2).
474. *Id.* §§ 116.004, 163.004.
475. *Id.* §§ 117.004, 163.004.
476. *Id.* §§ 117.005, 163.004(e)(4).
477. *Id.* § 117.004(e).
478. *Id.* §§ 117.005, 163.004(c)(2).
479. *Id.* § 117.004(f).
480. *Id.* §§ 117.011, 163.006.
481. *Id.* §§ 117.110, 163.006.
482. *Id.* § 117.009.

The duties of prudence under UPIA and UPMIFA may go one step further than merely allowing, and may actually demand, delegation of certain functions, such as the delegation of the management of gifted mineral interests.[483] If the organization lacks directors or trustees with a level of acumen appropriate to certain investments of the organization, it should seek professional guidance from a third-party agent and delegate those investments as appropriate.[484] The directors should be mindful of the fees associated with the delegation to ensure that they are acting prudently in managing the organization's liquid resources.[485] In choosing an outside manager for delegation of an asset or investment, the directors must complete a thorough vetting process of not only the investment team, but also the key principals and money managers that will be involved.[486] This should include a background check, reference checks, and interviews with the key individuals and any superiors of those individuals most closely linked to the management of the organization's assets.[487]

3. Donor Advised Funds: Application of UPMIFA

As seen earlier in Part III.F, certain federal tax rules apply to DAFs which affect their investment decisions; however, uncertainty lies in the intersection of some of these principles and the prudent investment standards.[488] An outstanding question is whether an investment must be considered prudent in terms of the overall assets of the DAF sponsoring organization or in terms of each individual DAF.[489] To the extent a sponsoring organization segregates a DAF and makes investments separately from each DAF, rather than pooling funds, a state attorney general could very well take the position that each individual DAF is an "institutional fund" subject to UPMIFA.[490] This position could make it more difficult to meet the goal of a diversified portfolio, as each investment would make up a larger portion of the DAF's overall portfolio assets.[491] A state attorney general could also look into the issue of whether the managers of the sponsoring organization have violated fiduciary duties by not properly diversifying the individual DAF.[492] Until more guidance is

483. *See id.* §§ 117.004, 163.007.
484. *Id.* §§ 117.004, 163.007.
485. *Id.* §§ 117.004, 163.007.
486. *Id.* §§ 117.004, 163.007.
487. *Id.* §§ 117.004, 163.007.
488. *See infra* Part III.F.
489. Levitt, *supra* note 412, at 7.
490. *Id.*
491. *Id.*
492. *See id.*

provided, the safer course of action is to attempt to achieve diversification at both the DAF and sponsoring organization levels.[493]

Further, because donor intent can override the statutory investment standards, a sponsoring organization should procure a written record of the donor's approval of specific investments, or types of investments, that the donor desires to be a part of his or her DAF.[494] It may be well advised that the organization obtain a letter from the donor at the time of the initial contribution authorizing the investments the sponsoring organization otherwise would not want to make under the standards of prudent investment.[495] However, it is debatable as to whether the sponsoring organization should go as far as to allow the donor to approve and recommend an investment outside of the organization's investment policy because this could be viewed as an imprudent management of the organization's assets.[496] For example, the Council on Foundations suggests that allowing the approval of an investment, as well as an investment strategy, outside of the organization's standard investment policy could be seen as excessive donor control over the DAF.[497]

Private foundations have the ability to rely on the exception from the jeopardizing investment rules for program-related investments (PRIs); however, there is no parallel definition of a PRI for a public charity, including DAF sponsoring organizations, and the section 4944 jeopardizing investment restrictions have not been extended to apply to DAFs.[498] PRIs are those investments made primarily to accomplish the organization's exempt purposes, rather than to produce income.[499] To qualify as a PRI, the following must be met: (1) the primary purpose of the investment is to further at least one exempt purpose of the foundation, (2) the production of income or appreciation of property cannot be a major purpose of the investment, and (3) the investment can only serve limited lobbying purposes, and absolutely no electioneering.[500] If an investment is considered an allowable PRI for a foundation, it seems reasonable that the same or similar investments would be permissible for other organizations less heavily regulated than private foundations.[501]

The uncertainty lies in whether the IRS will distinguish PRIs from other investments of a DAF.[502] If an investment by a DAF would be a PRI to a private foundation, should that investment provide the tax advantages

493. *Id.*
494. *Id.* at 7–8.
495. *Id.*
496. *Id.* at 8.
497. *Id.*
498. *Id.*
499. *Id.*
500. *Id.*
501. *Id.* at 8–9.
502. *Id.*

to the DAF as it would to a private foundation?[503] For example, PRIs are exempt from a foundation's excess business holding restrictions, which have now been applied to DAFs.[504] Additionally, there is the question of whether a DAF investment could be exempt from the state law prudent investor standards if it would be considered a PRI to a private foundation.[505]

If a donor is specifically concerned about these uncertainties regarding the proper investments of a DAF, the donor could create a field of interest fund or designated fund at a sponsoring organization, which are not included within the Code definition of a DAF, and thus would not be subject to these rules.[506] A field of interest fund involves multiple donors who pool their funds to support a particular charitable field or program area, such as education or medical research.[507] Unlike the advice for a DAF, the designation of a field of interest can be legally binding on the charity sponsoring the fund, subject only to an ability to change the field of interest in a limited capacity (and depending on the charity's variance power).[508] A designated fund is one that makes distributions to one or more specified charities; it allows a donor to provide long-term funding to a charity when the donor has concerns regarding the charity's ability to manage the funds.[509] Again, the charity generally cannot make distributions to other charities unless it becomes impossible or impractical to follow the donor's designation, and any successor charity must be substantially similar.[510]

4. Private Foundations: Jeopardizing Investments

In addition to the state law standards that impose fiduciary responsibilities upon foundation managers, the Code prohibits foundation managers from making "jeopardy investments" that could risk the foundation's assets and ability to further its charitable purposes.[511] First, it is important to note that the IRS differentiates the assets the foundation receives through donations and what the foundation itself invests in with its own resources in the context of jeopardizing investments.[512] The IRS does not consider an investment asset that has been donated to a foundation a jeopardizing one in regards to the foundation.[513] This is because the foundation is not treated as having made the investment; when the

503. *Id.*
504. *Id.*
505. *Id.*
506. *Id.* at 12.
507. *Id.*; Choi, *supra* note 425, at 387.
508. Choi, *supra* note 425, at 387.
509. *Id.* at 388.
510. *Id.*
511. Treas. Reg. § 53.4944-1(a)(1) (as amended in 1973).
512. *Id.* § 53.4944-1(a)(2)(ii)(a).
513. *Id.*

foundation receives a gratuitous transfer, it is not using its own resources, which the charitable covenant imposed by the Code and its organizational documents protect.[514]

For example, in Private Letter Ruling 9614002, the IRS noted that the foundation had nothing to lose in accepting the donated assets; the foundation would incur no obligation to use its other resources in the future in connection with maintenance of the bequeathed assets, and the foundation only stood to gain from the gratuitous transfer.[515]

> Section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. If such foundation furnishes any consideration to such person upon the transfer, the foundation will be treated as having made an investment (within the meaning of section 4944(a)(1)) in the amount of such consideration.[516]

Once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the IRS will never consider the investment to jeopardize the carrying out of such purposes, even if, as a result of such investment, the foundation subsequently realizes a loss.[517]

If and when the foundation decides to invest its own resources in a new entity or investment, the applicability of the jeopardizing investment prohibition must be analyzed. The penalties for engaging in a jeopardizing investment apply "[i]f a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes."[518] The sanction for the violation of section 4944 is a series of tax penalties, but it does not describe any transactions as per se jeopardy investments.[519] The regulations merely list examples of types of transactions that the IRS will closely scrutinize, such as trading on margin, purchase of puts, calls and straddles, and selling short.[520] Unfortunately, the IRS has not classified any specific investments as jeopardy investments.[521] This is likely due to the fact that the standard of care requires a facts-and-circumstances type of analysis, and is not a general prohibition against specific types of investment policies.[522] Furthermore, no reported cases involve a private foundation losing its exempt status solely due to the violation of the jeopardizing investment rules.[523]

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514. *Id.*
515. I.R.S. Priv. Ltr. Rul. 96-14-002 (Apr. 5, 1996).
516. Treas. Reg. § 53.4944–1(a)(2)(ii)(a).
517. *Id.* § 53.4944-1(a)(2)(i).
518. I.R.C. § 4944(a) (2012).
519. *Id.* § 4944(a)–(b).
520. Treas. Reg. § 53.4944-1(a)(2)(i).
521. *Id.*
522. *See id.*
523. I.R.C. § 507 (2012).

The standard that must be met by all investments is that of the prudent trustee; the foundation managers must exercise ordinary business care and prudence, under the facts and circumstances at the time of making the investments, "in providing for the long and short-term financial needs of the foundation to carry out its exempt purposes."[524] In exercising this standard of care and prudence, the foundation manager may consider the expected return (both income and appreciation of capital), the risk of rising and falling price levels, and the need for diversification within the investment portfolio (i.e. "type of security, type of industry, company maturity, degree of risk, and potential for return").[525] The consideration of the facts and circumstances also requires a determination of the financial requirements of the foundation and the consideration of how the proposed investment completes the foundation's investment portfolio as a whole.[526]

For example, in Revenue Ruling 80-133, the foundation retained a life insurance policy (originally received as a donation) as an investment, annually paying premiums and interest due on the policy and policy loan.[527] The IRS found that the continuing investments of the foundation (via premium and policy loan payments) were jeopardy investments, as the combined interest and premium payments were so great that the foundation would have invested more in premiums and interest than it could have received in the form of insurance proceeds upon the insured's death.[528]

Similarly, in General Counsel Memoranda 39-537, the foundation borrowed funds to purchase stock in a publicly traded corporation, which was not of blue chip quality and in which the foundation managers were high-level employees.[529] The purchase constituted about 75% of the foundation's investments.[530] After considering three main factors: (1) the use of large loans to make the purchase, (2) the lack of sufficient diversification of the foundation's investments, and (3) the type of stock in which the foundation invested, the IRS determined the purchase was a speculative investment, jeopardizing the fulfillment of the foundation's exempt purposes.[531]

> The requisite standard of care and prudence required in section 53.4944-1(a)(2)(i) requires a case by case determination which involves some subjective evaluation. The prudent man rule is an investment standard which varies somewhat from state to state. It is defined in Black's Law Dictionary (5th ed. 1979) as '. . . the trustee may invest in a security if it is

524. Treas. Reg. § 53.4944-1(a)(2)(i).
525. *Id.*
526. *Id.*
527. Rev. Rul. 80-133, 1980-1 C.B. 258.
528. *Id.*
529. I.R.S. Gen. Couns. Mem. 39,537 (July 18, 1986).
530. *Id.* at 2.
531. *Id.* at 3.

> one which a prudent man of discretion and intelligence, who is seeking a reasonable income and preservation of capital, would buy.'[532]

Under case law analyzing the predecessor to section 4944, an inherently risky investment is not necessarily a jeopardy investment but only becomes one to the extent the possibility of loss would endanger the foundation's ability to carry out its charitable functions.[533] Thus, it seems to reason, that if the foundation's managers are not risking the foundation's assets to the detriment of its exempt purposes, the IRS should have no reason to apply the penalty taxes under section 4944.[534]

The penalties for making a jeopardizing investment include a tax equal to 10% of the amount improperly invested during that taxable year, to be paid by the private foundation, and an additional tax of 10% of that improperly invested amount, up to $10,000, to be paid by the foundation manager(s) who knowingly participated in the investment, unless the participation was not willful and was due to reasonable cause.[535]

A manager acts knowingly if he has actual knowledge of sufficient facts that such investment would be considered a jeopardizing investment, he is aware that such an investment may violate federal tax law, and he negligently fails to make reasonable attempts to ascertain whether the investment is jeopardizing, or if he is in fact aware that it is such an investment.[536] The manager's participation in the investment is considered willful if it is voluntary, conscious, and intentional; however, it is not willful if he does not know that it is a jeopardizing investment under the Code provision.[537] A manager is considered to have participated in the investment if he, in any way, manifests approval of such investment.[538] A manager's actions are considered "due to reasonable cause" if he has exercised his responsibility with ordinary business care and prudence, including acting on the advice of counsel after full disclosure of the factual situation, in certain circumstances.[539]

If the organization does not remove the investment from jeopardy within the taxable period, the IRS will impose additional taxes of 25% of the amount of investment as to the foundation and 5% of the amount of investment—or up to a $20,000 excise tax—as to a foundation manager refusing to agree to remove all or part of the investment from jeopardy.[540]

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532. *Id.*
533. Samuel Friedland Found. v. United States, 144 F. Supp. 74, 94 (D.N.J. 1956).
534. I.R.C. § 4944(a)–(b) (2012).
535. *Id.*; *Samuel Friedland Found.*, 144 F. Supp. at 94.
536. Treas. Reg. § 53.4944-1(b)(2)(i)(a)–(c) (as amended in 1973).
537. *Id.* § 53.4944-1(b)(2)(ii).
538. *Id.* § 53.4944-1(b)(2)(iv).
539. *Id.* § 53.4944-1(b)(2)(v).
540. I.R.C. § 4944(b)–(d).

5. Application to Mineral Assets

The rules regarding jeopardizing investments could potentially come into play when the foundation receives and retains an asset that incurs other types of taxes discussed above, or assets that do not provide for sufficient diversification of the foundation's asset holdings as a whole.

The IRS does not consider the assets received by the foundation from a purely gratuitous transfer to be jeopardizing investments.[541] Thus, the mere receipt of assets that cause UBIT or excess business holdings should not be deemed to also be jeopardizing investments under the Code. However, if the foundation receives an asset for which it must expend foundation funds to maintain (such as the insurance policy in the Revenue Ruling noted above), the future investments made into that asset could trigger the excise tax for jeopardy investing.

For example, in Private Letter Ruling 200621032, a trust left a 1% working interest in oil and gas to a private foundation, which would typically be considered a "high scrutiny" type of investment.[542] The foundation would need to supply additional funds and capital, as requested, to participate in certain proposed operations, but the costs and expenses associated with the exploration and development would not become an encumbrance against the foundation's existing diversified portfolio.[543] Thus, the IRS held that the mere receipt of this gift, without more, would not constitute a jeopardizing investment.[544] Contrast this scenario with an investment that requires active maintenance and further investments by the foundation in the speculative investment, not just mere receipt.

There is currently no clear authority on how diversified a foundation's investments must be under the Code; rather, any future assets or investments acquired by the foundation will be subject to the prudent trustee standard of investment.[545] In addition, state law fiduciary standards may be applicable to the foundation managers' decision regarding diversification. Until this issue is clarified, foundation managers are left to review other examples of jeopardy investments and use their own judgment in making investment decisions under the standard set forth above. However, the purpose of section 4944 is not to circumscribe the investment decisions of foundation managers except to the extent necessary to prevent the foundation from being used as a basis for speculation.[546]

The foundation would still be well advised to avoid relying on a single investment or asset class that could jeopardize its ability to fulfill its tax-

541. Treas. Reg. § 53.4944-1(a)(2)(ii)(a).
542. I.R.S. Priv. Ltr. Rul. 2006-21-032 (May 26, 2006).
543. *Id.*
544. *Id.*
545. *See* Treas. Reg. § 53.4944-1(a)(2).
546. *Id.*

exempt function. For example, a founder/donor may desire his foundation to operate in a similar manner to his extremely successful real estate business and so would like for the foundation to only invest in a single type of asset (i.e. very particular real estate investments that he deems appropriate); thus, the sole type of asset he contributes to his private foundation are those real estate investments. Unfortunately, a private foundation cannot operate exactly like his for-profit business, even though it may be highly lucrative. The foundation directors must be acutely aware of the situation and how to broach the subject with the founder/substantial contributor.

The key element the IRS will use in its determination under section 4944 is whether the foundation managers exercised ordinary business care and prudence in making the investment.[547] In Technical Advice Memorandum 92-05-001, the IRS found that the foundation "[t]rustees failed to exercise ordinary business care and prudence when they invested" 100% of the foundation's assets in the preferred stock of one closely held company.[548] The IRS based its ruling that the lack of diversification of assets was a jeopardizing investment on the factors that: "1) There was no reasonable expectation of a return from the investment; 2) The investment did not allow for diversification of [the foundation's] investments; and 3) The investment did not consider the risk of investing in the particular industry"[549]

As explained above, UPMIFA requires that foundation directors manage and invest the assets not in isolation, but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the foundation.[550] UPMIFA also assumes that prudence requires diversification of assets but allows a foundation to determine that nondiversification is appropriate due to special circumstances.[551] Under these provisions, a decision not to diversify must be reasonable and based on the needs of the charity, and not solely for the benefit of a donor.[552] A decision to retain property in the hope of obtaining additional contributions from the same donor may be considered made for the benefit of the charity, but the appropriateness of that decision will depend on the circumstances.[553]

Finally, UPMIFA requires that the organization, within a reasonable time of receiving property, decide to retain or dispose of such property or rebalance the portfolio, in order to bring the fund into compliance with the

547. *See id.* § 53.4944-1.
548. I.R.S. Tech. Adv. Mem. 92-05-001 (Jan. 31, 1992).
549. *Id.*
550. *See* Moore, *supra* note 449.
551. *See id.*
552. *See id.*
553. *See id.*

purposes, terms, and distribution requirements of the organization and the requirements of the Act.[554] Thus, although the receipt of exotic assets may not be jeopardizing investments under Code section 4944, there may be an issue under the applicable state law and UPMIFA with retaining those assets if they cause UBIT or other excise taxes to the foundation.

H. Use It or Lose It?

If the organization managers determine that the rewards outweigh the risks of receiving the mineral asset, then they must also consider whether they want to retain the asset, how long to retain the asset, how to manage the asset, and the best way to dispose of the asset. It is almost imperative that the organization has the asset(s) valued when making the determination of whether to retain or dispose of more significant assets, specifically with mineral interests and real estate. Sometimes unique assets, like those the article discusses, cannot be put to use in furtherance of the organization's charitable purposes, so the organization must dispose of them in the most practical and cost efficient way. However, the method and manner of disposition can be difficult to determine.

1. Mineral Interests

"Once mineral interests have been received by [the charitable beneficiary, the organization] must then determine how it will effectively manage these interests to ensure that the greatest benefit is realized for the charity over the long term."[555] Many charities' gut reaction to receiving these interests is to immediately sell them, especially when the donee is a smaller charity that can deal with cash proceeds much easier. This result largely depends on the area in which the charity is located and the size of the donee. However, it is often in the best interest of the organization to retain ownership of the mineral interests, when comparing the possible purchase price with the income stream the interests are capable of producing.

Most organizations will need to hire a third party to manage the mineral interests, which is usually "found within a larger banking organization, an investment manager, or a financial services organization large enough to support a minerals management group."[556] Charities typically do not manage these assets unaided very well; if managed internally, it will usually just be to cash checks received under an ongoing

554. *7.3.2 Investment Responsibilities (UPMIFA*), CHARITABLE ORG., http://www.wwc gift.org/giftlaw/glawpro_subsection.jsp?WebID=GL1999-0001&CC=7&SS=3&SS2=2 (last visited Oct. 22, 2014).

555. Hancock, *supra* note 9, at 13.

556. *Id.*

lease.[557] Further, large charities will often receive the surface estate in addition to the mineral interests. On ranches, this can be a very lucrative situation for the donee, but requires a third party manager to maximize the value of the minerals, along with any hunting leases, grazing leases, and farming leases contemporaneously.[558] Keep in mind that UPIA or UPMIFA may require the organization to hire outside advisors as part of the prudent management of the charity's assets.

For example, many banks have mineral management teams that exist to advise charities that are approached with these gifts on how to proceed with accepting the gift, so the charity has an advisor to evaluate, negotiate, and manage on their behalf.[559] In this way, the charities can also market these types of gifts as a part of their overall asset portfolio—they are able to show their benefactors and potential donors that they know what to do with this type of asset, and will not immediately sell the assets upon donation to the charity.[560]

In making the keep-or-sell determination, not only should the foundation consider the potential value of the interests but also the longevity and life of the reserves, whether this would be an expense-bearing interest and the liabilities and risks of the properties.[561] If the foundation does not have a written policy or procedure regarding the retention or disposition of these interests, the organization may rely on its mineral manager to make its recommendation, based on the annual review and analysis of the properties on a month-by-month basis.[562] This review will include weighing the prices of oil and gas, as well as production volumes on an asset-by-asset basis.[563] Thus, having an outside third-party mineral manager can be extremely beneficial.

When hiring an outside mineral advisor, the charity should ensure "that it will receive active management, administration and negotiation for all mineral interest" it owns—this should focus on every phase of the oil and gas production process, from the initial negotiation of the lease (if not yet done prior to the gift), through the lifetime of the producing well or field.[564] With producing minerals, "the manager should continually review all division orders [and] conduct a monthly review of revenues to confirm" that the charity's interests are being properly identified and paid, and identify any funds that may be held in suspense"[565] If the mineral interests

557. *Id.*
558. *Id.* at 6–7.
559. *See, e.g.*, *Oil & Gas Mineral Interest Management*, UNION BANK, https://www.unionbank.com/private-bank/trust-estate/oil-gas-mineral/index.jsp (last visited Oct. 22, 2014).
560. *See* Hancock, *supra* note 9, at 12.
561. *See id.* at 10.
562. *See id.* at 14.
563. *Id.*
564. *Id.* at 13.
565. *Id.*

are not yet producing, "the manager's goal should be to negotiate the maximum bonus and royalty, . . . should leasing activity begin, taking into consideration any existing trends and current demand."[566] Further, "the manager [must] update and maintain all undeveloped acreage records and a shut-in well requirements."[567] Finally, the manager should regularly "monitor all . . . lease terms and secure timely releases for expiring leases."[568] The mineral manager typically gets better lease terms and a much more protective lease for the lessor than when the charity attempts to negotiate its own lease.[569]

If the charity is being given a working or operating interest, it must take further steps to account for any environmental issues.[570] The owner of an operating or working interest bears the liability for environmental problems and any liability related to the surface usage.[571] The charity can avoid these types of liabilities by adopting a gift acceptance policy that prohibits any type of mineral interest gift other than a royalty interest.

If the charity does accept a gift of a working interest, it should consider adjusting its business structure, to provide for the greatest possible liability protection. For example, the organization may establish a wholly-owned subsidiary solely for the purpose of holding these interests.[572]

2. Real Estate, Business Interests & Other High-Value Items

If the organization receives a gift of improved real estate, it may be advantageous for the charity to retain the property and rent it to a third party, to increase its cash proceeds for charitable uses. As long as the property does not fall within the unrelated debt-financed rules noted above, the rental income will not be subject to UBIT. The property may also be used by the organization—such as using a donated building for offices—or used in furtherance of its own programs—such as a summer camp based on rural land that was donated or the organization may be able to develop an educational program using that land. If the charity decides it cannot use the property for its charitable purposes or as rental income, the best course of action may be to avoid any ongoing carrying costs and/or liability and sell the property as soon as possible. The charity could reserve any mineral interests in such sale or convey the minerals with the surface, as desired.[573]

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566. *Id.*
567. *Id.*
568. *Id.*
569. *Id.*
570. *See id.* at 7.
571. *See id.*
572. *See infra* Part IV.
573. *See generally* SHADE & BLACKWELL, *supra* note 17, at 16 (discussing that mineral estates can be subdivided into various types of interests).

When the organization determines it cannot accept a proposed noncash donation of a large item, such as real estate, business interests, or another highly valuable asset, due to a lack of capacity, expertise, or time to manage or dispose of the asset, the organization may want to consider referring the donor to another charitable organization or donor advised fund that can better deal with the disposition of the item then send the proceeds back to the organization. For example, the Dechomai Foundation is structured as a community foundation that accepts gifts of real estate, closely held business interests, restricted stock, S corporation stock, life insurance, notes, and other unique assets, then sells the asset and sends the proceeds back to the organization the donor initially wanted to support.[574] This enables the referring charity to receive a simple cash gift without the liability or expenses of managing and disposing of unusual assets. This particular organization has a minimum value of the item being donated of $100,000 and a minimum charitable fee of $10,000.[575] It has had success with selling paintings at Sotheby's auction house, a sports franchise (avoiding UBIT concerns for the end-donee organization), vacation homes, raw land, real estate partnerships, a seat on a financial exchange, coal rights, and a collection of trophy mounted big game animals.[576] However, it does not accept cars, planes, and boats.[577] Another example is the Minnesota Real Estate Foundation, which is a supporting organization of the Central Minnesota Community Foundation but "also handles gifts of buildings and land for other providers of donor-advised funds."[578]

IV. STRATEGIES

Below, this article will set out various strategies a charitable organization may use to either deal with the mineral asset after it has accepted and determined to retain it, or to advise donors as to how to make the contemplated gift of mineral interest assets in the most efficient way for the organization to receive the benefit from the value of, or income stream from, such asset. These techniques may enable charitable organizations to encourage donors to make more gifts of a type the organization would like to receive and manage for its exempt purposes.

574. THE DECHOMAI FOUNDATION, http://dechomai.org/ (last visited Oct. 11, 2014).
575. *Id.*
576. *Id.*
577. *Id.*
578. Ben Gose, *A Georgia Charity Accepts 'Weird' Gifts Contributed to Donor-Advised Funds*, CHRON. PHILANTHROPY (July 11, 2010), http://philanthropy.com/article/A-Georgia-Charity-Accepts/66187/.

A. Sell or Convert Partnership Units to Publicly Traded Stock

The organization could potentially sell donated interests in a closely held business, such as a family limited partnership, or convert them to publicly traded stock if that option presents itself.[579] If a foundation decides to sell the interests, care must be taken to avoid incurring excise taxes under the self-dealing rules explained above.

The conversion of the partnership units to publicly traded stock is considered a sale of the partnership units by the partner(s) making the conversion.[580] The sale of a partnership interest by an organization is treated under the aggregate approach to partnerships, meaning each partner is treated "as the owner of a direct and undivided interest in partnership assets and operations."[581] Although there is some disagreement among commentators on this issue, the IRS has held that the effect is the same on the exempt organization, whether it sells its interests in the partnership or whether the partnership is selling partnership property itself.[582] Thus, whether the proceeds received in connection with the sale of the partnership interests will be subject to UBIT will turn on the character of the underlying assets the partnership owns.

Therefore, if section 751 would classify the assets in the sale as ordinary income, that income would be subject to UBIT due to the look-through rule. However, if the income is passive income, such as interest or royalties, that income is excluded from UBI but would be included in the calculation of a foundation's net investment income.[583] For example, a foundation's sale of partnership interests that own debt-financed property is subject to UBIT. But if the underlying asset of the partnership is land without any acquisition indebtedness, the money or property received in exchange for the partnership interest attributable to that land would be excluded from UBIT.

A partner's gain on the sale of a partnership interest is generally considered capital gain, except for the portion of gain or loss attributable to certain unrealized receivables, certain depreciation recapture, or inventory items of the partnership.[584] The ordinary income characterization of these section 751 assets means they do not qualify for the exclusion from UBIT treatment.[585] Thus, "[t]o determine the [organization's] gain or loss from the sale of a partnership interest, it is first necessary to determine the

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579. I.R.S. Tech. Adv. Mem. 96-51-001 (June 27, 1996).

580. *See id.*

581. *See id.*

582. *Id.*

583. *See id.*

584. I.R.C. § 751(a) (2012).

585. *See, e.g.*, *id.* § 512(b)(5); Treas. Reg. §§ 1.1245-6(b) (as amended in 1976), 1.1250-1(c)(2) (as amended in 1972); John V. Woodhull, *Selling a Partnership Interest Means Complexity for Tax-Exempt Partners*, 23 TAX'N EXEMPTS 03 (Mar./Apr. 2012).

portion of [the organization's] gain or loss from the sale that is attributable to the Section 751 assets of the partnership," which will be UBIT (or loss) to the organization.[586] Also, to the extent any underlying partnership assets are subject to debt, more of the gain may be considered debt-financed UBIT to the organization.[587] Section 751 assets include unrealized receivables, including depreciation recapture under sections 1245 and 1250, and the partnership's inventory.[588] "The remainder of the tax-exempt partner's amount realized on the sale in the partnership interest [outside of the section 751 assets] is capital gain, which should not be subject to tax as UBTI, except to the extent it is treated as debt-financed UBTI."[589] Thus, before deciding to sell or convert its partnership interests, an exempt organization "should carefully examine its allocable share of partnership income and assets, as well as any partnership debt . . . during the prior 12 months."[590] Any ordinary income from the partner's gain will be UBI to the partner.[591]

Therefore, if upon the conversion of the partnership interests to public stock, most income from the sale would be classified as ordinary income then that ordinary income would trigger UBIT, making this strategy more tax-adverse to the organization.[592] If the organization were holding corporate stock instead, the sale of the stock would be treated as capital gain, and thus not subject to UBI tax, regardless of what types of properties or transactions the corporation conducted.[593]

B. Disclaimer

If the organization knows it is about to receive a testamentary gift of unique assets, or the residue of an estate, but not all assets are desirable for the organization to accept, it can strategically plan to disclaim the items that are unwanted in accordance with the applicable state law. For example, if an organization is to receive a bequest of land, which will also include producing minerals, but the surface estate is undesirable (either due to location, condition, or some other factor), the organization can disclaim the bequest of the surface but still receive the gift of the underlying minerals.[594] This provides for a result that otherwise could not be accomplished if the donor were living and wished to give only the minerals from under his land due to the partial interest rule (assuming the donor also wanted an income tax charitable deduction).

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586. *See* Woodhull, *supra* note 585.
587. *Id.* at 4–5.
588. *Id.* at 5.
589. *Id.* at 7.
590. *Id.* at 11.
591. *See id.* at 3.
592. *See id.*
593. *See id.* at 9.
594. TEX. EST. CODE ANN. § 122.002 (West 2014).

In Texas, the standard nine-month filing deadline for disclaimers is not applicable to charitable beneficiaries.[595] Rather, when

> the beneficiary is a charitable organization or a governmental agency of the state, a written memorandum of disclaimer of a present or future interest must be filed [before] the later of: (1) the first anniversary of the date the beneficiary receives the notice required by Subchapter A, Chapter 308; or (2) the expiration of the six-month period following the date the personal representative files: (A) the inventory, appraisement, and list of claims due or owing to the estate; or (B) the affidavit in lieu of the inventory, appraisement, and list of claims.[596]

C. Disregarded LLC or Supporting Organization

Depending on the type of mineral interest being given to the organization, there may be liability concerns with working interests and production payments that the organization is not willing to, or is not allowed to, assume under its governing documents. Additionally, accepting gifts of real property, whether improved or not, can expose the organization to liability.[597] A potential solution to this liability exposure may be for the organization to create a sub-tier LLC wholly owned by the organization as a disregarded entity, and have these types of gifts made to that sub-tier LLC rather than the parent organization.[598] The IRS now recognizes a contribution to a disregarded single member LLC that is wholly owned and controlled by an American charitable entity as a deductible gift to the organization itself; however, the outstanding issue will be at the applicable state level, and whether the state will recognize the LLC as also being tax-exempt.[599]

For example, in Private Letter Ruling 200134025, a supporting organization, which was functioning as the fundraising arm of a state university, managed liquid investments and converted contributions to liquid assets.[600] The supporting organization also wanted to hold, manage, and develop real property—an activity that could subject the liquid investments to claims of creditors.[601] The organization proposed to organize a single-member LLC for each piece of real estate contributed, to manage the potential liability of the real estate activities, and the IRS blessed the proposal.[602]

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595. *Id.* § 122.005(c).
596. *Id.*
597. *See supra* Part III.A.5.
598. *See* I.R.S. Notice 2012-52, 2012-35 I.R.B 317.
599. *See id*.
600. I.R.S. Priv. Ltr. Rul. 2001-34-025 (Aug. 25, 2001).
601. *See id.*
602. *See id.*

Public charities are also beginning to form supporting organizations, to which donors of these types of interests contribute the property. The charity then is able to manage the expenses and liabilities of those interests in the supporting organization, rather than subjecting all of the assets of the charity to those risks. If the organization is being approached with a gift of closely held business interests, it may be desirable to have a supporting organization receive these types of assets. For example, a public charity structured as a charitable trust may want to have a supporting organization established as a C corporation, which receives any gifts of closely held interests in order to isolate potential liability away from the charity itself. However, if the organization expects to sell the interests relatively soon and such sale will cause UBIT, it would be more advantageous to receive those interests into the parent charitable trust, so that the amount of UBIT would be at a lower rate (trust tax rates versus corporate tax rates).

D. Development of, and Shifting Unrelated Business Activities to, a Taxable Subsidiary

Organizations may create separate subsidiary legal entities in order to protect liquid assets from activities or other assets that may give rise to liability, and achieve administrative efficiency by organizing distinct activities into separate entities; however, this strategy is not as effective for minimizing UBTI. Tax-exempt organizations may want to create a taxable subsidiary to avoid UBTI "by moving certain commercial or non-traditional activities" or assets to the taxable subsidiary.[603] While this restructuring may initially minimize UBTI issues at the tax-exempt parent level, the "[i]ntercompany transactions between the taxable subsidiary and the tax-exempt parent" result in complex tax issues.[604] Unfortunately, not all dealings with the subsidiary are considered capital contributions by the parent and not all receipts by the parent from the subsidiary can be characterized as dividend distributions. Payments flowing from the tax-exempt parent must be characterized as either loans, payments for services, sales, or capital contributions.[605] Payments flowing from the "subsidiary to a tax-exempt parent organization will be treated as dividends, payments for services, repayments of a loan or sales"[606] It is critical that the parent tax-exempt entity identifies and categorizes each intercompany transaction properly, and is cognizant of the associated tax consequences.[607]

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603. John V. Woodhull & Erica D. Reiderbach, *Taxable Subsidiaries of Tax-Exempt Organizations*, 25 TAX'N EXEMPTS 19, 19 (Jan./Feb. 2014).

604. *Id.*

605. *Id.* at 20.

606. *Id.*

607. *Id.*

The organization must also be careful that it does not operate primarily for the benefit of the taxable subsidiary, or the private benefit of board members who serve both the for-profit entity and the tax-exempt entity.[608] For example, in Private Letter Ruling 201216040, the IRS denied the foundation tax exemption because the IRS found substantial private benefit flowed to the for-profit LLC and to the founder of both the LLC and foundation, rather than primarily benefitting the parent organization's charitable purposes.[609]

1. Choice of Entity Form

An exempt organization contemplating the establishment of a separate subsidiary entity to house an unrelated business should consider what form of entity is most appropriate. Most often, the C corporation form is used for this purpose; these are taxable entities treated as separate from the exempt organization, so long as the corporate form is respected for purposes of federal tax laws.[610] This form preserves the exempt status of the charity and allows it "to control the amount . . . of income flowing from the for-profit entity."[611]

Creating the separate entity as a partnership, LLC, or other form of joint venture is usually inadvisable because of the flow-through treatment of this type of entity to the exempt organization.[612] Thus, there would be no ability to control the flow of unrelated business income to the charity, as can be done with a C corporation.[613] Likewise, a single-member LLC should likewise not be used.

> These entities are generally disregarded for federal tax purposes, so all of their economic activity is [treated] as conducted by the member. When the member is an exempt organization, unrelated business in this form of [LLC] would be treated (and taxed) as if it [was] undertaken directly by the exempt organization member.[614]

2. UBIT Problem

Otherwise passive, nontaxable income that is derived from a controlled taxable subsidiary is generally taxed as UBTI to the exempt (controlling) organization. Therefore, when a tax-exempt organization parent receives

608. *See id.* at 27.
609. I.R.S. Priv. Ltr. Rul. 2012-16-040 (Apr. 20, 2012).
610. BRUCE R HOPKINS, THE TAX LAW OF UNRELATED BUSINESS FOR NONPROFIT ORGANIZATIONS 193 (John Wiley & Sons, Inc. 2005).
611. *Id.*
612. *Id.*
613. *Id.*
614. *Id.*

rent, interest, royalties, or annuities from a controlled taxable subsidiary, those revenues are generally taxable.[615] Congress enacted this rule to prevent double benefit to the exempt organization: avoiding taxation on unrelated business income by housing the activity in a subsidiary then receiving passive, nontaxable income from the subsidiary.[616]

Therefore, when a controlling organization receives, directly or indirectly, interest, annuities, royalties, or rent from a controlled entity (whether or not tax exempt), the controlling entity must treat that payment as UBTI, to the extent the payment reduced the net "unrelated income" of the controlled entity or increased any net unrelated loss of the controlled entity.[617] Net unrelated income means the part of the controlled entity's taxable income that would be considered UBTI, if the entity were exempt and had the same purposes as the controlling exempt organization.[618] The controlling organization can deduct expenses directly connected with amounts treated as UBI under this rule.[619]

Under these special rules, the income from the taxable subsidiary must first "be identified as rental, annuity, royalty, or interest income."[620] This characterization may not be clear at first blush. A taxable subsidiary's use of the space in a building owned by the parent may be pursuant to a rental agreement, but if services are also provided as part of the lease agreement, it could be considered a services agreement.[621] Similarly, contracts for the use of the parent organization's intangible property may be a licensing or royalty agreement, according to the substance of the arrangement rather than the form.[622]

Then, the rules regarding "control" must be carefully analyzed: the standard for determining "control" in this context is a "more than 50%" rule, including any ownership interests via indirect holdings and constructive ownership.[623] Therefore, control of a corporation means ownership by vote or value of more than 50% of its stock; control of a partnership means ownership of more than 50% of the profits interest or capital interests; and in a trust or in other circumstance, control is measured in terms of more than 50% of the beneficial interests in the entity.[624]

If it is determined such income is from a taxable subsidiary controlled by the tax-exempt organization, the tax-exempt parent must determine whether any of the taxable subsidiary's taxable income would be UBTI if

615. I.R.C. § 512(b) (2012); Treas. Reg. § 1.512(b)-1 (as amended in 1992).
616. *See* I.R.C. § 512(b); Treas. Reg. § 1.512(b)-1.
617. Woodhull & Reiderbach, *supra* note 603, at 27.
618. *See* I.R.C. § 512(b)(1)–(3).
619. *See id.*
620. Woodhull & Reiderbach, *supra* note 603, at 27.
621. *See id.*
622. *See id.*
623. I.R.C. § 512(b)(13)(D).
624. *Id.*

the subsidiary were similarly exempt.[625] The only real instance where this would not be true is if the "subsidiary is engaged in an activity that is in furtherance of the parent['s]" exempt purpose.[626] For example, if a taxable subsidiary rents a building to conduct both activities that are exempt and nonexempt, then the parent must report that portion of the rental income paid as UBTI that corresponds with the proportion of use of the building for nonexempt activities.[627]

3. Private Operating Foundations

Private operating foundations are subject to very strict rules requiring their assets to be used in the active conduct of their exempt programs, but the foundation may be able to effectively use subsidiary entities to separate and fulfill their direct qualifying distribution requirements.[628] For example, in Revenue Ruling 78-315, the private operating foundation (organized as a trust) operated a cultural center and formed a subsidiary corporation to carry out the operations of the center.[629] The subsidiary would receive property solely in its fiduciary capacity on behalf of the foundation, and any contracts for goods or services would be entered into in the same manner.[630] The IRS treated the subsidiary as a separate trustee and treated distributions to and from the subsidiary as distributions directly from the foundation, satisfying the foundation's qualifying distribution requirements.[631]

Furthermore, a private operating foundation can structure direct ownership in distinct subsidiary entities as a means to make direct qualifying distributions.[632] For example, in Private Letter Ruling 9834033, the foundation proposed to create an LLC with a public charity (50/50 ownership).[633] The IRS found that the foundation's ownership in the LLC was a program-related investment, and that such investment was made directly for the conduct of the activities constituting the foundation's exempt purposes because the foundation maintained significant involvement in the LLC.[634] In Private Letter Ruling 200431018, the private foundation proposed to operate its educational programs through a disregarded single-member LLC. The IRS concluded that distributions

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625. Woodhull & Reiderbach, *supra* note 603, at 27.

626. *Id.*

627. *Id.*

628. *See* Andrew F. Dana, *Structuring Separate and Subsidiary Entities for Private Operating Foundations*, 22 TAX'N EXEMPTS 33 (July/Aug. 2010), *available at* http://www.mldana.com/tax-research/mldana-tax-articles/structuring-separate-and-subsidiary-entities-for-private-operating foundations.pdf.

629. Rev. Rul. 78-315, 1978-2 C.B. 271; Dana, *supra* note 628, at 35.

630. Rev. Rul. 78-315, 1978-2 C.B. 271; Dana, *supra* note 628, at 35.

631. Rev. Rul. 78-315, 1978-2 C.B. 271; Dana, *supra* note 628, at 35.

632. Dana, *supra* note 628, at 33.

633. I.R.S. Priv. Ltr. Rul. 98-34-033 (Aug. 21, 1998).

634. *See id.*

made through the LLC for the educational program operations would constitute qualifying distributions directly for the active conduct of the foundation's exempt activities.[635]

4. Conversion or Sale of Taxable Subsidiary

The IRS will treat any conversion to tax-exempt status by a taxable corporation as a deemed sale resulting in corporate tax liability on the difference between the fair market value of the corporate assets and their adjusted basis pursuant to Code section 337(d).[636] Thus, if a tax-exempt organization purchases the stock of a taxable corporation, it has three choices on how to manage the subsidiary: (1) operate the business and pay corporate income taxes on the net taxable income of the business, with any excess earnings or profits distributed to the tax-exempt parent as a dividend; (2) liquidate the taxable subsidiary, which will result in a deemed sale of the assets and taxable gain equal to the fair market value of the assets less the adjusted tax basis of the assets (and the exempt organization can continue to operate the actual business activity, assuming it is not an unrelated trade or business); or (3) convert the taxable subsidiary into a separate tax-exempt organization, pay corporate income tax on the capital gain from the deemed sale, and operate the subsidiary as a related tax-exempt organization going forward.[637] However, there are more expenses with the third option, as the charity would have to pay tax on the gain realized in the deemed sale plus the expenses of setting up another exempt organization.[638] "If the tax-exempt purchaser wants [to purchase] and operate the business as a tax-exempt activity, it should try to negotiate a direct purchase of the assets of the taxable corporation rather" than its stock.[639]

E. Contribution Through Donor Advised Fund

A Donor Advised Fund (DAF) is a great alternative by which an individual donor can convert illiquid assets into philanthropic capital. Additionally, a private foundation may create a DAF to receive the types of assets it deems inappropriate to accept and manage itself.

Either an individual or another entity, such as a private foundation, creates a DAF by a gift to the sponsoring charitable organization that has legal control over the fund.[640] "The sponsoring organization typically is a

635. I.R.S. Priv. Ltr. Rul. 2004-31-018 (July 30, 2014); Dana, *supra* note 628, at 38.
636. Woodhull & Reiderbach, *supra* note 603, at 24.
637. *Id.* at 25.
638. *Id.* at 26.
639. *Id.*
640. Treas. Reg. § 1.170A-9(e)(11)(ii); *see* Levitt, *supra* note 412, at 3.

local community foundation or the charitable affiliate of a financial services provider."[641] The DAF agreement allows the donor (or someone the donor appoints) to advise the charity on what distributions to make from the DAF; however, the sponsoring public charity is the legal owner of the funds and thus has the ultimate control over the distributions.[642] Some "[s]ponsoring organizations may offer mission-related allocations within existing general investment pools, investment pools specifically dedicated to a mission-related purpose," and other options provided as an opportunity for donors to further their chosen social missions.[643] These options can be especially beneficial to a private foundation searching for a charitable receptacle to receive difficult-to-manage assets while still being able to fulfill its charitable purpose.

In addition to the charitable deduction benefits to individual donors, DAFs provide several advantages to either individual or private foundation donors: (i) DAFs are relatively simple and quick to establish; (ii) the sponsoring organization administers the fund, relieving the donor of the complexities of administration; (iii) the sponsor organization assumes all risk related to managing and investing the assets; and (iv) compliance with some of the strict private foundation requirements are not necessary.[644] The main disadvantage is that the donor must surrender absolute control over the fund, although the supporting organization has a practical incentive to cooperate with recommendations of the donor.[645]

DAF investments are subject to the UBIT rules explained above; however, mission-related investments avoid UBIT if they qualify as being substantially related to the charity's exempt purposes.[646] To otherwise avoid UBIT, the DAF should invest in assets meeting a statutory exception, such as limited partnership interests owning only passive investments.[647] "The sponsoring [public charity] would be responsible for reporting and paying any UBIT, although the tax presumably would be allocated to the individual DAF from which the investment [is] made."[648]

1. Individuals

If the organization—particularly a private foundation—decides it cannot accept the type of alternative asset the donor would like to contribute, the directors or planned giving officer may want to advise the

641. *See* Levitt, *supra* note 412, at 3.
642. *Id.*
643. *Id.* at 3–4.
644. HENKEL, *supra* note 413, ¶ 38.06 n.62.2a; Eileen R. Heisman, *Donor-Advised Funds Gain Popularity for Charitable Giving*, 41 EST. PLAN. 27, 28 (July 2014); *see supra* Part III.D.
645. HENKEL, *supra* note 413, ¶ 38.06 n.62.2a.
646. Levitt, *supra* note 412, at 10.
647. *Id.*
648. *Id.*

donor to contribute the assets to a community-based foundation or a DAF.[649] The donor would enter into an agreement that gives the donor (or others) the right to suggest, from time to time, to the organization the proposed recipients of distributions from the fund and the timing and amount of these distributions.[650]

To ensure that the IRS will treat the fund as a component fund of the particular public charity maintaining it, the agreement must provide that the charity is not required to follow the donor's advice and that the charity will have ultimate control over distributions from the fund.[651] In practice, the charity is likely to follow most, if not all, of the donor's suggestions.[652] However, an IRS ruling suggests that, in order for such a fund to qualify as an advise-and-consult fund that is not a private foundation, the charity maintaining the fund may be required, from time to time, to make distributions to organizations other than those suggested by the donor.[653]

An individual donor can take an immediate charitable contribution deduction in the year the gift to the DAF is made because the donated property becomes the property of the sponsoring organization upon donation.[654] Because public charities typically maintain DAFs, donors receive more favorable tax treatment for their contributions than if the donor made the same gift to a private foundation: a gift of property such as real estate or closely held business interests is entitled to a deduction for fair market value when contributed to a public charity—including a DAF—but limited to basis when making the same contribution to a private foundation.[655] In addition, the limits on a taxpayer's deductions that can be taken each year are greater than with a gift made to a private foundation (50% of AGI for cash and 30% for appreciated property, as opposed to 30% and 20%, respectively).[656]

DAFs can be a great approach for a donor in the year of a windfall, such as the receipt of a large inheritance or liquidation of a business, in order to reduce income tax burdens.[657] "If a donor were to liquidate securities and donate proceeds to [his or her] DAF, the amount would be reduced by capital gains," whereas, if the donor donated the securities

649. Lodge, *supra* note 4.

650. *I.R.S. Approves Deductions for Gifts to Charity Where Donor Obtains Right to Manage Investments*, NONPROFIT ISSUES (Nov. 2, 2004), https://www.nonprofitissues.com/public/features/leadfree/2004nov2-IS.html.

651. Craig Wruck & Helen Monroe, *Family Foundations: Donor Advised Funds and Supporting Organizations as Alternatives to Private Foundations*, PLANNED GIVING DESIGN CENTER (May 18, 2011), www.pgdc.com/pgdc/family-foundations-donor-advised-funds-and-supporting-organizations-alternatives-private-foundations.

652. *Id.*

653. Lodge, *supra* note 4.

654. *See* Levitt, *supra* note 412, at 3.

655. *See* Heisman, *supra* note 644, at 28–29.

656. *See id.* at 28.

657. *See id.* at 29.

directly to the DAF, the donor could avoid capital gains and allow the charity to sell the securities if desirable.[658]

For example, an Iowa farmer was looking to donate 15,000 bushels of soybeans to a charity.[659] He contacted a nonprofit consultant who procured a quote from a local commodities broker, and the farmer was able to make his donation through a DAF, receive his income tax deduction, and paid no capital gains tax on the sale of his soybeans.[660] Other examples include a Boeing 747, $800,000 of trees, and a Mexican beach house, all of which were steered into DAFs, so that the wealthy individuals could keep their liquid securities but still strategically make charitable gifts of assets they do not normally consider a key part of their overall wealth for everyday living expenses.[661] These methods provide a way for some individuals to make a larger gift than they could have made if solely relying on more liquid assets.[662] Additionally, the potential charitable deduction for the donor is greater when making a gift to a DAF than a private non-operating foundation, although this will really only matter to a donor whose charitable gift represents a significant portion of his or her adjusted gross income.[663]

2. Private Foundations

A private foundation may find a DAF useful in certain scenarios and can include the contribution as a qualifying distribution in the year of the DAF contribution.[664] It may also be possible for a foundation's distribution to a DAF to reduce its excise tax on net investment income from 2% to 1%.[665] The assets distributed to the DAF can then be advised over time, and the foundation avoids the complex management and oversight of assets that it does not have the resources to handle itself.[666] However, the private foundation should avoid just passing grants through a DAF or indefinitely parking assets in the DAF; rather, the foundation should approach the DAF with a consistent plan of contributing funds and recommending distributions to a variety of grantees.[667]

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658. *Id.* at 30.
659. Dagher, *supra* note 8.
660. *Id.*
661. *Id.*
662. *Id.*
663. Lesley Bosch Annen & Gary Garcia, *Family Foundation vs. Donor Advised Fund: Choosing the Right Philanthropic Entity for Your Client*, FAM. FOUND. ADVISOR, Mar./Apr. 2014, at 7. Gifts of long-term capital gain property other than publicly traded securities donated to a private non-operating foundation are limited to the donor's basis in the property, but a gift of the same property to a donor advised fund is not subject to the same restriction.
664. Levitt, *supra* note 412, at 3.
665. Choi, *supra* note 425, at 405.
666. *Id.*
667. *Id.*

F. Planned Giving Vehicles—Helping a Donor Find the Right Match

1. Family Limited Partnership

The donor may want to wrap up his interests in an entity, such as a family limited partnership, prior to making the donation to the charitable organization. The limited partnership (LP) form is favored in the oil and gas context, specifically because of the exemption from the Texas margin tax for passive income, such as nonparticipating interests like pure royalty interests.[668] The LP wrapper also provides the benefit of family succession planning and liability protection.[669] However, it is unlikely that the donor wants to hand over his or her family partnership to a charity but will want to retain at least some interests and control, to be able to pass down the interests through the family line. As discussed below, the donor should go one step further than just placing the interests in an LP in his or her charitable planning.

2. Charitable Lead Trust

The donor may be well advised to fund a charitable lead trust (CLT) with mineral interests or with limited partnership interests that have been funded with such assets. This would enable the income stream to flow to the charity, fulfilling the donor's charitable goals, and at the same time allowing his or her family to retain those interests at the end of the term, if that is also a goal of the donor. However, the donor must keep in mind that these assets should be income-producing assets in order to fulfill the annuity or unitrust payment obligations during the term of the CLT.

The CLT is an irrevocable trust/charitable giving mechanism that can be established during life or at the donor's death. This type of trust makes annual (or more often) payments to a charitable beneficiary for a number of years or for a life or lives in being at the trust's creation, and the remainder is paid to noncharitable beneficiaries, which may include (but is not limited to) the donor, the donor's estate, children, grandchildren, or other trust or trusts for children or grandchildren. The settlor of a CLT can name his children as trustees, and give them the discretion to choose the qualified charitable payout recipients each year, if he has the desire to benefit multiple charities or is not committed to a specific charity.[670]

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668. *See generally* Jeff Slade, *Drilling Down the Texas Margin Tax: A Gusher or Dry Hole of Taxes for the Oil and Gas Industry*, TEX. TAX LAW., Oct. 2008, at 28.

669. *See generally* John Hayes, *Protecting Your Family Limited Partnership*, PENDERSON & HOUPTY (Jan. 2005), http://www.pedersenhoupt.com/newsroom-publications-48.html (talking about the LP wrapper).

670. *See* I.R.S. Priv. Ltr. Rul. 96-04-015 (Oct. 27, 1996).

The initial charitable interest of the CLT must either be a guaranteed annuity interest (CLAT) or a unitrust interest (CLUT). During the term of a CLAT, the charitable payment is a fixed dollar amount or a fixed percentage of the initial net fair market value of the trust assets; during the term of a CLUT, the charitable payment is a fixed percentage of the net fair market value of the trust assets determined annually. In using CLTs for transferring wealth to a younger generation, CLATs tend to be more popular than CLUTs because (1) the present value of the annuity grows as the section 7520(a) rate falls; and (2) the annuity payout allows all growth in the value of the trust assets to be transferred downstream, free of gift and estate taxes (especially attractive when the CLAT holds appreciating assets).[671] Low interest rates are favorable to the use of a CLAT—the lower the Applicable Federal Rate (AFR), the higher the charitable income tax deduction.[672] However, the CLUT receives more favorable Generation Skipping Transfer (GST) tax treatment when transferring wealth two or more generations downstream.[673]

The CLT can be structured as either a grantor or non-grantor trust. A non-grantor CLT means the trust is a separate taxable entity, and the trust income will not be taxed to the grantor (donor).[674] The donor will not receive an income tax charitable deduction upon contribution to the trust, but will receive a gift tax deduction based on the present value of the stream of payments to be made to the charitable beneficiary.[675] The trust will receive an income tax charitable deduction for payments made to the charitable beneficiary(ies) from gross income.[676] However, a non-grantor CLT is subject to the UBIT rules discussed above.[677] For example, if a CLT owns an interest in an oil and gas limited partnership and the partnership must incur indebtedness to complete drilling of a new well, the CLT will have UBTI to the extent income arises from the debt-financed property. If the donor transfers debt-encumbered property to a non-grantor CLT, it will be considered a "'bargain sale' (considered a sale to charity for a price equal to the debt), whereas the transfer of such property to a grantor [CLT] is not a bargain sale, because there is no disposition of the property for tax purposes."[678]

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671. *See A Powerful Way to Plan: The Grantor Retained Annuity Trust*, MORGAN STANLEY (2011), http://www.morganstanleyfa.com/public/projectfiles/106f5bd9-6d48-44d0-b092-e0c71ace8ae5.pdf.

672. *See generally Low Interest Rates Make Charitable Lead Annuity Trusts Attractive*, LOEB & LOEB (Mar. 2009), http://www.loeb.com/articles-clientalertsreports-20090325-lowinterestratesmakecharitableleadannuitytrustsattractive (discussing low interest rates).

673. Jonathan G. Tidd, *The Ins and Outs of Charitable Lead Trusts – Making the Right Choices*, 119 J. TAX'N 20, 22 (2013).

674. *See generally id.* (explaining non-grantor trusts).

675. *Id.*

676. I.R.C. §§ 641, 642(c) (2012).

677. *Id.* § 642(c)(4).

678. Tidd, *supra* note 673, at 23.

A grantor CLT must be created during the donor's lifetime; this allows the donor an income tax and gift tax charitable deduction upon contribution to the trust. The grantor/donor "is taxed on the income from the trust as it is earned without a corresponding annual income tax charitable deduction."[679] Additionally, if the trustee distributes appreciated property in satisfaction of the required charitable payment, the donor will be taxed on capital gains from the assets distributed.[680] If the grantor dies during the trust term, in most cases, the CLT corpus will be included in the grantor's estate for federal estate tax purposes. However, this result can usually be avoided by granting the "swap" power to a nondisqualified person under the CLT terms.[681]

UBIT is not a concern with a grantor CLT, unlike the non-grantor CLT, because the grantor is taxed on the income.[682] Further, "[n]o income is recognized on the transfer of an installment obligation to a grantor lead trust, [a] grantor lead trust may hold S stock."[683] Family limited partnership interests can be used to fund either type of CLT; however, if there is debt on the partnership assets, the grantor CLT would be preferable to avoid the bargain sale rules and UBIT.[684]

Unlike a charitable remainder trust (CRT) and a private foundation, the CLT is not subject to the annual minimum distribution amount. However, the CLT is subject to the excise taxes applicable to a private foundation for self-dealing, excess business holdings, jeopardizing investments, and taxable expenditures.[685] For example, the donor must be careful to avoid self-dealing transactions when the CLT owns a general partner interest in a partnership, and the partnership engages in a transaction with a disqualified person.[686] Certain oil and gas interests, particularly working interests, can be considered jeopardizing investments and cause the CLT to be liable for excise taxes under these rules.[687]

In a CLAT, the annuity amount can fluctuate periodically, so long as the annuity percentage can be valued at the inception of the trust term; the

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679. Deren L. Worrell, Jeffrey N. Myers & Michael V. Bourland, *Charitable Lead Trusts,* BOURLAND, WALL & WENZEL (2009), http://www.bwwlaw.com/downloads/mvb/Charitable_Lead_Trust_outline.pdf.

680. Rev. Proc. 2007-45, 2007-2 C.B. 89.

681. *See generally* Michael V. Bourland & Shannon G. Guthrie, How to Coordinate Charitable Contribution Opportunities with Business Succession Planning: The Charitable Lead Trust, Presented to the 11th Annual Advanced ALI-ABA Course of Study (Aug. 1–3, 2002), *available at* http://www.bwwlaw.com/downloads/mvb/2002%20aliaba/2002%20CLTv13.htm (providing a framework for what a charitable lead trust consists of).

682. *See id.*

683. Tidd, *supra* note 673, at 23.

684. *See id.* at 24.

685. *See id.* at 26–27.

686. *See id.* at 27.

687. *See generally* I.R.C. § 4944 (2012) (providing information on taxes regarding investments that may jeopardize charitable purposes).

annuity can, therefore, be stated in the terms of a formula clause (more often seen in a testamentary CLT).[688] The drawback with a CLAT in this scenario is if the CLAT income is insufficient to pay the annuity payment to the charitable beneficiary, the trustee must make the distribution from corpus, meaning either a distribution in kind or cash from the sale of trust assets. This would be a very undesirable result if the CLAT trustee were forced to distribute the actual interests or family limited partnership units to the charity (or charities) that the donor used to fund the CLAT, expecting those assets to remain within the family at the end of the term. Even worse, if the CLAT borrows the money to make the payment, there will be UBIT ramifications (debt-financed income). If the CLAT does make a payment in kind, the charity should not sell back the asset to the donor, due to the self-dealing rules.

Contrast this with a CLUT, in which the amount to be paid to the charitable recipient is a fixed percentage of the fair market value of the trust's assets valued annually. When funding a CLT with unique assets, the CLUT has two advantages over the CLAT form: first, the trust assets are revalued each year, and thus the fluctuation in value of the CLUT's interests would not be critical to the CLUT; and second, the donor can make additional contributions to a CLUT, but not to a CLAT.

The foundation and donor should both be on alert when the CLT is set up to pay out to a private foundation and the settlor of the CLT is a board member or officer of the foundation. The donor/settlor may be subject to inclusion of the assets within the CLT, due to Code section 2036, if he has any kind of discretion in how the funds received from the CLT will be distributed.[689] Thus, the settlor in such a case should distance himself from any control over the assets (or earnings on those assets) paid to the foundation from his CLT.[690]

3. Charitable Remainder Trust

The primary disadvantage of the charitable remainder trust (CRT) planning vehicle is that the donor must give up access to the principal asset held in the CRT and can only receive the formula distributions from the CRT under the annuity or unitrust payouts.[691] The primary benefit, depending on the asset within the CRT, may be the ability to defer capital gains tax.[692] The CRT may be funded with appreciated assets, then when

688. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 91-12-009 (Mar. 22, 1991).

689. Tidd, *supra* note 673, at 22.

690. *Id.*

691. *See* David Wheeler Newman, *Rebirth of the Charitable Remainder Trust*, PLANNED GIVING DESIGN CENTER, http://www.pgdc.com/pgdc/rebirth-charitable-remainder-trust-0 (last visited Oct. 24, 2014).

692. *Id.*

the CRT sells the assets, this vehicle allows for "reinvestment of the full before-tax proceeds to produce income" and tax deferral.[693]

For clients with publicly traded stocks who are willing to give to a charitable organization, the CRT may be the perfect giving vehicle. However, the CRT would not be suggested as a viable planning option to use when making a gift involving unique assets, and particularly an asset that the donor would like to receive back or retain in the family, such as closely held business interests.

When using a charitable remainder annuity trust (CRAT), there must not be a greater than 5% chance that the trust funds will be exhausted before the end of the trust term.[694] This presents a potential problem when funding with an item such as mineral interests because if the lease payments end during the trust term, the trustee may need to make distributions in kind to the noncharitable beneficiaries, and be left with zero assets for the charitable remainder beneficiary. With a charitable remainder unitrust (CRUT), the donor can add more assets to the trust to ensure that there is a benefit remaining for the charity.[695] However, it may be difficult to even qualify the trust as a CRT when funding it with something like mineral interests, due to the speculative nature of the future value of such interests.[696] For example, if a donor has mineral interests that are currently producing, the donor likely wants the benefits to flow to the charity now, rather than in fifteen or twenty years, because by the time the CRT term has ended, the wells may have stopped producing, the lease may have terminated, and the interests may no longer be valuable. There may be little or nothing left for the charity at the end of the term.

Further, the donor likely does not want the charitable beneficiary to end up with his mineral interests at the end of the CRT term. In comparison to a CLT, the CLT would be a better alternative than using a CRT as the gifting vehicle for these interests, because the donor's family can be the remainder beneficiary in a CLT.

Code section 4947 also treats CRTs as private foundations.[697] Thus, they are subject to the self-dealing excise taxes of section 4941.[698] The substantial investment entities of CRTs are indirectly treated as disqualified persons if the principal beneficiary of the CRT is deemed, although indirectly, to own more than 35%.[699]

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693. *Id.*

694. *See* I.R.C. § 664(d) (2012); Treas. Reg. §§ 1.664-1 (as amended in 2011), 1.664-2 (as amended in 2011); Marc D. Hoffman, *Charitable Remainder Trust*, PLANNED GIVING DESIGN CENTER (May 5, 2003), http://www.pgdc.com/pgdc/charitable-remainder-trusts.

695. *See* I.R.C. § 664(d); Treas. Reg. § 1.664-3 (as amended in 2004).

696. *See* I.R.C. § 664(d); Treas. Reg. § 1.664-3.

697. *See* I.R.C. § 4947(a)(2) (2012).

698. *See id.*

699. *See* I.R.S. Priv. Ltr. Rul. 2003-15-028 (Jan. 13, 2003); *cf.* I.R.S. Priv. Ltr. Rul. 2002-30-004 (Apr. 10, 2002).

Finally, CRTs must pay tax on any UBTI it receives.[700] Due to CRT's increased sensitivity to UBTI, the investment industry has become accustomed to using "blocker" entities when the investment firm wants to use leverage in the use of fund investments (which is usually the case).[701] If leverage is used, the income is UDFI; thus, the fund establishes a foreign corporation, usually in Bermuda or the Cayman Islands, to own 10% of the fund.[702] Exempt organizations, including CRTs, can invest in the stock of the foreign corporation holding that 10% of the fund.[703] Any income the foreign corporation realizes is not subject to U.S. income tax, under the portfolio exemptions.[704] A foreign entity will only bear U.S. income tax on the portion of its income that is effectively connected with a trade or business in the U.S.[705] The dividends received are not treated as UBTI to the CRT under the dividend exception of section 512(b)(1).[706]

4. Charitable Gift Annuity

Like the CRT, a charitable gift annuity (CGA) also may not be a recommended planned giving technique for unique assets that do not produce much of an income stream. A CGA is a present interest gift in the form of a contract wherein property is given outright to charity in return for a promise to pay an annuity for life.[707] The donor is essentially gifting his interests or FLP units, which he will not receive back, nor will it remain in the family.[708]

Unless the CGA is funded with cash, there is an asset risk.[709] The risk is minimal with "publicly-traded securities because they generally don't lose much of their value during the short interval between their receipt and sale."[710] The asset risk is greater when a charity accepts "real estate, collectables, closely held stock, or some other illiquid asset for a gift annuity."[711]

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700. *See* Gregory W. Baker & Ted R. Batson, *Charitable Remainder Trust Handbook*, RENAISSANCE (2006), http://www.charitabletrust.com/pdf/CRT-Handbook.pdf.

701. Caudill, *supra* note 207, at 35–36.

702. *See* I.R.S. Priv. Ltr. Rul. 2003-15-028 (Jan. 13, 2003).

703. *See id.*

704. *See id.*

705. *See id.*

706. *Id.*

707. *See* Terry L. Simmons, *Planning Opportunities with Gift Annuities*, SJ087 A.L.I.-A.B.A. 171, 180 (2004); *Charitable Gift Annuities*, FIDELITY CHARITABLE, http://www.fidelitycharitable.org/giving-strategies/give/charitable-gift-annuities.shtml (last visited Oct. 10, 2014).

708. *See id.*

709. Frank Minton, *Maximizing the Benefits From Your Gift Annuity Program*, PLANNED GIVING DESIGN CENTER (June 2, 2004), http://www.pgdc.com/pgdc/maximizing-benefits-your-gift-annuity-program.

710. *Id.*

711. *Id.*

The CGA could potentially be funded with partnership units owning mineral interests; however, it may not be wise to rely on the annual production of the minerals to satisfy the annuity obligation over the long term. If this method is chosen, the charity should "set a payout rate that is significantly lower than current income from production so that a 'reserve amount' may be accumulated before the production from the interests start to decline."[712] It would also be helpful to fund the CGA with other assets, which could be used to satisfy the annuity as the minerals deplete.[713]

The charity will have to advance its own funds for an indeterminate period of time, it will realize net sales proceeds of an uncertain amount, and it may have to pay expenses associated with owning and maintaining the asset, as well as commissions and other selling costs equal to 10% or more of the proceeds.[714] Therefore, "unless steps are taken to mitigate the risk, such as offering a lower gift annuity rate, the charity could wind up losing money because the net proceeds are too small to sustain the annuity payments."[715]

5. Intentionally Defective Grantor Trust

A donor may be able to effectively coordinate his estate planning objectives with his charitable goals through the creation of an intentionally defective grantor trust (IDGT). Ordinarily, the irrevocable trust, or IDGT, is created to remove assets from the grantor/creator's estate for both federal income tax and estate tax purposes. The IDGT is structured so that the value of its assets are excluded from the creator's estate for federal estate tax purposes but considered owned by the creator (settlor-IDGT or S-IDGT) for federal income tax purposes. Ownership for income tax purposes is achieved by "intentionally" subjecting the trust to one of the income tax grantor trust rules under the Code so that both the income and principal portions of the trust are income, and taxed directly to the creator. The effect of having the creator taxed on trust income is that the trust's capital base is not eroded through income tax because the creator pays the income tax on all trust income while the trust is a grantor trust. Additionally, the IRS disregards certain transactions between the creator and trust for federal income tax purposes.

Under the S-IDGT, the creator is taxed as the owner for federal income tax purposes, typically funded with a portion of the creator's lifetime exemption amount. The creator can establish this type of trust for the benefit of his family and can allocate a GST tax exemption to gifts made to the trust. If a GST tax exemption is allocated to the trust, the value of the

712. Hancock, *supra* note 9, at 11.
713. *See id.*
714. *See id.*
715. *Id.*

trust assets (initial and appreciation) are removed from the creator's estate for federal estate tax purposes, and from the estates of his children and grandchildren. The creator may be the initial trustee, with the ability to distribute income and principal for the health, education, maintenance and support of the beneficiaries.

Furthermore, the creator of the S-IDGT may appoint a separate, special "charitable trustee" who is given the authority to make decisions regarding distributions to charitable beneficiaries, independent from the regular trustee. While the creator cannot require the charitable trustee to make certain distributions, the charitable trustee's duty is to satisfy the creator's intentions that the trust be in part used for charitable purposes. As such, the creator's charitable vision should be effectuated through the use of a charitable trustee, particularly when he has appointed a "friendly" trustee in this capacity.

Another advantage of the S-IDGT is its ability to purchase assets from the deemed owner for income tax purposes (i.e. the creator) in a non-income taxable event. When a standard promissory note is used, assets are sold to the S-IDGT in exchange for a promissory note that is secured by the S-IDGT's assets. The note would provide for periodic (at least annual) payments. The cash flow generated by the sold asset and other S-IDGT assets would be utilized to make the note payments. If the creator/owner dies prior to the promissory note being completely satisfied, only the promissory note's remaining value at his death is included in his gross estate for federal estate tax purposes.

Thus, the creator/owner could potentially either gift, through the use of his lifetime exemption amount, or sell to the S-IDGT a block of his mineral interest assets—whether held outright or in some other entity wrapper—that he thinks will appreciate or have some major liquidity event in the future. While this will remove the value of those assets from the creator's estate, any income stream from the assets can be used to fulfill the charitable goals through the actions of the charitable trustee.

For instance, if the creator/donor establishes this type of trust with an initial gift of $5,000 and thereafter sells to the S-IDGT a block of his family partnership units, other entity interests or mineral interests in exchange for a note, when the assets sold to the trust later begin producing income, the charitable trustee can independently decide to distribute income to the creator/donor's private family foundation or to other charitable organizations, in line with the creator's charitable inclinations. Also, the assets, and their income, can be held within the trust for the benefit of the creator's family, if and until the trustee decides to make a distribution for their benefit under the discretionary standard of distributions. If the donor owns S Corporation stock, the grantor trust is a great place to store these assets and avoid UBIT; the tax rates applicable to the stock inside the S-IDGT will be the same as the individual grantor/donor's tax rates, and the

charitable powerholder function can be used to move value generated by the stock to the intended charitable beneficiary, without passing along the UBIT consequences, which would occur if the donor directly donated the stock to the charity.

In addition, the S-IDGT and the grantor/creator are the same person for income tax purposes, due to the unique nature of this type of trust. This technique allows the alternative assets to remain in trust for the benefit of the creator-donor's family, but also allows income from those assets to be distributed to charitable beneficiaries, with the income tax benefits flowing to the creator-donor. The charitable beneficiaries should be pleased that they are receiving the economic benefits of these mineral assets, but they do not have to manage or finance the ownership of them.

The S-IDGT technique can also be used in conjunction with a CLT. For example, the remainder beneficiary of a CLT can be a non-GST IDGT, whose income is taxable to the grantor/donor (i.e., the S-IDGT technique outlined above) or an IDGT structured so that its income is taxable to the beneficiary. Thus, at the end of the charitable term, the remainder is paid out to the IDGT for the benefit of the donor's family or other chosen beneficiaries. Using the non-GST IDGT as the remainder beneficiary, rather than individuals, provides creditor protection and further family succession planning for those assets. Alternatively, the CLT could sell its interests (either LP units or mineral interests) to a GST IDGT in exchange for a promissory note, the length of which would track the length of the charitable lead term. The interest rate on the note should be the AFR or such rate that when combined with the note principal payments is sufficient to provide the CLT with its annuity or unitrust payments. The CLT then receives note payments from the GST IDGT and uses those payments to make the annuity or unitrust payments to the charitable term beneficiary. Using a CLT along with an IDGT provides for a unique opportunity for the donor to integrate his or her charitable goals, along with some estate planning, for a maximization of income tax benefits and charitable intentions.

V. DONOR'S CONCERNS

This section discusses the common concerns donors have with making a gift of illiquid assets. Some of these concerns also morph into concerns of the charitable donee, in that the organization would like to have the economic benefit of the donor's valuable assets but may not be able to receive them due to the donor not understanding how to manage his own concerns regarding the contribution.

A. Partial Interest Rule

Under the partial interest rule, a charitable deduction is generally not allowed if the donor transfers an interest in property to a charity while retaining an interest in that property, or transfers another interest in the property to a noncharity for less than full and adequate consideration.[716] The IRS allows an income tax, estate tax, gift tax, or GST tax deduction for the value of split-interest gifts going to a qualified charity only if made in one of the qualified forms, such as CLT, CRT, CGA, or a qualified remainder interest in personal residence or family farm. In order to avoid the partial interest rule, the donor must transfer an undivided interest in everything he owns to the donee. A contribution of a partial interest of the donor's entire interest in property "must consist of a fraction or percentage of each substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted."[717] If the parties do not comply with the partial interest rule, the IRS will not allow a charitable income tax deduction for the donor.[718]

For example, the donor may not retain the mineral rights while making a gift of the surface (or vice-versa). Thus, if the donor owns both the surface and mineral estate, he must gift a portion of each. Moreover, the donor may not sever these rights in anticipation of giving one interest to the charity and retaining the other interest, such as through the use of a partnership.[719] The IRS will allow a deduction if such partial interest is the taxpayer's entire interest in the property, such as an income or remainder interest; however, the IRS will disallow a deduction if the donor divided the property in order to create such separate interest and avoid the consequences of section 170(f)(3).[720]

This rule can become frustrating not only to the donor but also to the intended charitable recipient. The donor may decide to not make a gift at all due to the complexity of having to donate the surface estate along with the mineral interests, or if the donor decides to make a gift of both interests as he must, the charity may find the surface estate very undesirable. In that instance, receiving a gift of the surface estate can cause additional headaches; the charity may wish to sell the surface and retain the minerals, or in the case of a testamentary gift, the charity may disclaim the gift of the surface estate but keep the bequest of the mineral interests.

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716. *See* Treas. Reg. § 1.170A-7(a)(1)–(2) (as amended in 1994).
717. *Id.* § 1.170A-7.
718. *See id.*
719. *See id.*
720. *See id.*

B. Valuation and Substantiation

The IRS has recently become more concerned that taxpayers are over-valuing noncash contributions and not properly reporting the deductions pursuant to the substantiation requirements.[721] Congress is particularly concerned that donors use the fair market value for their deductions of property that are not used to further the charitable donee's exempt purposes, and the IRS is suspicious that the donee is complicit in these abuses.[722] The IRS is expanding its procedures to identify deficient income tax returns and appraisals, so donors should be even more careful when reporting their charitable deductions.[723]

In order for a donor to claim an income tax deduction for a charitable gift (cash or property), the donor must: (1) keep some type of record of the donation; (2) obtain a written acknowledgement of the gift from the donee; and (3) in quid pro quo contributions over $75, obtain a written disclosure from the charitable donee.[724] The written record or receipt from the donee should include: (1) the name of the donee; (2) the date and location of the contribution, if a gift is of noncash property; and (3) the amount of the contribution or, if it was a gift of property, a description of the property in detail (estimated value is not required to be stated on the receipt).[725] For a contribution of $250 or more, the donor must obtain a contemporaneous, written acknowledgement from the charitable organization in order to claim the tax deduction, pursuant to Code section 170(f)(8).[726]

A donor must procure an appraisal as part of completing Form 8283 when claiming contributions of noncash items over $500, and the donor must include such appraisal as an attachment to his or her income tax return when claiming a deduction for a noncash gift that exceeds $5,000.[727] The donee and the qualified appraiser must also sign and date such form.[728]

In such instances, the IRS requires the donor to: (1) obtain a "qualified appraisal" for the contributed property; (2) attach a complete appraisal summary to the income tax return on which the donor is first claiming the deduction (IRS Form 8283); and (3) maintain records, including certain specific information regarding the contribution.[729]

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721. *See* Treasury Inspector General for Tax Administration, *Many Taxpayers Are Still Not Complying with Noncash Charitable Contribution Reporting Requirements*, U.S. DEP'T TREASURY 1–3 (Dec. 20, 2012), http://www.treasury.gov/tigta/auditreports/2013reports/201340009_oa_highlights.pdf.

722. *See generally id.* (discussing the taxpayer's requirements for proving contributions).

723. *See id.*

724. *See* I.R.S. Pub. 1771 (Jan. 1, 2012).

725. *See* Treasury Inspector General for Tax Administration, *supra* note 721, at 2.

726. *See* I.R.C. § 170(f)(8) (2012).

727. *See* Treasury Inspector General for Tax Administration, *supra* note 721, at 1–2.

728. *See id.* at 2.

729. *See* I.R.C. § 170(f)(8), (11); Treas. Reg. § 1.170A-13 (as amended in 1996).

In order to be a qualified appraisal, the appraisal must be made no earlier than sixty days prior to the date of the contribution; be prepared, signed, and dated by a qualified appraiser; and include certain required information about the appraised property.[730] Treasury Regulation section 1.170A-13 sets forth the list of requirements for a qualified appraisal.[731] As discussed in Part III.B of this article, the donor and the donee should work together to obtain a proper appraisal of the contributed items.[732]

Finally, when it disposes of the contributed property within three years of the donation, the charitable organization must file Form 8282 to report the amount it received on disposition.[733] If the amount claimed by the donor on Form 8283 greatly exceeds the amount received by the charity as reported on Form 8282, the IRS may "have grounds to question the validity of the donor's claimed deduction," although it may be shown to simply result from market conditions when dealing with an asset of this type.[734]

C. Deduction Limits

The federal gift and estate tax deduction is without limit, other than the amount of the transfer itself, and the IRS grants the deduction without distinguishing between the types of charitable beneficiary.[735] However, under Code section 170(e), the type of contributed property and the type of charitable donee determine the amount of the donor's income tax charitable deduction.[736]

All contributions of ordinary income property to a charitable organization must be reduced by the amount of ordinary income or short-term capital gain that the donor would have recognized had the contributed property been sold at its fair market value at the time of contribution.[737] The amount of the contribution of the donor's deduction is effectively limited to basis for property that is not a long-term capital asset.[738] This includes gifts of property such as crops, dealer property, inventory, and capital assets held for one year or less.[739] A donor is entitled to a charitable deduction of the greater of fair market value or basis for a contribution of tangible personal property, which will be put to a use related to the donee's exempt

730. Treas. Reg. § 1.170A-13(c)(3).
731. *See id.*
732. *See supra* Part III.B.
733. Treas. Reg. § 1.170A-13.
734. *See* Hancock, *supra* note 9, at 11.
735. *See* Treas. Reg. § 1.170A-1(a) (as amended in 2008). The amount of the estate tax deduction may not be more than the value of the property included in the decedent's gross estate. *Id.*
736. I.R.C. § 170(e) (2012).
737. *See* Treas. Reg. § 1.170A-4 (as amended in 1994).
738. *Id.* § 1.170A-4(b).
739. *See id.*

purposes.[740] If the organization does not use the property to a related use, the IRS limits the donor's deduction to the property's basis.[741] The IRS considers items such as royalties and partnership interests to be intangible personal property, and thus, these types of properties would not come under this special rule for tangible personal property.[742]

Contributions of capital gain property generally are deductible at the asset's fair market value.[743] Capital gain property is defined as capital assets held for more than one year.[744] "Capital assets include most items of property [a donor] own[s] and use[s] for personal purposes or investment," such as "stocks, bonds, jewelry, coin or stamp collections, and cars or furniture used for personal purposes."[745] "[C]apital assets also include certain real property and depreciable property used in the [donor's] trade or business and, generally, held more than 1 year"—although in certain circumstances the donor may have to treat this property as partly ordinary income property and partly capital gain property.[746] "Real property is land and generally anything built on, growing on, or attached to land."[747]

In the following circumstances, the fair market value of a capital gain asset being donated must be reduced by the amount that would have been long-term capital gain if the donor had sold the property for its fair market value on the date of the contribution.[748] Generally, this means that the fair market value will be reduced to the property's cost or other basis, which is required if:

> 1. The property (other than qualified appreciated stock) is contributed to certain private nonoperating foundations,
> 2. [The donor] choose[s] the 50% limit instead of the special 30% limit for capital gain property [when making a contribution to a public charity or other 50% organization],
> 3. The contributed property is intellectual property . . . ,
> 4. The contributed property is taxidermy property. . . or
> 5. The contributed property is tangible personal property that is put to an unrelated use . . . by the charity, or [h]as a claimed value of more than $5,000 and is sold, traded, or otherwise disposed of by the qualified organization during the year [of the] contribution, and the qualified

740. *See* Marc D. Hoffman, *Tangible Personal Property*, PLANNED GIVING DESIGN CENTER, http://www.pgdc.com/pgdc/tangible-personal-property (last updated Sept. 16, 2012).
741. *Id.*
742. *See id.*
743. *See* I.R.S. Pub. 526 (Nov. 12, 2013).
744. *See id.*
745. *Id.*
746. *Id.*
747. *Id.*
748. *Id.*

> organization has not made the required certification of exempt use . . . .[749]

Additionally, the donor's income tax deduction is limited to a portion of the donor's adjusted gross income (AGI) for each year, but the donor may be able to carry forward to subsequent years the excess contributions.[750] A donor is generally limited to 50% of his AGI when making a gift of cash or nonappreciated property to a public charity or private operating foundation (50% organization); a gift of long-term capital gain property to the same organization will be limited to 30% of the donor's AGI.[751]

When the charitable donee is a private non-operating foundation, a donor is limited to 30% of his AGI for a gift of cash or property, other than appreciated property.[752] For gifts of appreciated property, the deduction is capped at 20% of the donor's AGI for the year.[753] The contribution deduction for gifts of appreciated property to a private non-operating foundation is further limited in that a donation of capital gain property—such as real estate held for more than one year—is limited to the lesser of the donor's basis in the asset or its fair market value, unless the asset is a qualified publicly traded stock.[754]

The excess of the allowable deduction(s) may be carried forward for five years, and must be deducted in a certain order: (1) the remaining 50% of gifts in excess of the current year's 50% gifts (earliest year first); (2) carryovers of gifts to 30% charities; (3) carryovers of the long-term capital gains property gifts limited to 30%; and (4) carryovers of the long-term capital property gifts limited to 20% of the contribution base.[755]

The American Taxpayer Relief Act of 2012 reinstated the Pease Limitation.[756] Subject to the limitations noted above, a donor's federal income tax deduction for a gift to a qualified charity in any year is further reduced by the lesser of 80% of the donor's itemized deductions for that year (excluding medical expenses, investment interest, wagering losses in excess of wagering gains, and casualty losses) or 3% of the amount by which the donor's AGI for that year exceeds that year's AGI Threshold Amount (i.e. married filing jointly: $300,000).[757]

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749. *Id.* at 12.

750. *See id.*

751. *See id.*

752. *See id.*

753. *See id.*

754. *See* I.R.C. § 170(e)(1)(B)(ii) (2012).

755. *Id.* § 170(d); Treas. Reg. § 1.170A-8 (as amended in 1972).

756. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 (codified as amended in scattered sections of the I.R.C.).

757. *See* I.R.C. § 68(a)–(c) (2012). Compare to the scenario of an estate payable to a qualified charity: The value of property transferred at death to a qualified charity is 100% deductible in

1. Mineral Interests

When making an outright gift of mineral interests, the donor must answer several questions in order to navigate the maze of the deductibility of his interests: (1) Is the interest real property or personal property?; (2) Is the interest a capital gain asset or ordinary income asset?; and (3) Is the interest tangible or intangible personal property?[758] As outlined earlier, mineral interests in place are considered real property under Texas law; however, once severed from the surface, they become personal property.[759] "Tangible personal property" for purposes of the IRS is "any property, other than land or buildings, that can be seen or touched."[760] This is distinguishable from intangible personal property, which is an item such as securities, currency, other negotiable instruments, royalties, and partnership interests.[761] Intangible personal property items are not subject to the special rule for tangible personal property items put to an unrelated use by the charity recipient.[762] It is only when tangible personal property is being put to a related use by the donee charity that the donor is allowed a fair market value deduction for that contribution.[763] "Unrelated use" means a use unrelated to the exempt purpose or function of the charitable organization.[764] If the charity sells the tangible personal property asset and uses the proceeds for the charity's exempt purposes, the IRS considers this an unrelated use, and will limit the deduction to basis.[765]

A donor contributing a royalty interest or net profits interest (i.e. an intangible personal property asset), or a gift of a fee simple interest in realty (i.e. the surface estate and mineral estate) can claim a charitable deduction for the fair market value of the interest if the donor has held the interest for over one year.[766] However, the fair market value of a capital gain asset being donated must be reduced by any amount that would have been long-term capital gain if the donor had sold the property for its fair market value when contributed to a non-operating private foundation.[767] If the same interest is held for less than a year, the donor must reduce the fair market

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determining the amount of federal estate tax. Michael V. Bourland, Estate Planning for the Family Business Owner, Presented to the 14th Annual Advanced ALI-ABA Course of Study (July 13–15, 2002).

758. *See generally* I.R.S. Pub. 526 (Nov. 12, 2013) (discussing different types of property deductions).

759. *See* SHADE & BLACKWELL, *supra* note 17.

760. I.R.S. Pub. 526 (Nov. 12, 2013).

761. *See* Marc Hoffman, *Intangible Personal Property*, PLANNED GIVING DESIGN CENTER, http://www.pgdc.com/pgdc/intangible-personal-property (last updated Sept. 15, 2012).

762. *Id.*

763. *See* Hoffman, *supra* note 740.

764. *Id.*; I.R.C. § 170(e) (2012).

765. *See* I.R.S. Pub. 526 (Nov. 12, 2013); Hoffman, *supra* note 740.

766. I.R.C. § 170(e).

767. *Id.*

value by the amount of ordinary income or short-term capital gain that the donor would have recognized had it been sold at its fair market value.[768] Therefore, depending on the type of interest being contributed, and if the contribution is made to a charity outright, a donor may be limited to deducting the basis in his mineral asset donated outright to a charitable organization under the foregoing rules.

A donor who is also an operator (i.e. those actively engaged in the business of drilling wells for oil and gas production, rather than merely holding an interest as a personal investment) will be limited to a deduction in the amount of his or her cost basis.[769] However, an operator/donor can "deduct any long-term capital gains, if the interest can be treated as real estate used in a trade or business."[770]

Donors must also be wary of the quid pro quo and bargain sale rules when receiving something in return for a contribution. A bargain sale is "partly a charitable contribution and partly a sale or exchange," which may result in taxable gain to the donor.[771] A donor should avoid a gift of production payments, or working interests subject to production payments, as these transfers can give rise to UBIT.[772] A donor may want to consider a gift of a "carried" working interest, which completely relieves the charity from its share of drilling expenses and development costs, so that this gift will be excluded from the definition of unrelated business income, protecting the charity from the penalties under the Code.[773]

Finally, the donor should avoid making a gift of property, which he plans on selling, after the sale has become subject to a binding commitment.[774] In that instance, the donor will be treated as having assigned his income from the sale to the charitable donee and will be treated, for tax purposes, as though he made a gift after engaging in a taxable sale, such that the donor does not end up shifting the capital gains tax burden as would otherwise be possible.[775]

2. Other Tangible Personal Property

If the donor is contributing land along with the mineral interests, the gift may include items such as livestock, crops, timber, or other agricultural products. Tangible personal property is "any property, other than land or buildings, that can be seen or touched," that would potentially include these

768. I.R.S. Pub. 526 (Nov. 12, 2013).
769. I.R.C. § 170(e)(2).
770. Hancock, *supra* note 9, at 9.
771. I.R.S. Pub. 526 (Nov. 12, 2013).
772. Buchanan, *supra* note 64, at 578.
773. *Id.* at 577–78.
774. Marc Hoffman, *Real Property*, PLANNED GIVING DESIGN CENTER (Apr. 9, 2009), http://www.pgdc.com//pgdc/real-property.
775. *See id.*

items.[776] If tangible personal property cannot be put to a use related to the tax-exempt purposes of the charitable donee, the donor will be limited to a deduction of his or her cost basis.[777]

Additionally, if donated tangible personal property, for which the donor claimed more than a $5,000.00 deduction and which was identified as related use property on Form 8283, is sold or disposed of by the charitable donee within the taxable year of the contribution, and the donee has not certified (such as on Form 8282) that the use of the property was related to its exempt purposes or stated that such intended related use was impossible, then the property is deemed to be unrelated use tangible personal property for these rules.[778] If this same property is disposed of by the charity after the year of the contribution, but within three years of the contribution date, unless this related use certification is made, the donor must recapture "the charitable deduction in an amount equal to the difference between the amount claimed as a deduction and the property's basis."[779] "The donor must include [such] amount in ordinary income in the year in which the disposition occurs."[780]

Grazing animals are considered livestock, including "cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals."[781] However, livestock "does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc."[782] If the taxpayer uses the livestock for draft, breeding, dairy, or sporting purposes, the taxpayer may be eligible for long-term capital gain treatment if: (1) he held for "24 months or more from the date of acquisition in the cases of cattle or horses," or (2) held "for 12 months or more from the date of acquisition in the case of other livestock."[783] Thus, a gift of qualified livestock may qualify for a full fair market value deduction if given to a related-use public charity.[784]

Crops are defined "as plants that can be grown and harvested or picked to be consumed or sold."[785] "'[U]nharvested' crops sold with the land on which [they] are located (and which has been owned by the seller for more than one year) are considered long-term capital gain property."[786] Thus, if

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776. I.R.S. Pub. 526 (Nov. 12, 2013).

777. *Id.*

778. *See* Edward J. Beckwith, Turney P. Berry & Michele W. McKinnom, *Selecting the Best Charitable Donee: Public Charity, Donor Advised Fund or Private Foundation*, SS007 A.L.I.-A.B.A. 369 (2010).

779. *Id.*; *see* I.R.S. Pub. 526 (Nov. 12, 2013).

780. *See* Beckwith, Berry & McKinnom, *supra* note 778.

781. Marc D. Hoffman, *Tangible Personal Property*, PLANNED GIVING DESIGN CENTER, http://www.pgdc.com/pgdc/tangible-personal-property (last updated Sept. 16, 2012).

782. Treas. Reg. § 1.1231-2(a)(3) (as amended in 1971); I.R.C. § 1231 (2012).

783. *Id.*

784. Hoffman, *supra* note 740.

785. *Id.*

786. *Id.* (citing Treas. Reg. § 1.1231-1(a)).

the donor contributes land containing unharvested crops, held more than a year, to a public charity, he is entitled to a fair market value deduction.[787] The donor is also subject to the 30% AGI limitation.[788] It is immaterial as to what use the charity places the crops because "they are not considered tangible personal property" in this instance.[789] If the crops have already been harvested, they are considered tangible personal property, subject to the rules stated above.[790]

Contributions of timber present a complexity as to the amount to be deducted when a donor's land includes this type of asset.[791] "Standing timber on land held by the taxpayer primarily for investment purposes is considered a capital asset." If the timberland and its standing timber are held for more than one year and contributed to a public charity, the donor's deduction would be based on the property's fair market value and subject to the 30% limitation.[792] If the timber is contributed to another organization, the deduction would still be effectively limited to the donor's basis.[793] Because "[s]tanding timber itself is not considered tangible personal property," the charity's use of the same is irrelevant.[794] However, if the timber has been cut and the donor is not engaged in the timber business, the timber would be considered tangible personal property.[795] If that property has not been held long term or if the timber is given to a charity that puts it to an unrelated use, the deduction will be limited to the lesser of the donor's basis or the timber's fair market value.[796]

3. Charitable Lead Trust

As previously mentioned, a CLT can be structured as either a grantor or non-grantor trust. A non-grantor CLT means the trust is a separate taxable entity, and the trust income will not be taxed to the grantor (donor). The donor will not receive an income tax charitable deduction upon contribution to the trust but will receive a gift tax deduction based on the present value of the stream of payments to be made to the charitable beneficiary.[797] The trust will receive an income tax charitable deduction for

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787. *Id.*

788. *Id.*

789. *Id.* However, be wary of the UBIT consequences when the charity looks to sell the crops.

790. *Id.* However, if produced for sale in a trade or business, the crops would be considered ordinary income property, and the deduction would be limited to the lesser of cost basis or fair market value, regardless of the charity's use of them.

791. *Id.*

792. *Id.*

793. *Id.*

794. *Id.*

795. *See id.*

796. *Id.* In the case of timber that is cut and held for sale to customers, the rules become more complex, which is not addressed in this article. *Id.*

797. *See* I.R.C. § 170(f) (2012).

payments made to the charitable beneficiary(ies) from gross income.[798] A grantor CLT allows the donor an income tax and gift tax charitable deduction upon contribution to the trust.[799] The grantor/donor is taxed on income from the trust as it is earned, without a corresponding annual income tax charitable deduction.[800] "The extent to which a grantor is taxed on the income and capital gains of the CLT depends on the grantor's power over the trust."[801]

4. Charitable Remainder Trust

When making a gift via a CRT,

> [t]he value of the donor's federal income tax deduction is a function of: 1) the type of charitable remainderman; 2) the kind of property contributed to the CRT; and 3) whether, at the end of the non charitable term, the assets are: a) distributed outright to the charitable remainderman; or b) held in trust for the benefit of the charitable remainderman.[802]

If the remainder is to be paid out to a public charity, the donor is entitled to a federal income tax deduction for the fair market value of the remainder interest.[803] A gift of cash or nonappreciated property would be subject to the 50% AGI limitation, if the remainder passes outright, or the 30% AGI limitation, if it is held in trust, with a five year carry-forward.[804] Gifts of appreciated property would be subject to the 30% AGI limitation, if the remainder passes outright, or the 20% AGI limitation, if it is held in trust, again with the five year carry-forward.[805] Code section 170(e) (limiting the deduction to the donor's adjusted basis in the property) does not apply because a gift to a CRT is not a gift to a private foundation.[806]

If the remainderman is a private non-operating foundation, then gifts of cash and nonappreciated property—regardless of whether the remainder passes outright or in trust—entitle the donor to a charitable income tax deduction in the year of the gift for the fair market value of the remainder interest, limited to 30% of the donor's AGI with a five year carry-forward.[807] Again, regardless of whether the remainder passes outright or in trust, a charitable income tax deduction is allowed for a gift of long-term

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798. *Id.* §§ 641, 642(c).
799. *Id.* § 170(f).
800. *Id.* §§ 671–79.
801. Bourland & Guthrie, *supra* note 681.
802. Michael V. Bourland & Jeffrey N. Myers, *The Charitable Remainder Trust,* PLANNED GIVING DESIGN CENTER (Aug. 17, 1999), www.pgdc.com/pgdc/charitable-remainder-trust.
803. *See id.*
804. *See* I.R.C. § 170(b)(1)(B)(i)–(ii); *see also* Treas. Reg. § 1.170A-8(a)(1) (as amended in 1972).
805. I.R.C. § 170(b)(1)(D); Treas. Reg. § 1.170A-8(a)(2).
806. *See* I.R.C. § 170(e).
807. *Id.* § 170(b)(1)(B).

appreciated publicly traded securities to a CRT valued at the fair market value of the remainder interest passing to charity, limited to 20% of the taxpayer's AGI.[808] Finally, for gifts of any other kind of appreciated property, the donor's charitable income tax deduction is based on the donor's adjusted basis in the property contributed, limited to 20% of his AGI with a five year carry-forward.[809]

808. *Id.* § 170(b)(1)(B), (D).
809. *Id.* § 170(e)(1)(B)(ii).