INTERNAL REVENUE SERVICE
TECHNICAL ADVICE MEMORANDUM

May 5, 2004

Number: **200435022**
Release Date: 8/27/04
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T:EO:B3

TAXPAYER'S NAME:

TAXPAYER'S SSN:

EARLIEST YEAR UNDER EXAMINATION:

TAXABLE YEARS UNDER EXAMINATION:

DATE OF CONFERENCE: November 26, 2003

Legend:

X =
A =
B =
C =
D =
E =
Q =

A. Issues:

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

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

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

(4) What is the taxable period for period for assessment of possible tax liability for excess benefit transactions.

(5). Whether C 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 C 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.

B. <u>Facts:</u>

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 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, 1979. As of January 1, , these rulings were still in effect, and had not been revoked or modified.

On September 26, , X adopted restated 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, wife of A, is X’s secretary-treasurer and a director. C, son of A and B, is vice-president and a director.

<u>Credit Cards:</u>

During the years under examination, X had charge accounts with , and . C had access to these 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 the X’s credit cards was used for X purposes, and any personal charges would be reimbursed to X. 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 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%.”

a. Meals:

The agent found that aside from the meals charged around the time of X’s seminars and other acceptable meal charges, e.g., Christmas lunch for employees, C charged more than $

for meals during the period on his X credit cards.

b. Gasoline:

The agent found that aside from the gas charges associated with seminar travel, C charged more than $ 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 the miscellaneous charges associated with X seminars, C charged more $ in miscellaneous expenses during the period on his X credit cards.

Cell Phone**:**

During the years under examination, X provided a cell phone to C.

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 X 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 , C incurred cellular telephone charges of more than $.

Computer Purchase:

On October 5, , an X check (#) was issued to C for the amount of $. A handwritten note indicated that the check was for a computer. No further documentation regarding this purchase was provided.

C. Legal Principles:

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 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(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 sections 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)(ii) 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 an employee fails to establish to the satisfaction of the Service that the employee has substantially complied with the adequate records requirements of the regulations, 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 each element, plus (ii) other corroborative evidence sufficient to establish each element.

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 income 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 John Marshall Law School v. United States, 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.

ANALYSIS:

Before the enactment of section 4958 of the Code in 1996, inurement violations resulted only in adverse consequences to the exempt organization. Section 4958 now 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.

C is a disqualified person as defined by section 4958(f)(1)(B) 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.

Section 4958(f)(1)(B) defines a disqualified person as a member of the family of an individual described in section 4958(f)(1)(A) of the regulations.

Section 4958(f)(4) defines a family member as the family of any individual to include his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren and great grandchildren. Brothers and sisters and their spouses are also part of the family.

A is the Founder and President of X. B is A's wife. C is a son of A and B and an X director.

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 the organizations 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, C 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 father, mother, brother (D), and brother-in-law (E). C 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 C 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 be treated as automatic excess benefits.

Credit Cards:

Sections 162 and 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 credit card statements and a few receipts. However, neither X nor C documented the business purpose or relationship of his expenditures. It does not appear that C kept any account books, diary, or other records demonstrating that the charges he made on the X credit cards were for business purposes.

The excess benefit transaction amounts involving the use of the credit cards by C are as follows:

Meals-Cr Card	$	$	$
Gas-Cr Card	$	$	$
Miscellaneous-Cr Card	$	$	$

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 cell phones is taxable to the employee.

Our Office has been provided with voluminous records listing calls from X cellular phones. However, the documents list only the telephone numbers, and do not indicate with whom C spoke and the business reasons for their conversation. Aside from phone calls made to X phones that would most likely be X business, all other calls were not substantiated as required. The excess benefit transaction amounts for C’s use of the cell phones are as follows:

$	$	$

Computer Purchase:

On October 5, , an X check (#) was issued to C for the amount of $. A handwritten note indicated that the check was for a computer. No further documentation for this purchase was provided.

There has been no evidence provided to substantiate that X's purchase of a used computer from C for $ should be categorized as an arm's length transaction. Although counsel has argued that it was, and that X benefited from the computer's capabilities, counsel has failed to provide any supporting documentation assessing the value and condition of the computer at the time it was sold. Accordingly, the sale of the computer constituted an excess benefit transaction attributable to C.

C's total excess benefit transactions for all years under examination are listed below:

Meals-Cr Card	$	$	$
Gas-Cr Card	$	$	$
Miscellaneous-Cr Card	$	$	$
Cell Phone	$	$	$
Computer	$	$	$
	$	$	$
TOTAL FOR ALL YEARS	$		

Issue 4**.** Taxable Period.

The excess benefit transactions occurred in the years under audit. The taxable periods are determined to begin on January 1, , January 1, and January 1, .

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 C. C is the son of X's founder, A, and as such constitutes a disqualified person under the applicable regulations.

In addition, we note that A was 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 son or he 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 son and other 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 the excess benefits outlined in technical advice memoranda of today regarding D, B, C, and E. See John Marshall Law School v. United States, supra; Code Section 4958(d)(1).

Issue 6. Second Tier Tax on the Disqualified Person

It is proposed that an excise tax, as provided by section 4958(b) of the Code, equal to 200 percent of the excess benefit, be imposed, in this 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.