GIFTS FROM COUSIN EDDIE

ACCEPTANCE, OWNERSHIP & MANAGEMENT OF BIZARRE ASSETS

Author:
Megan C. Sanders
Bourland, Wall & Wenzel, P.C.
Attorneys and Counselors
301 Commerce Street, Suite 1500
Fort Worth, Texas 76102
(817) 877-1088
(817) 877-1636 (facsimile)
Email: msanders@bwwlaw.com

Author

Megan C. Sanders
Bourland, Wall & Wenzel, P.C.
Fort Worth, Texas

Megan C. Sanders joined the firm as an associate in 2011. An honors graduate of Baylor University School of Law and Texas Christian University, her practice focuses primarily on estate planning, probate, charitable entity formation, charitable giving, and tax planning issues. She represents professionals, families, charitable entities and closely-held businesses in the firm's areas of expertise to achieve their estate planning, wealth migration, asset protection, and transfer tax planning goals, among others.

SELECTED PRESENTATIONS, COURSES AND PUBLICATIONS

Author and Presenter, *Form 1023 Workshop*, presented to The University of Texas School of Law 2017 Nonprofit Organizations Compliance and Internal Review Workshop, January 11, 2017

Author and Presenter, *Tomayto, Tomahto – There Really Is a Difference: Comparing Private Foundations and Donor Advised Funds*, presented to the State Bar of Texas 27th Annual Estate Planning & Probate Drafting Course, October 6, 2016

Author and Co-Presenter, *Gifts from Cousin Eddie: Acceptance, Ownership & Management of Bizarre Assets*, presented to the Planned Giving Council of Central Texas, April 11, 2016

Author and Presenter, *Advising Donors and Managing Gifts of Oil, Gas and Mineral Interests*, presented to the Partnership for Philanthropic Planning Lone Star Council, February 23, 2016

Author and Presenter, *Things They Didn't Teach You in Law School: Practical Considerations for the Initial Client Conference*, presented to the 2015 Tarrant County Probate Bar Association Nuts and Bolts Seminar, September 18, 2015.

Author, *Self-Dealing Pitfalls and Strategic Solutions – Part 1: Problems Related to Compensation and Shared-Cost Arrangements* and *Self-Dealing Pitfalls and Strategic Solutions – Part II: Problems Related to Estate Administration, Facility Use, Sale/Provision of Goods, Debt Assumption, and Controlled Entities*, published in Family Foundation Advisor, Vol. 14, Nos. 5 & 6, 2015.

Author, *It's Tea Time – "Texas Tea" Time: Advising Donors and Managing Gifts of Oil, Gas and Mineral Interests,* published in the Texas Tech University School of Law Estate Planning & Community Property Law Journal, Vol. 7, Book 1, Fall 2014. Presented to the State Bar of Texas 12th Annual Governance of Nonprofit Organizations Conference, August 22, 2014.

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Author, *Resolving Trustee Disputes: Foundation Split-Ups and Other Approaches,* presented to The University of Texas School of Law-Conference of Southwest Foundations 31st Annual Nonprofit

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Author, *Roundtable Discussion: Charitable Giving With Oil and Gas Interests*, presented to The American College of Trust and Estate Counsel 2013 Fall Meeting, October 24-27, 2013.

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I. INTRODUCTION

We all know "that guy" in "that family" who has strange collectibles and gems stowed away, his prized possessions. You know – one man's trash is another man's treasure – reminiscent of Cousin Eddie in the famed National Lampoon movie series. But to you, when handed these items as a charitable donation, you probably cringe, thinking "what are we going to do with this?!" We all have experiences with some out-of-the-ordinary thing that someone wants to donate, or, it just lands on our doorstep due of the generous gift of a donor's *entire* residuary estate to his favorite charity. It's a sort of love-hate relationship – the gift is welcome, but can't we just have the cash?

Universities have had a history of receiving items such as horses, sculptures, yard art, animal byproducts for research and education, farmland and grain, depending on the area of the country in which they are located. A school in Indiana was even given a castle in England, which it was able to work with other universities to turn it into a joint study abroad program. Other charities have seen items such as mineral interests, buildings, libraries and newspaper collections being donated, as donors want to make a transformational gift and are looking to assets other than just cash.

Whether it is through a deliberate gift of unusual interests, or through a gift of a testator's residuary estate, even private foundations never know what they may get – family partnership interests, a library full of old dingy books, an airplane, a Tuscan villa, ranch land (maybe *with* goats, chickens, pigs and the like), precious jewels, mineral interests, or even a yacht?

Additionally, recently there has been a dramatic increase in the use of alternative asset classes to fund an individual's charitable donation. According to industry experts, hard economic times as well as the appeal of maximizing tax benefits are driving the popularity of making non-cash donations.[1] Real property and closely-held business interests are at the forefront of this trend, followed by items such as wine and art collections, furniture, timber holdings and mineral rights, particularly with high net wealth individuals.[2] Due to the economic climate, financial advisors have had to recommend their clients look across their entire balance sheet to find a more non-traditional asset to fund their charitable inclinations.[3] For instance, before the economic troubles of 2008, donors would use appreciated stock for their donations; however, those same donors now would rather hold onto that liquidity and contribute other long-term capital gain assets like real estate, closely held stocks and others.[4] Some of the drawbacks to this type of charitable giving strategy are 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, and not every donation is appropriate for all types of charitable organizations. 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 after it is liquidated, have the net proceeds fund his or her donor advised fund.[5] However, charitable organizations also must be aware when potential donors are just trying

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[1] CHARLES PAIKERT, "HOW HNW CHARITABLE GIVING IS CHANGING", Registered Rep. The Source for Financial Advisors, Dec. 21, 2011, available at 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 STREET, January 1, 2012, available at http://www.onwallstreet.com/ows_issues/2012_1/bryan-clontz-five-questions-2676477-1.html.

[5] PAIKERT, *supra* note 1; JANET NOVACK, "HOW TO GIVE LIKE MARK ZUCKERBERG", FORBES MAGAZINE dated December 06, 2010, available at http://www.forbes.com/forbes/2010/1206/investment-guide-charity-fidelity-schwab-give-like-zuckerberg.html.

to unload an undesirable asset, which they can no longer handle and just want to give away.[6] For example, individuals in the southern part of the country attempted to donate their horses to charities during the economic downturn of 2008 simply 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. This article addresses these uncertainties and provides strategies for managing these concerns and working with donors, including a discussion of the most challenging issues presented to charitable organizations when considering the receipt of a unique gift: whether to accept the gift, how to value the item, 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.

II. EXOTIC ASSET CLASSES

Public charities and private foundations alike may be approached with assets of varying types, sizes, and values. 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 unique asset. The issues of concern will be approached using general groupings of asset types (keeping in mind that there may be times when an organization sees gifts of a combination of these asset types).

A. PERSONAL PROPERTY AND COLLECTIBLES

Tangible personal property could include anything from as simple as used clothing and household goods, furniture and electronics, to art, antiques, jewels, precious metals, and "hobby collectibles". According to the Internal Revenue Service ("IRS"), the most common gifts of hobby collectibles include rare books, autographs, sports memorabilia, dolls, manuscripts, stamps, coins, guns, phonograph records and natural history items.[7] These types of assets can present complex questions as to the proper valuation methodology and whether the foundation can put these items to use within its charitable purposes or whether the assets must be immediately disposed of (or perhaps, never accepted in the first place).

A relatively new type of intangible personal property comes in the form of virtual currency, such as Bitcoin. The IRS announced in March, 2014 that it will treat this virtual currency as property, and not currency.[8] This treatment raises several questions: since it is property, claimed deductions exceeding $5,000 of Bitcoin would have to be appraised – at this time, who is considered a qualified appraiser of Bitcoin? If Bitcoin is immediately liquidated upon transfer to the charity, what does that mean for the donor's income tax deduction? There is

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[6] *See, e.g.* VERONICA DAGHER: "KEEP THE STOCK, DONATE THE BEANS", THE WALL STREET JOURNAL, Nov. 28, 2011, available at http://online.wsj.com/news/articles/SB10001424052970204394804577007992610748490.

[7] I.R.S. Pub. 561 (rev. April 2007).

[8] IRS Notice 2014-21.

also the unsettled regulatory environment to consider on both the donor's and charity's parts.[9]

B. MINERAL INTERESTS

The basic question to begin with when dealing with some type of mineral interest is: who owns what interest?[10] Under Texas law, the term "minerals" not only refers to oil and gas, but also includes coal, iron ore, sulphur and precious metals. However, water, sand, gravel, salt, building stone, limestone and surface shale are not minerals but belong to the surface owner.[11]

There are two theories related to mineral ownership. 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. This is qualified by the Rule of Capture: if the oil and gas is drained from beneath the land by a neighbor, ownership of those interests is lost. Minerals in place are considered real property, until severed from the surface and extracted, at which time they become personal property and are governed by personal property laws. If a landowner is conveying the surface property, he must expressly state the intent to keep the mineral interests, if desired. The "non-ownership" theory 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. Once the mineral has been captured, the landowner owns the mineral pursuant to this second theory.[12]

If an individual owns all of the private rights in land, including both the surface and subsurface rights, he owns a "fee interest." If only the surface estate is owned, he owns a surface interest, or if only the mineral interest is owned, a mineral interest or mineral estate is owned.[13] 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.[14]

There are a few types of severance that may be used to fractionalize the ownership of these interests: vertical severance creates two fee simple estates, each fee simple estate including a piece of both the surface and minerals, while horizontal severance creates two fee simple estates, one of which is the surface estate and the other is the mineral estate (i.e. conveying the minerals but retaining the surface). A reservation is a sale of the surface estate, but retention of the minerals. A conveyance is the sale of the mineral rights, while keeping the surface estate.

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

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[9] Bryan Clontz, "Charitable Gifts of Bitcoin: Tax, Appraisal, Legal and Processing Considerations", available at http://www.pgdc.com/pgdc/charitable-gifts-bitcoin-tax-appraisal-legal-and-processing-considerations.

[10] Shade, Joseph, PRIMER ON THE TEXAS LAW OF OIL AND GAS, Lexis Nexis, 4ed., 2008, p. 5

[11] JOE HANCOCK, "BLACK GOLD: GIFTS OF OIL AND GAS INTERESTS MADE SIMPLE", presented to Oklahoma Planned Giving Council, September 10, 2009, p. 3.

[12] *Id.*

[13] Hancock, *supra* note 11, at 3.

[14] *Id*.

economic benefits under the oil and gas lease (i.e. bonus, delay rentals, royalties, etc.).[15] Each of these incidents of mineral ownership is alienable, divisible and inheritable under Texas law.[16] The executive has a duty of the utmost good faith toward the non-executive owner, to execute a lease on the same terms and conditions as a reasonably prudent landowner.

When the owner of a mineral interest enters a lease with an oil/gas company, the lessee (oil/gas company) has a "leasehold interest", typically called a working interest or operating interest. The lessee has the rights to use the surface of the property to obtain the minerals, as well as the rights to incur costs of exploration and production, and retain profits subject to the lessor's retained rights. In exchange for the lease, the lessor usually receives a royalty interest, initial bonus, delay rental and shut-in royalty. The lessor also has a reverter in the mineral interest, effective upon the expiration of the lease.[17] 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 may already be leased. To this end, some of the more common types of economic interests are discussed in more detail below.[18]

The term "bonus" is used to define the consideration received by the landowner (i.e. lessor) upon execution of an oil and gas lease. Lease bonuses are often thought of as being an amount of money paid by a lessee in order to induce the lessor to execute the lease. 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.

A "royalty interest" generally consists of an interest in the underlying oil and gas reserves which is retained when the owner of 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.[19] 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. A royalty is usually expressed as a fraction (e.g., a 1/5th) and bears no portion of the costs of exploration, development and production.[20] Accordingly, it is referred to as a "non-operating" mineral interest.[21] A "delay rental" is a payment to defer development rather than a payment for oil and gas. 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.

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. The property interest acquired by the operator is known as the "operating" mineral interest or "working interest".

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[15] Shade, *supra* note 10, at 12.
[16] *Id.*
[17] *Id.*, at 6.
[18] 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 Fall Meeting, October 24-27, 2013.
[19] U.S. v. 525 Company, 342 F2d 759.
[20] PRUETT, et.al., *supra* note 18.
[21] I.R.C. § 614(e)(2).

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. 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. The working interest expires upon termination of the lease.

An "overriding royalty" is a royalty that is carved out of the lessee's interest in an oil and gas lease. An overriding royalty will terminate whenever the underlying oil and gas lease terminates. Unlike a royalty interest, which is connected to the ownership of the minerals in the ground, an overriding royalty interest stems from the ownership of a portion of the revenues generated as a result of the production of oil and gas. Overriding royalties are frequently used to compensate parties that have assisted in the creating or structuring of a drilling venture and/or parties that provided services to the lessee (e.g., landmen, geologists, etc.). Overriding royalties may also be reserved upon an assignment of the lease by a lessee.

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. A net profits interest, similar to a royalty interest, is expressed as a percentage of production and is free of the costs of production. 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.[22]

C. REAL ESTATE

Gifts of real estate will always require a formal appraisal; however, a simple gift of real property, which could include a personal residence, farm or ranch land, becomes much more complex when there are other items involved, such as animals on the land or mineral interests. For example, if the gift of minerals *does not* include the surface estate, is that because the donor previously severed them from the surface? Does the donor still own the surface estate? If they are previously severed, 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 must be analyzed? Are there structures on the property which need to be valued? What about the contents of those structures – does the gift include tangible personal property to value and somehow sell or use? How are things like timber or ranch animals valued and how does a charity use them within its purposes? All of these questions must be addressed to fulfill the governing board's fiduciary obligations.

D. BUSINESS INTERESTS

Donors of unique items such as mineral interests often have "wrapped up" their interests in some type of entity, such as a family limited partnership or limited liability company. 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 charitable organization is approached with a gift of closely held business interests, such as a partnership owning mineral interests, these closely held

[22] PRUETT, et.al., *supra* note 18.

interests can be difficult to value, requiring a formal appraisal. 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/her family members) are involved in the management of the entity, and/or concerns regarding unrelated business income tax, with either a foundation or public charity.

E. MOTOR VEHICLES (LAND AND WATER)

Charitable organizations may see donations of motor vehicles in the form of used cars, yachts or even airplanes. For example, an individual may desire to donate a used car to an organization that provides education on car repair or driving classes. Or, an individual may no longer have use for his personal recreational boat and donate it to an exempt organization that runs programs designed to teach delinquent youths responsibility by chartering sea cruises.[23] Further, a wealthy individual's residuary estate which is distributed to a charitable organization may include his personal aircraft, yacht, and/or motor vehicles, which has no connection to the charity's exempt purposes in any way.

These assets present significant questions to the recipient charity, as to how to value and dispose of them within the charity's exempt purposes; in most cases, a private foundation will need to dispose of the item quickly, as the item itself would not fit within its charitable purposes, but it is not every day that a purchaser comes along looking for a yacht or airplane.

For example, a University located in California received a gift of a boat slip, which took them three years to sell, even though they are located near the ocean. A cancer research center located in Washington State, known for having a large boat population, receives gifts of boats and yachts frequently, as that is a large source of value in the area, but the charity struggles with the best way to accept the donations and sell boats once they are received.

In some instances, a donor may find it more appealing to contribute the expense-free use of his boat, vehicle or airplane to an exempt organization, so he can retain ownership of that asset for his personal use at a later time. This may also be desirable on the foundation's part, to have the free use of a chartered boat or plane but not have to manage the expenses and upkeep of ownership of that asset. Prior to the amendments to Section 170 of the Code, the Tax Court allowed a charitable deduction based on the value of rent-free use of property granted to an exempt organization, if the gift resulted in a legally enforceable conveyance of a present interest under local law.[24] However, due to the restrictions on deductions for gifts of partial interests, the foundation should address this issue when in negotiations with a donor for the contribution of the use of property.

[23] Fair v. C.I.R., 68 T.C.M. (CCH) 1371 (T.C. 1994).

[24] *See*, *e.g.* McNamara v. C. I. R., 32 T.C.M. (CCH) 11 (T.C. 1973) acq. recommended by 1973 WL 34784 (IRS AOD Apr. 19, 1973); Orr v. U.S., 343 F.2d 553 (C.A.5 1965) affirming 226 F.Supp. 809 (M.D. Ala. 1963).

III. COMMON CONCERNS FROM THE DONEE'S PERSPECTIVE

A. GIFT ACCEPTANCE

The first primary concern of a charitable organization approached with an unusual gift is 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 be wary of being turned into dumping grounds for unwanted assets.[25]

i. Issues

Before accepting a potential gift, the board should consider items such as:

Is there liability associated with the asset?

Will accepting and managing the gift cost more than its true value to the organization?

What restrictions have been placed on the gift by the donor?

How is the asset owned by the donor - 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?

It must be determined exactly what is being given before going any further in the process.

ii. Gift Acceptance Policy

While a gift acceptance policy is not required by the Internal Revenue Code ("Code") or on the Form 990, the development and regular use of such a policy promotes due diligence and fulfillment of the organization managers' fiduciary duties, as well as provides guidance on the complex issues presented to the board when approached with exotic gifts. Any nonprofit organization engaging in fundraising should develop and periodically review the organization's gift acceptance policy. A gift acceptance policy can be used as an internal management tool, reduce the risk of excise taxes for foundations and may provide better results with the IRS when compliance questions arise. It 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.[26]

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. It can also 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

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[25] *See, e.g.* DAGHER, *supra* note 6.

[26] DONALD W. KRAMER, NOEL A. FLEMING, AND DEBORAH J. ZATEENY, "ADVISING NON-PROFITS: TOP TEN POLICIES AND PRACTICES FOR NONPROFIT ORGANIZATIONS," The American Law Institute, March 26, 2013, video presentation.

circumstances occur, and enhancing the likelihood that restricted gifts will be potentially deductible. These procedures and policies can also be incorporated 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 received by the organization, which could be deemed a conflict of interest, implicate their duty of loyalty, and possibly be considered prohibited conduct under the Code and Treasury Regulations.

A good gift acceptance policy addresses the types of property the organization is willing to accept, will never accept, and what comes in between. 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 required. The approval process may include considerations such as: Does the gift have conditions that unacceptably tie up the use of the property itself? Will the type of asset tie up the use of other property of the organization, incurring expenses for holding or maintaining the gifted item? Will gifts of real estate be accepted, and if so, will the acceptance be conditioned upon an inspection and evaluation? Will acceptance of the gift hinder or promote the overall mission and purpose? These issues all correspond with the directors' duty of obedience: the considerations noted should be carefully weighed 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, securities, life insurance, retirement benefits and the various types of tangible personal property, real estate, vehicles and other exotic items mentioned in section II above. It should also address the types of gifting vehicles the charity is willing to deal with: 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, and if so, what type 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 should, and must, be provided to donors.

The policy should be reviewed and revised over time. For example, organizations may now want to consider adding provisions in their gift acceptance policies addressing virtual currencies. It would be wise to encourage automatic conversion of Bitcoin upon donation, due to price volatility.[27] Once a donor has decided to make a donation of Bitcoin to a charity, he can use a payment processor, such as BitPay, to immediately convert the donation to cash. BitPay can directly deposit the value of the Bitcoin in the charity's bank account, and will process payments for exempt organizations for free. If not using a payment processor such as this, the charity would have to go through a virtual currency exchange to sell the Bitcoin, which can be a more complicated process.[28]

iii. Split Ownership

If the item being offered to the charitable donee is owned in conjunction with other individuals or entities, this fact of split ownership can cause issues with the charity's ability

[27] Bryan Clontz, "Charitable Gifts of Bitcoin: Tax, Appraisal, Legal and Processing Considerations", available at http://www.pgdc.com/pgdc/charitable-gifts-bitcoin-tax-appraisal-legal-and-processing-considerations.
[28] *Id.*

to accept and manage the property as part of its asset holdings, whether the co-ownership is concurrent or successive.

Divided ownership occurs frequently with oil and gas, and in Texas is usually encountered in the form of tenancy in common.[29] 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).[30] This could be a potential issue of concern if the charity receives a gift of minerals with a co-tenant. Any co-tenant which has chosen to develop without the other co-tenants must account to them for their proportionate share of the net profits.[31] The developing co-tenant bears the entire risk of the operations; if the well produces, the developing co-tenant must share the benefits with the non-consenting co-tenant on a pro rata basis.[32] 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. The non-consenting co-tenant has the option of ratifying the lease, in which he would begin receiving his proportionate share of the royalty immediately, rather than being required to wait until payout to claim his share of the net profits.[33] The developing co-tenant can also try to force the non-consenting 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.[34]

Further, if the charity is the remainderman of successive ownership of a piece 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.[35] If a lease is executed, the economic benefits of the lease are divided by the allocation of the receipts to income or corpus, unless agreed to otherwise.[36] For example, delay rentals are considered income and are paid to the life tenant, but royalty and bonus are considered corpus: the life tenant will receive the interest generated by the invested funds, while the remainderman will receive the principal after the life tenant's interest terminates.[37]

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 also made a gift of 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 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,

[29] Shade, Joseph, PRIMER ON THE TEXAS LAW OF OIL AND GAS, Lexis Nexis, 4ed., 2008, p. 18-19.
[30] *Id.*, at 19.
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id.*, at 20.
[35] *Id.*, at 21.
[36] *Id.*
[37] *Id.*

and can even cause an organization to have to turn away a gift such as this. Also, see section V.A. below regarding the partial interest rule.

iv. Restricted Gifts

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

If the organization has determined that it will accept certain restricted gifts, it should include this fact in its gift acceptance policy, as well as what types of restrictions are allowed, 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 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 it will not accept such a gift, and any check listing a named individual as ultimate beneficiary will be accepted on the organization's assumption, binding on the donor, that the donor intended the notation as a non-binding 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.

v. Liability Concerns with Certain Assets

1. Mineral Interests

When approached with a gift of mineral interests, the charity should first determine exactly what type of mineral interest is at stake, so the potential liability of the organization is understood in making the gift acceptance determination.[38] Once the board fully understands the type of interest being offered to the organization, it must then delve further into considerations regarding that specific interest and the specific property. Issues such as the following should be addressed:

Is the asset of a size that would allow the charity to obtain third party management?

Is the charity willing to accept producing and/or non-producing assets? (keeping in mind there are no carrying costs associated with an oil/gas asset which is not in production, unlike accepting a gift of solely the surface estate).[39]

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?

[38] For example, see the definitions provided in part II., section B. above.

[39] HANCOCK, *supra* note 11, at 7.

2. How was the mineral interest acquired?
3. What is the donor's understanding of what is owned?
4. What exactly does the donor want to gift and what are his/her goals for this gift to the foundation?
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[40]

If the charity is being given a working or operating interest, it must take further steps to account for any environmental issues. The owner of an operating or working interest bears the liability for environmental problems and liability related to the surface usage. 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.[41] 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. All of the above issues should be addressed within the organization's gift acceptance policy, including guidance for the board members on how to approach and resolve liability concerns.

2. Real Estate

Depending on the type, size and location of the real property being donated, the organization may not be able to use or dispose of the property within its exempt purposes, and/or there may be expenses associated with holding or using the property. 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). 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 clean-up costs, unless it conducts a sufficient investigation of the proposed gift pursuant to the innocent landowner exception. Thus, the organization should perform due diligence by having environmental evaluation and other consultations completed prior to accepting such gift. The organization would be well advised to provide guidance to its management through internal policies as to the proper review of such property, including when outside experts must be used, who will manage the property, how maintenance and insurance costs are handled, and issues regarding latent defects, tax liens and title issues.

3. 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.

[40] *Id.*, at 8.
[41] *Id.*, at 13.

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 made the gift.

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, even the S Corporation's passive investment income is included within the UBIT calculation. Third, a sale of appreciated S Corporation stock will trigger UBIT liability (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. Since generally a charity will be paying a higher tax rate on its long-term capital gains than what the donor would have paid individually, there would likely be less overall income tax if the donor would simply sell the stock, incur the individual long-term capital gain tax, and gift cash from the sales 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. 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 interest, and (2) no deduction is allowed for the ordinary income component of the S Corporation's assets.

Further, private foundations (and donor advised funds) must be attuned 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.

vi. 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. *See the discussion of substantiation requirements in section V.B. below.* The donee may also desire to provide donor acceptance agreements once the acceptance decision has been finalized, 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 for a mechanism for non-judicial modification of the donor's restrictions if changes occur. It may also provide for naming rights, including a variance clause and provisions related to enforcement and state law

choice if there is ever litigation raised over the contribution. This type of donor agreement can also be useful as a fundraising tool and 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 restrictions and potential liability of the asset(s) being contributed, the next issue facing the board will be how to value the item and, if an appraisal is necessary, who will be providing for that expense, which may be addressed in the Donor Agreement. Proper valuation of the assets is not only extremely important in order for tax compliance on the part of the donor, but also for the determination by the donee of whether, after accepting the gift, to retain or sell the asset(s).

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 with the IRS regarding the value. Substantiation requirements will be discussed further in section V.B. below; however, proper valuation of the contributed property should be a concern of both the donee and donor for the purposes stated herein.

Generally, the amount of a charitable contribution made of non-cash property is the fair market value of the property at the time of the contribution (with certain limitations).[42] Fair market value is defined as the price the property would sell for on the open market, i.e. what would be agreed upon by a willing buyer and willing seller, with both having reasonable knowledge of the relevant facts and neither being required to participate in the purchase.[43] The willing buyer and willing seller are hypothetical persons; this is meant to be an objective test, requiring the transaction to be analyzed from the perspective of a seller whose sole goal is to maximize his profit on the sale of his interest.[44] The Tax Court has held that the more difficult it is to appraise property, the more leeway it will give before finding a party's position to be not substantially justified.[45]

If there are restrictions on the use of the donated property, that should be reflected in the fair market value determination.[46] 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. Certain donated items will require an expert opinion as to the value of the item, which will be discussed in the following sections. 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). Only the facts known at the time of the gift and those which can be reasonably expected at the time of the gift may be considered in the valuation determination, and not unexpected future events.[47]

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[42] Treas. Reg. § 1.170A-1(c)(1).
[43] I.R.S. Pub. 561 (April 2007).
[44] AGHDAMI, FARHAD "VALUATION PLANNING", ST025 ALI-ABA 345 (2011).
[45] Fair v. C.I.R., 68 T.C.M. (CCH) 1371 (T.C. 1994).
[46] I.R.S. Pub. 561 (April 2007).
[47] *Id.;* Jacobson v. C.I.R., 58 T.C.M. (CCH) 645 (T.C. 1989) (citing Estate of Spruill v. C.I.R., 88 T.C. 1197, 1233 (1987)).

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 item was not purchased reasonably close in time to the date of contribution. The cost or selling price is a good indication of value if: (i) the purchase took place close to the valuation date in an open market; (ii) it was at "arm's-length"; (iii) the buyer and seller knew all relevant facts; (iv) the parties were not forced into the deal; and (v) the market did not change between the date of purchase and the valuation date. The terms of the purchase would also need to be considered in determining the value if they influenced the price, such as restrictions, understandings or covenants limiting the use or disposition of the property. Further, only reasonable increases (or decreases) in value of the donated property should be considered in the value determination, unless the donor can show there were unusual circumstances. If the sale was made in a market that was artificially supported or stimulated so that it was not truly representative of the market, the price at which such sale was made does not indicate the true fair market value. For example, a liquidation sale price usually does not indicate the fair market value. An arm's length offer to buy the property which 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. To rely on that offer, there should be proof of the offer and the details of the amount to be paid. Offers to purchase property similar to the donated property can also be helpful in determining value of the contributed property.[48]

Sales of Comparable Properties

The sale price of comparable properties can be important in determining the fair market value of the contributed property. However, the weight which should be given to each similar sale depends on: (i) the degree of similarity between the property sold and the donated property; (ii) the proximity in time of the sale and contribution date; (iii) the circumstances of the sale (was it at arm's length, with a knowledgeable seller and buyer?); and (iv) the market conditions in which the sale was made (was it an unusually inflated or deflated market at the time?). For example, if the donor makes a gift of a rare book to an organization, but it is a third edition and in poor condition, a sale of the same book but which 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.[49]

Replacement Cost

The cost of buying or making property similar to the contributed asset may be considered in determining fair market value, although there must be a reasonable relationship between such replacement cost and the fair market value. The replacement cost of the donated property should be calculated by taking the estimated cost to replace that item as new, and subtract an amount for depreciation due to its physical condition and obsolescence of the donated property.[50]

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[48] I.R.S. Pub. 561 (April 2007).
[49] *Id*.
[50] *Id*.

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.[51] The opinion must be corroborated by facts, or else it may be disregarded.[52] 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 obtained; (3) the bases on which the appraisal was made, including any restrictions, understandings or covenants limiting the use or disposition of the property; (4) the date the property was valued; and (5) the signature of the appraiser and date the appraisal was made.[53] Ultimately, the burden of supporting the fair market value as listed on the income tax return is the taxpayer's.[54] Revenue Procedure 66-49 provides guidelines for an appraisal of non-cash property gifted to a charitable organization, for which an appraisal is required, including unique tangible personal property, real property and securities.[55]

i. Tangible Personal Property, Art & Collectibles

1. Household Items & Clothing

"Household items" for charitable contribution purposes includes furniture, furnishings, electronics appliances, linens and similar items, but does not include food, paintings, antiques, other art objects, jewelry, gems and collections.[56] A donation of used household goods likely has little value, especially if the item is out of style or no longer useful. A donor is not entitled to take a deduction for household goods donated after August 17, 2006, unless they are in good used condition or better. Similarly, used clothing and other personal items are usually worth much less than the original purchase price; however, their value can be determined by looking at the price buyers of used items pay in consignment or thrift shops. Like with household goods, a deduction is not allowed for a donation of clothing unless it is in good used condition or better. In the case of valuable furs or expensive evening gowns or even designer accessories, the donation may require a formal appraisal and Form 8283 to be filed (see section V.B. below).[57]

2. Jewelry and Gems

Jewelry, precious gems and metals are of such a nature that a gift of this type of property almost always requires an appraisal by a qualified appraiser specializing in that type of jewelry or metal. The appraisal should describe the style of jewelry, cut and setting of the gem, the history and whether the item is currently in fashion and if not in fashion, the possibilities for having it redesigned. The appraiser should analyze a gem or stone's weight, cut, coloring, brilliance and any flaws. While personal sentimental value has no effect on the item's fair market value, the value may increase if it was owned or worn by a celebrity.[58]

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[51] Rev. Proc. 66-49, 1966-2 C.B. 1257.
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] I.R.S. Pub. 526 (2013).
[57] I.R.S. Pub. 561 (April 2007).
[58] *Id.*

3. Art and Antiques

A contribution of paintings, antiques and other art objects should usually be supported by a written appraisal by a qualified appraiser, unless the deduction taken is $5,000 or less (even then, an appraisal may be the best way of determining value for these types of contributions).[59]

The physical condition and extent of restoration are important items to be noted in the valuation of both art and antiques. These factors have a significant effect on value and thus must be fully reported in an appraisal. An antique in damaged condition or lacking "original brasses" may be worth much less than a similar piece in excellent condition.[60] However, the creators of valuable creative works are limited to a deduction in the amount of the cost of the materials used, rather than being able to deduct the work of art's fair market value, such that the foundation itself will likely have to bear the expense of having such work valued.[61]

To locate experts on unique, specialized items or collections, the Official Museum Directory of the American Association of Museums may be helpful, which lists museums by state and by category. An art historian at a nearby college or the director or curator of a local museum, or even contacting associations of art and antique dealers can lead the donor and donee to qualified appraisers specializing in the type of item being donated.[62] See section V.B. below for further details regarding the valuation of a contribution of art.

4. Collections

Collections of items such as stamps, coins, books, manuscripts, and other hobby collections can be difficult to value, although many of the principles discussed in regards to items of art can be applied to these objects as well.[63] Publications including catalogs, dealers' price lists and specialized hobby periodicals can serve as good reference material for valuing these items; however, the edition of the price guide which is current at the date of contribution should be used and these sources should be supported by other evidence in determining fair market value. For example, a dealer may sell an item for much less than what is shown on a price list, especially if the item has remained unsold for a period of time. If the donation appears to be of little value, the donor may be able to make a satisfactory valuation using the reference materials available at a local library or museum library. However, if the donation is more valuable, an appraisal should be sought, and the appraiser should analyze the reference material, making adjustments for misleading entries and other nuances.[64]

Stamp dealers generally know the value of their merchandise and can prepare satisfactory appraisals of valuable stamp collections.[65] Also, most libraries have catalogs that report the publisher's estimate of values. Like many collectors' items, the value of a coin depends on the demand for it, its age, rarity and condition. Catalogs and other reference materials establish categories for coins based on their physical condition, with different valuations for

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[59] *Id.*
[60] *Id.*
[61] I.R.C. § 170(e).
[62] *Id.*
[63] I.R.S. Pub. 561 (April 2007).
[64] *Id.*
[65] *Id.*

each category (such as mint or uncirculated, extremely fine, very fine, fine, very good, good, fair or poor).[66]

If a book collection is of modest value, not requiring a written appraisal, the donor and donee may be able to determine the fair market value without that expense. A book that is very old, or very rare, is not always valuable – there may not be a market for that book. Further, the condition of the book has a great influence on its value. When a book has a missing page, loose binding, tears, or stains or is otherwise in poor condition, its value is substantially lowered. Further, the type of binding (i.e. leather, cloth or paper), page edges and illustrations are other considerations in determining value. Collectors usually consider a first edition more valuable than other editions of the same book, but this also depends on the specific book and what changes or additions were made between editions. Generally, the value of books is determined by selecting comparable sales and adjusting the value according to the differences between those sales and the specific item being valued; because this method is difficult to perform, it should be effectuated by a specialized appraiser when the collection is deemed valuable.[67]

Handwritten manuscripts, autographs, diaries and similar items signed by famous individuals are often in demand and valuable. The writings of unknown individuals may also be of value, if they are of historical or literary importance. Determining the fair market value of these materials is difficult – there may be a large difference in the value between two diaries kept by the same person, one from childhood and one from later in life. The appraiser can determine value in these scenarios by applying knowledge and judgment to factors such as comparable sales and conditions. However, signatures or sets of signatures cut from letters or other paper usually have little or no value.[68]

The appropriate market for determining the fair market value of something like a collection must be determined by looking at the market in which such item is most commonly sold to the public – i.e. a sale to the retail customer who is the "ultimate consumer" of the property, and not a customer who holds the item for later resale.[69] For example, there are two possible markets for a collection of old newspapers: first, the retail market, in which individual newspapers are sold to purchasers who want a newspaper from a specific date, whether it be a significant event or birthdate.[70] The sale of these individual newspapers is usually done through a newspaper dealer; the price of an individual newspaper has a broad range, depending on the significance of the event.[71] The second market is the wholesale market, in which newspaper collectors and newspaper dealers are interested in purchasing an entire collection of newspapers, either for their personal use (collectors) or to sell individual issues in the retail market (dealers).[72] The value attributable to an individual issue is usually lower when sold as part of a collection.

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[66] *Id*.
[67] *Id*.
[68] *Id*.
[69] Arbini v. C.I.R., T.C.M. (RIA) 2001-141 (T.C. 2001).
[70] *Id*.
[71] *Id*.
[72] *Id*.

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. The Tax Court has found that certain factors such as the costs of preparing an inventory and catalog, marketing expenses, inventory retention and shrinkage, the vast quantity and uniqueness of the collection and the length of time it would take to sell each piece of the collection are all relevant to determining its value.[73] The appraiser must consider how many of the items would be available for sale at one time and the length of time needed to liquidate the entire inventory.[74] It cannot be assumed that, at any one time, one or more willing buyers would be found for the entire group of contributed items, such as a collection of thousands of books, a collection of a certain artist's pieces of art or a collection of hundreds of antique sheet music.[75] When valuing this type of property, the number of items of that property, number of duplicate items, the specialized nature of the items and the carrying costs for inventory are necessary to consider, in addition to the monetary value.[76] For example, the addition of 85,000 pieces of sheet music on the public market would depress the market for each piece or result in multiple copies being held for sale, incurring carrying costs.[77]

The market can usually only handle so many pieces of one type of property in a limited time, and when the tendered number of a single type of property is greater than what the market can absorb, a seller may be forced to sell the block at a price per piece which is less than the expected price for one piece.[78] Therefore, a discount to reflect blockage may be appropriate when valuing a contribution of a collection of items, whether it be a collection of art by a single artist, rare books, autographs, sports memorabilia, manuscripts, stamps, coins or guns.

The Tax Court has expanded the concept of blockage to the sale of assets such as art, *Calder v. Commissioner*[79], (market absorption discount applied to gifts of a large number of works of art created by one artist); *Estate of Smith v, Commissioner*[80], (market absorption discount applied to 425 works of art created by and kept in sculptor's collection); *Estate of O'Keeffe v. Commissioner*[81], (market absorption discount applied to approximately 400 works or groups of works of art); sheet music, *Rimmer v. Commissioner*[82], (market absorption discount applied to charitable contribution of collection of sheet music containing approximately 85,000 pieces); manuscripts, *Jarre v. Commissioner*[83], (market absorption discount applied to charitable contribution of large collection of original music manuscripts and other related material); books, *Skripak v. Commissioner*[84], (market absorption discount applied to charitable contribution of large collection of books); animal trophies, *Epping v.*

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[73] Rimmer v. Comm'r., 69 T.C.M. (CCH) 2620 (T.C. 1995).
[74] *Id*.
[75] *Id*.
[76] *Id*.
[77] *Id*.
[78] Auker v. C.I.R., 75 T.C.M. (CCH) 2321 (T.C. 1998); AGHDAMI, *supra* note 44, at 365.
[79] 85 T.C. 713, 722–723, 1985 WL 15408 (1985).
[80] 57 T.C. 650, 658, 1972 WL 2557 (1972), affd. on other grounds 510 F.2d 479 (2d Cir.1975).
[81] T.C. Memo.1992–210.
[82] T.C. Memo.1995–215.
[83] 64 T.C. 183, 1975 WL 3060 (1975).
[84] 84 T.C. 285, 324, 1985 WL 15315 (1985).

Commissioner[85], (market absorption discount applied to charitable gift of mainly animal mounts); *Estate of Miller v. Commissioner*[86], (market absorption discount applied to donation of animal trophies); and real estate, *Estate of Sturgis v. Commissioner*[87], (20–percent market absorption discount applied to 11,298.86 acres of undeveloped land); *Carr v. Commissioner*[88], (30–percent market absorption discount applied to 175 developed lots; no discount applied to 437.5 undeveloped lots); *Estate of Folks v. Commissioner*[89], (20–percent market absorption discount applied to five leased lumberyards with the same tenant and in the same geographical area); and *Estate of Grootemaat v. Commissioner*[90], (15–percent market absorption discount applied to undeveloped lots totaling 302 acres).[91]

For example, in *Arbini v. Commissioner,* the Tax Court found that in determining the value of the taxpayer's charitable contribution of bound volumes of 33,710 Los Angeles and Chicago newspapers donated to a museum of comic art, it would consider the condition, content, date and title of the newspapers, and comparable recent sales of other newspaper collections.[92] It gave greater value to newspapers produced during historic times, such as during World Wars, eras of gangsters or other significant events, and would discount the value of individual issues because they were contributed as part of a large collection. The method of multiplying hypothetical retail value of one newspaper by the number of individual newspapers in the bound collection was found unreasonable.

ii. Real Estate

A detailed appraisal by a professional appraiser should be used to determine the value of any piece of real estate being donated to the organization, because every piece of real estate is unique.[93] The appraiser should be thoroughly trained in the appraisal methods and processes, and preferably should be knowledgeable of the local area conditions.[94] This type of appraisal will contain a complete description of the property, physical features, condition and dimensions, as well as the use to which the property is put, zoning, permitted uses and its potential use for higher and better uses.[95]

There are three generally accepted methods for valuing real estate: the market approach, the income approach and the cost approach. The final value determination should really be a comparison and examination of the value based on all approaches and factors.[96] The assessed value for local real estate taxes is not used unless it is regarded as the fair market value (and even then, must be confirmed by the other methods noted above).[97]

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[85] T.C. Memo.1992–279.
[86] T.C. Memo.1991–515, affd. without published opinion 983 F.2d 232 (5th Cir.1993).
[87] T.C. Memo.1987–415.
[88] T.C. Memo.1985–19.
[89] T.C. Memo.1982–43.
[90] T.C. Memo.1979–49.
[91] Auker v. C.I.R., 75 T.C.M. (CCH) 2321 (T.C. 1998).
[92] T.C.M. (RIA) 2001-141 (T.C. 2001).
[93] I.R.S. Pub. 561 (April 2007).
[94] *Id.*
[95] I.R.S. Pub. 561 (April 2007).
[96] *Id.;* AGHDAMI, *supra* note 44.
[97] AGHDAMI, *supra* note 44.

The most common method of valuing single-family residential property is the market approach, if there are enough comparable sales. The market price of the actual sale of the subject property is usually accepted as the fair market value for estate tax purposes, although the sale must be an arm's length transaction and within a reasonable time of the applicable date. The market data approach, or comparable sales valuation, is often used for residential real estate and vacant land, which depends on comparable properties in an active market.[98] Recent sales of comparable, nearby land are often chosen as the best indicator of value.[99] The comparable sales method involves locating physically similar properties which have been sold on the open market in non-forced sales for cash or cash equivalents, within a reasonable time of the date for which the subject property must be valued.[100] The features of the subject property which are most pertinent to its value are then compared to the same features on the comparable properties.[101] The value of those features of the comparable properties must then be adjusted to be more closely equivalent to those of the subject property.[102] Only the comparable sales which have the least adjustments in terms of items or total dollar adjustments should be considered as "comparable" to the donated property.[103]

The income approach, or capitalization method, analyzes the present worth of the income the property generates or is expected to generate in the future. The main elements of this approach are the calculation of the income to be capitalized and the rate of capitalization. This method is most applicable for valuing apartment buildings, hotels, offices and other commercial real estate.[104] For example, the Tax Court in *Estate of Hatchett* determined the income approach to valuation is appropriate when valuing productive farmland.[105] "Clearly, unproductive vacant land cannot be valued using the income approach to valuation because there is no income stream to capitalize."[106]

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.[107] However, 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. (This would not be true if a similar property cannot be created because of location, unusual construction or another extraordinary reason).[108] When this method is used to value improved property, the land and improvements must be valued separately.[109] 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.[110]

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[98] Rev. Proc. 79-24, 1979-1 C.B. 565; *id.*
[99] *Id.;* Zable v. Comm'r. 58 T.C.M. (CCH) 1330 (T.C. 1990).
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] I.R.S. Pub. 561 (April 2007).
[104] AGHDAMI, *supra* note 44.
[105] Estate of Hatchett v. C.I.R., 58 T.C.M. (CCH) 801 (T.C. 1989).
[106] *Id.*
[107] I.R.S. Pub. 561 (April 2007); AGHDAMI, *supra* note 44.
[108] I.R.S. Pub. 561 (April 2007).
[109] *Id.*
[110] *Id.*

The estimated cost to replace is reduced by an estimated amount of depreciation, including physical deterioration, functional obsolescence (usually in older buildings, with inadequate plumbing, heating, etc.) and economic obsolescence (outside forces causing the area in general to be less desirable).[111]

iii. Mineral Interests

In order to determine whether the donor's interest is of the size which 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 gas industry can be used to generate an estimate of the value of the interest: annual income multiplied by four.[112]

Absent an actual sale, the fair market value of oil and gas interests can be difficult to determine. Both non-analytical and analytical methods are available, but the Service prefers non-analytical methods, which are based on sales comparisons rather than engineering studies.[113] The comparable sales method is based on four basic elements: similar quantity, similar quality, same time period and same geographic area. The net back method for calculating the market value of gas at the lease would be used if there are no comparable sales, and takes the sales price at some distant location, making an adjustment for how much it would cost to transport the gas to the respective location. Analytical appraisals may only be used if the value of the mineral property cannot be determined on the basis of cost or comparative values and if the fair market value cannot be reasonably determined by any other non-analytical method.[114]

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. Mineral interests which lack economic value are not good candidates for a charitable deduction.[115] 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 Mineral Appraisers or the American Institute of Professional Geologists.[116]

In valuing a mineral interest property, an engineer's appraisal will determine the present value of future cash flow from that property.[117] Some of the most important factors in the appraisal process of an oil property include (1) estimation of volume of oil reserves; (2) production decline rate; (3) price of oil and gas; (4) oilfield operating costs; (5) economic life of the property; and (6) discounted cash flow.[118] An appraisal is usually made by first estimating the recoverable oil, multiplying such estimate by the current price of oil or gas to determine expected future gross income, then estimating the expected life of the

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[111] *Id.;* AGHDAMI, *supra* note 44.
[112] HANCOCK, *supra* note 11, at 9.
[113] 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).
[114] 26 C.F.R. § 1.611-2 (2011).
[115] HANCOCK, *supra* note 11, at 9.
[116] *Id.*, at 10.
[117] BUCHANAN, *supra* note 113, at 569.
[118] *Id.*

property.[119] Then, the expenses to be incurred in the operation of the property over that lifetime are estimated and deducted from the estimated gross income, to calculate the expected future net operating income over the life of the property.[120] The salvage value which is to be realized from 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 reach the present value of the future net income to a purchaser, also accounting for the risks involved in mineral properties.[121]

As with oil properties, the initial step in appraising a natural gas property is determining the estimated volume of recoverable gas reserves.[122] However, special considerations must be taken into account when making this determination. 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 or reservoir gas.[123] 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.[124] 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.[125] 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 made by the appraiser, because the rate of production of natural gas may be dictated or influenced by such contract.[126] Also, the rate at which gas from a particular well is forced into a pipeline along with pressure from other wells may be affected by the number of other wells and the total reservoir pressures on them and the pipeline.[127]

The IRS has discussed the use of the present value method as an analytical appraisal method of valuing mineral property.[128] Under this method, the essential factors to be considered are: (1) the total quantity of mineral, in terms of the principal or customary unit(s) paid for in the product marketed; (2) quantity of mineral expected to be recovered during each operating period; (3) average quality or grade of the mineral reserves; (4) allocation of total expected profit to the processes or operations necessary for preparation of mineral for market; (5) probable operating life of the deposit in terms of years; (6) development cost; (7) operating costs; (8) total expected profit; (9) rate at which that profit will be obtained; and (10) rate of interest commensurate with the risk for the particular deposit.[129] If the mineral property has been sufficiently developed, these valuation factors can be determined from past operating experience; however, an allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral,

[119] Stanton v. C.I.R., 26 T.C.M. (CCH) 191 (T.C. 1967).
[120] *Id.*
[121] *Id.*
[122] BUCHANAN, *supra* note 113, at 574.
[123] *Id.*
[124] *Id.*
[125] *Id.*
[126] *Id.*
[127] *Id.*, at 574-75.
[128] Treas. Reg. § 1.611-2(e).
[129] *Id.*

percentage of recovery, costs of development and production, interest rate and the selling price of the product marketed during the expected operating life of that mineral deposit.[130]

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 deposit, characteristics of the area in which it occurs, habit of the mineral deposits, intensity of mineralization, oil to gas ratio, the rate at which additional mineral has been found by exploration, stage of the operating life of the deposit, and any other evidence tending to establish a reasonable estimate of the above factors.[131] Mineral deposits of different grades, locations, and dates of extraction are to be valued separately.[132] 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 available.[133] The estimate of value of these mineral deposits should include as to both quantity and grade: (1) the ores and minerals in sight, blocked out, developed, or assured, and (2) 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).[134] The value of each mineral deposit is measured by the expected gross income, less the estimated operating cost.[135] That number is then reduced to a present value as of the date for which 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.[136]

In addition to the above valuation issues and tax issues noted later, the donee should consider the consequences of accepting a contribution of certain types of mineral properties. The statutory depletion deduction under Treasury Regulation 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.[137] 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.[138] 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.[139] 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.[140]

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[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] Treas. Reg. § 1.611-2(c).
[134] *Id.*
[135] *Id.*
[136] Treas. Reg. § 1.611-2(e).
[137] BUCHANAN, *supra* note 113, at 576.
[138] *Id.*
[139] *Id.*
[140] *Id.*

iv. Business Interests

The value of a stock or bond is the fair market value of a share or bond on the proper valuation date.[141] For example, if the donor delivers a properly endorsed stock certificate to the organization, the date of the contribution is the date of delivery. If the certificate is mailed and received through regular mail, it is the date of mailing. 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.[142]

If there is an active market 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 there were no sales 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. Those averages are then weighted in inverse order by the respective number of trading days between the selling dates and the valuation date.[143]

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; its goodwill; the economic outlook in the particular industry; the company's position in the industry; its competitors and management; and the value of interests of entities engaged in the same or similar business. For preferred stock, important factors are its yield, dividend coverage and protection of its liquidation preference. The donor should be able to 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.[144]

Classes of stock which 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.[145] Further, sales of stock under unusual circumstances such as sales of small lots, forced sales and sales in a restricted market, may not represent the fair market value.

A lack of control (or minority) discount may be appropriate when valuing an interest in an entity which does not give the holder of the interest the right to decide when distributions will be made, when the entity will be liquidated, and other issues affecting the financial benefits of ownership in the entity.[146] Additionally, lack of marketability discounts 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. The risk of ownership of a

[141] I.R.S. Pub. 561 (April 2007).
[142] *Id.*
[143] *Id.*
[144] *Id.*
[145] *Id.*
[146] AGHDAMI, *supra* note 44, at 352.

closely held business interest is increased due to the fact there is no ready market in which to sell these interests and liquidate in a short period of time.[147]

v. Motor Vehicles

If the charitable organization sells a donated vehicle, deductions over $500 are limited to the gross proceeds received by the donee and reported to the donor within 30 days of the sale; therefore, an appraisal may not be necessary if the foundation intends to sell the vehicle. In contrast, if the charity retains the vehicle for its own use or plans to give it to a needy individual, the donor would be eligible for a fair market value deduction, so long as the donee and donor certify to the IRS that the use is in direct furtherance of the donee's charitable purposes.[148] Thus, only if an exception to the gross proceeds limit applies to the donor's potential deduction, or if the deduction would be for $500 or less, would the donor need to know the fair market value. If the deduction is over $5,000 and not limited to the gross proceeds from the sale, then a donation of a qualified vehicle will require a formal appraisal meeting the requirements of Regulations Section 1.170A-13.

A "qualified vehicle" includes a car or any motor vehicle manufactured mainly for use on public streets, roads and highways, a boat or an airplane.[149] An acceptable measure of the fair market value of a donated car, boat, or airplane is an amount not in excess of the price listed in a used vehicle pricing guide for a private party sale, not the dealer retail value, of a similar vehicle.[150] The fair market value may be less than that amount it if has engine problems, body damage, high mileage or other excessive wear.[151] There are commercial firms and trade organizations which publish monthly or seasonal guides for different regions of the country, including complete dealer sales prices or average prices for recent model years.[152] The price listed in a used vehicle pricing guide for a private party sale should not be used unless it lists a sales price for a vehicle with the same make, model, year, and condition, and sold in the same area, with the same options, accessories and warranties as the donated vehicle.[153] These may be available at public libraries, a local bank, credit union or finance company, as well as on the internet.[154] These guides also provide estimates for adjusting the value of a vehicle based on unusual equipment, mileage and physical condition; while these guides provide a basis for making an appraisal and suggest comparable prices, they are not considered an appraisal of any specific donated property.[155]

Other than inexpensive small boats, the value of yachts and boats donated to an organization should be determined by an appraisal by a marine surveyor, as their physical condition is so critical to the item's value.[156] The requirements of such an appraisal, as well as certain limits applicable to the donor's charitable deduction for this type of donation, are explained further below. For example, in *Styron v. Commissioner*, the taxpayer was entitled

147 *Id.*, at 354.
148 *See* I.R.S. Pub. 4303.
149 I.R.S. Pub. 526 (2013).
150 I.R.S. Pub 561(April 2007).
151 *Id.*
152 *Id.*
153 *Id.*
154 *Id.*
155 *Id.*
156 *Id.*

to a charitable income tax deduction for the contribution, through a bargain sale, of a boat to a qualified exempt organization.[157] The IRS valued the boat based on a joint appraisal from a valuation engineer and a private marine survey firm. The appraisal relied on two "blue books" for boats: the BUC Used Boat Price Guide and the N.A.D.A. Large Boat Appraisal Guide.[158]

In *Fair v. Commissioner,* the taxpayers' expert used the comparable sales method to estimate the value of their custom built boat for deduction purposes.[159] The appraiser compared the taxpayers' trawler, contributed by the taxpayers through a bargain sale to a charitable organization, to seven trawlers built between 1977 and 1982, and personally surveyed all of the boats used as comparables.[160] The IRS's appraiser estimated the value of the boat by estimating the total cost of the boat to the taxpayers, multiplying that amount by a fixed percentage depreciation rate, without using any comparables (as he believed no comparables existed for a custom built boat). The Tax Court ultimately held the IRS expert's appraisal to be reasonable: he was a qualified expert with 24 years' experience in marine surveying and appraisals, used a generally accepted valuation method, estimated the cost of the boat based on the taxpayers' own records, and visually inspected the boat before finalizing the report. Even though the Tax Court found his use of a fixed depreciation schedule to be inappropriate, the taxpayers' expert overstated the value of the boat at issue and understated the higher quality of the comparables used in applying the comparable sale method. Furthermore, the IRS expert likely had difficulty in appraising the boat 8 years following the donation, especially since it had seriously deteriorated during that time. The Tax Court held that the more difficult it is to appraise property, the more leeway it will give before finding a party's position not substantially justified.[161]

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.[162] Further, some practitioners consider the realization of reportable UBTI as increasing their audit exposure on other activities of the organization.[163]

UBIT is triggered when the organization has income from an activity which it regularly carries on, for the production of income from the sale of goods or performances of services, and which is not substantially related to the exempt purposes of the organization.[164] Most passive income is not subject to UBIT, but may be if it is from a controlled entity or from debt-financed property.[165] The

[157] TC Summary Opinion 2001-64.
[158] *Id.*
[159] 68 T.C.M. (CCH) 1371 (T.C. 1994).
[160] Fair v. C.I.R., 68 T.C.M. (CCH) 1371 (T.C. 1994).
[161] *Id.*
[162] I.R.C. §§ 511, 512.
[163] CAUDILL, WILLIAM H. "UNRELATED BUSINESS ACTIVITIES: STRATEGIES FOR COPING", University of Texas School of Law Nonprofits Organizations Institute, January 2014.
[164] Treas. Reg. §1.513(b); U.S. v. Am. Bar Endowment, 477 U.S. 105 (1986).
[165] *See* GUTHRIE, SHANNON G., "ADVANCED UNRELATED BUSINESS INCOME TAX ISSUES", State Bar of Texas Governance of Nonprofit Organizations Course, Chapter 11, August 2013.

policy behind the concept of taxing unrelated business income is to eliminate unfair competition: the unrelated business activities of the nonprofit sector are to be placed on the same tax basis as the for-profit marketplace with which they compete.[166] 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, an abbreviated version of the return is to be filed. If the organization has unrelated business gross receipts exceeding $5,000,000.00, the entity must use the accrual method of accounting.[167]

UBTI generally occurs in two situations: (1) when the organization has income from an unrelated trade or business, and (2) when the organization has income earned in regards to unrelated debt-financed property ("UDFI").[168]

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.[169] A trade or business is an activity which is carried on for the production of income from the sale of goods or performance of services; this element will consider the existence of a profit motive in the activity. 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. For example, business activities which are engaged in only periodically would not be considered "regularly carried on" (such as an annual 10k or bake sale), but if the commercial activity is typically seasonal, such as selling beach chairs during the summer, the activity may be considered to be regular. The time spent preparing for the activity is also considered in the computation of the organization's time involved in the business activity.[170]

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. 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 in each case.

Specifically, the IRS will consider the size and extent of the activity in relation to the nature and extent of the purported exempt function; therefore, it will find UBI where the activity is conducted on a scale larger than reasonably necessary to perform the organization's exempt functions. 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 business in order to further that exempt purpose; it is related if operated primarily as an integral part of the exempt function, but is

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[166] *See id.; see also* FUENTES TOUBIA, NICOLA, "UBIT: ADVANCED ISSUES AND PRACTICAL APPLICATIONS", presented to the University of Texas School of Law Nonprofit Organizations Institute, January 2014.
[167] GUTHRIE, *supra* note 165.
[168] *Id.*
[169] I.R.C. § 513(a); Treas. Reg. § 1.513-(a).
[170] PLR 201251019.

considered unrelated if operated in substantially the same manner as a commercial operation.[171] 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 a chance it has of the activities being found to substantially relate to its exempt purposes; further, the activities should be conducted on a scale no larger than necessary to further the charity's purposes. 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 Rev. Rul. 76-37, the organization's business of building and selling homes as part of vocational training of students was held to not be UBTI, because 70% of the building was done by the students, so that the homes were products of the exempt function, and the homes were built only on an as-needed basis for the training program. However, in Rev. Rul. 73-127, the organization operated a grocery store to sell food to residents of an impoverished area at lower prices, provided free grocery delivery service to residents, and job training for unemployed residents. The grocery was held to incur UBTI to the organization because the store operation was conducted on larger scale than reasonably necessary to perform the organization's training program and exempt functions: only 4% of the store's earnings was 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.

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. Some exceptions include the convenience exception, the exception for entertainment events at fairs, the trade show exception and hospital services exception. The volunteer exception allows an activity in which substantially all of the work in carrying on such business is performed for the organization without compensation. The convenience exemption allows activity which is carried on primarily for the convenience of the organization's members, students, patients, officers or employees to be exempt. 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.[172] An activity which consists of selling merchandise which was donated to the organization (such as a Goodwill store) is an exception to UBTI under the thrift shop exception. Qualified sponsorship payments are also an exception from UBTI, so long as there is no arrangement or expectation that a person/donor will receive a "substantial return benefit" other than the use or acknowledgement of that person's trade or business name or logo. It is irrelevant whether the sponsored activity is related or unrelated to the charity's exempt purposes.[173] Income derived from the distribution of low cost articles (currently having a cost of $10.20 or less[174]) incident to the solicitation of charitable contributions is exempt, such as a mass mailing of donation requests along with pens, notepads or address labels with the charity's name and logo.[175]

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[171] Rev. Rul. 55-676, 1955-2 C.B. 266.
[172] I.R.C. § 514.
[173] Treas. Reg. § 1.513-4(c).
[174] Rev. Proc. 2012-41, 2012-45 I.R.B. 539 (2012).
[175] I.R.C. § 513(h).

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 512(b). For example, passive income is not seen as a source of unfair competition with for-profit entities and thus is not subject to UBIT. 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, 10%, of the total rents received or accrued under the lease).

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.[176] Acquisition indebtedness can be debt incurred by the exempt organization itself in acquiring or improving the property (i.e. property purchased by the organization 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.[177] It includes new debt as well as debt assumed by the organization (such as a mortgage or similar lien).[178] Property is considered "debt financed" if there was acquisition indebtedness at *any time* during the taxable year. 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.[179] The sale of debt financed property within one year of retirement of the debt will cause UDFI that year.[180]

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 if the organization makes any payment for the equity in the property owned by the decedent or the donor.[181] Additionally, if the organization uses the property to perform its exempt function, or the property is used in an unrelated trade or business which was already included in the calculation of UBTI, then the UDFI will not be included in UBTI (thus preventing double taxation).[182] Rents from real property which are financed with acquisition indebtedness are 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. The same causal connection rules which apply to determine when organizations are subject to UBTI also apply to determine whether the property meets the definition of UDFI.

When a tax-exempt organization holds property subject to a mortgage, and which is not being used for its exempt purposes, its UBIT liability can be avoided during a 10-year grace period following acquisition. 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 place on the property more than 5 years prior to the gift and the property was held by the donor for more than 5 years, the organization can escape UBI taxation.[183]

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[176] I.R.C. § 514.
[177] *Id.*
[178] *Id.*
[179] GUTHRIE, *supra* note 165.
[180] I.R.C. § 514(b)(1).
[181] I.R.C. § 514.
[182] *Id.*
[183] I.R.C. § 514(c); SETTING THE STAGE FOR CHARITABLE GIVING, SS045 ALI-ABA 1.

The primary purpose of a tax-exempt organization must be one or more of its exempt purposes. Stated differently, a single non-exempt purpose, if substantial, is enough to destroy exemption regardless of the number of truly exempt purposes.[184] Thus, the organization should not accept, or retain, a gift which would cause it to incur substantial UBIT. Where an exempt organization has substantial unrelated business income and/or activities in relation to its exempt income or activities, the organization risks loss of exemption. Unrelated business income is derived from unrelated business activities. 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. Rather than setting out a specific limitation, the IRS considers the percentage of the organization's time spent on unrelated business activities and the percentage of the organization's revenue generated by the unrelated business activities. The IRS has ruled that where 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 non-exempt purpose being a primary purpose.

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; therefore, the following will focus on these asset classes.

i. 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. However, the type of interest which is to be owned by the charity must be carefully scrutinized in order to determine whether it is truly a "royalty" for Code purposes and excluded from UBIT. 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.[185] Royalties are defined as 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.[186] To be a "royalty" interest, the right to payment must be free of both development and operating costs.[187] If the owner is liable for expenses of operating the property (i.e., a working interest), it is not a "royalty" interest, and thus, is subject to UBIT.[188]

Where the holder's interest is a net profits interest, not subject to expenses which exceed gross profits, the holder is not liable for the expenses of development or operations within meaning of Treas. Reg. 512(b)-1(b); thus, this is a "royalty interest" for purposes of section 512.[189] The IRS, in a General Counsel Memorandum, agreed that income from a net profits interest generally constitutes a "royalty interest", because unlike the owner of a working

[184] The Supreme Court held, in *Better Business Bureau of Washington D.C., Inc. v. United States*, 326 U.S. 279 (1945), that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes.
[185] *See* T.A.M. 77-41-004 (1977).
[186] Fraternal Order of Police III. State Troopers Lodge No. 41 v.C.I.R., 833 F.2d 717, 723 (7th Cir. 1987).
[187] 26 C.F.R. § 1.512(b)-1(b); Rev. Rul. 69-179, 1969-1 CB 158.
[188] Rev. Rul. 69-179, 1969-1 CB 158.
[189] T.A.M. 77-41-004 (1977).

interest, the holder of a net profits interest bears no personal liability for development and operation costs.[190]

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. 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. Each of these are generally treated as "royalties" for UBIT purposes.[191] Bonus payments are one-time payments received by the royalty interest owner at the time the new mineral lease is executed; thus, it does not meet the basic definition of UBTI (it is not income from an unrelated, regularly carried-on, activity of the charity).[192] One transaction may include multiple types of the above interests, so each must be analyzed to determine the effect under the UBI rules.

ii. 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; so 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.[193]

Because of the potential interactions of UBTI and excise taxes *(discussed further below)*, private foundations are subject to much more risk than public charities when considering their involvement in a joint venture or acceptance of a gift of business interests.[194] 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.

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.[195] If the partnership conducts a trade or business unrelated to the organization's exempt purposes, the charity's share of the business income must be reported as UBTI, with the exceptions of passive income.[196] 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 UBTI if earned directly by tax-exempt investors will flow through as such, to tax-exempt

[190] I.R.S. G.C.M. 38,216 (Dec. 28, 1979). *See also* I.R.S. P.L.R. 2011-42-026 (Oct. 21, 2011).
[191] HANCOCK, *supra* note 11, at 16.
[192] Id., at 17.
[193] FUENTES TOUBIA, NICOLA, "UBIT: ADVANCED ISSUES AND PRACTICAL APPLICATIONS", presented to the University of Texas School of Law Nonprofit Organizations Institute, January 2014.
[194] ANSARI, MARYAM K. "FOUNDATIONS MUST BE WARY WHEN ENTERING JOINT VENTURES", Taxation of Exempts (WG&L) Jul/Aug 2011.
[195] I.R.C. § 512(c)(1); 26 C.F.R. § 1.512(c)-1; 26 C.F.R. § 1.681(a)-2(a).
[196] *Id.*

partners.[197] 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.[198]

For example, in Rev. Rul. 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. 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 which would jeopardize the university's exempt status. 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. 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.

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. "Control" 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.[199] This rule is triggered even if the activity of the controlling organization which generates the income does not represent a "trade or business" or the activity is not "regularly carried on."[200] However, this rule does not apply to dividend income since the payments of dividends would not generate a deduction for the controlled, subsidiary, entity.[201] *(see section IV.D. below for further details on controlled organizations).*

Further, the debt financed income rules can come into play here and cause additional UBTI when the organization 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 debt was incurred by the organization to acquire partnership interests, or debt was incurred by the partnership itself to acquire property, that must be included in calculating the organization's portion of the partnership's income related to that debt-financed property.[202]

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 take into consideration the rules regarding controlled entities in section 512(b)(13) and foreign corporations in section 512(b)(17)). The dividends and capital gains received from an exempt organization's investment in a C Corporation are not subject to UBIT.

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[197] *Id.;* CAUDILL, *supra* note 163.
[198] I.R.S. P.L.R. 200147058.
[199] I.R.C. § 512(b)(13).
[200] CAUDILL, *supra* note 163.
[201] I.R.C. § 512(b)(13).
[202] TAM 9651001.

Ownership in an S Corporation presents an even bigger UBI issue than disregarded entities: stock of an S Corporation represents an interest in an unrelated trade or business, *per se*.[203] 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. This includes passive income and other income which would normally be excluded. Gains and losses upon the sale of that stock are also required to be considered as part of the organization's UBTI. Thus, the organization may likely 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, to shield the organization from as much liability as possible. *See section IV. below.*

D. PRIVATE FOUNDATIONS: RISK OF INCURRING EXCISE TAXES

Private foundations are generally privately funded and controlled organizations which make grants to various charitable causes.[204] Because they are privately controlled, private foundations and their managers are subject to more stringent sanctions and excise taxes than are public charities, to discourage activities resulting in private gain.[205] 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 organization(s).[206] Public charities are subject to intermediate sanction provisions as opposed to the excise tax penalties imposed upon private foundations.

i. Excess Business Holdings

Section 4943 imposes an excise tax on the amount of a private foundation's excess business holdings in a business enterprise. However, a "business enterprise" for these purposes does not include a functionally related business (defined in section 4942(j)(4)) nor a trade or business which derives at least 95% of its gross income from passive sources. For example, an LLC's sole activity in PLR 201329028 was the operation of an investment hedge fund. Because all of its income was from passive sources, it was not considered a business enterprise, and thus, the foundation's holdings were not subject to taxation under section 4943.

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. Thus, if a business activity is considered substantially related under the UBIT analysis, that 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 similar activities or within a larger complex of other

[203] I.R.C. § 512(e).
[204] BNA Portfolio 877-2nd: Private Foundations and Public Charities – Termination (§507) and Special Rules (§508).
[205] *Id.*
[206] *Id.*

endeavors that is related to the exempt purposes of the foundation (outside of the need for income or funds). 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.[207]

A private foundation created after May 26, 1969 has prohibited 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 which is not substantially related to the foundation.[208] A private foundation may not have any ownership interests in an unrelated sole proprietorship, but it is allowed to own a de minimus 2% voting stock in a corporation.[209] If all disqualified persons own less than 20% of the voting stock of a corporation, then the foundation can hold any amount of non-voting stock.[210]

Disqualified persons for the purposes of a private foundation include: (1) foundation managers; (2) substantial contributors, defined as having 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 more than 35% controlled by any of the above.[211]

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 90 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.[212] Further, private equity fund partnership agreements often contain provisions allowing the foundation to opt-out of an investment, withdraw from the fund, or reduce its commitment to avoid the excise taxes or meet this 90-day disposition period.[213]

The foundation will generally have a 5 year period from the date it acquires such excess business holdings to dispose of them.[214] 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 5 year period to dispose of the excess business holdings, if: (i) the foundation establishes that (a) it made diligent efforts to dispose of such holdings during

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[207] ANSARI, MARYAM K., "FOUNDATIONS MUST BE WARY WHEN ENTERING JOINT VENTURES", Taxation of Exempts (WG&L), Vol. 23, No. 01, July/August 2011.
[208] Treas. Reg. § 53.4943–1.
[209] Treas. Reg. § 53.4943–3.
[210] *See*, *e.g.* PLR 201329028 (2013).
[211] Treas. Reg. § 53.4946-1.
[212] Treas. Reg. § 53.4943-2(a)(1)(ii).
[213] CAUDILL, *supra* note 163.
[214] Treas. Reg. § 53.4943–6.

the initial 5-year period, and (b) disposition within that initial period was not possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of the holdings; (ii) before the close of the first 5-year period, (a) the foundation submits to the IRS a plan for disposition of the holdings and (b) the foundation submits the plan 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 IRS any response the foundation received during the 5-year period; and (iii) the IRS determines that such plan can reasonably be expected to be carried out before the close of the extension period.

The excise taxes applicable to the retention of excess business holdings will include an initial 10% tax on the value of the excess holdings, to be paid by the private foundation 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.[215] 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.

ii. Self-Dealing

Section 4941 of the Code imposes an excise tax on each act of self-dealing, direct or indirect, between a private foundation and a disqualified person.[216] 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 if it is without charge and used solely for charitable purposes; (4) payment of compensation to a disqualified person, unless if 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, other than one to employ such individual for a period after the termination of his governmental service.[217]

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, a donor can easily morph into being a disqualified person over time. Therefore, foundations should carefully monitor contributions against the threshold, since the self-dealing rules take effect on the date the donor's cumulative contributions become "substantial".

The excise tax for an act of self-dealing will be imposed on both the disqualified person and foundation manager. The first tier assesses a tax of 10% of the amount involved for the taxable year, to be paid by the disqualified person; also, if the foundation manager willingly and knowingly participated, he or she must also pay an excise tax of 5% of the amount, up to a maximum tax of $20,000.[218] Further, if the transaction is not corrected, the IRS will

[215] Treas. Reg. § 53.4943–2.
[216] I.R.C. § 4941.
[217] *Id.*
[218] *Id.*

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.[219]

1. No Purchase-Back

If a donor makes an outright gift to his family private foundation of an asset that is significant to his family, whether it is an LP interest in a family partnership owning ranch land, or valuable art or collectibles, 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 his family) were to attempt to purchase the asset back from the foundation, even for fair market value, the transaction would be considered self-dealing and subject the foundation to the above excise taxes. Further, the foundation cannot merely give the asset back to the donor or his family. Thus, if a donor-insider is proposing to make a gift to the foundation of a significant personal item, the foundation should suggest that he 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. This can be especially important when approached with a gift of mineral interests: the foundation should advise the proposed donor that he/she will not be able to receive those assets back from the foundation, if the gift of the interests themselves is made outright to the foundation. If the donor would like the foundation to only receive the income and benefits from those interests, but retain the interests himself for his family later in life, he should be directed toward other methods of charitable giving (discussed later in section IV.).

In the case of a testamentary gift, such as a founder's residuary estate being distributed to the family foundation, if the foundation directors determine that property given to the foundation, such as an undivided interest in property or one of our bizarre assets, 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.[220] Because the property is not yet the property of the foundation, the IRS allows some leeway in allocating or selling assets among the other beneficiaries of the estate or revocable trust for a certain amount of time. The foundation directors would need to work closely with the estate administrator or trustee, as applicable, to ensure 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 has authority to sell the property or reallocate it to another beneficiary, or is required to sell the property by the terms of the trust or will; (2) a probate court having jurisdiction over the estate approves the transaction (although it is unclear whether this 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 occurs before the estate or trust is terminated; (4) the 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

[219] *Id.*
[220] Treas. Reg. § 53.4941(d)-1(b)(3).

the estate (or trust); and (5) the foundation receives an interest at least as liquid as the one which was given up for an exempt function asset, or receives an amount of money equal to that required under an option binding upon the estate.[221] Special care must be exercised 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 ever received. The exception does not shelter payments of excess compensation, loans or indirect self-dealing that could occur between a company owned by the estate or the foundation.

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.[222] For example, in PLR 9252042, the proposed substitution of art between the decedent's children and private foundation was held to be 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. Also see *Estate of Reis v. Commissioner* for another example of self-dealing between an estate and private foundation which is a beneficiary of the estate.[223] 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. The expectancy interest the foundation had in the estate was treated as an asset of the foundation, and transactions affecting property of the estate are thus treated as affecting assets of the foundation.[224]

Compare the above results to the same fact scenario, but where the donee is a public charity: so 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 (there should be no issues of private excess benefit or private inurement when the transaction is completed for fair market value). If he 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. But, take caution of possible step-transaction application, in which the IRS could collapse the two transactions, and 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.[225]

2. Gift of Debt-Encumbered Property

Further, a foundation should be extremely careful when accepting a gift which 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

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[221] *Id.;* BLAZEK, JODY, TAX PLANNING AND COMPLIANCE FOR TAX-EXEMPT ORGANIZATIONS, 4th Ed., John Wiley & Sons, Inc., p. 306.

[222] Rockefeller v. U.S., 572 F.Supp. 9 (D.C. Ark. 1982), aff'd. 718 F.2d 290 (8th Cir. 1983), cert. den., 466 U.S. 962 (1984).

[223] Estate of Reis v. C.I.R., 87 T.C. 1016, Tax Ct. Rep. (CCH).

[224] *Id.*

[225] SETTING THE STATE FOR CHARITABLE GIVING, SS045 ALI-ABA 1.

similar lien that the disqualified person placed on the property within a 10-year period ending on the date of the transfer.[226] The term "similar lien" includes deeds of trust and vendors' liens, but does not include any other lien which is insignificant in relation to the fair market value of the property transferred.[227]

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.[228]

The IRS interprets this rule broadly, as evidenced by its finding 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.[229] This was based 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 on it considered charges against the property, rather than amounts that must be paid to the insurer.[230] The IRS found that the effect of the transfer was basically the same as the transfer of property subject to a lien, in that the transfer of the policy relieved the donor of the obligation to repay the loan, pay interest on it as it accrued, or suffer continued diminution in the value of the policy.[231] The fact that the insurer would not demand repayment of the loan or payment of interest as it accrued does not mean that the loan was not considered a "mortgage or other lien" within the meaning of the self-dealing rules.[232] Further, 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.[233] This holding shows the IRS's position that even where the private foundation has no duty to pay off the lien, but 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 substantial in value and placed on the property by a disqualified person within the 10-year period.[234] Upon further analysis, the IRS ruled that each premium and interest payment made by the foundation was a jeopardizing investment under Code §4944.[235]

"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.[236] The IRS has held that the membership interests of an LLC donated to a

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[226] I.R.C. § 4941(d)(2)(A).
[227] Treas. Reg. § 53.4941(d)-2(a)(2).
[228] GCM 37105, 1977 WL 46070.
[229] Rev. Rul. 80-132, 1980-1 C.B. 255.
[230] *Id.*
[231] *Id.*
[232] *Id.*
[233] *Id.*
[234] *Id.*
[235] Rev. Rul. 80-133; The foundation retained the policy as an investment and paid annual premiums and interest due on the policy and the loan. 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. The IRS ruled in PLR 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.
[236] TAM 9137006 (1991).

private foundation did not cause self-dealing, despite the LLC having liabilities attached to it.[237] In this case, the operating liabilities of the LLC were less than 2% of its fair market value, and therefore were considered "insignificant" and not a "similar lien" for the purposes of section 4941.[238] 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 considered a disqualified person as to the private foundation because the combined holdings of disqualified persons in the LLC did not reach the threshold 35% interest.[239] Therefore, the private foundation was not assuming any indebtedness as a result of the transfer.

In TAM 9137006, 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. The note, the National Office concluded, was a "similar lien" under the regulations.[240] The National Office also decided that the note did not qualify for the exception of "insignificant" liens where the face amount of the note was 10.4% of the value of the related asset.[241]

Further, each time the foundation made repayments of the note (originally payable by the disqualified person), those were also considered acts of self-dealing.[242] 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).[243] If a private foundation makes a payment satisfying the legal obligation of a disqualified person, such payment usually constitutes self-dealing within these rules.[244] The transfer of the assets to the foundation, on condition that the foundation continue the payment of the donor's liabilities, relieves the donor of the obligation to either repay the loan or pay interest; such relief of an obligation improperly benefits the disqualified person, and therefore is considered self-dealing.[245]

iii. Required Minimum Distribution

A private foundation is annually required to pay out or spend in "qualifying distributions", via charitable grants or project expenditures, equal to its prior year's minimum investment return. 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 requires 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.[246]

The minimum investment return is calculated as 5% of the fair market value of its investment assets for the preceding year (i.e. non-charitable use assets), less the amount of

[237] PLR 201012050.
[238] *Id.*
[239] *Id.*
[240] TAM 9137006.
[241] *Id.*
[242] *Id.*
[243] *Id.*
[244] Treas. Reg. § 53.4941(d)-2(f)(1); *id.*
[245] *Id.* The "insignificant" exception was not available to save the foundation from this result, as explained above.
[246] Treas. Reg. 53.4942(b)-1(b)(1).

any debt incurred to acquire that property (i.e. their acquisition indebtedness) and less a 1 ½% provision for cash reserves: minimum investment return = 5% x (investment assets – debt – cash reserves).[247] This requirement means an amount equivalent to the foundation's return on its investments must be spent, transferred or used for charitable purposes. 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.

This minimum investment return is calculated based on the foundation's investment assets, other than those which are specifically excluded; thus, it is important to distinguish investment assets from exempt function assets.[248] 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. The standard private foundation investment portfolio of stocks, bonds, certificates of deposit and rental properties usually forms the basis for calculating the distributable amount; if property is used for both investment and program purposes, its value will be allocated between both uses.[249] Business properties, such as cattle and other fixtures of a working ranch which has been donated to a foundation, and partnership interests are included in the calculation of minimum investment return. Note, this rule is very different from the rules for calculating the excise tax on investment income.

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. Further, assets which 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 cash balances; and program-related investments and functionally related businesses that further the foundation's exempt purposes. A "functionally related" business is one that is not unrelated; thus, a business run by volunteers and which is substantially related to furthering the foundation's exempt purposes would not be counted as an investment asset for this purpose.[250] However, a long-term leasing of heavy equipment or parking lot is treated as an unrelated business even if the management is donated, and thus, its value would be included.[251]

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 (c)(2)(B)); 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. "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

[247] I.R.C. § 4942.
[248] *See* Treas. Reg. § 53.4942(a)-2.
[249] BLAZEK, *supra* note 221.
[250] Treas. Reg. § 53.4942(a)-2; Rev. Rul. 76-85, 1976-1 C.B. 357.
[251] Rev. Rul. 78-144, 1978-1 C.B. 168.

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.[252] Depreciation expenses, excise taxes and investment expenses are excluded. 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. Grants to accomplish charitable purposes to any type of exempt or non-exempt organization throughout the world can qualify, if the proper procedures are followed.[253] However, before making grants to individuals, the foundation must obtain prior IRS approval; also, distributions to non-charities for charitable purposes require the foundation to follow strict expenditure responsibility guidelines, in order to monitor the charitable use of the funds.[254]

These minimum distributions must be made within twelve (12) months after the close of the taxable year to satisfy the requirements for that year, or within twenty-four (24) months if the foundation had just been created.[255] Also, the foundation may retroactively satisfy the prior year's requirements with the current year's qualifying distributions.[256] 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.[257]

A potential issue with the foundation holding exotic assets such as land, animals, vehicles, art, collectibles, etc., is that if this is the primary makeup of the foundation's investment assets, the assets may not supply enough liquidity in order 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 which 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.[258] 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 which should have been distributed.[259] An additional penalty of 100% of the undistributed amount is assessed if the original penalty is assessed and the distribution is not timely made.[260] A private operating foundation would not be subject to this tax, but instead would be subject to losing its operating status.

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.

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[252] I.R.C. § 4942(g)(1).
[253] *See* Treas. Reg. § 53.4942(a)-3.
[254] I.R.C. § 4945.
[255] I.R.C. § 4942.
[256] *Id.*
[257] Unless a set-aside distribution applies. BLAZEK, *supra* note 221.
[258] I.R.C. § 4942.
[259] *Id.*
[260] *Id.*

iv. Jeopardizing Investments

Please see part G.iv., below, for discussion of these rules.

v. Taxable Expenditures

Private foundations will be taxed on the amount of expenditures made which are not in furtherance of their exempt purposes.[261] Taxable 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.[262] The expenditure responsibility provision requires the foundation to exert all reasonable efforts and establish adequate procedures to ensure the grant is used solely for the purposes made, to obtain full reports from the grantee and make full reports regarding the expenditures to the Secretary.[263]

Both the foundation and management will be taxed on these taxable expenditures. The foundation must pay a tax equal to 20% of the taxable expenditure amount.[264] A foundation 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.[265] 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.[266] Further, if the expenditure is not corrected within the taxable period, an additional tax equal to 100% of the amount of the expenditure will be imposed on the foundation.[267] Also, an additional tax of 50% of the amount of 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.[268]

E. PUBLIC CHARITIES: INTERMEDIATE SANCTIONS

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." Transactions between the public charity and a disqualified person must be made at fair market value; any excess benefit above the value of what the disqualified person gave to the charity, including the provision of services, is considered "excess benefit."[269] The rules apply an excise tax

[261] I.R.C. § 4945.
[262] *Id.*
[263] *Id.*
[264] *Id.;* Treas. Reg. § 53.4945-1.
[265] *Id.*
[266] *Id.*
[267] *Id.*
[268] *Id.*
[269] 26 U.S.C.A. § 4958.

on both the disqualified person and any organizational manager who participated in the transaction which improperly benefited the disqualified person.[270]

A disqualified person under this provision is defined as 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.[271] That person's family and business, if he or she owns 35% or more of that business, are also included in the definition of "disqualified person."[272] Persons who have substantial influence would include presidents, chief executive officers, chief operating officers, treasurers, and persons with a material financial interest in a provider-sponsored organization.[273] Persons who are deemed to *not* 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.[274] In other instances, facts and circumstances will govern; 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 which is a disqualified person.[275]

Payments to a disqualified person are rebuttably presumed reasonable, and therefore not an excess benefit transaction, if: (1) the transaction was approved by an authorized body of the organization composed of non-conflicted individuals; (2) prior to making the determination of approval, the authorized body obtained and relied upon appropriate comparability data; and (3) the authorized body adequately documented the basis for the determination concurrently with making its decision of approval.[276] If all three of these requirements are met, the Service can only rebut the presumption if it develops sufficient evidence to rebut the value of the data relied upon by the authorized body.[277]

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.[278] The disqualified person must pay an excise tax equal to twenty-five percent (25%) of the excess benefit and return the excess benefit to correct the error.[279] The term "correct" means, with respect to any excess benefit transaction, 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.[280] The organization is not required to rescind the underlying agreement;

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[270] *Id.*
[271] *Id.*
[272] *Id.*
[273] Treas. Reg. § 53.4958-3.
[274] *Id.*
[275] *Id.*
[276] Treas. Reg. § 53.4958-6.
[277] *Id.*
[278] 26 U.S.C.A. § 4958.
[279] *Id.*
[280] *Id.*

however, the parties may need to modify an ongoing contract with respect to future payments.[281] Additionally, if the excess benefit transaction is not corrected within the taxable period, the disqualified person must pay another two hundred percent (200%) tax of the excess benefit.[282] An organizational manager who participated in the transaction, knowing it was such a transaction, is liable for an excise tax of ten percent (10%) of the excess benefit, up to $10,000, unless the participation was not willful and was due to reasonable cause.[283] If the organizational manager was also the disqualified person who received the excess benefit, he or she can be subject to both of the excise taxes.[284]

F. DONOR ADVISED FUND: APPLICATION OF EXCISE TAXES

An alternative that may be desirable to a donor is to make his or her gift through a Donor Advised Fund (DAF). 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. DAFs do not have a minimum payout requirement, although that may soon change with the Treasury having been put to the task of further studying the issue. The PPA mandated the Treasury Department specifically consider whether the existing deduction rules for contributions to DAFs are appropriate, whether DAFs should be subject to distribution requirements and whether a donor's advisory role in the investment or distribution of donated funds is consistent with a completed gift.[285] Co-investments involving a DAF and donor or donor advisor may raise concerns of improperly benefitting the donor or donor advisor and incurring some of these taxes.[286] 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.

i. 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) provides that any grant, loan, compensation or "other similar payment" from a DAF to a disqualified person is *automatically* considered an excess benefit transaction. This would mean items such as expense reimbursement or compensation are considered excess benefit transactions in the context of a DAF. 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. The *full amount* of such payment is considered the amount of the excess benefit, not just the differential between the value of economic benefit provided to the disqualified

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[281] http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Intermediate-Sanctions-Excess-Benefit-Transactions.
[282] *Id.*
[283] *Id.*
[284] *Id.*
[285] 38.06 Community Foundation, WG&L ESTATE PLANNING TREATISES, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS – HENKEL, note 62.2a. A copy of this study was submitted to Congress on December 5, 2011.
[286] D.A. Levitt, "Impact Investing Through a Donor-Advised Fund", 25 Taxation of Exempts, No. 5, 3 (March/April 2014).

person and the consideration received by the organization, as it is under the general 4958 rules.

The excise tax of 25% of the excess benefit must be paid by the disqualified person receiving such benefits.[287] 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 correction cannot be held in a DAF.[288] An additional 10% tax can be imposed on a fund manager who agreed to making the distribution, knowing it would be considered an excess benefit.[289]

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 compensation in his role, the DAF could be considered to be providing compensation to the donor advisor, triggering these excess benefit penalties.[290]

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. 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.[291]

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 (discussed above in regards to public charities).[292] 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. The 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.[293]

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. Rather, such sale would be subject to the general rules of section 4958. Thus, if a donor to a DAF purchased securities (originally contributed by the donor to the DAF) from the DAF, the purchase is

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[287] 26 U.S.C.A. § 4958(a).
[288] 26 U.S.C.A. § 4958; Joint Committee on Taxation, *Technical Explanation of H.R.4, the "Pension Protection Act of 2006", As Passed by the House on July 28, 2006, and As Considered by the Senate on August 3, 2006* (the "JCT" Report"; JCX-38-06) page 347.
[289] 26 U.S.C.A. § 4958.
[290] Levitt, *supra* note 286.
[291] Choi, William, DONOR-ADVISED FUNDS: PRACTICAL PROBLEMS WITH EQUALLY PRACTICAL SOLUTIONS, CV018 ALI-CLE 385, 402.
[292] *See* Levitt, *supra* note 286.
[293] 26 U.S.C.A. § 4958 (West).

subject to the rules of 4958 because the donor is a disqualified person to the DAF; but, 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). If the donor were to purchase the securities directly from the sponsoring organization, rather than from the DAF, the transaction would not even be within the purview of 4958. However, if a donor is contemplating the purchase back of an asset from his or her DAF, even at fair market value (preferably using the same appraisal information which 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 his or her own DAF (see part IV below).

ii. 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 his/her family or a 35% controlled entity of them) receives, directly or indirectly, more than an incidental benefit. 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 benefit was received by the donor or donor advisor as part of the contribution in a direct donation to the sponsoring organization.[294] 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 is not considered to have received more than an incidental benefit.[295] 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. 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.[296] However, if the transaction also incurred a tax under section 4958 as an excess benefit transaction, the tax under this prohibition will not be imposed.

iii. 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, and a 5% tax is imposed on a fund manager who agreed to the distribution knowing it was a taxable distribution.[297] A taxable distribution is any distribution (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. Expenditure responsibility is another private foundation concept (of section 4945(h)), but has not been specifically applied to DAFs through IRS guidance.

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[294] Joint Committee on Taxation, *Technical Explanation of H.R.4, the "Pension Protection Act of 2006", As Passed by the House on July 28, 2006, and As Considered by the Senate on August 3, 2006* (the "JCT" Report"; JCX-38-06) page 350.

[295] Choi, *supra* note 291.

[296] 26 U.S.C.A. § 4967.

[297] 26 U.S.C.A. § 4966.

Distributions are not "taxable" if made to: (i) certain 50% charities (public charities and private operating foundations), other than disqualified supporting organizations, (ii) the sponsoring organization of the DAF and (iii) another DAF. 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.

A disqualified supporting organization is a Type III supporting organization which 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.[298] 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 Rev. Proc. 2011-33, 2011-25 IRB.[299]

iv. Excess Business Holdings

The PPA also extended the private foundation excess business holdings rules to DAFs. Disqualified persons for this purpose includes a donor, donor advisor, his/her family members and entities which are at least 35% controlled by either. DAFs receiving gifts of interests in a business entity have 5 years to dispose of the holdings over the permitted amount, with the possibility of having an additional 5 years if approved by the Treasury Secretary.

G. DUTIES OF PRUDENT INVESTMENT

In deciding whether to accept, retain and how to manage a gift of bizarre assets, the foundation or charity's directors and officers must ensure compliance 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 funds 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. When receiving and holding bizarre assets, questions must be addressed such as:

Is the continued management of these assets 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 is going to 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?

[298] *Id.*
[299] 34 Am. Jur. 2d Federal Taxation ¶ 18967.

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: risk is to be managed, not avoided. The standards of prudent investment and management stem from common law fiduciary duties, state statute and federal standards.[300] These standards must be considered whether the organization is contemplating the need to diversify, is thinking about selling the gifted interests, and/or considering the retention of a third party agent to manage the interests.

i. State Law Fiduciary Duties

Fiduciary duties are a product of common law, with some aspects having been codified in state business organization and trust codes. These duties are generally defined as the duties of care, loyalty and obedience. The duty of care simply stated is the duty to stay informed and exercise ordinary care and prudence in managing the organization.[301] 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. Directors and officers must make decisions reasonably believed to be in the best interest of the organization, based on the objective facts available to the decision-maker at the time.[302]

The duty of loyalty requires the decision makers to have undivided loyalty to the organization: he must act for the benefit of the organization and not for his personal benefit, avoiding conflict of interest scenarios.[303] While the breach of the duty of loyalty gives rise to a tort claim under state law, it may also implicate federal tax law, as such a breach typically gives rise to private inurement, self-dealing, and/or excess benefit transactions (discussed above).

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

ii. UPIA and UPMIFA

The law of prudent investment is also found 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

[300] For a more in depth discussion of these standards, see MOORE, DARREN B., "GOVERNING INVESTMENTS: NAVIGATING THE MAZE OF UPIA, UPMIFA AND JEOPARDIZING INVESTMENTS", presented to SALK INSTITUTE 42nd Annual Tax Seminar for Private Foundations, May, 2014.

[301] *See* Internat'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576 (Tex. 1963).

[302] Tex. Bus. Org. Code § 22.221.

[303] *See* Landon v. S&H Marketing Group, Inc., 82 S.W.3d 666, 672 (Tex. App.-Eastland 2002, no pet.).

of Institutional Funds Act (UPMIFA). UPIA governs the investment and management of trust assets, including charitable trusts with either individual or institutional trustees. A trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule.

In Texas, UPMIFA applies to "institutions" managing "institutional funds" or "endowment funds", and only to the extent a gift instrument does not provide otherwise. 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. "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.[304] "Institutional fund" means a fund held by an institution exclusively for charitable purposes. 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.[305] UPMIFA specifically imposes the common law duty of loyalty (discussed above) upon institutional managers, and 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.[306]

UPMIFA also addresses the investment requirements of endowment funds, with specific presumptions of prudent expenditures in section 163.005 of the Texas Property Code. 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. The term does not include assets that an institution designates as an endowment fund for its own use.[307] 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", create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund. These terms do not otherwise limit the authority of the institution to appropriate the funds for expenditure or accumulation.

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. 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/fund.[308]

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[304] *See* Tex. Prop. Code § 163.003(4).
[305] *See* Tex. Prop. Code § 163.003(5).
[306] Tex. Prop. Code § 163.004(b).
[307] Tex. Prop. Code §163.003(2).
[308] UPIA: Tex. Prop. Code § 117.004; UPMIFA: Tex. Prop. Code § 163.004.

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.[309] Any investment may be considered, so long as it is consistent with the obligations of prudence under UPIA or UPMIFA, as applicable. However, the trustee/directors must make reasonable efforts to verify facts relevant to the management and investment of the trust/fund.[310] A manager with special skills or expertise will generally be held to a higher standard – i.e. the standard of a reasonable person with those same skills and expertise.

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. 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.[311] Because an institution or trust should only incur appropriate and reasonable costs in managing and investing the charitable assets, delegating a management function to an outside agent should be thoughtfully considered.

The duties of prudence under UPIA/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. If the organization lacks directors or trustees with a level of acumen appropriate to certain investments of the organization, it should seek professional guidance in a third-party agent and delegate those investments as appropriate. The directors should be mindful of the fees associated with the delegation, to ensure they are acting prudently in managing the organization's liquid resources. 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. 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.

iii. 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. 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.[312] 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. 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. A state attorney general could also look into the issue of

[309] UPIA: Tex. Prop. Code. § 117.005; UPMIFA: Tex. Prop. Code § 163.004(e)(4).
[310] UPIA: Tex. Prop. Code § 117.004(d); UPMIFA: Tex. Prop. Code § 163.004(c)(2).
[311] UPIA: Tex. Prop. Code § 117.110; UPMIFA: Tex. Prop. Code § 163.006.
[312] Levitt, *supra* note 286.

whether the managers of the sponsoring organization have violated fiduciary duties by not properly diversifying the individual DAF. Until more guidance is provided, the safer course of action is to attempt to achieve diversification at both the DAF and sponsoring organization levels.

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. 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. 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 - this could be viewed as an imprudent management of the organization's assets. 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.[313]

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 4944 jeopardizing investment restrictions have not been extended to apply to DAFs).[314] PRIs are those investments made primarily to accomplish the organization's exempt purposes, rather than to produce income. To qualify as a PRI, the following must be met: (i) the primary purpose of the investment is to further at least one exempt purpose of the foundation, (ii) the production of income or appreciation of property may not be a significant purpose of the investment, and (iii) no electioneering (and only very limited lobbying) purposes may be served by the investment. 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.[315]

The uncertainty lies in whether the IRS will distinguish PRIs from other investments of a DAF. If an investment by a DAF would be a PRI to a private foundation, should that investment provide the tax advantages to the DAF as it would to a private foundation? For example, PRIs are exempt from a foundation's excess business holding restrictions, which have now been applied to DAFs. 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.[316]

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

[313] *Id.*
[314] *Id.*
[315] *Id.*
[316] *Id.*

thus would not be subject to these rules.[317] 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.[318] 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).[319] 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. 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).[320]

iv. Private Foundations: Jeopardizing Investments

In addition to the state law standards which impose fiduciary responsibilities upon foundation managers, the Code prohibits foundation managers from making "jeopardy investments" that could risk its assets and ability to further its charitable purposes. 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. An investment asset which has been donated to a foundation is not considered a jeopardizing one in regards to the foundation.[321] This is because the foundation is not treated as having made the investment; when receiving a gratuitous transfer, the foundation is not using its own resources that are protected by the charitable covenant imposed by the Code and its organizational documents.

For example, in PLR 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 only stood to gain from the gratuitous transfer. "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."[322] Once it has been ascertained that an investment does not jeopardize the carrying out of a foundation's exempt purposes, the investment shall *never* be considered to jeopardize the carrying out of such purposes, even if, as a result of such investment, the foundation subsequently realizes a loss.[323]

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 manner as to jeopardize the carrying out of any of its exempt purposes…"[324] The sanction for the violation of 4944 is a series of tax penalties, but it does

[317] *Id.*
[318] *Id.*; Choi, *supra* note 291.
[319] Choi, *supra* note 291.
[320] *Id.*
[321] Treas. Reg. § 53.4944-1(a)(2)(iii).
[322] Treas. Reg. § 53.4944–1.
[323] Treas. Reg. § 53.4944–1 (emphasis added).
[324] 26 U.S.C.A. § 4944(a).

not describe any transactions as *per se* jeopardy investments. The regulations merely list examples of types of transactions which the IRS will closely scrutinize, such as trading on margin, purchase of puts, calls and straddles, and selling short. Unfortunately, the IRS has not classified any specific investments as jeopardy investments. This is likely due to the fact that the standard of care requires a facts-and-circumstances type of analysis, and not a general prohibition against specific types of investment policies. Further, no reported cases involve a private foundation losing its exempt status solely due to the violation of the jeopardizing investment rules.

The standard which 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.[325] 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, maturity of company, degree of risk and potential for return).[326] The consideration of the facts and circumstances also requires a determination of the financial requirements of the foundation, and the consideration of the proposed investment to complete the foundation's investment portfolio as a whole.

For example, in Rev. Rul. 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. 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.[327]

Similarly, in GCM 39537, the foundation borrowed funds to purchase stock in a publicly traded corporation, but which was not of blue chip quality, and in which the foundation managers were high-level employees. The purchase constituted about 75% of the foundation's investments. After considering three main factors: (1) the use of large loans to make the purchase, (2) the lack of sufficient diversification of the foundations 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:[328]

> 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

[325] Treas. Reg. § 53.4944-1(a)(2)(i).
[326] *Id.*
[327] 1980-1 C.B. 258.
[328] GCM, 1986 WL 373000 (I.R.S. July 18, 1986).

> one which a prudent man of discretion and intelligence, who is seeking a reasonable income and preservation of capital, would buy.[329]

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.[330] 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 4944.

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 his participation was not willful and was due to reasonable cause.[331]

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.[332] 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.[333] A manager is considered to have participated in the investment if he in any way manifests approval of such investment.[334] 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.[335]

Additional taxes will be imposed if the investment is not removed from jeopardy within the taxable period, 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.[336]

1. Application to Exotic Asset Classes:

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.

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[329] *Id.*
[330] Friedland Foundation v. U.S., 144 F. Supp. 74 (D. N.J. 1956).
[331] 26 U.S.C.A. § 4944; *Id.*
[332] Treas. Reg. § 53.4944-1.
[333] *Id.*
[334] *Id.*
[335] *Id.*
[336] 26 U.S.C.A. § 4944.

The assets received by the foundation from a purely gratuitous transfer are not considered jeopardizing investments under the Code. Thus, the mere receipt of assets which 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 PLR 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. 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. Thus, the IRS held that the mere receipt of this gift, without more, would not constitute a jeopardizing investment. Contrast this scenario with an investment that requires more than mere receipt, but requires active maintenance and further investments by the foundation in the speculative investment.

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. Further, state law fiduciary standards may be applicable in the foundation managers' decision regarding diversification. Until this issue is clarified, foundation managers are left to reviewing other examples of jeopardy investments and using 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.

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-exempt function. For example, a founder/donor may desire his foundation to operate in a similar manner to how he has been running his (extremely successful) real estate business, and thus 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 4944 is whether the foundation managers exercised ordinary business care and prudence in making the investment. In TAM 9205001, the IRS found that the foundation trustees 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. 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, (2) the investment did not consider the risk of investing in the specific industry and (3) the investment did not allow for diversification.

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. UPMIFA also assumes that prudence requires diversification of assets, but allows a foundation to determine that non-diversification is appropriate due to special circumstances. 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. 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.

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 purposes, terms and distribution requirements of the organization and the requirements of the Act. Thus, although the receipt of exotic assets may not be considered "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?

Once the organization managers have determined the rewards outweigh the risks of receiving the exotic asset type, the determination of whether to retain the asset, and if so for how long, how to manage the asset, and the best way to dispose of the asset must be thoroughly analyzed. It is almost imperative that the organization have 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. Often times, unique assets like those discussed in this article cannot be put to use in furtherance of the organization's charitable purposes, and thus *must* be disposed of in the most practical and cost efficient method. But that method and manner of disposition can be difficult to determine.

i. Tangible Personal Property

1. Art

Unless the organization's exempt purposes include something in the nature of art education, operating an art museum, or some other purpose closely connecting with maintaining a collection of art, it will need to analyze the options for selling the asset so that the proceeds may be used for the organization's charitable purposes. A critical component of collecting art is determining when and how to dispose of a piece (or several pieces) of art in a collection[337]; the same is true when an organization receives a piece, or a collection, of art from a donor.

Collectors themselves are likely much more knowledgeable about the pieces of art and appropriate methods of divesting of their art collections than the organization directors will be.[338] Thus, it may be helpful for the charity to work closely with the donor when accepting the gift of art, if possible, to obtain detailed records of the collection and a sort of roadmap

[337] HORWOOD, RICHARD M., "KEY ISSUES FOR COLLECTORS: WORKING WITH DEALERS AND AUCTION HOUSES", Family Foundation Advisor, Vol. 13 No.1, Nov./Dec. 2013.
[338] *See id.*

for the organization; otherwise, it is possible the value of the collection could be diminished inadvertently.

Once a decision is made to sell the donated art, various strategies of disposition must be considered: whether to sell at auction, through private sale or a combination of the two.[339] The costs and timing of each option must be considered in relation to the specific piece, or pieces, of art to be sold.[340] The first factors in the decision on how and when to sell the art should be provenance (the history of the physical possession of a piece of art from its creation to the current date) and authenticity.[341] If selling through a dealer, the art dealer and auction houses will usually conduct their own research regarding these considerations; however, with more valuable pieces, the organization may want to have independent research conducted rather than relying only on the selling process.

Selling through an art dealer brings certain advantages to the sales process: they are usually knowledgeable about the works they are selling, are experienced in the field, take their job seriously (since this is their "day job", as opposed to collectors), offer an element of privacy that public auctions may not, and have a broad network of potential buyers – they know other dealers and collectors, and regularly visit museums, galleries and art fairs.[342] There are two ways to sell through a dealer: by immediate sale or by consignment. Deciding to sell on consignment could lead to a better sales price for the organization than an immediate sale, where the dealer determines the fair market value of the piece, but will want room in the price for significant mark-up for his own profit when he re-sells it in the future. Selling on consignment also offers flexibility without harming the value of the art object via a negative stigma for not selling quickly at auction, but the sale could stretch out for a lengthy period of time, which may be disadvantageous from the charity's standpoint.

Collectors generally prefer to sell by public auction because of the perceived transparency, long tradition of the auction houses and belief that it will result in the best price.[343] The auction process "uses competition and ego to pursue the highest possible price."[344] While a public auction may allow the seller to reach a bigger audience of buyers, there is no certainty as to whether the item will sell for fair market value, or if it will even sell at all – if the item does not sell, that fact will almost certainly negatively impact the value of the piece in attempting a future sale.[345] The public auction scenario is a principal-agent relationship, by which the agent auction house will receive a commission based on the final selling price.[346] *Whether the organization decides to sell through an auction house or art dealer, it should seek professional advice when negotiating the consignment agreement.*

Finally, some auction houses are offering a private method of sale: the buyer and seller negotiate a price in private, rather than allowing a bidding war by the public market.[347] This

[339] *Id.*
[340] *Id.*
[341] *Id.*
[342] *Id.*
[343] *Id.*
[344] *Id.*, quoting Dan Thompson, The $12 Million Stuffed Shark: The Curious Economics of Contemporary Art, Palgrave Macmillan (2008), p. 96.
[345] *Id.*
[346] *Id.*
[347] *Id.*

is similar to a deal that could be made for immediate sale with an art dealer, but with the expertise of an auction house. When an auction house agrees to sell a work privately, it will have in mind a specific purchaser for the item; if the item does not sell within a set time period (such as a few weeks), it will be returned to the seller, giving the seller another chance to decide whether to move forward with a public auction sale format or other alternative.

2. Personal Property and Collectibles

If the organization has received a collection of personal property items which are not at all useful to furthering its exempt purposes, just causing dust to collect (and perhaps expenses of storage and maintenance), the directors may be able to find a public charity which could use the items for its charitable purposes. If a private foundation were to donate the items to a public charity, it would be effectively working towards satisfying its minimum distribution requirement, while also disposing of an asset not serving its own purposes. If the donation consists of items such as household goods, furnishings, clothing and other pieces of tangible personal property, the best method of disposal may be to donate those goods to a public charity similar to Goodwill or a homeless shelter, which can use those items for its charitable purposes. Or, in the case of a collection of books, manuscripts, or items with historical significance, the directors may find a university, library or museum to which it would be appropriate to donate the items.

A private foundation can therefore apply that donation in its calculation of meeting its required minimum distributions, based on the amount an individual would take an income tax charitable deduction in relation to donating that item. For example, thousands of bound volumes of historic Los Angeles and Chicago newspapers were donated to a San Francisco charity which ran a research center and library devoted to the American comic strip.[348]

There may also be a market of collectors for that type of item, who would be interested in purchasing the item(s). If the items are of more value or of a type that is more collectible, the organization may be able to sell the collection to a collector or gallery that specializes in that type of asset, whether it is precious metal, jewels, books or some other item of historical significance, and convert the otherwise useless item into cash proceeds. If the collection is rather large or of great value, the fair value should have already been determined through an appraisal when the donor made the gift to the organization, and can be used for such a sale, depending on the timing of the transaction from the date of contribution and the type of asset. If not, expert advice can be sought through connecting with the local university or museums, depending on the type of asset (or another source, as described in section III.B. above).

ii. Mineral Interests

Once mineral interests have been received by the charitable beneficiary, the organization must determine how it will properly manage the interests, to ensure the greatest benefit is realized for the charity over time. Many charities' gut reaction to receiving these interests is to immediately sell them, especially when the donee is a smaller charity which 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

[348] Arbini v. C.I.R., T.C.M. (RIA) 2001-141 (T.C. 2001).

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 in a large banking organization, an investment manager or financial services organization which has a minerals management group. Charities typically do not manage these assets very well unaided; if managed internally, it will usually just be to cash checks received under an ongoing lease. 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. Keep in mind that UPIA/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, which exist to advise charities when they are approached with these gifts on how to proceed with accepting the gift, and so the charity has an advisor to evaluate, negotiate and manage on their behalf. 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.

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. 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. This review will include weighing the prices of oil and gas, and production volumes, on an asset-by-asset basis. 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 interests it owns – this should focus on every phase of the oil/gas production process, from the initial negotiation of the lease (if not yet done prior to the gift), through the entire lifetime of the producing well or field. With producing minerals, the manager should continuously review the division orders and conduct monthly reviews of revenues to ensure the charity's interests are being properly identified and paid, and identify any funds that may be held in suspense.[349] If the mineral interests are not yet producing, the manager should be working to negotiate the maximum bonus and royalty, should leasing activity begin, taking into consideration any existing trends and current demand. Further, the manager must update and maintain all undeveloped acreage records and shut-in well requirements.[350] Finally, the manager should regularly monitor all lease terms and secure timely releases for expiring leases.[351] 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.

[349] HANCOCK, *supra* note 11, at 13.
[350] *Id*.
[351] *Id*.

If the charity is being given a working or operating interest, it must take further steps to account for any environmental issues. The owner of an operating or working interest bears the liability for environmental problems and liability related to the surface usage. 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.[352]

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 *(see section IV. below)*.

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

If the organization has received 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. So 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 useful to the organization, such as using a donated building for offices, or in furtherance of its own programs, such as a summer camp based on rural land which 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 (remembering that the charity may want to reserve any mineral interests associated with the property in such a sale).

When the organization determines it cannot accept a proposed non-cash 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, 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.[353] 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. 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. It does not, however, accept cars, planes and boats (addressed further below). Another example is the Minnesota Real Estate Foundation, which is a supporting

[352] *Id.*
[353] http://dechomai.org/.

organization of the Central Minnesota Community Foundation, but also handles gifts of buildings and land for other providers of donor-advised funds.[354]

iv. Motor Vehicles

If the organization has received a gift of a motor vehicle, boat, farm equipment or similar item, the charity may do any of the following without adverse tax consequences: (1) sell the donated vehicle and use the proceeds for its charitable purposes, (2) regularly use the vehicle for a significant period of time in activities that substantially further its charitable programs, (3) sell the vehicle after making a material improvement to the vehicle, then use the proceeds to exclusively further its charitable purposes, or (4) distribute the vehicle at a price significantly below fair market value to needy individuals in direct furtherance of its charitable purpose of relieving the poor and distressed, or the underprivileged who are in need of a means of transportation.[355]

If the charity itself runs a vehicle donation program, it can permissibly involve a for-profit entity in various ways. The charity can hire a for-profit entity as an agent to operate its vehicle donation program in an agency relationship valid under applicable state law. The for-profit entity will act on the charity's behalf, and its activities under the agency agreement should be subject to the charity's oversight. The charity should actively monitor the program operations and have the right to review all contracts, establish rules of conduct, choose or change program operators and examine the program's books and records.[356]

Alternatively, the charity can grant the for-profit entity the right to use the charity's name for the purpose of soliciting donations of used vehicles, in which case the for-profit entity would receive and sell the vehicles, with the charity having no control over its activities. The charity would receive either a flat fee or a percentage of the proceeds from the sale of the vehicle(s). In this case, a donor's contribution is made to the for-profit entity, not the charity, and thus is not deductible to the donor, which may be a deterrent to using this technique.[357]

One option to dispose of a gift of vehicles, boats or planes in the most timely and cost-effective manner may be through a third party vehicle donation program. For example, Vehicle Donation to Any Charity, or "v-Dac", accepts donations of cars, trucks, motorcycles, RV's, boats, airplanes, farm equipment and similar items, liquidates the asset and sends the net proceeds to the charity chosen by the donor.[358] This allows any charity to have its own vehicle donation program without the costs and liabilities of running the program itself: the charity signs up for the program, markets the program to supporters, then a donor sends the asset information to v-Dac through its website, v-Dac sells the item and sends the requisite paperwork and tax deduction forms to the donor, subtracts fees and sends the proceeds to the donor's chosen charity. The donor actually makes the donation to v-Dac's central charity, Independent Charities of America, for the benefit of the chosen ultimate

[354] GOSE, BEN, "A GEORGIA CHARITY ACCEPTS 'WEIRD' GIFTS CONTRIBUTED TO DONOR-ADVISED FUNDS," The Chronicle of Philanthropy, July 11, 2010.
[355] I.R.S. Pub. 4302.
[356] *Id.*
[357] *Id.*
[358] http://www.v-dac.com/

donee. Because the central charity is what receives the donation, it reports the donations and sales, including filing the Form 1098-C. Another similar option is CARS, which accepts most cars, trucks, trailers, boats, motorcycles, off-road vehicles and other motorized vehicles, turning the item into cash and sending the net proceeds from the sale (usually 70% of the sale price) to the exempt organization chosen by the donor.[359] The basic requirement for the CARS donation program is that the item has an engine and be towable. Programs such as these can be very beneficial for smaller charities that do not have the resources, time or expertise to deal in vehicle donations themselves; the charity can simply register, or keep its donors educated as to these donation options, so that the organization receives cash proceeds without the headaches and expenses of its own donation program. However, the foundation should also be aware of the fees such a program charges, when choosing what type of third-party program to use or suggest to donors.

What the charity does with the donated vehicle will determine the information the charity must provide in the written acknowledgment to the donor. If the donor contributes a vehicle and claims its value is more than $500, the charity must provide a contemporaneous written acknowledgement to the donor, as well as information on what the charity did or intends to do with the vehicle. The acknowledgment can be in the charity's own form or by the use of Form 1098-C, and must include: (1) the donor's name and taxpayer identification number, (2) the vehicle identification number, (3) the date of the contribution, and (4) a statement as to whether goods or services were provided in return for the donation, and if so, a description and good faith estimate of the value of the same.

- Additionally, if the charity sells the vehicle for more than $500, it must include a statement certifying it was sold in an arm's length transaction between unrelated parties, the date sold, the gross proceeds received from the sale and a statement that the donor's deduction may not exceed those gross proceeds.[360]
- If the charity intends to make a significant intervening use of the vehicle, the written acknowledgement must include a statement certifying that the charity intends to make a significant intervening use of the donated vehicle, a detailed statement of the intended use and duration of that use, and a certification that the vehicle will not be sold before completion of the use.[361] To qualify as a "significant intervening use", the charity must actually use the vehicle to substantially further its regularly conducted activities and the use must be considerable. This depends on the nature, extent, frequency of the use, and does not include an incidental use, nor a use which was not intended at the time of contribution. Further, it does not include use to provide training in general business skills. For example, if an individual donates a used van to a charity which delivers meals to the homeless, but the charity only uses the vehicle a few times to deliver meals before selling it, this use is considered infrequent and would not qualify as "significant intervening use." However, the use of the van to deliver meals every day for one year would qualify, because it is significant and substantially furthers the charity's regularly conducted activity of delivering meals to the homeless.[362]
- If the charity's intent with the donated vehicle is to make a "material improvement" before selling it, the charity must include in the acknowledgement to the donor a

[359] http://www.donatingiseasy.org/car-donations.htm
[360] I.R.S. Pub. 4302.
[361] *Id.*
[362] I.R.S. Pub. 4302.

statement that it intends to make a material improvement to the vehicle, a detailed description of the same, and a certification that the vehicle will not be sold before completion of the improvement.[363] A "material improvement" includes a major repair or change that results in a significant increase in the vehicle's value, but does not include cleaning, minor repairs or routine maintenance. An improvement will not qualify if funded by an additional payment from the donor.[364]

- If the charitable organization's exempt purposes include relieving the poor and distressed, or the underprivileged who are in need of a means of transportation, and it intends to give away or sell the donated vehicle to a needy individual at a price significantly below fair market value, the charity must include in the acknowledgement a certification of this intent, and that the gift or sale is in direct furtherance of the charitable purposes of relieving the poor and distressed or the underprivileged who are in need of a method of transportation.[365] This does not include the application of the proceeds from the sale of the vehicle to a needy individual for another charitable purpose, nor the sale of the donated vehicle at auction.[366]

The charity must provide the appropriate written acknowledgement to the donor within 30 days from the date of sale of the vehicle, or if it intends to make a significant intervening use or material improvement to the vehicle, within 30 days of the contribution. Certain penalties will apply if the charity knowingly furnishes the donor with a false or fraudulent acknowledgement, or knowingly fails to furnish the acknowledgement with the requisite information.[367]

The charity must then report this same information to the IRS by filing Copy A of Form 1098-C by February 28 (March 31 if e-filing) of the year following the year in which the charity provides the acknowledgement to the donor.[368] However, if the acknowledgement is for a charitable deduction of $500 or less, only Copy C of Form 1098-C should be provided to the donor, and Copy A should not be filed with the IRS. Regardless of what portion of Form 1098-C is filed, the charity must still fulfill its obligation to file Form 8282 with the IRS, to report information regarding the disposition of the vehicle within 3 years of the date it received the vehicle. Form 8282 must be filed within 125 days after the charity disposes of the vehicle, and a copy must be provided to the donor.

IV. STRATEGIES

The below sets out various strategies a charitable organization may use to either deal with the bizarre asset after it has accepted it and determined to retain it, or to advise donors as to how to make the contemplated gift of non-cash 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.

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[363] *Id.*
[364] *Id.*
[365] *Id.*
[366] *Id.*
[367] *Id.*
[368] *Id.*

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. 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. 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. 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.[369] 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 owned by the partnership.

Therefore, if assets in the sale would be classified as ordinary income under Section 751, the look-through rule would deem that income to be subject to UBIT. 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. For example, a foundation's sale of partnership interests which owns debt-financed property is subject to UBIT.[370] 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 under the UBIT rules.

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.[371] The ordinary income characterization of these "Section 751 assets" means they do not qualify for the exclusion from UBIT treatment.[372] Thus, to determine the organization's gain or loss from the sale of its partnership interests, it is necessary to first determine the portion of the organization's gain or loss from the sale which is attributable to the Section 751 assets of the partnership, which will be UBI (or loss) to the organization.[373] Also, to the extent any underlying partnership assets are subject to debt, an additional portion of the gain may be considered debt-financed UBI to the organization.[374] Section 751 assets include unrealized receivables, including depreciation recapture under sections 1245 and 1250, and inventory items of the partnership. The remainder of the tax-exempt partner's amount realized on the sale of its partnership interest outside of the 751 assets is capital gain, which should not be subject to

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[369] TAM 9651001.
[370] *Id.*
[371] I.R.C. § 751(a).
[372] *See, e.g.*, I.R.C. § 512(b)(5), Treas. Reg. §§ 1.1245-6(b), 1.1250-1(c)(2); WOODHULL, JOHN V., SELLING A PARTNERSHIP INTEREST MEANS COMPLEXITY FOR TAX-EXEMPT PARTNERS, Taxation of Exempts, March/April, 2012.
[373] WOODHULL, JOHN V., SELLING A PARTNERSHIP INTEREST MEANS COMPLEXITY FOR TAX-EXEMPT PARTNERS, Taxation of Exempts, March/April, 2012.
[374] *Id.*

UBI taxation, except to the extent it is treated as debt-financed UBI.[375] 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. Any ordinary income from the partner's gain will be UBI to the partner.

Therefore, if upon the conversion of the partnership interests to public stock, most income from the sale would be classified as ordinary income, that ordinary income would trigger UBIT, making this strategy more tax-adverse to the organization. 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.

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 could 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), it can disclaim the bequest of the surface but still receive the gift of the underlying minerals. This provides for a result that otherwise could not be accomplished if the donor were living and wishing 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).

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 subject the organization to liability exposure as explained above. A potential solution to this liability exposure may be for the organization to create a sub-tier limited liability company ("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. The IRS now recognizes a contribution to a disregarded single member LLC that is wholly owned and controlled by a U.S. charitable entity as a deductible gift to the organization itself[376]; however, the outstanding issue will be at the applicable state level, and whether the state will recognize the LLC as also being tax-exempt.

For example, in PLR 200134025, a supporting organization which was functioning as the fundraising arm of a state university managed liquid investments and converted contributions to liquid assets. The supporting organization also wanted to hold, manage and develop real property, an activity that could subject the liquid investments to claims of creditors. The organization proposed to organize a single-member LLC for each piece of real

[375] *Id.*
[376] I.R.S. Notice 2012-52.

estate contributed, to manage the potential liability of the real estate activities, and such proposal was blessed by the IRS.

Public charities are also beginning to form supporting organizations, to which they have 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, in which it 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 v. corporate tax rates).

D. DEVELOPMENT OF, AND SHIFTING UNRELATED BUSINESS ACTIVITIES TO, A TAXABLE SUBSIDIARY

Organizations may create separate, subsidiary legal entities to protect liquid assets from activities or other assets which may give rise to liability, and can achieve administrative efficiencies 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.[377] While this restructuring may initially minimize UBTI issues at the tax-exempt parent level, the intercompany transactions between the taxable subsidiary and the tax-exempt parent result in complex tax issues – 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.[378] Payments flowing from the tax-exempt parent must be characterized as either loans, payments for services, sales or capital contributions. Payments flowing from the subsidiary to the tax-exempt parent organization must be treated as dividends, payments for services, repayments of a loan or sales. It is critical that the parent tax-exempt entity identify and categorize each intercompany transaction properly and be cognizant of the associated tax consequences.[379]

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 tax-exempt entity. For example, in PLR 201216040, the foundation was denied tax exemption because the IRS found substantial private benefit flowed to the for-profit LLC and founder of both the LLC and foundation, rather than primarily benefitting the parent organization's charitable purposes.

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[377] WOODHULL, JOHN V. AND ERICA D. REIDERBACH, TAXABLE SUBSIDIARIES OF TAX-EXEMPT ORGANIZATIONS, Taxation of Exempts (WG&L, 2014).
[378] *Id.*
[379] *Id.*

i. 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 entities separate from the exempt organization, so long as the corporate form is respected for purposes of federal tax laws. This form preserves the exempt status of the charity and allows it to control the amount of income flowing from the for-profit entity.[380]

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. Thus, there would be no opportunity to control the flow of unrelated business income to the charity, as can be done with a C Corporation. A single-member LLC should likewise not be used, because 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 type of LLC would be treated, and taxed, as if it was undertaken directly by the exempt organization member.[381]

ii. 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 rent, interest, royalties or annuities from a controlled taxable subsidiary, those revenues are generally taxable.[382] 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, and thereafter receiving passive, nontaxable income from the subsidiary.

Therefore, when a controlling organization receives, directly or indirectly, interest, annuities, royalties and/or rent from a controlled entity (whether or not tax-exempt), the controlling entity must treat that payment as UBIT, to the extent the payment reduced the net "unrelated income" of the controlled entity or increased any net unrelated loss of the controlled entity. 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. The controlling organization can deduct expenses directly connected with amounts treated as UBI under this rule.

Under these special rules, the income from the taxable subsidiary must first be identified as rental, annuity, royalty or interest income. 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. 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.[383]

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[380] HOPKINS, BRUCE R., THE TAX LAW OF UNRELATED BUSINESS FOR NONPROFIT ORGANIZATIONS, John Wiley & Sons, Inc., 2005, at p. 192-93.
[381] *Id.*
[382] I.R.C. § 512(b)(13).
[383] WOODHULL, *supra* note 377.

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. Therefore, control of a corporation means ownership by vote or value of more than 50% of its stock; in a partnership, control is ownership of more than 50% of the profits interest or capital interests; in a trust or other circumstance, control is measured in terms of more than 50% of the beneficial interests in the entity.

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 UBIT if the subsidiary were similarly exempt. 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. For example, if a taxable subsidiary rents a building to conduct both activities that are exempt and non-exempt, 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 non-exempt activities.[384]

iii. Private Operating Foundations

Private operating foundations are subject to very strict rules requiring their assets be used in the active conduct of their exempt programs, but may be able to effectively use subsidiary entities to separate and fulfill their direct qualifying distribution requirements.[385] For example, in Rev. Rul. 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.[386] 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. 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.

Further, a private operating foundation can structure direct ownership in distinct subsidiary entities as a means to make direct qualifying distributions.[387] For example, in PLR 9834033, the foundation proposed to create an LLC with a public charity (50/50 ownership). 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. Program-related investments cannot be made to an organization "controlled" by the contributing foundation, unless the donee makes a qualifying distribution of the full amount of the contribution and the foundation has adequate records and evidence of such distribution. Thus, an operating foundation likely needs to team up with at least one other exempt organization to effectively pursue a subsidiary structure similar to the above which qualifies as a direct qualifying distribution; additionally, if non-exempt members are to own part of the subsidiary, the use of voting and

[384] *Id.*
[385] DANA, ANDREW F. "STRUCTURING SEPARATE AND SUBSIDIARY ENTITIES FOR PRIVATE OPERATING FOUNDATIONS", Taxation of Exempts (WG&L), Jul/Aug 2010.
[386] 1978 C.B. 271.
[387] Dana, *supra* note 385.

non-voting interests will be critical.[388] In order to be considered "directly for the active conduct" of an operating foundation's exempt purposes, the foundation must maintain significant involvement in the grantee entity.[389]

Also see PLR 200431018, in which the private operating foundation proposed to operate its educational programs through a disregarded single-member LLC; the IRS concluded that distributions made through the LLC for the educational program operations would constitute qualifying distributions directly for the active conduct of the foundation's exempt activities.[390]

iv. Conversion or sale of taxable subsidiary

Any conversion to tax-exempt status by a taxable corporation will be treated as a deemed sale and result 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).[391] Thus, if a tax-exempt organization purchases the stock of a taxable corporation, it has three choices with 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.[392] 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. If the tax-exempt organization wants to purchase and operate the business as a tax-exempt activity, it should negotiate a direct purchase of the assets of the corporation rather than its stock.[393]

E. CONTRIBUTION THROUGH DONOR ADVISED FUND

A 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.

A DAF is created by an outright gift, by either an individual or another entity such as a private foundation, to the sponsoring charitable organization which has legal control over the fund.[394] The sponsoring organization is usually a local community foundation or the charitable affiliate of a financial services provider.[395] The DAF agreement allows the donor (or someone appointed by the donor) to advise the charity on what distributions to make from the DAF; however, the sponsoring

[388] *Id.*
[389] Treas. Reg. 53.4942(b)-1(b)(1)(ii).
[390] DANA, *supra* note 385.
[391] WOODHULL, *supra* note 377.
[392] *Id.*
[393] *Id.*
[394] Treas. Reg. § 1.170A-9(e)(11)(ii); Levitt, *supra* note 286.
[395] Levitt, *supra* note 286.

public charity is the legal owner of the funds and thus has the ultimate control over the distributions. Some sponsoring organizations offer mission-related allocation with existing general investment pools, investment pools specifically dedicated to a mission related purpose, and other options provided as an opportunity to give donors to further their chosen social missions.[396] These options can be especially beneficial to a private foundation searching for a charitable receptacle to receive difficult to manage assets, and still be 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, as discussed above in section III.[397] 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 by the donor.[398]

DAF investments are subject to the UBIT rules explained above; however, mission-related investments would avoid UBIT if they qualify as "substantially related" to the charity's exempt purposes.[399] To otherwise avoid UBIT, the DAF should invest in assets meeting a statutory exception, such as limited partnership interests owning only passive investments. While the sponsoring public charity would be responsible for reporting and paying any UBIT, the tax would likely be allocated to the individual DAF in which the investment is made.[400]

i. 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 donor to contribute the assets to a community-based foundation or a donor-advised fund.[401] The donor would enter into an agreement that gives donor (and/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.

To ensure that the fund is treated as a component fund of the particular public charity maintaining it, the agreement must provide that the charity is not required to follow donor's advice and that the charity will have ultimate control over distributions from the fund. In practice, the charity is likely to follow most, if not all, of donor's suggestions. However, an IRS ruling suggests that, in order for such a fund to qualify as an advise-and-consult fund which is not a private foundation, the charity

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[396] *Id.*

[397] 38.06 Community Foundation, WG&L ESTATE PLANNING TREATISES, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS – HENKEL, note 62.2a.; E.R. Heisman, "Donor-Advised Funds Gain Popularity for Charitable Giving", 41 Estate Planning, No. 7, 27 (July 2014).

[398] 38.06 Community Foundation, WG&L ESTATE PLANNING TREATISES, ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS – HENKEL, note 62.2a. A copy of this study was submitted to Congress on December 5, 2011.

[399] Levitt, *supra* note 286.

[400] *Id.*

[401] LODGE, MICHELLE, " FIVE QUESTIONS WITH BRYAN CLONTZ", on wall street, January 1, 2012, available at http://www.onwallstreet.com/ows_issues/2012_1/bryan-clontz-five-questions-2676477-1.html.

maintaining the fund may be required, from time to time, to make distributions to organizations other than those suggested by the donor.[402]

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 asset of the sponsoring organization upon donation. Because DAFs are typically maintained by public charities, donors receive more favorable tax treatment for their contributions than making 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. In addition, the limits on a taxpayer's deductions which 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).[403]

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.[404] If a donor were to liquidate securities and donate the proceeds to his or her DAF, the amount would be reduced by capital gains, whereas if the donor donated the securities directly to the DAF, the donor could avoid capital gains and allow the charity to sell the securities (if desirable).[405]

For example, an Iowa farmer was looking to donate 15,000 bushels of soybeans to a charity. He contacted a non-profit consultant, who procured a quote from a local commodities broker, and the farmer was able to make his donation through a donor advised fund, get his income tax deduction and paid no capital gains tax on the sale of his soybeans.[406] Other examples include beans, a Boeing 747, $800,000 of trees and a Mexican beach house, all of which were able to be steered into donor advised funds, so that the wealthy individuals could keep their liquid securities, but still make charitable gifts in strategic ways of assets they do not normally consider a key part of their overall wealth for everyday living expenses.[407] 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.[408] Additionally, the potential charitable deduction for the donor is greater when making a gift to a DAF than a private non-operating foundation[409], although this will really only matter to a donor whose charitable gift represents a significant portion of his or her adjusted gross income.[410]

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[402] *Id.*

[403] *See* E.R. Heisman, "Donor-Advised Funds Gain Popularity for Charitable Giving", 41 Estate Planning, No. 7, 27 (July 2014); Levitt, *supra* note 286; Choi, *supra* note 291.

[404] Heisman, *supra* note 403.

[405] *Id.*

[406] DAGHER, VERONICA: "KEEP THE STOCK, DONATE THE BEANS", THE WALL STREET JOURNAL, Nov. 28, 2011, available at http://online.wsj.com/news/articles/SB10001424052970204394804577007992610748490.

[407] *Id.*

[408] *Id.*

[409] 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.

[410] LESLEY BOSCH ANNEN AND GARY GARCIA, "FAMILY FOUNDATION VS. DONOR-ADVISED FUND: CHOOSING THE RIGHT PHILANTHROPIC ENTITY FOR YOUR CLIENT," FAMILY FOUNDATION ADVISOR, Vol. 13, No. 3, March/April 2014, p. 7.

ii. Private Foundations

A private foundation (which could include a charitable trust) may find a DAF useful in certain scenarios and can include the contribution as a qualifying distribution in the year of the contribution.[411] 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%.[412] 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. It is suggested, however, that 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.[413]

F. PLANNED GIVING VEHICLES – HELPING A DONOR FIND THE RIGHT MATCH

i. Family Limited Partnership

The donor may want to wrap up their interests in an entity, such as a family limited partnership, prior to making the donation to the charitable organization. The LP form is favored in the oil and gas context, specifically because of the exemption from Texas margin tax for passive income, such as non-participating interests like pure royalty interests. The LP wrapper also provides the benefit of family succession planning and liability protection. 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/or 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.

ii. Charitable Lead Trust

The donor may be well-advised to fund a charitable lead trust ("CLT") with his or her non-cash asset, or with family limited partnership interests which have been funded with such asset(s). This would enable the income stream to flow to the charity, fulfilling the donor's charitable goals, and at the same time allowing his 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 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 which can be established during life or at the donor's death, and 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 to non-charitable beneficiaries, which may include (but is not limited to) the donor, 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.[414]

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411 Levitt, *supra* note 286.
412 Choi, *supra* note 291.
413 *Id.*
414 PLR 9604015.

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 (i) the present value of the annuity grows as the Section 7520(a) rate falls; and (ii) 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). Low interest rates are favorable to the use of a CLAT – the lower the AFR, the higher the charitable income tax deduction. However, the CLUT receives more favorable GST tax treatment, when transferring wealth two or more generations downstream.[415]

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). 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.[416] The trust will receive an income tax charitable deduction for payments made to the charitable beneficiary(ies) from gross income.[417] However, a non-grantor CLT is subject to the UBIT rules discussed above. 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), but the transfer of the same property to a grantor CLT is not a bargain sale because there is no "disposition" of property for tax purposes.[418]

A grantor CLT must be created during the donor's lifetime, and allows the donor an income tax and gift tax charitable deduction upon contribution to the trust.[419] The grantor/donor is taxed on income from the trust as it is earned, without a corresponding annual income tax charitable deduction.[420] If the Trustee distributes appreciated property in satisfaction of the required annuity payment, the donor will be taxed on capital gains on the assets distributed.[421] 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 non-disqualified person under the CLT terms.

UBIT is not a concern with a grantor-CLT, unlike the non-grantor CLT, since the grantor is taxed on the income. Further, no income is recognized on the transfer of an installment

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[415] TIDD, JONATHAN G., "THE INS AND OUTS OF CHARITABLE LEAD TRUSTS – MAKING THE RIGHT CHOICES", Journal of Taxation, Vol. 119, No. 01, July 2013.
[416] I.R.C. § 170(f).
[417] I.R.C. §§ 641, 642(c).
[418] Tidd, *supra* note 415.
[419] I.R.C. § 170(f).
[420] I.R.C. §§ 671-679.
[421] Rev. Proc. 2007-45, section 8.02(2).

obligation to a grantor CLT, and a grantor CLT may hold S Corporation stock.[422] FLP 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.[423]

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. For example, the donor must be careful to avoid self-dealing transactions when the CLT owns a general partner interest in partnership, and the partnership engages in a transaction with a disqualified person. 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.

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 annuity can therefore be stated in the terms of a formula clause (more often seen in a testamentary CLT).[424] 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 FLP units to the charity(ies) 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 the above 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 re-valued each year, and thus the fluctuation in value of the CLT's interests would not be critical to the CLUT' charitable payments; 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. Thus, the Settlor in such a case should distance himself from any control over the asset distribution (or earnings on those assets) paid to the foundation from his CLT.[425]

Caution should be taken when grandchildren or "skip persons" (as defined in section 2613) are named as (or could become) the remainder beneficiaries of a CLT, as the transfer may

[422] TIDD, *supra* note 415.
[423] *Id.*
[424] See, e.g. P.L.R. 9112009 (March 22, 1991); Rev. Proc. 2007-45, section 5.02(6).
[425] TIDD, *supra* note 415.

be subject to GST tax.[426] If subject to GST tax, a taxable termination will occur when the lead term of the CLT ends, if the remainder beneficiaries are all skip persons (beneficiaries who are two or more generations younger than the donor's generation).[427] GSTTE can be better leveraged with a CLUT than a CLAT: with a CLUT, GSTTE can be allocated at the time the trust is created, in an amount equal to the value of the noncharitable remainder interest, resulting in a zero inclusion ration for the CLUT.[428] Thus, if the donor has sufficient GSTTE, no GST tax will be incurred when the lead term ends or when distributions are made to skip persons. However, with a CLAT, the amount of GSTTE allocation needed to produce a zero inclusion ration cannot be determined at the CLAT's creation, even though the allocation must be made then. The method required to allocate GSTTE to a CLAT results in an adjusted exemption, calculated as the amount of GSTTE allocated to the trust on creation, increased by the interest determined at the rate used for valuing the charitable interest, compounded annually for the term of the charitable interest.[429] This adjusted GST exemption becomes the numerator of the CLAT's applicable fraction, with the denominator being the value of all property held in the CLAT immediately after the termination of the charitable lead annuity interest. The amount of the exemption allocated may not be reduced even though it is ultimately determined that the allocation of a lesser amount to the CLAT would have resulted in an inclusion ratio of zero (such as when the trust property does not appreciate to the extent expected).[430] It is virtually impossible to accurately determine the amount of GSTTE to allocate to a CLAT at the creation of the trust, which can result in an inclusion ration of greater than zero, or excess exemption being allocated and thus wasted.

iii. 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; the primary benefit, depending on the asset within the CRT, may be the ability to defer capital gains tax.[431] The CRT may be funded with appreciated assets, then when the CRT sells the assets, this vehicle allows for reinvestment of the full before-tax proceeds to produce income and tax deferral.[432]

For clients with publicly traded stocks they 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 which the donor would like to receive back or retain in the family, such as closely-held business interests.

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[426] HESTER, MARY C., "CHARITABLE LEAD TRUSTS: THE TIME IS RIGHT", Journal of Taxation, Jan. 2009.
[427] *Id.*
[428] I.R.C. § 2642(a).
[429] BOURLAND, MICHAEL V. AND JEFFREY N. MYERS, "ESTATE PLANNING FOR BUSINESS OWNERS – MAXIMIZING THE VALUE OF THE BUSINESS TO BENEFIT BOTH FAMILY AND CHARITY; ESTATE PLANNING WITH CHARITABLE LEAD TRUSTS", presented to Midland Odessa Estate Planning Council, Feb. 9, 2016.
[430] HESTER, *supra* note 426.
[431] NEWMAN, DAVID WHEELER "REBIRTH OF THE CHARITABLE REMAINDER TRUST", Planned Giving Design Center, available at http://www.pgdc.com/pgdc/rebirth-charitable-remainder-trust-0.
[432] *Id.*

When using a CRAT, there must not be a greater than 5% chance that the trust funds will be exhausted before the end of the trust term; 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 be forced to make distributions in kind to the non-charitable beneficiaries, and be left with zero assets for the charitable remainder beneficiary. With a CRUT, the donor could add more assets to the trust so that there is a benefit remaining for the charity. However, it may be difficult to even qualify the trust as a CRT when funding with something like only mineral interests, due to the speculative nature of the future value of such interests. 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 15 or 20 years; by the time the CRT term has ended, the wells may have stopped producing, the lease may have terminated, and/or 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, since the donor's family can be the remainder beneficiary in a CLT.

CRTs are also treated as private foundations, pursuant to Section 4947. Thus, they are subject to the self-dealing excise taxes of Section 4941. 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%.[433]

Finally, CRTs must pay tax on any UBTI it receives. 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).[434] 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. Exempt organizations, including CRTs, can invest in the stock of the foreign corporation holding that 10% of the fund. Any income realized by the foreign corporation is not subject to U.S. income tax, under the portfolio exemptions. A foreign entity will only bear U.S. income tax on the portion of its income which is effectively connected with a trade or business in the U.S. The dividends received are not treated as UBTI to the CRT under the dividend exception of 512(b)(1).[435]

iv. Charitable Gift Annuity

A charitable gift annuity (CGA) may also not be a recommended planned giving technique for unique assets which do not produce much of an income stream – this 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. The donor is essentially making a gift of his interests or FLP units, which he will not receive back, nor will it remain in the family.[436]

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[433] Priv. Ltr. Rul. 200315028 (Jan. 13, 2003); *cf.* Priv. Ltr. Rul. 200230004 (April 10, 2002).
[434] CAUDILL, *supra* note 163, at 35-36.
[435] *Id.*
[436] PLANNING OPPORTUNITIES WITH GIFT ANNUITIES, SJ087 ALI-ABA 171, 180.

Unless the CGA is funded with cash, there is an asset risk. The risk is minimal with publicly-traded securities because they generally do not lose much of their value during the short interval between their receipt and sale. The asset risk is greater when a charity accepts real estate, collectibles, closely held stock, or some other illiquid asset for a gift annuity. 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 the current income from production, so that a "reserve amount" may be accumulated before the production from the interests start to decline. It would also be helpful to fund the CGA with other assets, which could be used to satisfy the annuity as the minerals deplete.[437]

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. 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.[438]

v. 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. Ordinarily, the irrevocable trust or IDGT is created to remove assets from the grantor-creator's estate for both federal income 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, 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, certain transactions (described below) between the creator and trust are disregarded 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. This trust can be established by the creator for the benefit of his family. Generation-skipping transfer tax ("GSTT" or "GST tax") exemption can be allocated to gifts made to the trust. If GSTT exemption is allocated to the trust, the value of the trust assets (initial and their 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, so long as his/her power to make distributions are limited to a defined standard (such as the ability to distribute income and principal for the health, education, maintenance and support of the beneficiaries), to prevent the creator from having certain control over the

[437] HANCOCK, *supra* note 11, at 11.
[438] MINTON, FRANK, "MAXIMIZING THE BENEFITS FROM YOUR GIFT ANNUITY PROGRAM", available at http://www.pgdc.com/pgdc/maximizing-benefits-your-gift-annuity-program.

trust assets that would bring the value of the trust back into his/her estate under Code section 2036.

Further, the creator of the S-IDGT may appoint a separate special "Charitable Distribution Trustee", who would make decisions regarding distributions to charitable beneficiaries, independently from the regular Trustee. While the creator cannot require the Charitable Distribution Trustee to make certain distributions, the Charitable Distribution Trustee's duty is to satisfy the creator's intentions that the trust be in part used for charitable purposes, and as such, the creator's charitable vision should be effectuated through the use of a Charitable Distribution 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 the promissory note that is secured by the S-IDGT assets. The note would provide for periodic (at least annual) payments. Cash flow generated by the asset sold, other 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 a use of his lifetime exemption amount, or sell to the S-IDGT a block of his non-cash assets (whether held outright or in some other entity wrapper) which he thinks will appreciate or have some major liquidity event in the future. While this will remove the value of those assets from his estate (as described above), any income stream from those assets can be used to fulfill his charitable goals through the actions of the Charitable Distribution 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 interests, art collection, land and/or mineral interests (or other unusual asset) in exchange for a note, when the assets sold to the trust later begin producing income, the Charitable Distribution Trustee can independently decide to distribute income to the creator-donor's private family foundation and/or 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 (although it will not be required that they receive any of those assets from the trust). 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 would be the same as the individual grantor/donor's tax rates, and the charitable powerholder function can be used to move value generated by that stock to the intended charitable beneficiary, without passing along the UBIT consequences that would apply if the stock were directly donated to the charity.

Further, 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 allow income from those assets to be distributed to charitable beneficiaries, with the income tax benefits flowing to the creator-donor. The charitable beneficiaries should additionally be pleased

that they are receiving the economic benefits of these weird assets, but not having to manage or finance the ownership of them.

vi. IDGT-CLT Combination

The S-IDGT technique can also be used in conjunction with a CLT. For example, in the establishment of a CLAT, the grantor-donor can appoint a non-GST IDGT as the remainder beneficiary; such non-GST IDGT could be structured in the technique outlined above, such that its income is taxable to the grantor-donor (S-IDGT), or as an IDGT structured so that its income is taxable to the beneficiary (what is called a beneficiary-IDGT or B-IDGT). Thus, at the end of the charitable term, the remainder would be 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, although it does not have the multi-generational capabilities of a GSTTE trust.

In order to move the economics of a CLAT through a multi-generational vehicle, more complex planning must be considered, to give a CLAT the GSTTE effects it otherwise could not realistically have (see the discussion above in part IV.F.ii.).

If dealing with a testamentary CLAT, the Executor of the decedent's estate could sell the assets to be distributed to the CLAT to a GST IDGT for the benefit of the donor/decedent's children, grandchildren, etc., by using the estate administration exception to self-dealing (outlined in part III.D.ii. above). This sale can only be accomplished using the estate administration exception, because the GST IDGT would be treated as a disqualified person to the testamentary CLAT.

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 at least the applicable AFR or such rate, when combined with the note principal payments, is sufficient to provide the CLT with its annuity or unitrust payments. The CLT would then receive note payments from the GST IDGT and use those payments to make the annuity or unitrust payments to the charitable term beneficiary.

Alternatively, following the funding of a CLAT, the remainder interest, which is usually held by beneficiaries one generation below the donor or in a non-GST trust, can be sold by that remainder interest beneficiary to a GST trust. The GST trust purchasing the remainder interest could be a regular irrevocable asset trust with *Crummey* withdrawal rights, a S-IDGT or B-IDGT. In such a sale, there is rarely any income tax because the remainder interest is deemed to be have such little value. This sale thus assigns the rights to the remainder interest to the purchasing GST trust, which does not terminate the CLAT but rather moves the economics of the CLAT to a structure with multi-generational capabilities.

It is unclear as to how the Service will treat the sale of a remainder interest in a CLAT to a GST trust, especially in light of PLR 200107015. In that Ruling, the Service stated that the remainder beneficiary in a CLAT would be treated as the "transferor" for GSTT purposes when the remainder beneficiary assigns by gift his remainder interest to a GSTT trust, but that the Service may collapse the entire transaction as a disregarded transaction and treat

the CLAT creator as the "transferor," thereby resulting in GSTT being applied at the end of the CLAT term (if paid to skip persons, including trusts). However, if the remainder interest is *sold* rather than gifted, it is arguable that the GSTT trust has paid fair-market value for what it received: the right to receive the remainder interest at the end CLAT term is merely an asset of the GSTT trust. If a sale is anticipated, the CLT document should be inspected to see if the spendthrift provision must be modified to allow the transfer.

Using the 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 universal concerns donors have with making a gift of non-cash assets, particularly focusing on exotic gifts. Some of these concerns also morph into concerns of the charitable donee, in that the organization would like to receive the economic benefit of the donor's valuable assets, but may not have that opportunity because of the donor's lack of understanding or awareness of how to manage his own concerns regarding the contribution.

A. VALUATION AND SUBSTANTIATION

The IRS has recently become more concerned that taxpayers are over-valuing non-cash contributions, and not properly reporting the deductions pursuant to the substantiation requirements. Congress is particularly concerned that donors use the fair market value for their deduction of property which is not used to further the charitable donee's exempt purposes and are suspicious that the donee is complicit in these abuses. 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.[439]

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 $75.00, obtain a written disclosure from the charitable donee.[440] The written record or receipt from the donee should include: (1) the name of donee, (2) the date (and location, if a gift of property) of the contribution, 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). For a contribution of $250.00 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).

A donor must procure an appraisal as part of completing Form 8283 in the case of claimed contributions of non-cash items over $500.00, and to include as an attachment to his or her income tax return, when claiming a deduction for a non-cash gift of over $5,000.00. Form 8283 to be included with the donor's income tax return must be signed and dated by the donee charity, as well as by the qualified appraiser.

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[439] Treasury Inspector General for Tax Administration Report: Many Taxpayers Are Still not Complying with Noncash Charitable Contribution Reporting Requirements, Report Number 2013-40-009, December 20, 2012.

[440] For more details, see Rev. Proc. 2011-52, 2011-45 IRB, as well as IRS CCA 201014056.

The donor is required 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.[441]

In order to be a "qualified appraisal", the appraisal must be made within 60 days of the date of the contribution, be prepared, signed and dated by a qualified appraiser, and include certain required information on the appraised property. Treas. Reg. §§ 1.170A-13 sets forth the list of requirements for a qualified appraisal. As discussed in part III.B. of this article, obtaining a proper appraisal and value of the contributed items should be a joint effort of the donor and the charitable donee in this process.

Taxpayers donating motor vehicles valued at more than $500.00 must attach Copy B of Form 1098-C and Form 8283 to their tax returns. If a taxpayer electronically files his tax return, he must also send paper forms of Forms 8283 and 1098-C including the original donee and/or appraiser signatures to the IRS.

Finally, the charitable organization must file Form 8282 when it disposes of the contributed property within three years of the donation, to report the amount received on disposition. 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).[442]

i. Art

When contemplating making a charitable gift, the donor should carefully consider whether an outright donation of the object(s) or a sale followed by a donation of the proceeds makes more sense.[443] Unless the donee is a museum or other organization which will use the art in some manner related to its exempt purposes, the charity will likely have to determine how to sell the art, so the proceeds can be used toward the furtherance of the foundation's charitable purposes. Note, that while most generally art is thought of to have a related use only to museums, the IRS has allowed "related use" to include art being used for therapeutic purposes, such as in a nursing home public area.[444] Any sale of art which will not be used in a manner related to the charity's exempt purposes will also affect the donor's income tax charitable deduction, as will be explained below. Substantiation requires that an appraisal be completed within 60 days of the gift, in order for the donor to be entitled to his charitable deduction.

When valuing a unique work of art or collectible that is being contributed to a charitable organization, the general rules of valuation do not provide sufficient guidance. The regulations generally refer to a retail market, whereas there is no common market for selling works of art.[445] The valuation of a work of art contributed to a charitable organization is extremely important, as a "substantial valuation misstatement" will cause a

[441] I.R.C. § 170(f)(8), (11); Treas. Reg. § 1.170A-13.
[442] HANCOCK, *supra* note 11, at 11.
[443] HORWOOD, *supra* note 337, at page 1.
[444] *See*, *e.g.*, PLR 8247062.
[445] RALPH E. LERNER, VALUING WORKS FOR ART FOR TAX PURPOSES, 28 Real Prop. Prob. & Tr. J. 593, 595 (1993).

penalty equal to 20% to 40% of the underpayment, with an exception available for a good faith investigation and valuation based on a qualified appraisal made by a qualified appraiser.[446] This penalty is incurred when the correct value of the art is less than 50% but more than 25% of the value reported on the income tax return.[447] If the value of the gifted property is 25% or less than the value claimed, the penalty increases to 40% of the underpayment.[448]

Revenue Procedure 66-49 provides that an appraisal of art objects in particular should include: (1) a complete description of the item, including size, subject matter, artist name, medium, date created and interest transferred; (2) cost, date and manner of acquisition; (3) history of the item, including its authenticity; (4) a photograph of the size and quality sufficient to fully identify the subject matter; and (5) a statement of the factors that were the basis for the appraisal, to include:

> (i) facts regarding sales of other works by the same artist, preferably near the valuation date;
> (ii) quoted prices in dealers' catalogs of works by the artist or comparable artists;
> (iii) economic state of the art market near the time of valuation, particularly regarding the type of art subject of the appraisal;
> (iv) a record of any exhibitions at which the art was displayed; and
> (v) a statement regarding the standing of the artist in the profession and his or her school, time or period.[449]

The appraisal must be performed by a qualified person and include a summary of his or her qualifications.[450] The IRS will likely give different weight to appraisals depending on the competence and knowledge of the appraiser with regards to the particular type of art or collectible.[451] The appraisal should go beyond the basic requirements and discuss all facts relevant to a thorough valuation, including comparable sales and the relation of the appraiser to both parties to the transfer.[452] The IRS is likely to discount an appraisal that is merely conclusory, opinion, or unreasonable or arbitrary.[453] The United States Tax Court has found that, in determining the value of unique items, the item's condition, uniqueness, rarity, authenticity, size and the market value of comparable objects are all considerations.[454] Further, the value of art is the price a customer would pay an art gallery, dealing in that time period and type of art, for a piece of that kind of art.[455] The fair market value is not determined by a single price, but a range of prices for which several art galleries would sell that piece.[456] Comparable retail sales at galleries are considered the most significant criterion of fair market value when it comes to rare art pieces, according to the Tax Court.[457]

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[446] *Id* at 639 – 40; Revenue Reconciliation Act of 1989, Pub. L. No. 100-239, 103 Stat. 2301 § 6662.
[447] *Id.*
[448] *Id.*
[449] Rev. Proc. 66-49, 1966-2 C.B. 1257.
[450] *Id.*
[451] *Id.*
[452] *Id.*
[453] LERNER, *supra* note 445.
[454] *See* Ferrari v. C.I.R., 58 T.C.M. (CCH) 221 (T.C. 1989).
[455] *Id.*
[456] *Id.*
[457] *Id.*

If the donor claims a deduction of $20,000 or more, a complete copy of the signed appraisal must be attached to the appropriate tax return. If an individual object is valued at $20,000 or more, a photograph of the size and qualify sufficient to show the object (preferably an 8x10 inch color photograph) must be provided upon request.[458]

Donors of art appraised at $50,000 or more and executors of estates including art appraised at $50,000 or more may request an advanced valuation of such art from the IRS. Revenue Procedure 96-15 provides taxpayers with the procedure to request this Statement of Value from the IRS, which can be used to substantiate the value of art for income, estate or gift tax purposes. For this purpose, "art" includes paintings, sculptures, watercolors, prints, drawings, ceramics, antique furniture, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia and other similar objects. A taxpayer who complies with this Revenue Procedure may rely on that Statement of Value in completing the tax return reporting the transfer of art; however, in order to request this statement, the request must include a formal appraisal and appraisal summary that meets the general requirements of Treasury Regulations Section 1.170A-13. Once procured, a copy of the Statement of Value must be attached to and filed with the applicable tax return reporting the transfer of that art value, even if the taxpayer does not agree with the value, although in such a case, the taxpayer may submit additional information in support of a different value.[459]

When art is part of an estate, the administrator should be sure to get an appraisal as part of completing the estate tax return. This will provide for the value of the items for purposes of the estate tax deduction, if the items are being distributed to charity, or if not, it will provide the recipient's cost basis, which may be crucial to that recipient if he or she later donates it to charity.

A donor generally will not want to make a contribution of a partial interest in art to the foundation, due to the rules restricting charitable deductions of partial interests (discussed above); however, the gift of a partial interest in tangible personal property, such as an undivided interest in a piece of art, will be deductible if 100% of the interest in such item is held immediately before the contribution by the donor, or a combination of the donor and the foundation. For example, an undivided ¼ interest in a painting that entitles an art museum to possession of the painting for 3 months of each year is a fractional interest in the property, subject to the special rules of partial interest gifts.[460]

B. DEDUCTION LIMITS

The Federal gift and estate tax deduction is without limit, other than the amount of the transfer itself, and is granted without distinguishing between the type of charitable beneficiary. However, under Code Section 170(e), the type of contributed property and the type of the charitable donee determine the amount of the donor's income tax charitable deduction. Donors must also be wary of the quid pro quo and bargain sale rules when receiving something in return for a contribution. A

[458] I.R.S. Pub. 561 (April 2007).
[459] Rev. Proc. 96-15, 1996-1 C.B. 627.
[460] I.R.S. Pub. 526 (2013).

bargain sale is partly a charitable contribution and partly a sale or exchange, which may result in taxable gain to the donor.[461]

i. Basis or Fair Market Value?

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.[462] The amount of the donor's deduction is thus effectively limited to basis for property that is not a long-term capital asset.[463] This includes gifts of property such as crops, dealer property, inventory and capital assets held for one year or less.[464] 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 purposes. If the property will not be put to a related use, the donor's deduction is limited to the property's basis. "Unrelated use" means a use unrelated to the exempt purpose or function of the charitable organization.[465] If the tangible personal property asset is sold and the proceeds used by the charity for its exempt purposes, this is considered an unrelated use, and the deduction will be limited to basis.[466] Items such as royalties and partnership interests are considered *intangible* personal property, and thus would not come under this special rule for tangible personal property.[467]

Contributions of capital gain property generally are deductible at the asset's fair market value.[468] "Capital gain property" is defined as capital assets held for more than one year. Capital assets include most items of property a donor owns and uses for personal purposes or investment, such as stocks, bonds, jewelry, coin or stamp collections, and cars or furniture used for personal purposes.[469] Capital assets also include certain real property and depreciable property used in the donor's trade or business and, generally, held more than one year (although, in certain circumstances the donor may have to treat this property as partly ordinary income property and partly capital gain property).[470] Real property is land and generally anything built on, growing on, or attached to land.[471]

However, the fair market value of a capital gain asset must be reduced to the property's cost or other basis if given to certain donees. Generally, this is required if: (1) the property (other than qualified appreciated stock) is contributed to certain private non-operating foundations, (2) the donor chooses 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 (i.e. a private operating foundation), (3) the contributed property is intellectual property or taxidermy property, or (4) the contributed property is tangible personal property put to an unrelated use by the charity or has a

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461 I.R.S. Pub. 526 (April 2007).
462 I.R.S. Pub. 526 (April 2007).
463 *Id.*
464 *Id.*
465 26 U.S.C.A. §170(e).
466 I.R.S. Pub. 526 (April 2007).
467 MARK D. HOFFMAN, "TANGIBLE PERSONAL PROPERTY", May 2, 2003, available at http://www.pgdc.com/pgdc/tangible-personal-property.
468 I.R.S. Pub. 526 (April 2007).
469 *Id.*
470 *Id.*
471 *Id.*

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 organization has not made the required certification of exempt use (such as on Form 8282, Donee Information Return, Part IV).[472]

ii. AGI Limits

Additionally, with any charitable donation, 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 the excess contributions forward to subsequent years. A donor is generally limited to 50% of his AGI when making a gift of cash or non-appreciated 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.

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. For gifts of appreciated property, the deduction is capped at 20% of the donor's AGI for the year. Keep in mind that the contribution deduction for gifts of appreciated property to a private non-operating foundation is further limited to the lesser of the donor's basis in the asset or its fair market value, unless the asset is qualified publicly traded stock.[473]

The excess of the allowable deduction(s) may be carried forward for five years, and must be deducted in order: (1) first, the remaining 50% of gifts in excess of the current year's 50% gifts (earliest year first); (2) second, carryovers of gifts to the 30% charities; (3) third, carryovers of the long term capital gains property gifts limited to 30%; and (4) fourth, carryovers of the long term capital property gifts limited to 20% of the contribution base.[474]

iii. Pease Limitation

The American Taxpayer Relief Act of 2012 reinstated the "Pease" Limitation. 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).[475]

iv. 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 non-charity for less than full and adequate consideration.[476] An income tax, estate or gift tax and generation-skipping transfer tax deduction is allowed for the value of split-interest gifts going to a qualified charity only if made in one of the qualified forms, i.e. CLT, CRT, CGA or a qualified remainder interest in

[472] I.R.S. Pub. 526 (April 2007).
[473] 26 U.S.C.A. § 170(e)(1)(B)(ii).
[474] I.R.C. § 170(b); Treas. Reg. §1.170A-8; MARILYN E. PHELAN & ROBERT J. DESIDERIO, NONPROFIT ORGANIZATIONS LAW AND POLICY (Am. Casebook Series, Thomson/West 2d ed. 2007) (2003), at 389-91.
[475] 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 determining the amount of Federal Estate Tax.
[476] *See* Treas. Reg. § 1.170A-7(a)(2).

personal residence or family farm. In order to avoid the negative impact of 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 last for the entire term of the donor's interest in such property and in other property into which it is converted.

For example, the donor may not retain the mineral rights associated with his land, while making a gift of the surface estate (or vice-versa). Thus, if the donor owns both the surface and mineral estate, he must make a gift of a portion of each. Further, 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). A deduction is allowed if such partial interest is the taxpayer's entire interest in the property, such as an income or remainder interest; however, the deduction will be disallowed if the property was divided in order to create such separate interest and avoid the consequences of section 170(f)(3).

This rule can become frustrating not only to the donor, but also to the intended charitable recipient – it is possible that the donor decides to not make a gift at all, due to the complexity of this restriction. Further, for example, if the donor decides to make a gift of both interests as he must, the charity may find the surface estate 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, disclaim the gift of the surface estate but keep the bequest of the mineral interests.

Donors with sizeable art collections and a heart for charity have historically favored making partial interests in works of art to their favorite museum over their lifetime, rather than giving the entire work at one time. However, under the relatively new requirements of the PPA, the charity must take substantial physical possession of the property immediately and use it towards its own charitable purposes. Additionally, the charity must receive the balance of the artwork within the shorter of 10 years or the donor's death, or else the income tax charitable deduction generated by the contribution (plus interest) will be recaptured.[477] Thus, these donors must track their gifts, to ensure that their piecemeal gifting technique will not cause a recapture of their charitable deductions taken in previous years. Also, in the case of such recapture, the donor's income tax for that year of recapture may be increased by a penalty in the amount of 10% of the recaptured amount.[478] Finally, the donor's tax deduction for subsequent gifts of that work of art will be limited to the *lesser of* the market value at the time of the first fractional gift or the market value at the date of the subsequent gift.

v. Art

The amount of the income tax deduction to which a donor is entitled depends first on the donor's status, as an art collector, investor, dealer, or creator. Most purchasers fall under the category of collector: someone who appreciates art and accumulates it for personal enjoyment. To be considered an investor, an individual must show he or she collects art primarily for investment purposes, and sells the art for profit. The IRS considers a dealer of

[477] I.R.C. § 170(o)(3)(A).
[478] *Id.*

art to be someone engaged in the business of dealing art, which depends on the facts and circumstances in each case; however, a dealer's art is considered inventory to him, not qualifying under the definition of a capital asset, and as such, will never allow the dealer to claim the fair market value as the amount of his income tax deduction. A donor's status as creator of the donated art will limit his deduction to his cost basis. Thus, only collectors and investors can own art as a capital asset, and thereby be eligible to claim the fair market value of the art as the amount of his/her income tax charitable deduction.

A donor (collectors and investors) of a work of art will receive an income tax deduction equal to the work's fair market value only if three conditions are satisfied:

(1) The gift is made to a public charity or a private operating foundation;
(2) The work of art has been held by the donor for over one year (i.e. if sold by the donor, it would generate long-term capital gain for income tax purposes); and
(3) The donee charity will use the work in a manner related to the charity's tax-exempt purpose.

If any of the three requirements above are not met, the donor's income tax charitable deduction is generally limited to the lesser of the donor's tax cost basis or the work's fair market value at the time of the contribution. *Note that this means if the charity immediately sells the donated work of art, the donor is not entitled to a deduction for its fair market value.* Also, keep in mind that if the charity sells the piece within three years of the donation, there is a potential recapture of a portion of the donor's deduction which was taken, which is why the IRS requires Form 8282 to be completed by the charity. The IRS has surprisingly interpreted the third requirement above relatively liberally, allowing a full fair market value deduction for, for example, a gift of art to a nursing home which will have therapeutic value to its residents.[479]

It is possible for a donor to have different types of treatment of one donation of a collection of art. For example, a donor whose father was a well-known artist received art in three ways: (1) by purchase, on the open market, (2) gifts by her father during his lifetime and (3) inheritance from her father's estate. Upon making a gift of this art to a public charity, each type of art must be analyzed separately to determine the amount of her income tax deduction. The items received by gift during her father's lifetime are tainted with her father's status as the creator; thus, they are ordinary income property to her, and she is limited to deducting their cost basis. The items she received as an inheritance received a step-up in basis at her father's death, and thus, depending on how long she has owned the art, will be entitled to a deduction in an amount greater than the art she received by gift. The items she purchased she will just need to hold for over one year in order to get a deduction in the amount of their fair market value.

As mentioned above, creators of creative works are limited to a deduction in the amount of the cost of the materials used, rather than being able to deduct the work of art's fair market value.[480] Thus, for example, a painter would only be able to deduct the cost of the paint and canvas for his contribution of the work to a charity. Congressman John Lewis (D-GA) has

[479] A POTPOURRI OF CHARITABLE PLANNING TRICKS AND TRAPS, SR038 ALI-ABA 125, 132 (citing PLR 8247062).
[480] I.R.C. § 170(e).

introduced a bill that would dramatically affect this current issue by amending the Code: the Artist-Museum Partnership Act of 2013, which was referred to the House Committee on Ways and Means on June 25, 2013. The creator of "literary, musical, artistic or scholarly composition, or similar property, or the copyright thereon" would be able to deduct the fair market value of such work if it was created, and the donor received a qualified appraisal of such item, no earlier than 18 months prior to the contribution.[481] The deduction would be limited to the amount of the donor's "artistic adjusted gross income" for the year in which the gift is made (defined as income from the sale or use of property created by the donor of a similar nature and income from teaching, performing or similar activity with respect to the contributed property), with no carryover of the excess to later years.[482] The standard substantiation rules would apply; in addition, the donee charity would be required to provide a written statement that the donee's use of the property will be within the scope of its exempt purposes.[483]

vi. Mineral Interests

When making an outright gift of mineral interests, the donor must answer several questions in order to navigate the maze as to 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? (3) is the interest tangible or intangible personal property? As outlined earlier, mineral interests in place are considered real property under Texas law; however, once severed from the surface, they become personal property. "Tangible personal property" for purposes of the IRS is any property, other than land or buildings, that can be seen or touched.[484] This is distinguishable from *intangible* personal property, which is an item such as securities, currency, other negotiable instruments, royalties and partnership interests.[485] 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. (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.)

A donor contributing a royalty interest or net profits interest (i.e. an intangible personal property asset), or a gift of the 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 asset if they have held the same for over one year.[486] 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. If the same interest is held for less than a year, the donor must reduce the fair market 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. 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/gas production, rather than merely holding an interest as a personal investment) will be limited

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[481] ARTIST-MUSEUM PARTNERSHIP ACT OF 2013, H.R. 2482, 113TH CONGRESS.
[482] *Id.*; http://beta.congress.gov/bill/113th-congress/house-bill/2482.
[483] *Id.*
[484] I.R.S. Pub. 526 (April 2007).
[485] HOFFMAN, *supra* note 467.
[486] 26 U.S.C.A. §170(e).

to a deduction in the amount of his or her cost basis. An operator-donor can, however, deduct any long-term capital gains, if the interest can be treated as real estate used in a trade or business.[487]

A donor should avoid a gift of production payments, or working interests subject to production payments, as these transfers can give rise to UBIT.[488] 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.[489]

Finally, the donor should avoid making a gift of property which he plans on being sold, after the sale has become subject to a binding commitment. 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.[490]

vii. Other Tangible Personal Property

Like with art, donors (collectors and investors, not dealers) of items of tangible personal property, such as coins, collectibles, cars, etc., will receive an income tax deduction equal to the item's fair market value only if three conditions are satisfied:

(1) The gift is made to a public charity or a private operating foundation;
(2) The item is a capital asset and has been held by the donor for over one year (i.e. if sold by the donor, it would generate long-term capital gain for income tax purposes); and
(3) The donee charity will use the work in a manner related to the charity's tax-exempt purpose.

If any of the three requirements above are not met, the donor's income tax charitable deduction is generally limited to the lesser of the donor's tax cost basis or the item's fair market value at the time of the contribution.

If a donor contributes land, 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, which would potentially include these items.

Additionally, if donated tangible personal property, 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. 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

[487] 26 U.S.C.A. § 1.162-1; HANCOCK, *supra* note 11, at 9.
[488] BUCHANNAN, *supra* note 113, at 578.
[489] *Id.*, at 577-78.
[490] LESLY BOSCH ANNEN, *supra* note 410, at 7.

difference between the amount claimed as a deduction and the property's basis.[491] The donor must include such amount in ordinary income in the year in which the disposition occurs.[492]

Grazing animals are considered livestock, including cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals and other mammals.[493] However, "livestock" does not include turkeys, poultry, chicken, other birds, fish, frogs, reptiles, etc. Livestock held by the donor for draft, breeding dairy or sporting purposes may qualify for long-term capital gain treatment if: (1) 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.[494] Thus, a gift of qualified livestock may qualify for full fair market value deduction, if given to a related-use public charity.[495]

Crops are defined as plants that can be grown and harvested, or picked to be consumed or sold.[496] Unharvested crops sold with the land on which they are located (and which has been owned by the donor for more than one year) are considered long-term capital gain assets.[497] Thus, if 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 (and subject to the 30% AGI limitation).[498] It is immaterial as to what use the charity places the crops, since they are not considered tangible personal property in this instance.[499] If the crops have already been harvested, they are considered tangible personal property, subject to the rules stated above (and if produced for sale in a trade or business, 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).[500]

Contributions of timber present a complexity as to the amount to be deducted when a donor's land includes this type of asset. Standing timber on land held by the donor for investment purposes is considered a capital asset; if 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).[501] (If contributed to another organization, the deduction would still be effectively limited to the donor's basis). Because standing timber is not considered tangible personal property, the charity's use of the same is irrelevant. 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. If that property has not been held long-term or if the timber is given to a charity which 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.[502]

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[491] I.R.S. Pub. 526 (April 2007).
[492] *Id.;* EDWARD JAY BECKWITH, TURNEY P. BERRY AND MICHELE A. W. MCKINNOM, SELECTING THE BEST CHARITABLE DONEE: PUBLIC CHARITY, DONOR ADVISED FUND OR PRIVATE FOUNDATION, SS007 ALI-ABA 369 (2010).
[493] Hoffman, *supra* note 467.
[494] 26 U.S.C.A. § 1231; *Id.*
[495] Hoffman, *supra* note 467.
[496] *Id.*
[497] *Id.* (citing Treas. Reg. § 1.1231-1(a)).
[498] *Id.*
[499] *Id.;* However, be wary of the UBIT consequences when the charity looks to sell the crops.
[500] *Id.*
[501] *Id.*
[502] *Id.* In the case of timber that is cut and held for sale to customers, the rules become more complex which are not addressed in this article.

Since the IRS has said that it will treat Bitcoin as intangible personal property, the potential amount of a donor's income tax deduction of such asset will depend on how he or she received the virtual currency and how long he or she has owned it, similar to the assets described above.

viii. Charitable Lead Trust

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). 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.[503] The trust will receive an income tax charitable deduction for payments made to the charitable beneficiary(ies) from gross income.[504] A grantor CLT allows the donor an income tax and gift tax charitable deduction upon contribution to the trust.[505] The grantor/donor is taxed on income from the trust as it is earned, without a corresponding annual income tax charitable deduction.[506] 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.

ix. Charitable Remainder Trust

When making a gift via a CRT, the 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.[507]

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. A gift of cash or non-appreciated 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. 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.[508] 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.

If the remainderman is a private non-operating foundation, gifts of cash and non-appreciated 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.[509] Again, regardless of whether the remainder passes outright or in trust, a charitable income tax deduction is allowed for a gift of long-term 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. Finally, for gifts of

[503] 26 U.S.C.A. § 170(f).
[504] 26 U.S.C.A. §§ 641, 642(c).
[505] 26 U.S.C.A. § 170(f).
[506] 26 U.S.C.A. §§ 671-679.
[507] 26 U.S.C.A. §170.
[508] 26 U.S.C.A. §170(b)(1)(A); 26 C.F.R. §1.170A-8(a)(2).
[509] 26 U.S.C.A. §170(b)(1)(B).

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, and limited to 20% of his AGI with a five year carry-forward.[510]

[510] 26 U.S.C.A. §170(e)(1)(B)(ii).