



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

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

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This is in response to the ruling request by A dated August 12, 2005 submitted by your representative. A ("Foundation") requests a ruling that its receipt of a one percent working interest in an oil and gas and related pipeline investment will not constitute a jeopardy investment, under Section 4944 of the Internal Revenue Code

FACTS

The Foundation is a private foundation recognized as tax exempt under Section 501(c)(3) of the Code. The charitable purpose of the Foundation is to "receive and administer a fund or funds of real or personal property, or both, and . . . to use and apply the income therefrom and the principal thereof exclusively for charitable, or religious, scientific, literary or educational purposes either directly or by contributions (a) to organizations that qualify as exempt organizations under Section 501(c)(3). . . ."

The Foundation currently has approximately   x   in assets invested primarily in cash, bonds and common stock. Substantially all the assets of the Foundation were contributed by B and C, husband and wife, the founders of the Foundation.

Over twenty years ago, B acquired a one percent working interest in an oil and gas exploration and development venture known as the D (the "Project"). As the result of estate planning, and the subsequent death of B, and later, C, that working interest is now owned by the B Marital Trust (the "Trust").

The Trust's one percent working interest in the Project is estimated to have a current fair market value of approximately   x  . The Trust seeks to contribute the entirety of its working interest (including the pipeline interest) of the Project to the Foundation, and the Foundation desires to accept the contribution of that working interest.

The contribution by the Trust to the Foundation would be made gratuitously without the payment of any consideration by the Foundation to the Trust. Following its receipt of the gift of the working interest, the Foundation would not plan to liquidate the investment, but would instead plan to retain and continue to hold the investment indefinitely. In addition, the Foundation would from time to time respond to certain calls for capital and pay certain expenses for ongoing maintenance, exploration and development, as described more fully below.

The Project essentially has two (2) components: an oil and gas exploration and development component, and a gas gathering system (i.e., pipeline) component. The exploration and development component of the Project is governed by an "Operating Agreement" the current "Operator" of the Project, and five other investors (including the Trust), described as "Non-Operators", and an "Addendum to Operating Agreement."

The exploration and development component of the Project involves leases to   y   acres located in E and F. Since           , the Project has developed this field through the drilling of over   z   development and exploration wells. As of December           , nine of those wells were shut in as noncommercial wells, ten wells were shut in due to surface coal mining activity, and eleven wells were plugged and abandoned. The remaining gas wells are all producing wells.

The pipeline component of the Project is governed by an Agreement for Construction, Ownership and Operation of the D Gathering System, and related agreements and attachments ("Pipeline Agreement").

Although not a profit center for the Trust, the pipeline interest has a significant advantage in allowing the Trust to market its share of the gas sales without the burden of a transportation fee. In other words, the pipeline interest supports the profitability of the exploration and development interest.

Over time, these wells will become depleted and no longer productive. In order to maintain production at a relatively stable level, the Operator has determined that it should develop approximately twenty-five to thirty new wells each year.

Under the terms of the Operating Agreement, the Operator will invite the Non-Operators to participate in the exploration and development of these new wells (a "Proposed Operation"). If a Non-Operator elects to participate in a Proposed Operation, it will be responsible for the payment of certain costs and expenses associated with that operation, which will require it to pay additional sums into the Project. If a Non-Operator is required to pay additional sums into the Project, the Operator will simply deduct those expenses from the monthly distribution of profits to the Non-Operator, which deductions are set forth in a statement accompanying the payment. In other words, the obligation of the Non-Operator to pay these additional expenses does not require the separate payment of additional sums to the Operator; rather, it simply increases the amount of deduction taken from the Non-Operator's distributive share of profits. If a Non-Operator elects not to participate in a Proposed Operation, then the Non-Operator becomes a "Non-Consenting party" with respect to that operation, and as a result, will not be entitled to participate in any production from that operation until the other consenting parties (the "Consenting Parties") have recouped all of their costs and expenses associated with the operation, as well as 300% of all of the costs and expenses associated with any drilling, reworking, sidetracking, deepening, plugging back, testing, completing, and recompleting of the operation. The Foundation represents that the foregoing participation provisions are customary and typical in investments of this nature.

The Trust, and all of the other investors in the Project, have historically elected to participate in most of these Proposed Operations, and have supplied the additional funds and capital as requested.

The Pipeline Agreement requires, among other things, that the investors (defined as "System Owners") contribute their proportionate share of capital expenditures and pay their proportionate share of operating expenses incurred by the System Operator in connection with the pipeline operations. If an investor (i.e., a System Owner) fails to pay its share of costs and expenses under the Pipeline Agreement, the unpaid indebtedness accrues interest at the rate of eighteen percent per annum. In addition, the System Owner is empowered to foreclose on a lien which the System Operator holds on the defaulting System Owner's interest in the pipeline system. As a result of these provisions, the Trust has historically always paid such costs and expenses when invoiced.

If the Foundation accepts the contribution of the working interest from the Trust, the Foundation would intend to likewise participate in these Proposed Operations, and to

supply additional capital and pay its proportionate share of costs and expenses, in the same manner as did the donor (the Trust) and the other investors in the Project.

The Foundation represents that the Project has historically been a highly profitable financial investment, and is expected to continue to be so in the foreseeable future. Moreover, the aggregate dollar amount of funds which Non-Operator investors historically have been asked to contribute in response to Proposed Operations has been significantly less than that which the Project has generated and distributed to those investors. The Foundation expects that this record of profitability to continue, at least for the foreseeable future, if it accepts the gift of the working interest from the Trust. If the Foundation were to lose all or any substantial portion of the amount it might expend in payment of costs, expenses and other capital requirements through its participation in Proposed Operations, such loss would not, in the opinion of the Foundation's manager, imperil the ability of the Foundation to carry out its exempt purposes given (i) the relatively small amount of such expenses relative to the large, remaining principal investment, and (ii) the anticipated continued profitable return on that investment.

Moreover, under the terms of the operative agreements and contracts, none of the expenses, costs or interest charges associated with either gas exploration and development, or the gathering system (pipeline) will be used in anyway as an offset or encumbrance against the existing current diversified portfolio of stocks, bonds and other investments of the Foundation.

There is no public market for the sale of the working interest, and any liquidation of that interest would, in all likelihood, require a sale to the other investors in the Project at a substantial discount.

#### RULING REQUESTED

That the Foundation's acceptance and receipt of a gift from the Trust of the one percent working interest in the Project, without the payment of any consideration, will not constitute a jeopardizing investment under Section 4944.

#### LAW

Section 4944(a)(1) of the Code imposes an excise tax on any private foundation that "invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes."

Section 53.4944-1(a)(1) provides that an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the

foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment. The Regulation further provides that investments in working interests in oil and gas wells constitute an example of a type or method of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence.

Section 53.4944-1(a)(2)(i) of the Foundation and Similar Excise Taxes Regulations provides that an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio.

Section 53.4944-1(a)(2)(ii)(a) of the regulations provides that 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.

Rev. Rul 74-316, 1974-2 C.B. 389, provides that approval of an investment procedure governing investments to be made in the future is not possible. Advance approval of such procedures would necessarily preclude application of the "prudent trustee" approach.

#### ANALYSIS

In acquiring a one percent interest in the oil and gas and pipeline Project, the Foundation is not making an investment that would subject the Foundation to the tax on jeopardizing investments under section 4944 of the Code. Here, no consideration will be paid to the donor for the gift of the working interest. The Foundation may elect to pay cost and expenses associated with the oil and gas and /or pipeline Project, and in some instances may be obligated to pay such costs and/or expenses. However, in no event can such costs and expenses become an encumbrance against the current diversified    portfolio of stocks, bonds and other investments, and in no event could such Project costs and expenses become an encumbrance against other non-Project assets of the Foundation. Therefore, the Foundation's mere receipt of the gift, without more, does not constitute a jeopardizing investment.

#### RULING:

The Foundation's acceptance and receipt of a gift from the Trust of the one percent working interest in the Project, without the payment of any consideration, will not constitute a jeopardizing investment under Section 4944.

This ruling is limited as stated above. Specifically, it does not cover whether the Foundation's payment of operating, capital, or other costs and expenses associated with the oil and gas operations, or the pipeline, will violate Section 4944 or other provisions of the Internal Revenue Code.

This ruling is conditioned on the understanding that there will be no material changes in the facts upon which it is based.

Please keep a copy of this ruling in your organization's permanent records.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

Sincerely,

Andrew F. Megosh, Jr.  
Acting Manager  
Exempt Organizations Technical Group 2

Enclosure: Notice 437