INTERNAL REVENUE SERVICE
TECHNICAL ADVICE MEMORANDUM

May 5, 2004

Number: **200435020**
Release Date: 8/27/04
UIL: 4958.00-00
T:EO:B3

TAXPAYER'S NAME:

TAXPAYER'S EIN:

EARLIEST YEAR UNDER EXAMINATION:

TAXABLE YEARS UNDER EXAMINATION:

DATE OF CONFERENCE: November 26, 2003

Legend:

X =
Y =
A =
B =
C =
D =
E =
J =
K =
L =
M =
P =
Q =

Issues:

(1). Whether X is an applicable tax-exempt organization.

(2). Whether A is a disqualified person as defined by section 4958(f)(1)(A) of the Internal Revenue Code (Code), with respect to X.

(3). Whether the use of X's assets by A is an excess benefit transaction as defined by section 4958(c)(1)(A).

(4). What is the taxable period for the excess benefits transactions.

(5). Whether A is liable for the excise tax imposed by section 4958(a)(1) of the Code that is equal to 25 percent of the excess benefit.

(6). Whether A is liable for the excise tax imposed by section 4958(b) of the Code that is equal to 200 percent of the excess benefit transaction if the transaction is not corrected within the taxable period.

Facts:

X was granted tax-exempt status under Internal Revenue Code section 501(c)(3) on December 20, . It was subsequently ruled that X qualified as an organization described in IRC section 170(b)(1)(A)(i), as a church. X received a revised determination letter from the Chief, Exempt Organizations Rulings Branch on date "Q," maintaining its IRC section 501(c)(3) status, and modifying its foundation status to one under IRC sections 509(a)(1) and 170(b)(1)(A)(i) effective August 1, . As of January 1, , these rulings were still in effect, and had not been revoked or modified.

On September 26, , X adopted revised bylaws. Article III, The Founder, Section 1, identifies the founder of X to be A. Directors are appointed by the Founder and will serve until their death, disability, resignation or removal by the Founder.

A is X's founder and has always been its president and a director. B, A's wife, is secretary-treasurer and a director. Their sons, C and D, are directors of X. C also serves as X's vice-president. E, who is not an employee of X, is A and B's son-in-law.

Property "J":

The J property was purchased in late with no mortgage. The cost of the home was approximately $. A and B are the only individuals who have access to the property, other than their handyman.

On March 4, 2002, the agent toured the property, and found that it appeared to be a personal residence by all indications. Personal items such as clothing in the closets, family pictures of children and grandchildren, bathrobe and toiletry items were found in the house. Furnishings purchased for the house included, but are not limited to, sofa, loveseat, ottoman, end tables, chairs, bath towels, table lamps and patio furniture. The utilities, security system, cable TV and landscaping expenses were paid for by X.

The February issue of X's monthly newsletter described and advertised for sale the house as follows:

"

In , X asked the county assessor's office for real and personal property tax exemptions. The bases for the exemption were religious and educational. The assessor's office denied the request because "clearly the facility was not operating in this capacity. . . ."

X again applied for the tax exemptions in . The assessor's office, noting that the garage would be used for book storage, allowed an 11 percent exemption.

The agent's November 6, 2002, report established a $ yearly rental value for the house. The agent further found that during the period, X paid for utilities, security, cable TV, landscaping, and furnishing for the house. The agent computed the total expenses incurred by X during the period, including rental value, to be over $. X's cable TV accounts payable records were incomplete, and any additional payments could not be verified.

Property "K":

X purchased an investment property known as the K house in July and sold it in June . During the two years that X owned the house, C, son of A and B, resided there for six months from September through February . C did not pay rent during this period. C, A, and B were the only individuals who had access to the property, other than their handyman. On March 1, , A and B issued a check to X in the amount of $ for the purpose of belatedly paying rent for C's occupation of the house. A and his family have indicated that an indigent person lived on this property for a limited amount of time, but have not provided any documentation to that effect.

The K house was sold before the examination of X was conducted. The agent determined the rental value of the house to be the monthly mortgage payment, or $. X also paid monthly utility, landscaping, and cable TV expenses at the house. X has claimed that this residence was purchased as an investment only, and that it did not further X's exempt purposes other than as an investment.

The February issue of X's magazine included the following for sale ad:

"

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The agent computed the total expenses incurred by X during the period to be over $.

Credit Cards:

During the years under examination, X had charge accounts with , , , and . A had access and used all five of the credit cards for meals, gas, and miscellaneous items.

Information Document Request (IDR) No. 22 asked X to provide a copy of its policy statement ensuring that use of its credit cards was for X's purposes, and any personal charges would be reimbursed. X provided the following response: "X's policy regarding personal use of any credit cards in the name of X is that credit cards are to be used only for X's business and not for any personal use. In the event of any personal use, the person utilizing the credit card would be obligated to reimburse X 100%."

X retained its credit card statements and a few receipts. It did not note any business purpose or relationship with respect to entries on such statements. It did not otherwise maintain any records, account books, diary, etc. to establish the business purpose or relationship of such expenditures.

a. Meals:

The agent found that aside from the meals charged around the time of X's seminars and other acceptable charges, e.g., Christmas lunch for employees, A charged more than $ for meals during the period on his X credit cards.

b. Gasoline:

The agent found that aside from gasoline charges associated with seminar travel, A charged over $ for gasoline during the period on his X credit cards.

c. Miscellaneous Charges:

The agent found that miscellaneous items charged to X credit cards between and included department store purchases, car repairs, food purchases, hotel charges, clothing purchases, etc. Aside from miscellaneous charges associated with seminars, A charged more than $ worth of miscellaneous items to his X credit cards.

Cell Phone:

During and , X provided a cellular phone to A.

IDR No. 21 asked X to provide a copy of its policy statement ensuring that personal use of X-paid home phones, cellular phones, and calling cards would be reimbursed to X. In response to the IDR, X stated, "The policy of X regarding personal use of telephone is that personal telephone calls should not be charged to any X-paid telephone line. Any personal calls should be reimbursed 100% to X."

The agent found that during the years , A incurred cellular telephone charges of approximately $.

Miscellaneous Expenses:

a. A and B issued X check # to in the amount of $ on February 27, . No substantiating documentation was attached.

b. In February , X paid a private investigator for surveillance of A's daughter-in-law and a former X's employee. No business purpose was established. The total amount paid to the investigator was $. During , the towards her and her daughter by A. The former employee has had an ongoing employment dispute with X.

c. In March , X paid an attorney for legal services in connection with the and her appearance on a network television program. No business purpose was established. The total amount paid to the lawyer was $.

Vehicles:

During the years , X had approximately vehicles at its disposal. In March , X purchased a roadster, with the transaction financed through a bank in P. X borrowed $ and made monthly payments of $. A indicated that the is driven occasionally and only on X's business; however, the car is housed in the garage of A's personal residence. A and B are only ones who have access to the vehicle.

IDR No. 20 asked X to provide a copy of its policy statement regarding personal use of its vehicles. In response, X stated that "X's policy regarding personal use of any vehicles owned by X is that vehicles are to be used only for X business and not for any personal use. In the event of any personal use, any person utilizing the vehicle would be obligated to reimburse X at the current IRS approved rate per mile."

X also declared that "There are no employee expense accounts or reimbursements other than described herein. All employees and ministers have their own vehicles for their personal use and consequently have little or no reason to drive an X-owned vehicle for personal use. All vehicles owned by X are to be used for X business exclusively."

Property "L" (personal residence):

A and B's personal residence, L, is located in P. The agent found that during , X paid over $ in landscaping, cable TV, and security system costs at this residence.

Property "M" (personal residence):

A and B also maintain a personal residence, M, in an adjacent state. The agent found that during the periods, X paid more than $ in cable TV and telephone expenses for this residence. With regard to the cable TV payments, X's accounts payable records were incomplete for , and any additional payments could not be verified.

<u>Legal Principles:</u>

Section 501(c)(3) of the Internal Revenue Code (Code) exempts from Federal income tax organizations that are organized and operated exclusively for religious, charitable, scientific, or educational purposes where no part of the net earnings inures to the benefit of any private shareholder or individual.

Section 4958 imposes an excise tax on each excess business transaction between an applicable tax-exempt organization and a disqualified person. Section 4958 was added to the Internal Revenue Code by section 1311 of the Taxpayer Bill of Rights 2, P.L. 104-168, 110 Stat. 1452, enacted July 30, 1996. The section 4958 excise taxes generally apply to excess benefit transactions occurring on or after September 14, 1995. The Report from the Committee on Ways and Means on the Taxpayer Bill of Rights 2, H.R. 2337, was submitted March 28, 1996. H. Rep. No. 506, 104th Congress, 2d Sess. (1996) 53. Final regulations under section 4958, which apply as of January 23, 2002, represent a fair and reasonable interpretation of section 4958, based on the intent of Congress as expressed in the Report from the Ways and Means Committee submitted March 30, 1996.

Section 4958(a)(1) of the Code imposes on each excess benefit transaction a tax equal to 25 percent of the excess benefit. The tax imposed shall be paid by any disqualified person referred to in subsection (f)(1) with respect to such transaction.

Section 4958(b) of the Code imposes an additional tax on the disqualified person in any case in which an initial tax is imposed by subsection (a)(1) on an excess benefit transaction and the excess benefit involved in such transaction if not corrected within the taxable period, a tax equal to 200 percent of the excess benefit involved. The tax imposed by this subsection shall be paid by any disqualified person referred to in subsection (f)(1) with respect to such transaction.

Section 4958(c)(1)(A) of the Code defines an excess benefit transaction in general as any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. An economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit.

Section 4958(c)(1)(B) of the Code defines excess benefit as the excess referred to in subparagraph A.

Section 4958(d)(1) of the Code provides that if more than one person is liable for any tax imposed by subsection (a) or subsection (b), all persons shall be jointly and severally liable for such tax.

Section 4958(e)(1) of the Code defines ‘applicable tax-exempt organization’ as any organization which (without regard to any excess benefit) would be described in paragraph (3) or (4) of section 501(c) and exempt from tax under section 501(a).

Section 4958(e)(2) of the Code includes any organization, which was described in paragraph (1) at any time during the 5-year period ending on the date of the transaction.

Section 4958(f)(1) of the Code defines ‘disqualified person’ with respect to any transaction as (i) any person who was at any time during the 5 year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, (ii) a member of the family of an individual described in subparagraph (A), or (iii) a 35-percent controlled entity.

Section 4958(f)(4) of the Code provides that the members of an individual’s family shall be determined under section 4946(d); except that such members also shall include the brothers and sisters (whether by the whole or half blood) of the individual and their spouses.

Section 4946(d) of the code includes spouses, ancestors, children, and spouses of children in the definition of “disqualified person.”

Section 4958(f)(5) of the Code defines taxable period with respect to any excess benefit transaction, the period beginning with the date on which the transaction occurs and ending on the earliest of (A) the date of mailing a notice of deficiency under section 6212 with respect to the tax imposed by subsection (a)(1), or (B) the date on which the tax imposed by subsection (a)(1) is assessed.

Section 4958(f)(6) of the Code defines ‘correction’ and ‘correct’ with respect to any excess benefit transaction, as 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.

Section 53.4958-4(a)(4) of the Federal Income Tax Regulations provides that certain economic benefits are disregarded for purposes of section 4958, including benefits excluded from income under section 132 of the Code and expense reimbursement payments pursuant to an accountable plan that meets the requirements of section 1.62-2(c) and sections 53.4958-4(a)(4)(i) and (ii) of the regulations.

Section 1.62-2(c)(1) of the regulations provides that an accountable plan must meet the business connection, substantiation, and returning-excess-payments provisions of the regulation.

Section 1.62-2(d)(1) of the regulations provides that expenses reimbursable under an accountable plan must constitute deductible business expenses under section 162 or other business deduction statutes.

Section 1.62-2(e)(1) provides that expense reimbursements under an accountable plan must satisfy the substantiation rules of sections 1.162-17 or 1.274-5T of the regulations.

Section 162 of the Code provides in part that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including, (1) a reasonable allowance for salaries or other compensation for personal services rendered; (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business.

Section 1.162-1(a) of the regulations states, in general, that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer’s trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162.

Section 274(d) of the Code provides that no deduction or credit shall be allowed (1) under section 162 or 212 for any traveling expense, (2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, (3) for any expense for gifts, or (4) with respect to any listed property (as defined in section 280F(d)(4)) unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer’s own statement regarding amount, time and place, business purpose and business relationship.

Section 1.274-5T(b) of the regulations requires each employee to provide substantiation of the business purpose of each expense, generally in writing.

Section 1.274-5T(b)(2) of the regulations provides that no deduction or credit shall be allowed for travel unless the taxpayer substantiates the following elements:(1) Amount - amount of each separate expenditure for traveling away from home; (2) Time - dates of departure and return for each trip away from home and number of days away from home spent on business; (3) Places - destinations or locality of travel and (4) Business purpose - business reason for travel or nature of the business benefit derived as a result of the travel.

Section 1.274-5T(b)(6) of the regulations provides the elements that must be proved with respect to an expenditure for listed property to include the amount of each separate expenditure, the amount of business/investment use, the date of the expenditure or use, and the business or investment purpose.

Section 1.274-5T(c)(2)(i) of the regulations states that a taxpayer, to meet the "adequate records" requirements of section 274(d), shall maintain an account book, diary, statement of expense or similar record and documentary evidence which, in combination, are sufficient to establish each element of an expenditure.

Section 1.274-5T(c)(2)(ii) of the regulations states that the account book, diary, statement of expense or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure is made at or near the time of the expenditure.

Section 1.274-5T(c)(2)(iii), and for periods after January 20, 2000, section 1.274-5(c)(2)(iii), of the regulations requires the employee to maintain documentary evidence, such as receipts, paid bills, or similar evidence.

Section 1.274-5T(c)(3) of the regulations provides that, if the employee fails to establish to the satisfaction of the Service that the employee has substantially complied with the adequate records requirements of the regulation, the employee may satisfy such requirement by providing (i) the employee's own statement, whether written or oral, containing specific information in detail as to such element, plus (ii) other corroborative evidence sufficient to establish such element.

Section 1.274-5T(h)(2) of the regulations indicates that an independent contractor shall substantiate, with respect to his reimbursements, each element of an expenditure in accordance with the requirements of paragraph (c) of this section; and, to the extent he does not so substantiate, he shall include such reimbursements in income.

Section 280F(d)(4) of the Code defines listed property as any passenger automobile, other property used as a means of transportation, any computer or peripheral equipment, and any cellular telephone (or other similar telecommunications equipment).

Section 53.4958-4(c)(1) of the Foundation and Similar Excise Taxes Regulations provides that an economic benefit is not treated as consideration for the performance of services (i.e., compensation) unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. If an organization fails to provide contemporaneous substantiation of such intent, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction. If the substantiation requirement is not satisfied, then the value of the benefit will be treated as an automatic excess benefit taxable under Code Section 4958(a).

Section 53.4958-4(c)(3)(A) of the regulations provides that a benefit may be contemporaneously substantiated as compensation (i) if the organization reports the benefit as compensation on a Federal tax information return; or (ii) if the disqualified person timely reports the value of the benefit as income on the person's federal tax return; or (iii) if the benefit is described as compensation to the disqualified person in a contemporaneous employment contract, board of directors minutes, or other documents indicating that an authorized body of the organization approved the benefit as compensation.

In <u>John Marshall Law School v. United States</u>, 228 Ct. Cl. 902 (1981), the law school and the college paid for the founding family's automobiles, education, travel, expenses, insurance policies, and personal equipment. The court determined that the expenditures for the founding family were not ordinary and necessary expenses in the course of the law school's and the college's operations. The court also held that the payment of such personal expenses for the founder's children by the law school provided direct and substantial benefit to the founder of the law school and his brother. The court held that these payments constituted prohibited inurement of the law school's earnings to the founder and his brother, parents of the children receiving the benefits.

<u>ANALYSIS:</u>

Before enactment of section 4958 of the Code in 1996, inurement violations resulted in adverse consequences to the exempt organization. Section 4958 imposes intermediate sanctions, excise taxes, on each excess benefit transaction between an applicable tax-exempt organization and a disqualified person. The sanction is assessed against the disqualified person if a disqualified person has received excess benefits within the meaning of section 4958.

Issue (1). Applicable tax-exempt organization.

X is an applicable tax-exempt organization as defined under section 4958(e) of the Code and section 53.4958-2 of the regulations, since it was recognized as an organization described in section 501(c)(3) and was exempt from tax under section 501(a), but was not a private foundation as defined in section 509(a) for the years under examination.

Issue (2). Disqualified Person.

A is a disqualified person as defined by section 4958(f)(1)(A) of the Code.

Section 4958(f)(1)(A) defines a disqualified person as any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization.

A is the Founder and President of X and is thus a disqualified person.

Issue (3). Excess Benefit Transactions.

An excess benefit transaction is a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of any disqualified person, and the value of the economic benefit provided by the organization exceeds the value of the consideration (including the performance of services) received for providing such benefit.

Reimbursements of an employee's expenses by the exempt organization are disregarded for purposes of section 4958 if the reimbursements satisfy all of the requirements of section 1.62-2 of the regulations, including the requirements for substantiation of expenses (section 53.4958-4(a)(4)(ii) of the regulations).

Expenditures of organization funds by an employee that satisfy the deductions requirements under sections 162 and (to the extent relevant) 274, including the substantiation requirements of those provisions and the regulations thereunder, do not constitute excess benefits under section 4958.

Any reimbursement of expenses by an exempt organization to an employee, or direct expenditures of organization funds by the employee, are automatic excess benefits to the extent that they do not satisfy the requirements of section 1.62-2 (per section 53.4958-4(a)(4)(ii)), or sections 162 and (to the extent relevant) 274 of the Code and the regulations thereunder, unless they are substantiated as compensation pursuant to section 53.4958-4(c)(3) of the regulations.

In the instant case, A and his relatives expended funds of X, and used X assets, in a variety of ways described below and in separate technical advice memoranda issued to his wife, sons, and son in law. A does not contend that these expenditures and uses were intended as compensation to himself or his relatives. In any event, there is no evidence in the record that would satisfy the contemporaneous substantiation rules of section 53.4958-4(c)(3) of the regulations.

It follows that unless A can satisfy the accountable plan requirements of section 1.62-2 of the regulations, or the requirements of sections 162 and (to the extent relevant) 274 and the regulations thereunder for ordinary and necessary business expenses, the expenditures and use of X funds described below must qualify as automatic excess benefits.

Initially, we note generally that A does not contend that X had an accountable plan. As indicated below, most of A's benefits were in the form of his direct expenditures of X funds, or use of X's assets.

Credit Cards:

Sections 162 and (to the extent relevant) 274 of the Code provide that expenses must be ordinary and necessary to be a business deduction. The expenses must be contemporaneously documented with time, place, business purpose, and business relationship. X maintained its credit card statements and a few receipts. However, neither X nor A documented the business purposes of these expenditures. It does not appear that A kept any account books, diaries, or other records demonstrating that the charges the family made on X credit cards were for business purposes.

The excess benefit transaction amounts involving A's use of X credit cards are as follows:

Meals-Cr Card	$	$	$	
Miscellaneous-Cr Card	$	$	$	
Total	$	$		$

A incurred between $ and $ in gasoline charges per year during the period , all of which were allegedly for business travel. He has contended that he drove every day from L, his personal residence in P, to X's , and on occasion drove to its center. If A drove only the roundtrip to and from the

each day--and never rode with his wife B or sons C and D when they drove there--he would have accounted for between and miles per year.

A has cited Rev. Rul. 99-7, 1999-5 I.R.B. 4, which addresses the circumstances under which daily transportation expenses incurred by a taxpayer in traveling between his residence and a work location are deductible under section 162(a) of the Code. The Rev. Rul. provides the general rule that a taxpayer's cost of commuting between his residence and his place of business or employment are nondeductible personal expenses. It cites Rev. Rul. 55-109, 1955-1 C.B. 261, for the proposition that the costs of going between one business location and another generally are deductible. It also cites Curphey v. Commissioner, 73 T.C. 766 (1980), in which the U.S. Tax Court held that daily transportation expenses incurred in going between an office in the taxpayer's residence and other work locations were deductible when the home office was the taxpayer's principal place of business within the meaning of section 280A(c)(1)(A) of the Code, for the trade or business conducted by the taxpayer at those other work locations.

A has the burden of proving that his residence L was also his principal place of business. There is no documentary or other evidence in the record at this time to show that L was A's principal place of business. Accordingly, the gasoline charges as listed above constitute excess benefits. If A provides probative evidence that the L residence was his principal place of business, in a timely manner prior to issuance of a notice of deficiency, the Service may treat all or part of the gasoline charges as section 162 and 274 (to the extent relevant) business expenses that are not excess benefits under section 4958.

If A furnishes probative and timely evidence that the L residence was his principal place of business, it would follow that he would be entitled to travel expenses for trips made to and from "R" and "S," to the extent such trips can be documented. As noted herein, the regulations require some form of contemporaneous written evidence or other corroboration as to the dates and amounts of each travel expense. See section 1.274T-5(c)(3) or, to the extent relevant, section 1.274-5(c)(3) of the regulations. To the extent that the gasoline charges in those years exceeded such business travel expenses, they would constitute additional excess benefits.

In the absence of probative evidence that L was his principal place of business, and substantiation of the time, amount and purpose of each credit card expense, the excess benefit amounts determined in the technical advice request are correct.

Cell Phones:

Sections 274 and 280F of the Code provide that cellular telephones are listed property. Strict substantiation requirements must be in place, otherwise the use of the cell phones is taxable to the employee. However, the approximately $ in questioned cellular phone charges incurred by A—over a three-year period-- is a de minimis amount. Therefore, this amount will not be considered as resulting in excess benefit transactions.

Vehicles:

The is kept at A and B's personal residence, and they are the only people with access to it. A has argued that he drove this car occasionally, and only on business. However, use of a vehicle is treated as personal use unless a taxpayer substantiates business use. Accordingly, the excess benefit transaction amounts for A's use of the are as follows:

$ $ $

Property "J":

On March 4, 2002, two IRS revenue agents toured the Property J located near [town]. Their observations are as follows:

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The kitchen appeared fully stocked with cookware and dishes. It appeared to be for a single-family residence, as opposed to a commercial kitchen. The refrigerator was almost empty. The dining room contained a large dining table, decorated with linen, dishes, glasses and flatware.

The bedrooms were fully furnished with beds, nightstands, decorations; the closets were filled with personal clothing items. The clothing items were neatly hung in the closets as personal items would be, not boxed or stacked.

The great room contained couches, tables, chairs, a big screen television and satellite dish receiver, and photographs of some members of A's family.

The master bath was fully stocked with towels and toiletries, as well as a robe. The office contained a writing desk, and several bookshelves were filled. The agents noted that the patio behind the house contained a residential-type hot tub. The laundry room contained a typical residential washer and dryer.

The two-car attached garage contained boxes of stored items, but no autos. The contents of the boxes were not examined.

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X, on two occasions, applied to the county assessor for real and personal property tax exemptions. The applications were filed on , and , respectively. In a letter dated , the county's chief appraiser stated, "…plans for the property call for a

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The assessor's notes from a July 9, 1999, visit state, "A stays here…part of his residence, too…couple of meetings here…A stays in Master BR." On July 13, 1999, the appraiser notified X that a partial exemption had been granted for the tax year. Specifically, the county decided to remove 11 percent of the total property value from the assessment roll.

On November 6, 2002, an IRS agent proposed several adjustments to A and B's Form 1040. She stated the following in her report regarding Property J:

"

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In the agent's report, she determined an annual amount of $ as rental value for the property, divided equally between A and B ($ each). She stated:

> "Calling a property management company and asking about the house determined this rental value. I did not identify the address; rather I used the information about the house, how many acres, square footage and area, etc. The rental value was $ /$ per month. I took 80 percent of the $ value. This appears correct as the other houses owned and operated by A and B and X were consistent with this value. The other rentals were not as spacious, nor did they have the amenities consistent with this property. In addition, the other rentals were in [an adjacent county] as opposed to [name of county], which has a higher rental value. Those houses were being rented for approximately $ /month."

A and B, aside from the handyman, are the only individuals who have access to this property. All expenses are determined to be personal, and the use of the X asset is an excess benefit.

The excess benefit transaction amounts attributed to A by the examination agent are as follows:

$	$	$

The issue whether the value of Property J and related services are additional income to A is currently in dispute for one of the examination years. We agree with the findings of the Small Business/Self Employed Division, as reflected in the technical advice request.

<u>Property L</u>

IDR No. 23 stated that there are monthly payments being made to a security service for the Property J and Property L. The IDR asked whose house in P has the security system and to provide the address of the residence. There are also monthly payments to another security company. The IDR asked where the alarm system was located and if this is a personal residence, to whom does it belong.

X responded that alarm systems are provided for L, the personal residence of A and B due to death threats being made against A and other threats to his physical safety. These threats have come as a direct result of his and public statements in his capacity as a of X. Security systems are also provided to Property J and X's separate offices in P. In addition, X asserted that security is necessary at A and B's personal residence because X's equipment, computers, fax machines and other items are located there, where A originates some of his . A also with individuals at his residence and maintains his office there, X said.

Aside from the Property J, an alarm system is being paid by X for A and B's personal residence L. It pays [security company] $ per month for this service. The monthly amount was reduced by one-third because A uses one of the rooms for business purposes. The monthly payment used to determine the excess benefit amount is $, or $ per year.

Home security costs are considered personal expenses and are not deductible under section 262 of the Code. However, under section 132(d) of the Code, gross income does not include the value of a working condition fringe which is any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under section 162 of the Code. See section 1.132-5(a)(1) of the Federal Income Tax Regulations. Benefits excluded from income under section 132 are disregarded for purposes of section 4958. See section 53.4958-4(a)(4)(i) of the regulations. Unless A can establish that the cost of the alarm system would be deductible as an ordinary and necessary business expense under section 162 if he had paid for it himself, then the home security costs constitute excess benefits.

In its response to IDR No. 24, X disclosed that it is paying monthly fees to [satellite television companies], representing satellite television services provided to A at his personal residences L and M.

We find this is a personal expense, notwithstanding the fact that A may on occasion refer to current events on Y. In any case, he has not provided any documentation that would support a conclusion that a portion of these expenses were required for business purposes. Accordingly, we agree with the agent that X's payments for satellite television at both properties in the years constitute excess benefits to A.

In addition to television service at the M property, X paid $ in telephone charges incurred by A and B at this residence. A and B have failed to establish that these telephone charges were business-related. Accordingly, this amount constitutes an excess benefit to A.

The $ paid by X to a [landscaping company]. in were for A and B's personal expenses, and this amount constitutes excess benefits to A.

<u>Property K:</u>

The K property was purchased in and sold in . The property was held in a manner similar to Property J. The agent determined that no application was made to the state or county governments to exempt this property.

The property was sold before the IRS audit began, so no tour could be conducted. The examination agents determined that A and B were the only ones with access to the property aside from the handyman.

We find that A and B had exclusive control of the Property K, even though X was the legal owner. They did not treat the real estate purely as a corporate asset, but rather as their own asset. Therefore, the excess benefit transaction amounts attributed to A are correct, and are excess benefits.

<u>Other Miscellaneous Expenses:</u>

a. A and B issued X check # to in the amount of $ on February 27, . No substantiating documentation was attached.

b. I n February , X paid an investigator for surveillance services. No business purpose was established. The total amount paid for these services was $.

c. In March , X paid an attorney for legal services in connection with A's former appearance on the program. No business purpose was established. The total amount paid for the services was $.

All of the above miscellaneous expenses constitute excess benefits to A.

Issue (4). Taxable Period.

The excess benefit transactions occurred in the years under audit. The taxable periods are determined to begin on , and .

Issue (5). Initial Tax on the Disqualified Persons

An excise tax, as provided by section 4958(a)(1) of the Code, equal to 25 percent of the excess benefit amount, should be imposed on A. A was the founder, president, and chief executive of X. As a practical matter, he had total control of all X expenditures. He either approved of the excess benefit transactions by his wife, his two sons, and his son-in-law, or he at least acquiesced in them. If A had withdrawn funds from X and given them to his family members, there would have been no question that such gifts would be taxable excess benefits to him. By authorizing or allowing his relatives—the natural objects of his bounty—to make unlimited expenditures of X funds for personal purposes, without any substantiation or evidence of an X business purpose, he in effect improperly removed charitable assets from X and gave them to his relatives. Accordingly, A not only is liable for the excess benefit transactions from which he personally benefited, but also is jointly and severally liable for all of the excess benefits outlined in the technical advice memoranda of today regarding B, C, D, and E. See <u>John Marshall Law School v. United States, supra</u>; Code Section 4958(d)(1).

Issue (6). Second Tier Tax on the Disqualified Persons

It is proposed that an excise tax, as provided by section 4958(b) of the Code, be imposed equal to 200 percent of the excess benefit in the case in which a section 4958(a)(1) tax is imposed on an excess benefit transaction and the transaction is not corrected within the taxable period.

The taxable period means the period beginning with the date on which the transaction occurs and ending on the earlier of (1) the date of mailing a notice of deficiency or the date on which the tax imposed by section 4958(a)(1) is assessed.

Because the transactions were not corrected within the taxable period pursuant to section 4958(f)(6) of the Code, the 200 percent tax should be included in the statutory notice of deficiency.