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INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Date: 10/24/2014

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:

Foundation	=
Taxpayer	=
Disqualified Person (DP)	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
x	=
y	=
z	=

ISSUE:

Should the first-tier excise tax due under Internal Revenue Code (I.R.C.) § 4958 on Taxpayer's automatic excess benefit transaction for the year at issue be abated in accordance with § 4962?

FACTS:

The Foundation is an organization recognized as tax-exempt under § 501(c)(3) and classified as a supporting organization under § 509(a)(3). Taxpayer is a limited liability company that is treated as a partnership for federal tax purposes. Disqualified Person (DP), a former director of the Foundation, owned more than a 35 percent interest in Taxpayer as of the date of the taxable event on Date 1. DP resigned from the Foundation's board of directors within five years of the

date of the taxable event.

The Foundation held a note secured by a company's property and business assets that was in default and desired to sell it at a public foreclosure auction. DP, acting through Taxpayer, desired to purchase the note and sought a loan from the Foundation to finance the purchase.

On Date 1, Taxpayer purchased the note from the Foundation for $x at a public foreclosure auction (the "transaction"). Concurrently, the Foundation loaned $x to Taxpayer at y percent per annum with "limited recourse" to purchase the note (the "taxable event").

On Date 2, Taxpayer sold the note to an unrelated third party.

On Date 3, the Foundation's accountants informed the Foundation that the loan to purchase the note resulted in an automatic excess benefit transaction under § 4958 because, as explained in more detail below, Taxpayer was a disqualified person with respect to the Foundation.

Less than 30 days after discovering the excess benefit transaction, on Date 4, Taxpayer returned to the Foundation both the principal balance and all interest accrued on the loan.

On Date 5, the Foundation filed Form 4720, *Return of Certain Excise Taxes under Chapters 41 and 42 of the Internal Revenue Code*, for the taxable year in issue, to report the excise tax on taxable expenditures under § 4958 reporting excise taxes in the amount of $z and to request abatement of the first-tier tax on the basis that Taxpayer reasonably relied upon the legal advice of counsel, which turned out to be erroneous.

Approximately half a year after discovering the excess benefit transaction and reporting in on Form 4720, legal counsel (Counsel), who has represented the Foundation since its inception, provided a letter dated Date 6 describing the advice given regarding the transaction on Date 1. Specifically, Counsel stated that, shortly before Date 1, he was asked to provide guidance to concerning a pending transaction that might involve Taxpayer as a bidder for the note held by the Foundation. Counsel stated that, at this time, he orally advised the Foundation that neither DP nor Taxpayer were disqualified persons with respect to the Foundation because DP was a former board member. Accordingly, Counsel concluded that the Foundation could loan Taxpayer funds to purchase the note without adverse consequences and that in providing the advice, he concluded that these proposed transactions were designed to benefit the Foundation. However, Counsel stated that this advice was erroneous; Counsel explained that he failed to consider the five-year look back rule in § 4958(f)(1)(A) for determining who is a disqualified person and the treatment of loans from a supporting organization under § 4958(c)(3). Pursuant to this rule, DP was a disqualified person with respect to the Foundation because he was a Foundation director within a 5-year period ending on the date of the transaction that gave rise to the excess benefit transaction. Taxpayer was also a disqualified person with respect to the Foundation under §§ 4958(f)(1)(C) and 4958(f)(3) because DP owned more than a 35 percent controlling interest in Taxpayer at the time the taxable event occurred. Therefore, the Foundation's loan to Taxpayer, a disqualified person, resulted in an automatic excess benefit transaction under § 4958(c)(3)(A)(i).

Taxpayer provides no additional facts and circumstances showing that its reliance on the advice

of counsel was reasonable.

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

LAW:

I.R.C. § 4958(a)(1) imposes on the disqualified person a tax of 25 percent of the excess benefit, for each excess benefit transaction.

I.R.C. § 4958(c)(3) provides special rules applicable to supporting organizations. For organizations described in § 509(a)(3), the term "excess benefit transaction" includes any loan by such an organization to a disqualified person, and the term "excess benefit" with respect to such loan includes the amount of the loan. § 4958(c)(3)(A).

I.R.C. § 4958(f)(1)(A) provides that the term "disqualified person" means, with respect to any transaction, any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization. Paragraph (C) provides that "disqualified persons" also include any 35-percent controlled entity.

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 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. § 4963(a) provides that the term "first tier tax" includes taxes imposed under § 4958.

I.R.C. § 4963(e)(1) provides that term "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.

Treas. Reg. § 53.4958-1(c)(2)(iii) cross references § 4962 for the special rules relating to abatement of the 25-percent tax on disqualified persons.

Treas. Reg. § 53.4958-1(d)(6) provides that an organization manager's participation in a transaction is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.

Treas. Reg. § 53.4958-3(a) provides that § 4958(f)(1) defines disqualified person, with respect to any transaction, as any person who was in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization at any time during the five-year period ending on the date of the transaction (the look back period).

Treas. Reg. § 53.4958-3(b) provides that a "35-percent controlled entity" includes a partnership in which persons described in § 53.4958-3 own more than 35 percent of the profits interest.

Treas. Reg. § 53.4958-3(c) provides, in relevant part, that a person is in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization if he or she is a voting member of the governing body of the organization, including any individual serving on the governing body who is entitled to vote on any matter over which the governing body has authority.

Treas. Reg. § 53.4958-7(a) provides that an excess benefit transaction is corrected by undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the applicable tax-exempt organization involved in the excess benefit transaction in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

Treas. Reg. § 53.4958-7(b) provides that a disqualified person corrects an excess benefit only by making a payment of cash or cash equivalent equal to the correction amount, as defined in paragraph (c) of this section.

Treas. Reg. § 53.4958-7(c) provides that the correction amount with respect to an excess benefit transaction equals the sum of the excess benefit (as defined by § 53.4958-1(b)) and interest on the excess benefit.

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 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 Ely v. Commissioner, 19 T.C.M. (CCH) 743 (1960), the Tax Court notes that it has held that reliance upon the advice of reputable counsel may constitute reasonable cause for failure to file a tax return. However, reliance upon the advice of counsel does not constitute reasonable cause where the record fails to show that such advisor was qualified and fully informed of all the facts. The court held that the taxpayer's failure to file a declaration of estimated tax was due to reliance upon an advisor to whom insufficient information was disclosed, or who was unfamiliar with the requirements of the taxing statutes, and neither was a sufficient excuse.

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), in explanation of the abatement provision states a violation of the foundation rules "which was due to ignorance of the law is not to qualify for such abatement" under § 4962(a).

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. Taxpayer must satisfy all three prerequisites in order to be considered for abatement.

1. Did Taxpayer correct the taxable event for the year at issue within the correction period?

Section 4962(a) provides that the "taxable event" must be "corrected" within the "correction period." Section 4958(a) provides that an "excess benefit transaction" is a taxable event. Under § 4958(c)(3)(A)(i)(II), an automatic excess benefit transaction occurs when a supporting organization, such as the Foundation, makes a loan to a disqualified person. In this case, both DP and Taxpayer are disqualified persons, as defined in § 4958(f), with respect to the Foundation. As a board member within the five-year period prior to the transaction, DP is a person in a position to exercise substantial influence over the organization. Furthermore, Taxpayer is also a disqualified person by reason of DP's greater than 35 percent interest in Taxpayer. Accordingly, the loan from the Foundation to Taxpayer to purchase the note resulted in an automatic excess benefit equaling the amount of the loan.

Taxpayer corrected the taxable event within the correction period. Under § 4962, the taxable event must be corrected within the "correction period." As provided in § 4963(e)(1) and Treas. Reg. § 53.4963-1(e), the "correction period" begins with the date on which the taxable expenditure occurred and ends 90 days after the mailing of a notice of deficiency with respect to the second-tier tax. Pursuant to Treas. Reg. §§ 53.4958-7(a) through (c), an excess benefit transaction is corrected by undoing the excess benefit to the extent possible by making a payment of cash or cash equivalent equal to the correction amount (the sum of the excess benefit and interest). The information shows that after the Foundation was informed of the excess benefit transaction, Taxpayer returned to the Foundation both the principal and all accrued interest on the loan less than 30 days after discovering the excess benefit transaction, thereby correcting the taxable event.

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 Treas. Reg. § 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, the Supreme Court described "willful neglect" "as meaning a conscious, intentional failure or reckless indifference." 469 U.S. 241 (1985). 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 does not meet the reasonable cause requirement. But it does not meet the reasonable cause requirement. In Rembusch v. Commissioner, the Tax Court opined that a mere showing that the delinquency in filing tax returns was not due to willful neglect is not sufficient; the taxpayer must also show reasonable cause. 38 T.C.M. (CCH) 310 (1979).

We have no evidence that the taxable events occurred due to a voluntary, conscious, and intentional failure on the part of Taxpayer to exercise the care that a reasonable person would observe. Accordingly, we find no willful neglect that would preclude abatement of the first-tier tax.

Reasonable Cause

Section 4962 does not define "reasonable cause." However, Treas. Reg. § 53.4958-1(d)(6) defines "reasonable cause" with respect to foundation managers as exercising "ordinary business care and prudence." Other Code sections also 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), and 53.4955-1(b)(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. Boyle, 469 U.S. 241. 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). In this case, § 4958(a)(1) provides that the first-tier tax imposed on the excess benefit transaction is to be paid by the disqualified person. Accordingly, Taxpayer bears the burden of establishing reasonable cause in this case.

Generally, reliance in good faith on the advice of counsel may establish reasonable cause and show not willful neglect 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. Haywood Lumber & Mining Co. v. Commissioner, 178 F.2d 769 (2d Cir. 1950); Ely v. Commissioner, 19 T.C.M. (CCH) 743 (1960); Western Supply and Furnace Co. v. Commissioner, 18 T.C.M. (CCH) 288 (1959). Furthermore, a taxpayer may reasonably rely on the advice of counsel even if the advice given is erroneous, such as in this case. Boyle, 469 U.S. 241; Haywood Lumber, 178 F.2d 769. However, reliance on the advice of counsel alone does not establish reasonable cause; the attendant facts and circumstances must also support reliance. West Side Tennis Club, 111 F.2d 6.

In this case, Taxpayer failed to offer any evidence showing that its reliance on the advice of counsel was reasonable. First, Taxpayer provided no information about Counsel's expertise.

Second, Taxpayer provided no evidence that it provided necessary and accurate information to Counsel. In his letter, Counsel states that he has represented the Foundation since its inception, but he failed to state whether he represented Taxpayer in this matter as well. Additionally, although Counsel's letter does not specifically state which party sought his advice; the wording of the letter implies that the Foundation sought the advice, noting that Counsel advised Foundation that it would be permissible for it to enter into the transaction . Accordingly, no evidence exists that Taxpayer actually sought the advice of counsel. Furthermore, neither Counsel nor Taxpayer provides any information about the circumstances under which the advice was conveyed to Taxpayer. Fourth, assuming Taxpayer sought Counsel's advice, Taxpayer provides no information indicating that it considered this advice when deciding whether to bid at the public foreclosure auction. Finally, once again assuming Taxpayer sought Counsel's advice, Taxpayer provides no information about the circumstances under which it sought the advice of counsel. Counsel's letter provides the only information about the circumstances under which the parties sought his advice. However, Counsel's letter states only that he was contacted shortly before Date 1 to provide advice. The facts and circumstances could indicate that obtaining Counsel's advice within a short time frame was reasonable if, for example, the Foundation's decision to sell the note was sudden or if Taxpayer did not express interest in purchasing the note until shortly before the public foreclosure auction. However, Taxpayer provides no facts indicating the existence of these, or any other, circumstances that would tend to support a finding of reasonable cause.

Based on the foregoing facts, we find that:

Taxpayer does not satisfy the requirements of § 4962(a) for the abatement of the first-tier taxes assessed under § 4958 on the automatic excess benefit transaction for the year at issue. Taxpayer did not exercise ordinary business care and prudence when it relied on the oral advice of Foundation's Counsel and therefore has not established that the taxable event was due to reasonable cause. Accordingly, the request to abate the assessed first-tier taxes is denied by the Director, Exempt Organizations.

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

-END-