

**ROCKY MOUNTAIN TAX SEMINAR
FOR
PRIVATE FOUNDATIONS**

**IRS AUDITS – HOW TO PREPARE FOR AND SURVIVE THEM –
AND THE VALUE OF FORMAL LEGAL OPINIONS**

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IRS AUDITS – HOW TO PREPARE FOR AND SURVIVE THEM – AND THE VALUE OF FORMAL LEGAL OPINIONS

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Tax-exempt organizations – including private foundations – continue to face scrutiny from the Internal Revenue Service (IRS). According to the IRS Exempt Organizations Division’s FY 2010 Annual Report and FY 2011 Work Plan,¹ during FY 2010 the Exempt Organizations (EO) Exam unit examined the returns of over 15,000 organizations, 75% of which involved some form of audit, and 25% of which involved some form of compliance check. This outline describes the IRS audit process for exempt organizations, including private foundations; highlights current areas of enforcement focus; and discusses the value of formal legal opinions for private foundations and their managers.

I. IRS Enforcement in the EO Sector in General

The EO examinations function is handled by EO Exam, headed by Nan Downing, who is headquartered in Dallas. EO Exam conducts its enforcement activities through several specialized units within the division. The Exempt Organizations Compliance Unit (EOCU) conducts compliance checks and sends out educational letters to selected organizations to monitor compliance within the sector. Compliance checks inquire about an item on a return or solicit information about specific aspects of an organization’s operations. Review of Operations (ROO) monitors organizations that were previously found to have been noncompliant, and also conducts reviews of new exempt organizations that were flagged for follow-up during the determination process. The Compliance Strategies Critical Initiative (CSCI) coordinates EO’s strategic planning efforts, monitors the progress of critical initiatives, and analyzes the results of EO Exam’s various projects.

According to the FY 2011 Work Plan, EO Exam has been better able to target potential nonfilers by sharing information with outside agencies like the Social Security Administration and with states. EO Exam also relies on a unit created in 2004, the Data Analysis Unit, that is composed of economists, statisticians and research analysts who are tasked with analyzing trends in compliance throughout the sector and developing methods for the EO Exam staff to use in setting priorities and designing audit work plans. Once criteria are established within EO Exam for choosing types of organizations to examine, the IRS uses a computer system – the Returns Inventory and Classification System (RICS) – which sorts through filed information returns and pulls out the correct number and type of returns that fit a particular examination project. RICS users are instructed to pull returns that still have at least 18 months remaining on the statute.² Each return is turned over to the examination group where the organization is located, and an audit is begun. The Work Plan indicates that refined case selection techniques have led to a

¹ A copy of the Work Plan can be accessed at http://www.irs.gov/pub/irs-tege/fy2011_eo_workplan.pdf.

² I.R.M. 4.75.4.6.

higher percentage of cases that involve significant tax issues and resulted in agents securing a higher number of delinquent returns than in prior years.

II. IRS Selection of Organizations to Audit

A. The Team Examination Program (TEP)

The TEP focuses on larger organizations with assets or revenues in excess of \$250 million or, in the case of private foundations, \$500 million.³ The TEP utilizes automated return scoring and screening and other procedures to select organizations that meet the requisite revenue/asset criteria for examination. A TEP examination includes a review of areas in addition to exemption and income tax issues, including employment tax returns, pension and profit-sharing plans, related entities and sometimes personal income tax returns of key officers of the organization.

B. The General Program

EO Exam's General Program includes regular casework brought to its attention, plus targeted programs that are updated on a regular basis and made known to the public through the publication of the Work Plan. In general, these targeted programs involve a background study of the scope or prevalence of an activity within the exempt organization's sector and recommendations for increasing compliance with applicable rules through examinations or other more limited measures, including voluntary compliance programs.

C. Specialized Examination Projects and Procedures

1. Financial Investigations Unit (FIU)⁴

The FIU handles examinations of complex exempt organizations, with a particular focus on those suspected of being involved in fraudulent activity that might involve transactions with entities or individuals on the terrorist watch list or in sanctioned countries. The FIU groups also work on cooperating agent cases with the IRS Criminal Investigation division. There are currently two groups of forensic investigators in the FIU that handle cases nationally with teams from IRS offices around the country. According to the Internal Revenue Manual, the FIU targets potential fraud, which it describes as including:

- “Specific indicators involving the misuse of EO assets (diversion, embezzlement, inurement). Indicators may include evidence of funds going overseas without the appropriate control or oversight, or allegations of fraud that include specific documentation.
- Indication of unreported taxable income (UBIT), willful intent or intentional disregard by Exempt Organization or Disqualified Person(s).
- Intentional misuse of exempt status (use of exempt status for non-exempt activity).”

³ I.R.M. 4.75.29.3.

⁴ See generally I.R.M. 4.75.21.8.

FIU audits tend to focus on larger and more complex exempt organizations and may result from referrals from credible sources such as other government agencies, attorney or CPA referrals and internal IRS referrals from other divisions.

2. Political Activity Compliance Initiative (PACI)⁵

PACI investigates political referrals of allegations against church and non church Section 501(c)(3) organizations. IRS enforcement of the allegations of improper political campaign intervention by churches has been deferred due to uncertainty as to which executive, within the IRS, has authority to initiate church audits under the church audit procedures of Section 7611.

3. Referrals

EO Exam is frequently provided with information about potential abuse situations from the general public, state attorneys general and even members of Congress, and also obtains audit leads from newspaper and magazine articles about the activities of nonprofit organizations. These referrals can lead to an IRS audit if there is credible evidence of potential tax law violations. EO Exam also receives referrals from other units of the IRS, which provide the names of exempt organizations that have been the recipients of property in questionable deductibility situations or possible participants in tax shelter schemes under scrutiny. Individual audits of very high net worth individuals may also lead to audits of their associated private foundations.

III. Types of Audits

A. Office/Correspondence Examination Program (OCEP)

EO Exam conducts correspondence or office audits through the OCEP, which deals with limited-scope audits typically involving no more than three issues.⁶ OCEP audits generally, though not always, are used with organizations with revenues or assets of \$100,000 or less and are often used to clarify or substantiate particular line items on returns. In general, normal examination and closing procedures apply to OCEP examinations. If questionable items are found on returns during the course of an OCEP examination, it may be converted to a field audit.

B. Field Audits

Field audits involve an examination of the organization's records, typically at its business premises. The examining agent will be a specialist in exempt organization matters. The Internal Revenue Manual contains detailed procedures for conducting field examinations.

C. TEP Audits

TEP audits are very intensive, and in some cases they require line-by-line reviews of the 990 or 990-PFs and other relevant materials by revenue agents with expertise in a number of areas, not

⁵ See generally I.R.M. 4.75.21.16. See also "Political Activity Compliance Initiative; Procedures for Section 501(c)(3) Organizations" issued by the IRS on February 22, 2006, available at http://www.irs.gov/pub/irs-tege/paci_procedures_feb_22_2006.pdf.

⁶ See generally I.R.M. 4.75.27.

just exemption and income tax issues. These audits also aid the IRS in formulating the selection criteria for other routine audits and determining the amount of revenue being lost as a result of improper filing of returns.

IV. Examination Stage

A. Commencement of the Audit

An audit is usually initiated by the appropriate district office. Generally, the organization is first notified of the audit through a phone call from the examining agent, followed by a letter setting a date for the agent to come to the organization's premises to review the requested records. The IRS is likely to make an initial request to review some or all of the following:

- all organizational documents such as articles of incorporation, bylaws, and resolutions of the board;
- minutes of board meetings for the last several years;
- a list of directors and any transactions between the organization and directors;
- the application for recognition for exemption and any subsequent IRS correspondence;
- financial statements;
- publications of the organization;
- correspondence files;
- financial and management reports;
- accounting manual and a chart of accounts;
- tax reconciliation workpapers used in preparing returns;
- contracts;
- payroll and pension plan records;
- employment tax returns; and
- returns of affiliated organizations.⁷

The initial meeting with the IRS provides an opportunity to develop a positive working relationship with the examining agent(s) and assess the potential scale and length of the audit. It is advisable to have the organization's tax advisor attend this initial meeting to present a power of attorney and obtain an informal sense of the agents' areas of interest and whether the examination is targeted to limited issues. The initial meeting will cover certain procedural matters including agents' use of the organization's facilities, access to personnel as well as books and records, guidelines for prompt communication of important information throughout the audit, procedures for obtaining statute extensions, expected timeframes for receiving and responding to written Information Document Requests (IDRs) and the expected form and content

⁷ I.R.M. 4.75.11.6.

of IDRs. It is important to provide the IRS with a single contact person within the organization who will act as the clearinghouse for documents and information throughout the examination.

B. The Auditor's Objectives

An agent assigned to an audit knows that the organization's return has been classified as having audit potential and thus may expect to find issues, or indeed may already have identified potential issues. Depending on the scope of the audit and whether it arose from a referral, the agent may already have done some research about the organization, its prior compliance history, and any recent publicity. Agents are required to identify items that indicate adjustment may be proper, verify items on the return by gathering appropriate evidence and apply provisions of the Code, regulations and rulings as interpreted by the IRS. In the case of private foundations, the agent generally will examine the following areas:

- compliance with employment tax requirements and issuance of Forms 1099;
- reasonableness of compensation, evidence of private inurement and compliance with Section 4941 self-dealing rules;
- evidence of lobbying or political activity in violation of Section 4945;
- compliance with grant-making requirements of Section 4945, including individual grant procedures and expenditure responsibility; compliance with income tax withholding and/or reporting requirements for scholarships, fellowships and grants to foreign organizations;
- calculation of the excise tax under Section 4940; compliance with minimum distribution requirements under Section 4942, excess business holding rules under Section 4943, and jeopardy investment rules under Section 4944;
- potential unrelated business income from income-producing activities and investments; and
- transactions with affiliated or related individuals or organizations.⁸

After receiving initial documents for review at the start of an audit, the agent will generally request additional documents or information, which request the taxpayer should insist are put into a written IDR. Having a file of written IDRs and responses helps to clarify what has already been provided, and is also useful in determining the scope and direction of an audit. The agent has broad authority to compel production of information that may be relevant or material to the examination of a return, including tax returns of other entities, individuals associated with the organization or other years that may be related to the return under examination.

C. The Foundation's Objectives

1. Before the Audit Begins

The best time to prepare for an audit is before it begins. Every exempt organization – including private foundations – should periodically conduct an “in-house” audit to make sure that its affairs

⁸ *Id.*

are in order. An ideal time to do this is in connection with the preparation of the Form 990-PF each year. The “in-house” audit should consider, at a minimum, the following issues:

- Are the foundation’s activities conducted in compliance with its governing documents and its IRS determination letter? Has the foundation kept the IRS informed as to any material changes in operations since the original exemption letter?
- Are the foundation’s financial books and records adequate to document clearly the nature of revenues and expenses?
- Do the corporate minutes clearly document the relationship of program activities to the fulfillment of exempt purposes?
- Do the foundation’s grant-making procedures and files reflect compliance with the requirements of Section 4945?
- Does the foundation have a procedure for identifying its disqualified persons and does it use this information for purposes of compliance with Section 4941 and 4943?
- Are income-producing activities conducted and reported in compliance with UBIT rules? Does the foundation have alternative investments that generate debt-financed income?
- Has the foundation filed all required reports for foreign bank and financial accounts? Has it filed all required information schedules for foreign investments, such as Forms 926 (Return by a U.S. Transferor of Property to a Foreign Corporation), 8865 (Return of U.S. Persons with respect to Certain Foreign Partnerships), 8621 (Return by a Shareholder of a Passive Foreign Investment Company), and 5471 (Return of U.S. Persons with respect to Certain Foreign Corporations)?
- Are arrangements with independent contractors in compliance with employment tax rules, and are all required Forms 1099 filed?
- Does the foundation have salary surveys or other information to justify executive and/or board compensation? Does it follow the “rebuttable presumption of reasonableness” in setting executive compensation?
- Are all taxable benefits and perquisites reported as compensation on W-2s or 1099s?

2. During the Audit

The foundation’s primary objective during an audit is to maximize control over the situation and move the agent through the examination as quickly as possible. In addition to appointing a primary contact person to deal with the IRS as well as outside advisors, the foundation should spend time determining what documents the agent wants to review. The agent does not have the right to go on a “fishing expedition” and should be able to identify what documents are being sought for review. As to these, the foundation should:

- Review the materials to remove and separate any privileged matter such as legal counsel opinions from the files. The purpose of removal is not to keep the existence of such documents secret, but to segregate those documents as to which the taxpayer may have a privilege should the issue arise.
- Assemble files and records in good order. This reduces the time of examination and gives the agent an impression of efficiency and cooperation.
- In general, produce documents without explanation unless one is requested.
- Keep a record of what documents the agent has seen and provide copies for the agent; do not simply provide open access to files and a copier.

D. Completion of the Examination

During the course of larger examinations, the IRS will provide preliminary explanations of adjustments in a form known as a Notice of Proposed Adjustment (NOPA). A NOPA contains a summary of facts developed during the audit and applicable law and an analysis that includes a proposed tax adjustment. The foundation should be in regular communication with the agent to determine how many NOPAs are coming and when. The foundation should respond, in writing, to each NOPA either with its concurrence or with a detailed analysis of facts and law which shows why the adjustment is unwarranted. It is important, as those responses are prepared, to consider the impact of an assessment not only in the short term but also how it might affect the reporting of activities in the future.

Many issues can be resolved during the NOPA and response process. In some cases, however, there may be reasons that an issue cannot be resolved with the agent during the exam, particularly because the agent has limited authority to settle a case and is more likely to dispose of a factual issue than a legal issue. If the foundation has had a difficult working relationship with a particular agent, it may want to consider getting the agent’s Group Manager involved, or taking up an issue at the Appeals Division in order to get a fresh perspective and new persons involved in the issue. If an issue is agreed upon with the IRS, the agent will request that the foundation execute an agreement and make an advance payment of any deficiency and accrued interest to eliminate additional interest and save IRS collection costs.⁹ However, payment at this stage, prior to receipt of formal notice, is voluntary.

Under a current initiative, agents are directed, just before the end of the audit, to complete a checklist that is intended to gather information about the organization’s governance processes, including whether any tax law violations appear to be the result of governance deficiencies. At the conclusion of the audit, the IRS will issue a Revenue Agent’s Report – known as a “30-day letter” – which summarizes all of the proposed adjustments that the IRS and the foundation have not been able to settle and offers a review of the case by the IRS Appeals Division.¹⁰ The foundation has 30 days (which can be extended by mutual agreement) to file a written protest that sets forth any disputed issues and sufficient facts and law to support its position. If no response is received within 30 days, the foundation will be sent a statutory notice of deficiency,

⁹ Execution of Form 870 will preclude the organization from seeking declaratory judgment or going to Tax Court. However, the organization can still sue for a refund in federal district court or the Claims Court.

¹⁰ This letter is accompanied by IRS Publication 3498, “The Examination Process.”

which becomes a final assessment unless the organization files a Tax Court petition within 90 days.

E. Closing Agreements

Binding closing agreements between the IRS and the foundation are another option for resolving issues that arise during an audit.¹¹ These agreements are particularly useful when the IRS is considering revocation of exemption because of past conduct. A foundation can request a closing agreement with respect to an issue at any time during the examination. Under these agreements, the organization will typically agree to modify its future conduct with respect to an issue, and also pay any applicable back taxes, interest and perhaps some penalties in exchange for having the matter conclusively resolved without further IRS action. Foundations are bound by closing agreements and future audits will generally investigate whether the foundation is still following the terms of its closing agreement(s).

F. Penalties and Interest

Two penalties that the IRS may attempt to assert are accuracy-related penalties under Section 6662 and failure-to-file penalties under Section 6651. The accuracy-related penalty applies to any portion of an underpayment attributable to negligence or disregard of rules or regulations. Section 6662(c) provides that the term “negligence” includes any failure to make a reasonable attempt to comply with the Code, and the term “disregard” includes any careless, reckless, or intentional disregard. Negligence includes any failure to make a reasonable attempt to comply with the tax laws, exercise reasonable care in return preparation, keep proper books and records or properly substantiate items.¹² The accuracy-related penalty does not apply to any portion of an underpayment if the foundation can show that there was reasonable cause and that the taxpayer acted in good faith – a facts and circumstances determination made on a case-by-case basis.¹³

Section 6651(a) imposes a penalty for failure to file any required return unless such failure is due to reasonable cause and not willful neglect. The Supreme Court has held that willful neglect means “a conscious, intentional failure or reckless indifference,” and that “reasonable cause” exists where the taxpayer exercises “‘ordinary business care and prudence’ but nonetheless was ‘unable to file the return within the prescribed time.’”¹⁴ The failure to file penalty is not applicable and should be abated if the taxpayer has reasonable cause for the late filing.

V. Options for Appeal of an Adverse Determination

A. Protest to IRS Appeals Office

The foundation may appeal an adverse determination by submitting a protest to the IRS Appeals Office which contests the proposed determinations set forth in the 30-day letter and requests a

¹¹ See generally I.R.M. 4.75.25.

¹² Treas. Reg. § 1.6662-3(b)(1).

¹³ I.R.C. § 6664(c)(1).

¹⁴ *U.S. v. Boyle*, 105 S. Ct. 687, 690 (1985).

conference.¹⁵ The Appeals Office has broad authority to resolve tax controversies by taking into account the risks of litigation and can reject or compromise the agent's proposed deficiency. The IRS has announced on a number of occasions that it is more interested in seeing exempt organizations come into compliance with the tax laws than in revoking exemptions, and that it will consider entering into closing agreements with exempt organizations as an alternative to pursuing revocation. Note, however, that a settlement agreement or closing agreement that is reached with an Appeals Officer is subject to review before it becomes final. The Appeals Office can also return cases to the examining agent for further factual development.

B. Petition to Tax Court

The foundation may bypass the administrative appeal process altogether and, after receiving a statutory notice of deficiency, file a petition in the Tax Court within the appropriate 90-day period.¹⁶ If a foundation files within the 90-day period, it is not required to pay the tax before filing suit. Employment tax issues generally cannot be appealed to the Tax Court and must follow the suit for refund procedures listed below.

C. Suit for Refund

Alternatively, the foundation may pay the assessment, file a claim for refund, and if the refund claim is denied or is not acted upon within six months, file suit for refund in a federal district court or the Court of Claims.¹⁷ In the case of an employment tax refund, the foundation must pay the assessment attributable to one employee assessment for one quarter and then file a claim for refund.

D. Declaratory Judgment

If the adverse determination by the IRS involves revocation of exemption for a Section 501(c)(3) organization, there is another alternative under Section 7428 – seeking a declaratory judgment as to exempt status in the Tax Court, the Claims Court or the Federal District Court for the District of Columbia. Although a foundation must exhaust all administrative remedies before seeking a judgment, the court is not limited to reviewing only the administrative record that was before the IRS.¹⁸ In the case of a public charity, a major advantage of the declaratory judgment mechanism is that contributions made to an organization seeking a declaratory judgment concerning proposed revocation of exemption are deductible up to a maximum of \$1,000 per donor. If the organization ultimately prevails, the limit is inapplicable.

E. Fast-Track Mediation

Some IRS audit issues also qualify for fast-track mediation.¹⁹ A taxpayer may request this option and the dispute with the IRS will be heard by an Appeals Officer trained in mediation.

¹⁵ Rev. Proc. 84-44, 1984-1 C.B. 523.

¹⁶ I.R.C. § 6213.

¹⁷ I.R.C. §§ 6212, 6213 and 7422; 28 U.S.C. §§ 1346(a)(1) and 1491.

¹⁸ *Freedom Church of Revelation v. United States of America*, 588 F. Supp. 693 (D.D.C. 1984) (an action under IRC § 7428(a) is a “*de novo* proceeding in which neither the parties nor the Court is limited to the administrative record.”).

¹⁹ See generally IRS Publication 3605 for additional information about this program.

The advantages of this approach are that a taxpayer is not required to file a formal written protest before participating in mediation, and if the mediation process is unsatisfactory, the taxpayer may withdraw and still retain all of its appeal rights.

F. Retroactivity of an Adverse Determination

In the event a foundation receives notice of an adverse determination, the IRS has the authority to limit the retroactive effect of that determination under Section 7805(b). With respect to revocation of exemption, revocation will ordinarily take effect no later than the time at which the organization received written notice that its exemption might be revoked. However, retroactive revocation is appropriate if the foundation omitted or misstated a material fact, operated in a manner materially different from that originally represented or engaged in a prohibited transaction.

VI. Technical Advice

At any point during the administrative appeal stage, the foundation or the IRS may request intervention by the National Office in the form of “technical advice.”²⁰ The IRS is encouraged to request technical advice on any questions that cannot be resolved on the basis of law, regulations, rulings or other published precedent. EO Exam agents and Appeals Officers are required to request technical advice on exempt organizations cases concerning qualification for exemption “for which there is no published precedent or for which there is reason to believe that non-uniformity exists.”²¹

The foundation may request technical advice through the examining agent (or his or her local Group Manager) or through the Appeals Office on the grounds that a lack of uniformity exists as to the disposition of the issue in a case or that the issue is sufficiently unusual or complex to warrant consideration by the National Office. The foundation may appeal a decision by the agent or Appeals Officer not to seek technical advice to the EO Exam Area Manager or the Appeals Area Director.

Where the technical advice request is initiated by the examining agent or the Appeals Officer, the foundation will be given the proposed statement of facts and conclusions and will have 10 days to indicate any disagreement. The parties are required to attempt to reach an agreement; however, if no agreement can be reached, the taxpayer may submit a separate statement, which will be forwarded to the National Office with the IRS’s request for technical advice. The foundation has the right to a conference in the National Office in the event an adverse decision on the technical advice is indicated.

The examining agent may request reconsideration of the technical advice issued, but must follow the conclusions in the memorandum as to all issues. The Appeals Office must follow the conclusions in the technical advice memorandum on issues of an organization’s continuing exempt status.

²⁰ See generally Rev. Proc. 2011-5, 2011-1 I.R.B. 167 (updated annually, this Rev. Proc. sets forth administrative procedures for requesting technical advice).

²¹ *Id.*

VII. Current Areas of Focus for Examinations in the Tax-Exempt Sector

The EO FY 2011 Work Plan lists a number of audit initiatives, most of which are not relevant to private foundations. These include the college and university compliance project, planned audits of noncharitable exempt organizations (including Section 501(c)(4), (5) and (6) organizations), a nonfiler initiative, and a project to examine mortgage foreclosure assistance organizations. However, there are two initiatives that may impact private foundations – the international initiative and the employment tax initiative.

A. International Initiative

The FY 2011 Work Plan indicates that the IRS intends to audit some exempt organizations that engage in international activities. The objective is to determine whether charitable assets are being diverted overseas for non charitable purposes. The focus of the project will be foreign organizations that have received recognition of exemption under Section 501(c)(3), charities that report foreign addresses on their Form 990 and **large private foundations with international operations or significant international transactions (including alternative investments)**.

B. Employment Tax National Research Program Audit Initiative

The IRS has launched an Employment Tax National Research Project to audit the employment tax practices of 6,000 organizations over the next three years. EO Exam will examine 1,500 tax-exempt employers – 500 each year – and audits of the 2008 and 2009 tax years are already in progress. This project is intended to measure the compliance of tax return filers in order to determine how much employment tax misreporting contributes to the tax gap. For tax-exempt employers, the key areas of focus include worker classification, the taxability of fringe benefits and Form 1042 filings for nonresident alien taxpayers.

1. Worker Classification

The IRS will examine who receives Forms W-2 and Forms 1099 within an organization, and will cross-reference those lists to determine whether anyone receives both forms in one year in order to find persons who might be misclassified as independent contractors. In addition, certain categories of workers are considered statutory employees under IRC Section 3121(d), including a corporation's officers.²² The IRS will also determine whether any workers have filed Form SS-8 to determine their worker classification and may examine the classification of entire groups of workers, such as interns or seasonal employees.

2. Fringe Benefits

The IRS will review fringe benefits provided to employees, especially officers, to determine whether those benefits should be included in the income of the recipient. The IRS often finds violations in this area. It is important in an audit to be able to demonstrate that the organization

²² There are a couple of helpful sources for reviewing common law standards applicable to worker classification:

- Publication 15 (Circular E) Employer's Tax Guide: <http://www.irs.gov/pub/irs-pdf/p15.pdf>
- IRS Training Materials on Worker Classification: <http://www.irs.gov/pub/irs-utl/emporind.pdf>.

understands the fringe benefit rules and has a culture of compliance, such that any mistaken classifications or treatments can be treated more favorably as a one-off mistake rather than indicative of larger noncompliance issues.

VIII. Value of Formal Written Opinions

Private foundations and, in some cases, their managers are subject to excise tax liability under Sections 4942 - 4945. In addition, disqualified persons and foundation managers are subject to excise tax liability under Section 4941. The IRS regulations under some of these provisions provide liability protection for foundations and/or their managers if action is taken in reliance on a formal written opinion, typically of inside or outside counsel but in some cases of another expert. These include the following:

A. Section 4941

Section 4941 imposes an excise tax on a disqualified person that engages in an act of self-dealing with a private foundation, and on a foundation manager that participates in such an act “knowing that the act is an act of self-dealing.” Treasury Regulation 53.4941(a)-1(b)(6) provides that if a foundation manager, after full disclosure of the factual situation, relies on a reasoned legal opinion (from inside or outside counsel) that the act is not self-dealing, then even if the act is later held to constitute self-dealing, the manager ordinarily will not be considered to have met the “knowing” requirement and therefore will not be liable for the foundation manager penalty.

B. Section 4942

Section 4942 imposes an excise tax on private foundations that fail to make sufficient qualifying distributions to meet the minimum distribution requirement. Typically the excise tax results from either improper valuation of assets or improper treatment of expenditures as qualifying distributions, and having a written opinion can provide protection in both cases.

With respect to an incorrect valuation, the excise tax is not imposed if the valuation error was not willful and was due to reasonable cause. Treasury Regulation 53.4942(a)-1(b)(2) provides that the failure to value an asset properly ordinarily will not be considered willful and will be due to reasonable cause if the foundation obtained and relied on a bona fide appraisal by a person qualified to make such appraisal.

With respect to qualifying distributions, Treasury Regulation 53.4942(a)-3(a)(6) provides that distributions to foreign organizations that do not have a 501(c)(3) public charity ruling will be treated as qualifying distributions if the foundation makes a “good-faith” equivalency determination, which can be based on an affidavit of the grantee or an opinion of counsel that the grantee is the foreign equivalent of a public charity.

C. Section 4944

Section 4944 imposes an excise tax on private foundations that make jeopardy investments and on foundation managers that approve such investments, knowing them to be jeopardy investments. There is an exception for program-related investments. Treasury Regulation 53.4944-1(b)(2)(v) provides that a foundation manager who obtains and relies on a written

opinion of counsel that an investment is not a jeopardy investment (including that it is a program-related investment) will not meet the “knowing” requirement and therefore will not have foundation manager liability even if the investment is later determined to be a jeopardy investment. Similarly, a foundation manager may rely on a written opinion from qualified investment counsel as to the prudence of a particular type of investment.

D. Section 4945

Section 4945 imposes an excise tax on private foundations that make taxable expenditures and on foundation managers that approve such expenditures knowing them to be taxable expenditures. Treasury Regulation 53.4945-1(a)(2)(vi) provides that a foundation manager who relies on a reasoned written opinion will not meet the “knowing” requirement and therefore will not have foundation manager liability.

In addition, in the case of a grant to a foreign organization that does not have a public charity ruling, a foundation may rely on an equivalency determination made by counsel, or an affidavit provided by a grantee, to avoid any penalty for failure to exercise expenditure responsibility.