INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Internal Revenue Service
Attn: EO Mandatory Review
MC 4920 DAL
1100 Commerce Street
Dallas, TX 75242

Release Number: **201129050**
Release Date: 7/22/2011
UIL Code: 4962-00-00

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Tax Years Involved:

Date of Conference:

Legend:

Trust =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =
Date 3 =

x =
y =
z =
xx =
yy =

Issues:

1. Should the first-tier excise taxes due under section 4942 of the Internal Revenue Code (Code) on the Trust's undistributed income for the years 1999-2003 be abated in accordance with section 4962?

2. Does the Trust qualify for a set-aside for the various projects, including but not limited to historical renovations and mechanical improvements?

Facts:

Trust is a section 501(c)(3) of the Code organization established in Year 1 and classified as a private foundation. Trust operates and maintains two historical properties. Prior to and during the years at issue, the Trust changed its investment strategy with the objective to increase portfolio growth and returns on investments. In turn, the Trust limited spending and cut staffing to reduce expenditures.

During the years at issue, the Trust engaged an accounting firm to prepare the monthly financial statements and all of its federal income tax filings, including Form 990-PF. Beginning in Year 3, the value of the Trust's non-charitable use assets increased (from $x in Year 2 to $y in Year 3), but its expenditures declined. As a result, the Trust had undistributed income as of the end of each year from 1999-2003.

Trust states that during this time, it was never informed by the accounting firm that the Trust failed to distribute the required amount for the years at issue, even though the firm was engaged to advise the Trust on such matters. Trust also claims that it was advised by the accounting firm that it met the requirements as a private operating foundation and was not required to make any minimum distributions. Trust provided a signed affidavit dated Date 3 from the accounting firm attesting to its belief that the Trust met the requirements as a private operating foundation and was therefore not required to make the distributions. Trust has not submitted any contemporaneous information or documents showing that it was advised by the accounting firm that it met the private operating foundation status.

On its timely filed Forms 990-PF for each of the years at issue, Trust did not file as a private operating foundation. Trust represents that these returns were signed by its bank trustee and the paid return preparer, who is the same accountant that prepared the affidavit. It did not check the private operating foundation box in Part XI (Distributable Amount), and it did not complete Part XIV (Private Operating Foundations). Instead, Trust completed the sections that were applicable to non-operating foundations, including Part XI (Distributable Amount), Part XII (Qualifying Distributions), and Part XIII (Undistributed Income). In Part VII-B (Statements Regarding Activities for Which Form 4720 May Be Required) and Part XIII, Trust reported that it had undistributed income at the end of each of the years at issue. A review of the Forms 990-PF for the years at issue shows that the Trust did not meet the requirements as a private operating foundation.

In Year 4, when Trust changed its accountants and tax advisors, the Trust was advised of its failure to make the minimum distributions for the years at issue. Trust states that it became aware of the deficiencies in the fall of Year 4, and made a $z distribution to meet its Year 4 distribution requirements. At that time, Trust set-aside funds for specific projects with the intention that such set-asides would correct the failure in meeting its distribution requirements by reducing the undistributed income for the years at issue to zero.

In Year 5, Trust filed Form 4720, requesting abatement of the first tier tax under section 4942 of the Code and approval of a set-aside to cover the undistributed investment income. Trust is requesting abatement of taxes assessed under section 4942 for $xx for the years at issue. The Notice of Proposed Adjustment (30-day letter) was issued on Date 1.

In addition to the request for abatement, the Trust requested that the 90-day correction period with respect to section 4942 tax be extended pursuant to section 53.4963-1(e)(3) of the Foundation & Similar Excise Taxes Regulations (foundation regulations). The Trust states that it is actively seeking in good faith to correct the taxable event, and that adequate and responsible corrective action cannot reasonably be expected to occur before the 90-day correction period ends due to the nature of the capital expenditure projects. Trust would like to treat the undistributed income amounts as a set-aside for the years at issue.

Trust has taken the following steps to correct the taxable event:

1. Made additional charitable expenditures of $z before the end of its Year 4 tax year to meet its Year 4 minimum distribution requirement under section 4942(d).
2. Filed the Form 4720 and reported the deficiency to the Internal Revenue Service (Service), immediately after identifying and determining the deficiency.
3. Since the filing of Form 4720, the Board and staff have worked diligently in finalizing plans and projects needed to ensure the Trust's viability and to expand its programming to the outlying communities. The staff is working to finalize renovations with the architects, construction contractors and restoration experts.
4. Made an entry in its books and records to record this undistributed income as an obligation of the Trust.
5. Worked with tax professionals to ensure that the minimum distribution is met for future years.

The sum of all qualified Chapter 42 tax deficiencies at issue exceeds the substantial threshold amount set out in Delegation Order No. 7-11. Trust represents that it has distributed all of the undistributed income for the years 1999-2003 as of Date 2.

Law:

Section 4942(a) of the Code imposes a tax on the undistributed income of a private foundation which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year (if such day falls within the taxable period).

Section 4942(c) of the Code defines "undistributed income" as the amount by which the distributable amount for such taxable year exceeds qualifying distributions made before such time out of such distributable amount.

Section 4942(e) of the Code defines minimum investment return for any private foundation for any taxable year as five percent or the aggregate fair market value of all assets of the foundation other than those which are used directly in carrying on the foundation's exempt purpose over any acquisition indebtedness with respect to such assets.

Section 4942(f) of the Code defines the "distributable amount" as an amount equal to the sum of the minimum investment return (as adjusted) reduced by the sum of the taxes imposed on such private foundation under subtitle A and section 4940.

Section 4942(g)(1) of the Code provides that a "qualifying distribution" is any amount paid for tax exempt purposes as defined in section 170(c)(2)(B) of the Code.

Section 4942(j)(1) of the Code provides that the term "taxable period" means with respect to the undistributed income for any taxable year, the period beginning with the first day of the taxable year and ending on the date of mailing of a notice of deficiency.

Section 4942(j)(2) of the Code provides that the term "allowable distribution period" means, with respect to any private foundation, the period beginning with the first day of the first taxable year following the taxable year in which the incorrect valuation (described in section (a)(2) of this section) occurred and ending 90 days after the date of mailing of a notice of deficiency extended by (a) any period in which a deficiency cannot be assessed under section 6213(a), and (b) any other period which the Secretary determines is reasonable and necessary to permit a distribution of undistributed income under this section.

Section 4962(a) of the Code provides that if it is established to the satisfaction of the Secretary that:

1. a taxable event was due to reasonable cause and not to willful neglect, and
2. such event was corrected within the correction period for such event, then any qualified first tier tax imposed with respect to such event (including interest) shall not be assessed and, if assessed, the assessment shall be abated and, if collected, shall be credited or refunded as an overpayment.

Section 1.507-1(c)(5) of the Income Tax Regulations (regulations) provides that no motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an act (or failure to act) willful. However, a foundation's act (or failure to act) is not willful if the foundation (or a foundation manager, if applicable) does not know that it is an act of self-dealing, a taxable expenditure, or other act (or failure to act) to which chapter 42 applies. Rules similar to the regulations under chapter 42 (see, for example, section 53.4945-1(a)(2)(iii) of this chapter) shall apply in determining whether a foundation or a foundation manager "knows" that an act (or failure to act) is an act of self-dealing, a taxable expenditure or other such act (or failure to act).

Section 53.4942(a)–3(a)(1) of the foundation regulations provides that an organization's qualifying distributions will be determined solely on the cash receipts and disbursements method of accounting; and the amount of a qualifying distribution of property is the fair market value of the property on the date the qualifying distribution is made.

Section 53.4942(a)–3(a)(2) of the foundation regulations defines the term "qualifying distribution" as:

a. Any amount paid by a private foundation to accomplish one or more purposes described in section 170(c)(2)(B) or 170(c)(1) of the Code. That is to say, amounts paid to accomplish charitable, religious, educational, etc., purposes or amounts contributed to a governmental unit for exclusively public purposes.

b. Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in 170(c)(2)(B) or 170(c)(1).

c. Any amount set aside which meets the criteria for set-asides.

d. Included in amounts paid for one or more purposes described in section 170(c)(2)(B), or 170(c)(1), are amounts paid for program-related investments, as defined in section 4944(c). Also distributions or expenditures that are creditable against a private foundation's obligation to distribute its distributable amount are referred to as "qualifying distributions".

Section 53.4963-1(e) of the foundation regulations provides that the correction period with respect to any taxable event shall begin with the date on which the taxable event occurs and shall end 90 days after the date of mailing of a notice of deficiency under section 6212 of the Code with respect to the second tier tax imposed with respect to the taxable event. Subparagraph (3) provides that the correction period may be extended by any period which the Commissioner determines is reasonable and necessary to bring about correction of the taxable event.

Section 301.6651-1(c) of the regulations provides rules for imposition of additional taxes and penalties for failure to file tax returns or pay tax, applies a standard of "ordinary business care and prudence." This section provides that a failure to pay tax will be considered to be due to reasonable case to the extent the taxpayer satisfactorily shows that he or she exercised ordinary business care and prudence for the payment of the tax liability, but was either unable to pay or would have suffered an undue hardship if the liability had been paid on the due date.

Rev. Rul. 78-148, 1978-1 C.B. 380, held that a foundation may make a set-aside by means of a book-keeping entry, consisting of the amount by which its minimum investment return for its immediately preceding taxable year exceeds its adjusted net income for that year.

In United States v. Boyle, 469 U.S. 241 n.3 (1985), the Supreme Court described "willful neglect" "as meaning a conscious, intentional failure or reckless indifference." To show reasonable cause, the taxpayer must "demonstrate that he exercised 'ordinary business care and prudence.'" Boyle, 469 U.S. at 246 (quoting Treas. Reg. § 301.6651-1(c)(1).

In Rembusch v. Commissioner, 38 T.C.M. (CCH) 310 (1979), the court held that the taxpayer has the burden of showing that a failure to file timely returns was due to reasonable cause and not willful neglect. A mere showing that the delinquency in filing the returns was not due to willful neglect is not sufficient and that there must also be reasonable cause.

In de Belaieff v. Commissioner, 15 T.C.M. (CCH) 1426 (1956), the court held that ignorance of the law does not constitute reasonable cause. The taxpayer had shown that failure to file returns was not due to willful neglect, but was instead due to ignorance of the law. The taxpayer received advice from her attorneys regarding the tax treatment of income items, which at the time of the advice, was correct. Subsequently, for the years at issue, there was a change in the law and taxpayer continued to treat the items as nontaxable, even though they were now taxable. The court found that even though taxpayer had legal representation, the failure by the attorneys to provide advice and the failure by the taxpayer to seek advice, did not constitute reasonable cause.

In Rogers Hornsby v. Commissioner, 26 B.T.A. 591 (1932), the taxpayers filed their income tax return late, having forgotten to file them at the proper date. The court held that to abate penalties, the late filing had to be due to reasonable cause and not to willful neglect, stating that both conditions must exist. The court found that forgetting to file tax returns is not reasonable cause for failure to perform such an important act and does not relieve the taxpayer of the penalties for delinquent filing.

H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1472 (1984), and S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. 591 (1984), provide that where the foundation or foundation manager can establish that there was reasonable cause for such a violation and that there was no willful neglect of the rules, the Internal Revenue Service is to have discretionary authority to relieve the foundation or manager from the first-tier penalty tax, provided that the violation is corrected in the manner required in order to avoid liability for second-tier taxes. A violation which was merely due to ignorance of the law cannot qualify for such abatement.

Delegation Order No. 7-11 (11-08-2007) delegates authority to abate substantial first-tier excise taxes to the Director, Exempt Organizations. "Substantial qualified first-tier tax amount" is described as a sum exceeding $200,000 for all such tax payments or deficiencies (excluding interest, other taxes, and penalties) involving all related parties and transactions arising from chapter 42 taxable events within the statute of limitations as determined by the key district office involved. See IRM 1.2.46.12(2), (3).

Analysis

Issue 1: *Should the first-tier excise taxes due under section 4942 of the Code on the Trust's undistributed income for the years at issue be abated in accordance with section 4962?*

Section 4962(a) of the Code provides discretionary authority to the Service not to assess or to abate or refund, any "qualified" first-tier tax, if the foundation establishes to the satisfaction of the Service that the violation: (1) was due to reasonable cause; (2) was not due to willful neglect; and (3) has been corrected within the appropriate correction period. This section does not define "reasonable cause."

Trust has represented that it corrected the undistributed amounts for the years at issue as of Date 2. The issues are whether the Trust has shown that its failure to distribute did not result from willful neglect and that it was due to reasonable cause.

Trust's timely filed Forms 990PF for the years at issue, which were signed by its bank trustee and its paid preparer, take the position that Trust is a non-operating foundation and specifically report that Trust had past, continuing, and increasing undistributed amounts for each of the years at issue. Moreover, the Board's actions, including changing its investment strategy to increase growth and returns, and reducing Trust's expenditures, establish that Trust should have known its expenditures, as a percentage of its assets, were declining during the years at issue and thus creating distribution shortfalls. Further, the affidavit from Trust's accountant post-dated all of the Forms 990-PF for each of the years at issue, and no such returns were amended to conform to the accountant's purported advice that the Trust qualified as a private operating foundation. Trust has presented no other evidence that the accountant had advised the Trust that it was a private operating foundation. Finally, Trust did not in fact meet the statutory requirements for a private operating foundation. Based on these facts, Trust has failed to show that its failure to meet the minimum distribution requirements for each of the years 1999-2003 was due to reasonable cause and was not due to willful neglect. The request to abate the tax is denied by the Director, Exempt Organizations.

Issue 2: *Does the Trust qualify for a set-aside for the various projects, including but not limited to historical renovations and mechanical improvements?*

Since Trust has represented that as of Date 2, it has distributed all undistributed income for the years 1999-2003, we decline to address the request for a set-aside.

Based on the foregoing facts, we find that:

1. The first-tier excise tax due under section 4942 of the Code on the Trust's undistributed income for the years at issue should not be abated in accordance with section 4962. Trust failed to establish that it acted with reasonable cause and not with willful neglect.

2. Based on Trust's representation, we decline to address the request.

A copy of this memorandum is to be given to Trust. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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