Release Number: 201423035
Release Date: 6/6/2014
Date 12/30/2013
UIL Code: 4962.00-00

INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

E.O. Exams Programs and Review
Internal Revenue Service
Attn: EO Mandatory Review
MC 4920 DAL
1100 Commerce Street
Dallas, TX 75242

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Tax Years Involved:

Date of Conference:

LEGEND:

Trust =
Date1 =
Date2 =
Date3 =
Date4 =

ISSUE:

Should the first-tier excise taxes under I.R.C. § 4942 on Trust's failure to distribute income for the years at issue be abated in accordance with § 4962?

FACTS:

The settlor created Trust on Date1. According to the Second Amendment and Restatement of Trust Agreement ("Restatement"), after settlor's death the residue of the Trust estate is to be held in trust and the income distributed for a term of years to 24 named charities. At the end of the term, the balance of the Trust estate is to be distributed to "the then beneficiaries free of trust in the proportions in which such beneficiaries are receiving income." The Restatement further provides for "pro rata distribution to remaining eligible charitable beneficiaries if any one or more charitable beneficiaries cannot take."

The settlor maintained the revocable Trust for 20 years, until his death. The settlor died testate on Date2. At that time, under its terms, Trust became a nonexempt charitable trust pursuant to § 4947(a)(1). The trustee was a first cousin of settlor, with whom he lived in retirement. Trustee was elderly and not familiar with tax matters, sought the advice of a local tax preparer who advertised that he was an enrolled agent authorized to practice before the Internal Revenue Service. Rather than recognizing that Trust was a nonexempt charitable trust subject to the private foundation provisions under § 4942, the tax preparer advised the trustee that Trust was a complex, taxable trust and should file Forms 1041, *U.S. Income Tax Return for Estates and Trusts*. The trustee filed Form 706, *Estate Tax Return* and Forms 1041 for certain specified years. During many of these years, Trust made donations to the charitable beneficiaries of the Trust, but treated them as charitable deductions of a taxable trust, rather than as qualifying distributions of a private foundation. The amounts donated did not equal what would have been required distributable amounts of the private foundation during all of these years.

On Date3, the IRS conducted a correspondence examination of the Trust's Form 1041 income tax return. The IRS requested documentation to verify the charitable deductions claimed on the return, as well as, the trust instrument and any amendments. On Date4, the IRS issued a "no change" letter, stating [we] "have determined that no change to your tax return is necessary."

Subsequently, the 24 charitable beneficiaries brought civil actions against Trust and the trustee for: (1) an accounting; (2) a surcharge; and (3) removal of trustee. At that time, Trust engaged a new accountant to provide an accounting as requested in the civil suit. This new accountant informed the trustee that under the terms of its trust document, Trust was a nonexempt charitable trust described in § 4947(a)(1). Under this provision, Trust is treated as a private foundation after the death of the settlor. This requires the Trust to file Form 990-PF, *Return of Private Foundation,* pay excise tax on its net investment income pursuant to § 4940, and make required annual distributions to charity pursuant to § 4942. Trust also engaged new tax counsel to handle the court action. Tax counsel agreed with the new accountant that Trust was a nonexempt charitable trust. However, because Trust's federal tax status still needed to be resolved, the new accountant prepared and the trustee filed Form 1041.

To correct its failure to file the proper information return, and failure to pay tax on net investment income under § 4940, Trust filed Forms 990-PF for the specified years at issue. On each of the Forms 990-PF, Trust computed the tax on net investment income, penalty for underpayment of estimated tax, tax due, distributable amount, and qualifying distribution. Trust paid the excise tax on net investment income and penalty for underpayment of estimated tax, plus interest, for each of these tax years, where applicable. Trust made qualifying distributions of all remaining undistributed income from those years. This distribution was reported on the Form 990-PF.

Trust also filed Forms 4720 for the years at issue, calculating the total undistributed income at the end of each of these tax years that is subject to tax under § 4942. Pursuant to § 4962, Trust requests that the first-tier § 4942 excise tax reflected on the Forms 4720, be abated because the under distribution was due to reasonable cause and not willful neglect.

No notice of deficiency with respect to the first-tier tax has been issued.

LAW:

I.R.C. § 4942(a) 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).

I.R.C. § 4942(c) 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.

I.R.C. § 4942(d) 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 § 4940.

I.R.C. § 4942(e) defines minimum investment return for any private foundation for any taxable year as five percent of the excess of 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.

I.R.C. § 4942(g)(1) provides that a "qualifying distribution" is any amount paid for tax exempt purposes as defined in § 170(c)(2)(B).

I.R.C. § 4942(j)(1) 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.

I.R.C. § 4942(j)(2) 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 § (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 § 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.

I.R.C. § 4962(a) 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.

I.R.C. § 4947(a)(1) provides that a nonexempt charitable trust, which is a trust that is not exempt from taxation under § 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in § 170(c)(2)(B), and for which a deduction was allowed under §§ 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, shall be treated as an organization described in § 501(c)(3).

I.R.C. § 4962(b) provides that the term "qualified first tier tax" means any first tier tax imposed by subchapter A, C, D, or G of Chapter 42, with the exception of the initial tax on self-dealing imposed by § 4941(a).

I.R.C. § 4963 provides definitions for excise tax, taxable event, correction, and correction period with regard to Chapter 42 taxes. In the case of § 4942, "taxable event" means any act (or failure to act) giving rise to liability under § 4942; the taxable event occurs on the first day of the taxable year for which there was a failure to distribute income; "correct" means reducing the amount of the undistributed income to zero; and "correction period" means, with respect to any taxable event, the period beginning on the date on which such event occurs and ending 90 days after the date of mailing under § 6212 of a notice of deficiency with respect to the second tier tax imposed on such taxable event, subject to certain extensions.

Treas. Reg. § 1.507-1(c)(5) 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, Treas. Reg. § 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).
Treas. Reg. § 1.508-1(a)(3)(d) provides that a nonexempt charitable trust described in § 4947(a)(1) is excepted from the § 508 notice requirement for purposes of §§ 507, 508(d)(1), 508(d)(2)(A), 508(d)(3), 508(e), 509, and chapter 42.

Treas. Reg. § 53.4942(a)–3(a)(1) 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.

Treas. Reg. § 53.4942(a)–3(a)(2) defines the term "qualifying distribution" as:

a. Any amount paid by a private foundation to accomplish one or more purposes described in § 170(c)(2)(B) or § 170(c)(1). 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 § 170(c)(2)(B), or § 170(c)(1), are amounts paid for program-related investments, as defined in § 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".

Treas. Reg. § 53.4947-1(a) explains that the basic purpose of § 4947 is to prevent charitable trusts from being used to avoid the requirements and restrictions applicable to private foundations.

Treas. Reg. § 53.4947-1(b) provides, in part, a § 49447(a)(1) "charitable trust" is treated as a private foundation and is subject to the excise tax on its investment income under § 4940(b) rather than the tax imposed by § 4940(a).

Treas. Reg. § 53.4963-1(e) 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 § 6212 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.

In United States v. Boyle, 469 U.S. 241 (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)).

Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950) provides that when a corporate taxpayer selects a competent tax expert, supplies him with all necessary information, and requests him to prepare proper tax returns, the taxpayer has done all that ordinary business care and prudence can reasonably demand. The taxpayer had not "awaited passively for such tax advice," but affirmatively requested the preparation by his consultant of proper returns. To require the taxpayer to inquire specifically about the personal holding company act nullifies the very purpose of consulting an expert. The court continues, "we doubt if anyone would suggest that a client who stated the facts of his case to his lawyer must, in order to show ordinary business care and prudence, inquire specifically about the applicability of various legal principles which may be relevant to the facts stated. The courts have recognized that reliance on the advice of counsel or of expert accountants, sought and received in good faith is 'reasonable cause' for failing to file a tax return." The court held in favor of the taxpayer.

In West Side Tennis Club v. Commissioner, 111 F.2d 6 (2d Cir.1940), the court states that the burden of establishing reasonable cause is on the taxpayer, and that the taxpayer had "not shown a timely effort to get advice or to secure a ruling and has rested its case on the finding of the taxpayer's board that the officers and directors believed that it was exempt. But this, without more, was not sufficient." The board had stated, "We do not know the steps taken by petitioner to ascertain its status as a taxpayer, and without knowledge of the basis for the belief of its officers and directors that it was exempt from tax we are in no position to test the reasonableness of the conclusion." The court therefore held in favor of the Commissioner.

In Fides v. Commissioner, 137 F.2d 731 (4th Cir. 1943), the taxpayer claimed as an excuse for failing to file a return that its attorneys' belief that it was a personal holding company and therefore not subject to the statute in question. The court held that a mere statement that taxpayer's counsel entertained a subjective belief, whether well-founded or not, that taxpayer was not subject to the tax statute in question was not sufficient to show reasonable cause relieving the taxpayer of a penalty for failing to file a timely return. Therefore, the court held in favor of the Commissioner.

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 Hale v. Commissioner, 44 T.C.M. (CCH) 1116 (1982), the Tax Court states that the taxpayer bears the burden of showing reasonable cause to avoid penalties for failing to file a timely return under § 6651(a)(1).

In Western Supply and Furnace Co. v. Commissioner, 18 T.C.M. (CCH) 288 (1959), the Tax Court opines that reliance upon the advice of counsel or of expert accountants sought and received in good faith is reasonable cause for failure to file a tax return. However, the court was not persuaded that a bookkeeper had any special knowledge or training in tax law or that he was otherwise competent in tax matters. In fact, he testified that he did not know that corporate returns had to be signed by two officers. Nor is it established in the record that the taxpayer relied upon the advice of the bookkeeper. The court held that the taxpayer's failure to file proper corporate returns was due to willful neglect and not to reasonable cause.

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 7-11(formerly DO-237, Rev. 2) 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 area office involved. See IRM 1.2.46.12 (11-08-2007).

Analysis

Section 4962(a) provides discretionary authority to the IRS not to assess, or to abate or refund, any "qualified" first-tier tax, if the foundation establishes to the satisfaction of the IRS 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. Analysis for abatement requires determining whether Trust meets the threshold prerequisites of § 4962 for the years at issue to consider abatement of first tier taxes under § 4942 for failure to distribute income in each of those years. The questions and analysis for each question is set forth below.

1. Did Trust correct the taxable events for each of the years at issue within the correction period?

Under § 4962, the "taxable event" must be "corrected" within the "correction period." For § 4942, the "taxable event" occurs on the first day of the taxable year for which there was a failure to distribute income. I.R.C. § 4963(e)(2)(A). To "correct" the taxable event, the private foundation must reduce the amount of undistributed income to zero. I.R.C. § 4963(d)(2)(A). "Correction period" means, with respect to any taxable event, the period beginning on the date on which such event occurs and ending 90 days after the date of mailing under § 6212 of a notice of deficiency with respect to the second-tier tax imposed on such taxable event, subject to certain extensions. I.R.C. § 4963(e)(1).

Trust became aware that it was an § 4947(a)(1) nonexempt charitable trust treated as a private foundation. Subsequently and immediately after the discovery, Trust filed Forms 990-PF for the years at issue and remitted the § 4940 excise tax on net investment income and penalty for underpayment of estimated tax for each of these years. Trust also computed the distributable amount for each year, undistributed income for each year and from prior years, and qualifying distributions for each year. Trust filed Forms 4720 reporting the applicable taxes for the years at issue. As indicated above, no statutory notice of deficiency has been issued. Based on the information provided, Trust corrected the taxable events within the correction period for the specified years at issue by making qualifying distributions to reduce to zero the amount of undistributed income for those years.

2. Was the taxable event due to reasonable cause and not to willful neglect?

Willful Neglect:

Section 4962 does not define "willful neglect." Section 6653(3) (or, for returns due after

December 31, 1989, § 6662(c)) defines "negligence" for purposes of the negligence penalty as including any failure to make a reasonable attempt to comply with the provisions. In the generally accepted legal sense, negligence is the failure to do something that a reasonable person, guided by those considerations that ordinarily regulate the conduct of human affairs, would do, or doing something that a prudent and reasonable person would not do.

"Willful" is defined in several places, for example, in Treas. Reg. § 53.4945-1(a)(2)(iv), as "voluntary, conscious, and intentional," and in § 1.507-1(c)(5), which provides that no motive to avoid the foundation restrictions is necessary to make an act or failure to act willful, but that an act or failure to act is not willful if the foundation does not know that it is an act to which the foundation rules apply.

In United States v. Boyle, 469 U.S. 241 (1985), the Supreme Court described "willful neglect" "as meaning a conscious, intentional failure or reckless indifference." Thus, the term "willful neglect" implies a voluntary, conscious, and intentional failure to exercise the care that a reasonable person would observe under the circumstances to see that the standards were observed, despite knowledge of the standards or rules in question.

A finding that a violation was caused by willful neglect will preclude abatement of the first-tier tax, but a mere finding of no willful neglect does not, in itself, justify abatement. Ignorance of the law is a clear example of the operation of this principle: the fact that a foundation's managers or directors did not know that an act or failure to act was a violation demonstrates that it was not due to willful neglect. But it does not meet the reasonable cause requirement. In Rembusch v. Commissioner, 38 T.C.M. (CCH) 310 (1979), the Tax Court opined that a mere showing that the delinquency in filing [tax] returns was not due to willful neglect is not sufficient and there must also be reasonable cause.

We have no evidence that the taxable events occurred due to a voluntary, conscious, and intentional failure on the part of Trust and trustee to exercise the care that a reasonable person would observe. Trustee engaged an accountant, who held himself out as qualified in tax matters as an enrolled agent, because she was unfamiliar with the tax law issues related to her responsibilities as trustee. We find no willful neglect that would preclude abatement of the first-tier tax.

Reasonable Cause:

Neither § 4942 or § 4962 define "reasonable cause." However, regulations under other Chapter 42 Internal Revenue Code sections indicate that the standard should be "ordinary business care and prudence." See e.g., Treas. Reg. §§ 53.4941(1)-1(b)(5), 53.4944-1(b)(2)(iii), 53.4945-1(a)(2)(v), 53.4955-1(b)(6) and 53.4958-1(d)(6). Under § 301.6651-1(c) and other provisions that impose a reasonable cause standard, determining whether reasonable cause was shown requires consideration of all the facts and circumstances.

The Supreme Court also used this "ordinary business care and prudence" definition of reasonable cause in determining whether a taxpayer was entitled to relief from failure to file penalties. United States v. Boyle, 469 U.S. 241 (1985). However, the burden of establishing reasonable cause is on the taxpayer. See West Side Tennis Club v. Commissioner, 111 F.2d 6 (2d Cir. 1940); Hale v. Commissioner, 44 T.C.M. (CCH) 1116 (1982).

Generally, reliance in good faith on the advice of counsel may establish reasonable cause and show an absence of willful neglect. Pursuant to United States v. Boyle, 469 U.S. 241 (1985), a taxpayer must demonstrate that it relied on advice it sought from its own counsel. Where the taxpayer has obtained advice from a competent tax professional on the specific tax matter and the taxpayer has provided the advisor with all the necessary and relevant information to make a determination, the taxpayer has done all that ordinary business care and prudence can reasonably demand. Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950). In addition, the advice must be obtained in a timely manner. See West Side Tennis Club v. Commissioner, 111 F.2d 6 (2d Cir.1940), Western Supply and Furnace Co. v. Commissioner, Ely v. Commissioner, 19 T.C.M. (CCH) 743 (1960). However, a mere statement that taxpayer's counsel entertained a subjective belief that taxpayer was not subject to the tax statute in question is not sufficient to show reasonable cause. Fides v. Commissioner, 137 F.2d 731 (4th Cir. 1943).

Trustee was not a sophisticated investor. She retained accounting and legal professionals to handle the estate and Trust matters after the settlor passed away. The original accountant was an enrolled agent able to practice before the Internal Revenue Service who held himself out as a tax expert. The accountant prepared the Form 706, *Estate Tax Return,* and the Forms 1041 income tax returns for the Trust as a "complex trust" after the death of the settlor. The trustee relied on the accountant to prepare the proper tax forms for her to sign and file. She also followed the instructions of the Trust document itself and its Restatement to "distribute income to the stated beneficiaries" in the percentages stated. The accountant characterized these distributions as donations and listed them as charitable deductions on the Forms 1041. The language of the Trust and Restatement did not expressly indicate it was an § 4947(a)(1) non-exempt charitable trust to be treated as a private foundation. In fact, when the IRS conducted a correspondence audit and reviewed Trust's governing document, it did not recognize Trust as a § 4947(a)(1) non-exempt charitable trust that should be following the requirements of Chapter 42 and filing Form 990-PF.

Based on the facts provided, the trustee relied in good faith on the advice of the accountant. Further, the trustee relied in good faith on the findings of the audit when it was issued a "no change" letter. The trustee had no reason to question the advice of the accountant until she consulted a new accountant and tax counsel. Therefore, we find the taxable event[s] were due to reasonable cause.

Based on the foregoing facts, we find that:

Trust has met the requirements of § 4962(a) that its violation of § 4942 for years at issue was due to reasonable cause, was not due to willful neglect, and has been corrected within the correction period. The request to abate the tax is granted by the Acting Director, Exempt Organizations

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

-END-