Thorne v. Commissioner, 99 T. C. 67 (1992)

A foundation manager cannot be liable for second-tier excise taxes under sections 4944 and 4945 without prior notice and opportunity to correct the underlying taxable event.

Summary

In Thorne v. Commissioner, the U. S. Tax Court addressed the liability of a private foundation trustee for excise taxes under sections 4944 and 4945 of the Internal Revenue Code. The case centered on the trustee's management of the Harry E. Wright, Jr. Charitable Trust, which made questionable investments and grants. The court held that the trustee was liable for first-tier excise taxes under section 4945(a)(2) for knowingly making taxable expenditures but not for second-tier taxes under sections 4944(b)(2) and 4945(b)(2) due to the absence of a formal request to correct the issues before the deficiency notice was issued. The court also imposed penalties under section 6684 for the trustee's willful and flagrant conduct.

Facts

John E. Thorne, as trustee of the Harry E. Wright, Jr. Charitable Trust, deposited the entire trust corpus into a Bahamian bank, ABC, which had lost its business license. The trust made grants to individuals, non-exempt organizations, and foreign entities without obtaining necessary approvals or exercising required expenditure responsibility. Thorne relied on advice from his tax advisor, Harry Margolis, without further investigation. The IRS determined that Thorne was liable for first-tier and second-tier excise taxes under sections 4944 and 4945, as well as penalties under section 6684.

Procedural History

The IRS issued notices of deficiency in 1980 and 1985, asserting first-tier and second-tier excise taxes against both the trust and Thorne. The Tax Court dismissed the trust's cases for failure to prosecute, leaving Thorne's cases to proceed. The court heard arguments on the issues of taxable expenditures, jeopardy investments, and the applicability of second-tier taxes and penalties.

Issue(s)

1. Whether the burden of proof for section 4945(a)(2) is split between the petitioner and respondent.
2. Whether Thorne refused to agree to remove the trust's funds from the jeopardy investment with ABC.
3. Whether Thorne agreed to the making of taxable expenditures by the trust during 1980-1983.
4. Whether Thorne refused to agree to correct the taxable expenditures made by the trust during 1976, 1977, and 1980-1983.

5. Whether Thorne is liable for penalties under section 6684 for the taxable years 1980-1983.

Holding

1. Yes, because the petitioner must prove any error in the deficiency determination by a preponderance of the evidence, and the respondent must prove by clear and convincing evidence that the petitioner's conduct was "knowing. "
2. No, because Thorne did not refuse to agree to remove the funds from ABC; he was not requested to do so before the deficiency notice was issued.
3. Yes, because Thorne agreed to the making of taxable expenditures, knowing that they were taxable expenditures.
4. No, because Thorne did not refuse to agree to correct the taxable expenditures; no formal request to correct was made before the deficiency notice was issued.
5. Yes, because Thorne's conduct was willful and flagrant, warranting penalties under section 6684.

Court's Reasoning

The court analyzed the statutory language and legislative history of sections 4944 and 4945, emphasizing that second-tier taxes on foundation managers require a prior request to correct the taxable event. The court found that Thorne had not been formally requested to remove the jeopardy investment or correct the taxable expenditures before the deficiency notices were issued. For first-tier taxes under section 4945(a)(2), the court held that Thorne had actual knowledge of sufficient facts to know the grants were taxable expenditures, as he failed to exercise expenditure responsibility and relied on oral advice without further investigation. The court also noted that the burden of proof for these taxes is split, with the petitioner proving any error in the deficiency and the respondent proving knowing conduct. The penalties under section 6684 were upheld due to Thorne's repeated willful and flagrant conduct in managing the trust.

Practical Implications

This decision clarifies that foundation managers must be given notice and an opportunity to correct before second-tier excise taxes can be imposed. Legal practitioners should ensure that clients receive formal requests to correct any issues before a deficiency notice is issued. The ruling underscores the importance of diligent management of private foundations, including verifying the tax-exempt status of grantees and ensuring proper expenditure responsibility. Subsequent cases have cited Thorne for the principle that second-tier taxes require prior notice and opportunity for correction. The decision also reinforces the need for foundation managers to seek written legal opinions rather than relying solely on oral advice, as this can impact their liability for penalties under section 6684.