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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:

Foundation	=
Corporation	=
Grantee	=
x	=
Year 1	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=

ISSUE:

Should the first-tier excise tax due under Internal Revenue Code (I.R.C.) § 4945 on the Foundation's taxable expenditure for the years at issue be abated in accordance with § 4962?

FACTS:

Foundation is a § 501(c)(3) organization established in Year1 and classified as a private operating foundation.

Grantee is a not-for-profit membership entity whose membership at the time of the grants

included Foundation which held a 60 percent membership interest. The president of Foundation is also the president of Grantee. In addition to the president, Grantee's Board of Directors included the chief financial officer (CFO) of Foundation. Grantee applied for tax exemption under § 501(c)(3) on Date1.

Foundation contributed a total of $x on Date2 and Date3 to Grantee for community and economic development. At the time of the distributions, Foundation was aware that Grantee was not recognized as exempt under § 501(c)(3). In addition, Foundation and Grantee did not enter into a written terms/commitment document signed by both parties as required by Treas. Reg. § 53.4945-5(b)(3).

In Date4, the trustees of Grantee decided not to continue the application process and on Date5 the Service closed Grantee's application for tax exemption for failing to respond to a request for additional information. Foundation states that it was aware of the decision by Grantee to discontinue the process for its application for exemption. In addition, the president of Foundation as president of Grantee was involved in the decision to end the application process. Foundation states that it "did not understand the significance, in terms of the grant nor the result (disqualification), of that decision by (Grantee)." Grantee's assets and liabilities were transferred to a disregarded entity under another organization exempt under § 501(c)(3). The Grantee, which is not tax-exempt, continues with its activity limited to holding real estate interests.

During preparation of the 2006 Form 990-PF, Foundation as part of its annual review, considered the grant funds for expenditure responsibility. At that time, Foundation knew that Grantee had "discontinued its application process for § 501(c)(3) status" but did not request repayment of the funds. Instead, a statement was attached to the originally filed 2006 return in accordance with § 4945(h)(3) and § 53.4945-5(d) to demonstrate that Foundation exercised expenditure responsibility regarding the grants.

In a letter dated Date6, Foundation notified the Board of Managers of Grantee of the repayment issue, recalling the $x grant and requested repayment of the grant funds within 45 days. Foundation states that the unexpected repayment request as well as other factors prevented the Grantee from immediate access to the funds, the grant funds were not repaid until Date 7.

Foundation filed an amended 2006 Form 990-PF reporting the grants previously reported as qualifying distributions as taxable expenditures.

In a letter dated Date8 in response to the Service's request for a copy of the terms/commitment document, Foundation stated that during a review of its interaction with Grantee for expenditure responsibility purposes, Foundation discovered it was missing a key document, a terms/commitment document signed by both Foundation and Grantee as required by the regulations. Foundation stated that "due to an oversight by the Foundation, this key document was never entered into."

The Foundation filed Form 4720 Return of Certain Excise Taxes under Chapters 41 and 42 of the Internal Revenue Code for year ended December 31, 2006 on Date9 to report the excise tax on taxable expenditures under § 4945. Foundation paid the first-tier tax under § 4945(a)(1) in

addition to penalties and interest calculated through Date9. At the time of the filing of the return, Foundation requested that the initial tax be abated under § 4962.

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

LAW:

I.R.C. § 508 provides special rules with respect to § 501(c)(3) organizations. Subparagraph (a) provides that an organization organized after October 9, 1969 must notify the Secretary that they are applying for recognition of exempt status under § 501(c)(3). Subparagraph (b) provides that any such organization that does not notify the Secretary as prescribed that it is not a private foundation, shall be presumed to be a private foundation.

I.R.C. § 4945(a)(1) imposes an initial tax of 10% on a private foundation for each taxable expenditure.

I.R.C. § 4945(d)(4) provides that the term "taxable expenditure" means any amount paid or incurred by a private foundation: (A) as a grant to an organization unless such organization, (i) is described in paragraph (1) or (2) of § 509(a), (ii) is an organization described in § 509(a)(3) (other than an organization described in clause (i) or (ii) of § 4942(g)(4)(A)), or (iii) is an exempt operating foundation (as defined in § 4940(d)(2)); or (B) the private foundation exercises "expenditure responsibility" with respect to such grant in accordance with § 4945(h).

I.R.C. § 4945(h) provides that the "expenditure responsibility" referred to in § 4945(d)(4) means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures: (1) to see that the grant is spent solely for the purpose which made, (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports with respect to such expenditures to the Secretary.

I.R.C. § 4945(i)(1) defines the term "correction" to mean, with respect to any taxable expenditure, recovering part or all of the taxable expenditure to the extent recovery is possible and, where full recovery is not possible, such additional corrective action as is prescribed by the Secretary or his delegate by regulations.

I.R.C. § 4945(i)(2) defines the term "taxable period" to mean, with respect to any taxable expenditure, the period beginning with the date on which the taxable expenditure occurs and ending on the earlier of: (A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under § 6212, or (B) the date on which the tax imposed by subsection (a)(1) is assessed.

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. § 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. § 1.508-1(b) provides, in part, that any organization (including an organization in existence on October 9, 1969) which is described in section 501(c)(3), and which does not notify the Commissioner within the time and in the manner prescribed in subparagraph (2) that it is not a private foundation, will be presumed to be a private foundation. Subparagraph (3) states that the notice filed under this paragraph may not be relied upon by the organization so filing unless and until the Internal Revenue Service notifies the organization that it is an organization described in paragraph (1), (2), (3), or (4), of § 509(a). Subparagraph (6) provides that: (i) With respect to a grantor, contributor, or distributor to any organization for any period after the date on which the Internal Revenue Service makes notice to the public (such as by publication in the Internal Revenue Bulletin) that a grantor, contributor, or distributor to such organization can no longer rely upon the notice or statement submitted by such organization; and (ii) Upon any grant, contribution, or distribution made to an organization on or after the date on which a grantor, contributor, or distributor acquired knowledge that the Internal Revenue Service has given notice to such organization that its notice or statement has failed to establish that such organization either is not a private foundation, or is an operating foundation.

Treas. Reg. § 53.4945-1(d)(1) provides, in part, that, except as otherwise provided, correction of a taxable expenditure shall be accomplished by recovering part or all of the expenditure to the extent recovery is possible, and, where full recovery cannot be accomplished, by any additional corrective action which the Commissioner may prescribe.

Treas. Reg. § 53.4945-5(a)(1) provides that the term "taxable expenditure" includes any amount paid or incurred by a private foundation as a grant to an organization (other than an organization described in § 509(a)(1), (2), or (3)), unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with § 4945(h).

Treas. Reg. § 53.4945-5(b)(1) provides that a private foundation will be considered to be exercising "expenditure responsibility" under § 4945(h) as long as it exerts all reasonable efforts to establish adequate procedures: (i) to see that the grant is spent solely for the purposes for which made, (ii) to obtain full and complete reports from the grantee on how the funds are spent, and (iii) to make full and detailed reports with respect to such expenditures to the Commissioner.

Treas. Reg. § 53.4945-5(b)(3) provides that in order to meet the expenditure responsibility requirements of § 4945(h), a private foundation must require that each grant to an organization, with respect to which expenditure responsibility must be exercised under this section, be made subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization.

Treas. Reg. § 53.4945-5(b)(4) provides that in order to meet the expenditure responsibility

requirements of § 4945(h), with regard to the making of a program-related investment, a private foundation must require that each investment, with respect to which expenditure responsibility must be exercised under this section, be made subject to a written commitment signed by an appropriate officer, director, or trustee of the grantee organization.

Treas. Reg. § 53.4945-5(d) provides that to satisfy the report making requirements of § 4945(h)(3), a granting foundation must provide the required information on its annual information return for each taxable year with respect to each grant made during the taxable year which is subject to the expenditure responsibility requirements of § 4945(h). The report must include: (i) the name and address of the grantee, (ii) the date and amount of the grant, (iii) the purpose of the grant, (iv) the amounts expended by the grantee, (v) whether the grantee diverted any portion of the funds from the purpose of the grant, (vi) the dates of any reports received from the grantee, and (vii) the date and results of any verification of the grantee's reports undertaken by or at the director of the grantor foundation.

In Hans S. Mannheimer Charitable Trust v. Commissioner, 93 T.C. 35 (1989), the Tax Court held that a private foundation's grants to two related private foundations were taxable expenditures due to the foundation's failure to comply with the expenditure responsibility requirements, even though as a factual matter, the grantor kept itself fully aware of the recipients' activities. All three foundations shared a common founder and had officers and trustees in common. The grantor foundation made grants to the other two foundations, but failed to obtain the written agreements and annual reports required by Treas. Reg. § 53.4945-5(b)(3) or to report the grants to the IRS on its Form 990-PF as required by § 4945(h)(3). Acknowledging that the grantor kept itself informed of the activities of the other foundations and that none of the grant money was misspent, the court held that there must be strict compliance with the expenditure responsibility requirements in order to avoid the § 4945 tax.

Rev. Rul. 77-213, 1977-1 C.B. 357 holds that a private foundation that failed to list on its original annual information return a grant to an organization not described in either section 509(a)(1), (2), or (3) of the Code, but corrected the omission on an amended return filed after the due date, has failed to exercise the expenditure responsibility requirements of section 4945(h)(3) with respect to the grant, and the grant is a taxable expenditure.

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:

For the first-tier tax to be abated under § 4962, the tax assessed must be from a taxable event due to reasonable cause and not to willful neglect, and the taxable event was corrected within the correction period for such event. Here, Foundation's two transfers of funds to Grantee are taxable expenditures within the meaning of § 4945(d) and do not satisfy the requirement of § 4945(d)(4)(A), because at the time of the transfers, Grantee was not a public charity described in § 509(a)(1), (2), or (3). In addition, Foundation failed to enter into a written terms/commitment document signed by the parties as required by §§ 53.4945-5(b)(3) and (4).

Pursuant to § 1.508-1(b), Foundation's argument that it relied on the Grantee's pending application is without merit. Foundation was fully aware that Grantee was not exempt at the time of the grants. The standard for whether a grant to an organization is taxable expenditure, is based on whether the grantee has a letter classifying it under §§ 509(a)(1), (2), or (3). Grantee did not receive a determination letter.

Even though the transfers were not made to public charities, Foundation might have avoided making taxable expenditures under § 4945 had it complied with the expenditure responsibility requirements of having written agreements describing the terms and commitment signed by the parties as required by §§ 53.4945-5(b)(3) and (4). However, it did not do so. As discussed in Hans S. Mannheimer Charitable Trust v. Commissioner, 93 T.C. 35 (1989), there must be strict compliance with the expenditure responsibility requirements in order to avoid the § 4945 tax. The filing of an amended return containing the information omitted on the original return, will only prevent the imposition of the "additional tax" (e.g., the second-tier tax) under § 4945(b). For example, in Rev. Rul. 77-213, 1977-1 C.B. 357, a private foundation failed to list on its original annual information return a grant to an organization not described in either § 509(a)(1), (2), or (3), but corrected the omission on an amended return filed after the due date. The organization failed to exercise the expenditure responsibility requirements of § 4945(h)(3) with respect to the grant, and the grant is considered a taxable expenditure. Similarly, by failing to enter into the terms and commitment document, the contributions to Grantee are considered taxable events under § 4962.

Section 4962 does not define "reasonable cause." Other Code sections and the regulations, including § 53.4945-1(a)(2)(v), indicate that the standard should be "ordinary business care and prudence." 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. Examples that do not establish reasonable cause include ignorance of the law, a Form 990-PF was prepared by a paid professional and they gave no notice that a specifically identified questionable transaction occurred, the foundation or related foundation had a similar previous abated tax under § 4962 under a similar event. A situation in which a tax may be abated include a foundation relying in good faith, on the written advice of an attorney or accountant (dated prior to the transaction) that the transaction was not subject to Chapter 42 excise tax.

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, § 53.4945-1(a)(2)(iv), as "voluntary, conscious, and intentional," and § 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. 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.

Here, Foundation submitted no evidence that they had reasonable cause. Foundation argues that it relied on Grantee's pending application in making the grant. However, as noted above, the Grantee cannot be treated as an organization described as a public charity in § 509(a), unless the organization receives a determination letter from the Internal Revenue Service describing the organization as a public charity. Foundation also argues that the failure to enter into a written terms/commitment document was simply due to an oversight by the Foundation and that Foundation has, going forward ensured that any subsequent grants that it makes are subject to a written terms/commitment document, demonstrating Foundation's good faith efforts in complying with the statutory requirements.

Under § 4962, the taxable event must be corrected within the "correction period." As provided in § 4963(e)(1) and § 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. Section 4961(a) allows the abatement of the second-tier tax if a taxable expenditure is corrected during the "correction period," the second-tier tax imposed is not assessed, and if assessed, the assessment is abated. Treas. Reg. § 53.4961-1. Here, the "correction period" remains open because Foundation self-assessed the first-tier tax, closing the taxable period and then corrected the event prior to the Service issuing a statutory notice of deficiency with respect to the second-tier tax.

Based on the above facts and circumstances, Foundation has failed to show that the taxable event was due to reasonable cause. Factors showing lack of reasonable cause include Foundation failing to enter into a terms/commitment agreement as required by the regulations to exercise expenditure responsibility, and lack of explanation or documentation indicating that Foundation consulted with or sought professional advice before making the grants. Other factors that show a lack of reasonable cause was that Foundation was aware that Grantee had not received exemption and that the grants made by Foundation to Grantee were subject to § 4945 as a taxable expenditure indicated by the close ties of the Foundation and the Grantee (the president of Foundation is also president of Grantee; and Foundation's CFO is on Grantee's Board of Directors). In addition, the expenditure responsibility statements submitted with the originally filed return and the amended return do not satisfy the strict compliance requirements of §§ 53.4945-5(b)(3) and (4). The request to abate the tax is denied by the Acting Director, Exempt Organizations

Based on the foregoing facts, we find that:

The first-tier excise tax due under § 4945 of the Code on Foundation's taxable expenditure for the year at issue should not be abated in accordance with § 4962. Foundation has not established reasonable cause to justify abatement of the taxes.

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-