

Foundation Penalties: Reasonable Cause Exception?

04.11.17 | Linda J. Rosenthal, JD



Because private foundations receive financial support from a single source only or just a few sources, they are subject to much more significant restrictions than public charities. There are rules on how they operate and how they manage and distribute charitable dollars. If they fail to follow these rules, the IRS may impose significant penalties.

For instance, “self-dealing” transactions with “disqualified persons” are prohibited; violating this restrictions may result in a self-dealing penalty tax under Internal Revenue Code Section 4941. Similarly, a foundation that doesn’t make a minimum required amount of distributions in furtherance of charitable purposes will likely be subject to a Section 4942 tax. There is also a tax under Section 4943 on stock holdings that exceed a certain amount, a tax under Section 4944 on risky investments that may jeopardize the foundation’s ability to carry out its charitable mission, and a tax under Section 4945 for prohibited expenditures like political activities or lobbying.

In certain cases, not only the foundation itself but foundation managers, individually, may face these penalties. And the amounts imposed can be substantial and grow even larger after repeated violations.

But what if there has been a legitimate oversight or mistake, is it possible to argue for relief? Is there a “good cause” defense?

The answer is yes for most of these “first tier” taxes, except for the section 4941 self-dealing tax.

“Reasonable Cause” Relief

Internal Revenue Code section 4962, *Abatement of Certain First Tier Taxes in Certain Cases*, describes the conditions under which an excise or penalty tax under the code sections listed above can be “abated, credited or refunded.”

First, the private foundation officials must show that there was a “taxable event” – (that is, the

imposition of an excise tax) – but it was “due to reasonable cause and not to willful neglect.”

Second, they must demonstrate that it “was corrected within the correction period.”

So the question is how the IRS and the courts define and interpret “reasonable cause” and “willful neglect.”

There is legislative history on Internal Revenue Code section 4962:

”

[W]here the foundation or foundation manager can establish that there was reasonable cause for such a violation and that there was no willful neglect of the rules, the IRS has discretionary authority to relieve the foundation or manager from the first-tier penalty tax, provided that the violation is corrected in the manner required in order to avoid liability for second-tier taxes. A violation which was merely due to ignorance of the law cannot qualify for such abatement. 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)

While this history does nothing more than include the conclusory terms “reasonable cause” and “no willful neglect, there is the specific guidance that mere “ignorance of the law” is not enough to trigger abatement of any of these penalties.

There is a definition of “reasonable cause” in the Treasury regulations issued in connection with the Section 4944 tax on jeopardizing investments and the Section 4945 tax on “taxable expenditures” – that is, itemized prohibited activities.

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.” See Treas. Reg. Sections 53.4944-1(b)(2)(iii) and 53.4945-1(a)(2)(v).

There are court cases as well on this regularly litigated issue of “reasonable cause.” In *Thorne v. Commissioner*, 99 T.C. 67 (1992), the U.S. Tax Court ruled “that the taxpayer made numerous grants to organizations that were not tax-exempt, that he did not exercise expenditure responsibility under Section 4945(h) over grants made, and that he made grants to friends and relatives for personal purposes.” In addition,

”

the petitioner agreed to the making of the expenditures, knowing that they were taxable expenditures [and also] failed to exercise his responsibility with ordinary business care and prudence and acted without reasonable cause.

These violations, the Court ruled, were “both knowing and willful.” The Court “dismissed petitioner’s argument that he had acted according to advice given to him by his tax advisor, stating that section 53.4945-1(a)(2)(vi) requires that any legal advice be in the form of a ‘reasoned written legal opinion,’ and observing that the advice petitioner had received from his tax advisor was primarily oral.” Certain other cases provide helpful information, although they don’t relate directly to foundation excise taxes.

For instance, in *U.S. v. Boyle*, 469 U.S. 241 n.3 (1985), the court explained that the taxpayer must “demonstrate that he exercised ‘ordinary business care and prudence.’” *Boyle*, 469 U.S. at 246 (quoting Treas. Reg. Section 301.6651-1(c)(1)).

”

The failure to make a timely filing of a tax return is not excused by the taxpayer’s reliance on an agent, and such reliance is not “reasonable cause” for a late filing. It requires no special training or effort on the taxpayer’s part to ascertain a deadline and ensure that it is met. That the attorney was expected to attend to the matter does not relieve the principal of his duty to meet the deadline. Additionally, the court stated, “This case is not one in which a taxpayer has relied on the erroneous advice of counsel concerning a question of law. Courts have frequently held that ‘reasonable cause’ is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney that it was unnecessary to file a return, even when such advice turned out to have been mistaken.

Similarly, In *Woodsum v. Commissioner*, 136 T.C. 585 (2011), the Tax Court decided that “there was no reasonable cause for the failure to report \$3.4 million in income when the taxpayer had provided its tax preparer with all of the information for it to know that the taxpayer had earned that income.”

”

[A] determination of whether a taxpayer acted with reasonable cause and in good faith depends on the pertinent facts and circumstances, including his efforts to assess his proper tax liability, his knowledge and experience, and the extent to which he relied on the advice of a tax professional. The court noted that the tax preparer’s failure to report the income on the return does not constitute professional advice on which the taxpayer could rely for not reporting the income. Woodsum presented no evidence to show that the income was omitted because of any “analysis or conclusion” or “judgment” that the income was not taxable rather than a clerical error. Therefore, the defense of reliance on professional advice was not available to Woodsum.

Conclusion

Provisions for abatement of tax or waiver of a requirement are “safety valves”. They ameliorate problems that mechanical application of the laws can cause.