Reasonable Cause

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Introduction

Thank you for joining me for this presentation on Reasonable Cause for abating first tier excise taxes.

I have a few announcements before we get started. The information contained in this presentation is current as of the day it was presented, and should not be considered official guidance. Any stories, names, characters, and incidents portrayed in this production are fictitious. No identification with actual persons (living or deceased), places, buildings, and products is intended or should be inferred.
This program is being recorded and will be maintained in accordance with federal record keeping laws.

Now let's get started.

So why am I discussing Reasonable Cause? After all, the IRS has an Issue Snapshot on Reasonable Cause which explains everything you need to know, right? Well, while it's an excellent document, this presentation allows us to focus on Reasonable Cause and give you some examples. Lets have a quick review of Reasonable Cause.

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Review/Overview

First, abatement of taxes under §4962 requires that the failure to comply with the tax law was due to:

• Reasonable cause and

• Not from willful neglect and

• Corrected within the applicable correction period

As I mentioned earlier, we're just discussing reasonable cause.

Section 4962 does not define "reasonable cause." There are, however, guides in the regulations and in many court cases that have considered whether particular circumstances amounted to reasonable cause.

Treas. Reg. § 53.4944-1 and § 53.4945-1 provide rules for jeopardizing investments and taxable expenditures respectively. They state a foundation manager's actions are due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence.

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Treas. Reg. § 301.6651-1(c), which provides rules for imposition of additional taxes and penalties for failure to file tax returns or pay tax, applies a standard of 'ordinary business care and prudence.' Failure to pay tax is due to reasonable cause to the extent the taxpayer satisfactorily shows he exercised ordinary business care and prudence in paying the tax liability, but was either unable to pay or would've suffered an undue hardship if he paid the liability on the due date.

Under Treas. Reg. § 301.6651-1(c) and other provisions that impose a reasonable cause standard, determining whether reasonable cause was shown requires us to consider all the facts and circumstances.

While there isn't a specific definition of reasonable cause, these regulations describe a process for determining it. We'll look at:

- facts and circumstances and
- ordinary business care and prudence

as important factors for Reasonable Cause. We're going to talk about examples of reasonable cause from Private Letter Rulings. We can't cite Private Letter Rulings as guidance, but they do offer a good thought process in applying tax law in different situations.

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PLR 201448032, 2014 PLR LEXIS 1016 (I.R.S. 2014)

The first example is PLR 201448032. What's interesting about this PLR is the IRS found there was reasonable cause and the taxpayer had the taxes abated. I'm giving away the ending already with this particular ruling. However, it's a good exercise to review the ruling's facts and circumstances. The tax preparer for a private foundation misinterpreted the percentage allowable under IRC § 4943(c)(2) to conclude, incorrectly, that the foundation had no excess business holdings for the prior tax year. The foundation's tax preparer assigned new people to prepare the following year return and when they analyzed the foundation's business holdings, they discovered the earlier errors. To correct the excess business holdings position, the foundation made an installment sale of all of the stocks originally granted by the founder back to the corporation for the full value determined under a qualified valuation of the stock.

The foundation submitted a Form 4720 for both tax years in question seeking abatement of the first tier tax under § 4943 for both years.

The foundation claimed its error was due to reasonable cause based on the tax advice of its tax preparer. In the year in question, the foundation's tax preparer drafted a memo stating that it did not have excess business holdings. So, the tax preparer's written analysis concluded the amount of the holdings didn’t constitute excess business holdings and were permissible.

This analysis gave no indication the foundation's excess business holdings position would change without any change to the actual share holdings. The foundation received professional advice about the date it would need to reduce its excess business holdings, and that it did not have excess business holdings due to not reaching what it believed to be the applicable holdings. This tax advice was provided with full knowledge of the facts as demonstrated by email exchanges between the foundation and the preparer. Based on the preparer’s written advice, the foundation believed it didn’t need to reduce its business holdings.

In the first year in question, the foundation again relied on the analysis of the prior year's memo. Relying on this memo, the tax preparer examined the nearly identical tax holdings of the foundation and came to the same erroneous conclusion, which the tax preparer gave to the foundation.

When preparing the foundation second tax year filings, the tax preparer performed a new analysis with different individuals and promptly informed the foundation it had excess business holdings for both years. The foundation states it reasonably relied upon the advice of its tax preparer to mistakenly carry excess business holdings.

A written opinion isn’t considered reasoned if it recites the facts and expresses a conclusion. The written advice of counsel in this case addresses the facts and the applicable law. The written advice incorrectly concludes that the foundation should be below the 35 percent limit rather than the 20 percent limit. **It shouldn’t be incumbent upon the foundation to validate the professional tax preparer’s analysis.** The foundation had specific communications with its tax preparer and relied on the preparer’s specific analysis citing both the law and the facts for their case. There was no information in the written advice that notified the foundation of the erroneous conclusion. Therefore, the organization is considered to have reasonable cause to continue with its status quo level of business holdings until it had been advised otherwise.

The foundation's excess business holdings didn’t violate section 4943 with willful neglect and those excess holdings have been corrected. The foundation also had reasonable cause to maintain its business holding level since it received written advice from a professional tax preparer that addressed both the facts and the law on this issue. Abating the first-tier taxes in this case is consistent with that reasoning.

The IRS concluded the § 4943 taxes on excess business holdings should be abated under § 4962. Based on the facts, the foundation:

- sought the advice of a tax preparer

- had specific conversations with that preparer about its stock holdings, and
- received specific advice from that preparer noting that there were no excess business holdings.

This example shows the abatement was granted due to the organization's reliance on a professional and it was specifically discussed. The organization didn't know the tax professional made an error in the calculations.

This was an interesting example showing the IRS agreeing to the tax abatement.

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PLR 201351027, 2013 PLR LEXIS 1073 (I.R.S. 2013)

Our next example is PLR 201351027 which discusses an organization that sought an abatement of § 4945 excise taxes for taxable expenditures.

The foundation contributed cash for community and economic development to grantee, a not-for-profit membership entity whose membership included the foundation. 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).

The grantee didn't receive a determination letter. Even though the transfers weren't made to public charities, the 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 didn't do so.

The foundation's transfers of funds to the grantee are taxable expenditures within the meaning of § 4945(d) and don't satisfy the requirement of § 4945(d)(4)(A), because at the time of the transfers, the grantee was not a public charity per § 509(a)(1), (2), or (3). In addition, the foundation failed to enter into a written terms or commitment document signed by the parties as required by §§ 53.4945-5(b)(3) and (4).

Under § 1.508-1(b), the foundation's argument that it relied on the grantee's pending application is without merit. The foundation was aware the grantee wasn't exempt at the time of the grants.

Based on these facts and circumstances, the foundation failed to show the taxable event was due to reasonable cause. Factors showing lack of reasonable cause include:

- the foundation failing to enter into a terms or commitment agreement as required by the regulations to exercise expenditure responsibility, and

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- lack of explanation or documentation indicating that the foundation consulted with or sought professional advice before making the grants.

Other factors that show a lack of reasonable cause:

- The foundation was aware the grantee hadn't received exemption and that the grants the foundation made to the grantee were subject to § 4945 as a taxable expenditure indicated by the their close ties. (The foundation's president is also president of the grantee; and the foundation's CFO is on grantee's Board of Directors).

- Another factor that shows a lack of reasonable cause is 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 IRS found that first-tier excise tax due under § 4945 on the Foundation's taxable expenditure for the year at issue should not be abated under § 4962. The foundation has not established reasonable cause to justify tax abatement.

This example seemed straightforward in terms of the organization not being able to abate their excise tax liability since the organization didn't have many factors in its favor to demonstrate it used reasonable cause.

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PLR 201129050, 2011 PLR LEXIS 650 (I.R.S. 2011)

The third and last example: PLR 201129050 discusses an organization that did not meet the distribution requirements of section 4942.

A trust, which operated historical properties, had an accounting firm prepare its federal income tax filings, including Form 990-PF. It stated that the accounting firm never informed them to distribute the required amounts for a number of years. The trust also claimed it was advised it met the requirements as a private operating foundation and wasn't required to make any minimum distributions.

Beginning in year three, the trust's non-charitable use assets value increased from year two to year three, but its expenditures declined. As a result, the trust had undistributed income as of the end of each year.

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Again, the trust stated that, during this time, it was never informed by the accounting firm that it failed to distribute the required amount for the years at issue, even though the firm was hired to advise the trust on matters like these. The trust also claims it was advised by the accounting firm that it met the requirements as a private operating foundation and wasn‘t required to make any minimum distributions.

The trust provided a signed affidavit from the accounting firm attesting to its belief the trust met the requirements as a private operating foundation and was therefore not required to make the distributions. The trust didn’t submit any additional information. The accounting firm advised it met the private operating foundation status

On its Forms 990-PF for each of these years, the trust didn’t file as a private operating foundation or complete any of the required sections for a private operating foundation. The Forms 990-PF for these years shows that the trust didn’t meet the requirements as a private operating foundation. In year five, the trust filed Form 4720, requesting abatement of the first tier tax under section 4942.

The issues are whether the trust has shown its failure to distribute:

- Was not from willful neglect and
- Was due to reasonable cause.

The trust’s timely filed Forms 990PF for these years report both:

1. the trust is a non-operating foundation and
2. the trust had past, continuing, and increasing undistributed amounts in each year

Also, the board's actions -- including changing its investment strategy to increase growth and returns, and reducing Trust's expenditures -- establish the trust should have known its expenditures, as a percentage of its assets, were declining during the years at issue and thus creating distribution shortfalls.

Further, the affidavit from the trust’s accountant post-dated all of the filed Forms 990-PF and the returns weren’t amended to conform to the accountant's purported advice that the trust qualified as a private operating foundation. The trust didn’t present any other evidence that the accountant had advised the trust that it was a private operating foundation.

Finally, the trust didn’t meet the statutory requirements for a private operating foundation. Based on these facts, the trust didn’t show its failure to meet the minimum distribution requirements for each year was due to reasonable cause and was not due to willful neglect. The request to abate the tax was denied.

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Lets take a minute and look at the differences in Example 1 and Example 3 since both those organizations relied on advice from counsel. If you recall in Example 1, the IRS found that the excise tax should be abated since the foundation relied directly on the written advice of a tax professional which included analyzing that case's facts and the applicable law.

Likewise, in Example 3, the trust stated it was advised it met the requirements as a private operating foundation and was not required to make any minimum distributions. The trust provided a signed affidavit from the accounting firm attesting to its belief the trust qualified as a private operating foundation, however the trust didn't submit additional informationf from the accounting firm showing it advised them they qualified as a POF.

In addition, the trust didn't file as a private operating foundation on the Form 990-PF nor did it complete the required sections for that status. So in Example 1, the foundation was able to show it was advised by counsel and relied directly on advice from said counsel which is why they were able to abate the excise tax.

In contrast, the trust in example 3 did not provide contemporaneous evidence that the organization asked the professional for advice or that the professional provided advice. This coupled with return filings that contradicts the claims of advice. This is why the IRS denied their request to abate the tax.

Thank you for listening to this presentation. I hope the information we presented is useful.