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4945.00-00

DEPARTMENT OF THE TREASURY 200010052
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: DEC 10 1999

OP:E:EO:T:4

Contact Person:
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LEGEND

V =
W =
X =
Y =
Z =

Dear Taxpayer:

This is in response to a ruling request dated August 23, 1999, on the application of sections 4942 and 4945 of the Internal Revenue Code.

FACTS

V is a nonprofit corporation organized under the laws of the State of Z and is a private non-operating foundation described in sections 501(c)(3) and 509 of the Code. V's office is located in the City of X. V is proposing to finance the creation and development of a state-of-the-art, scientific, high-technology, research and business incubator and educational program at W (the "Program"). The Program will be a critical component of W's on-going scientific and educational mission to provide its faculty, its students, and the business community in the State of Z with the cutting-edge knowledge, experience, and scientific skills needed to succeed in an increasingly high technology-driven economy.

W is a private, accredited college of engineering, science, and mathematics, founded in the 1800s. W's campus is located in the City of Y, seventy miles west of X. W is an exempt educational organization described in sections 501(c)(3), 509(a)(1), and 170(b)(1)(A)(ii).

W offers a rigorous education in engineering, mathematics, and the physical and computer sciences that stresses both technical and interpersonal skills. Integral to the course of study at W is a commitment to the belief that the best way to learn is by doing. Therefore, W uses a hands-on educational approach. W consistently ranks at or near the top of specialized engineering schools in the country, and its students and faculty regularly receive national awards and honors.

Recently, W has struggled with a serious problem that exists in and around Y and the State of Z generally. W's students and faculty are handicapped by inadequate practical learning and teaching

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opportunities in the surrounding community and its graduates are lured to other parts of the country to find rewarding work and business opportunities. The State of Z ranks among the lowest in the nation in terms of the proportion of residents with a baccalaureate or higher educational degree and in the percentage of its workforce in professional specialty occupations, including high-technology careers. The Y area in particular, with an unemployment rate well above the national average and an economy dependent upon heavy industrial and manufacturing businesses, provides few opportunities for highly qualified engineering and science graduates. This problem has a chilling effect on W's capacity to maintain and expand its scientific and educational programs and Y's ability to attract new industry.

One of W's primary objectives for the program is to foster the development of an innovation economy in Z that will provide W's students and faculty with cutting-edge engineering experience and opportunities. W believes that to retain more of Z's college graduates in the State, particularly those trained in science and engineering, W must provide real-world experiences and opportunities to students and faculty and establish a clear path from classroom and computer study to personal and career fulfillment. Faculty must show and students must learn how to translate ideas into useful products and services that support economic growth, new jobs, and expanding businesses.

To help solve both the educational and the economic problems caused by the shortage of real-life business opportunities around its campus and throughout Z, W's Program is designed to provide training, resources, and experiences to its students and faculty along the full continuum of theoretical learning to practical business application. The Program includes a research and business incubator, new and expanded fellowships and internships, advanced computer and communications systems, and a venture capital fund.

The research and business incubator will be owned and operated by W and will include state-of-the-art laboratories, computer, drafting, and information systems, office space, administrative services (such as accounting and employee benefits), and training in business and marketing skills. The incubator facilities will be located on the main campus of W and in a nearby industrial park owned by W. The incubator has three goals: increase "real-world" engineering experiences that advance the scientific education of W's students, perfect the scientific acumen of its faculty and attract, develop, and retain high-technology industries in Z so that students, faculty, staff, and others have opportunities to continue and to apply their learning and skills in the State.

W hopes to attract entrepreneurs and businesses from across the spectrum of the high-technology sector. While not focusing on a particular industry or a specific kind of technology, W expects that, like other technology-based incubators, software ventures will constitute a large proportion of the projects housed at the incubator. An insufficient number of the key companies in this industry have established substantial operations in Z, thus limiting the number and depth of learning, research, and career opportunities in the State.

W also expects the Program to result in the creation of a number of fellowship opportunities that are not available in a traditional classroom setting. To further the product and process development initiatives conceived at the incubator, W may invite post-doctoral fellows, specialized technicians, practicing professionals, or faculty members from W or other universities to direct or join interdisciplinary teams that address specific problems or projects. These fellows will learn entrepreneurship and business planning skills from the entrepreneurs and start-up businesses located at the incubator, while at the same time providing W's graduate students who work on the teams with unique opportunities to study, sharpen their engineering skills, and develop graduate thesis projects.

The Program also will expand W's practicum offerings for undergraduate students. The college's students, as in the past, will continue to enjoy internship opportunities with small technology-based

companies at a variety of locations across Z and the nation, but the businesses located at the incubator will provide additional and more convenient internship experiences for these students. The interns will be challenged to apply their engineering, mathematical, and scientific knowledge to actual business problems on or near campus.

In addition, part of the Program funds will be used to develop an international internship project at W. International student interns will travel to and live in various regions of the world and engage in work study programs there with colleges, universities, and research and business incubators similar to W's. Upon their return to campus, the international interns' experiences with these global partners will be shared with students, faculty, staff, and other participants at W's incubator.

Another key component of the Program is the development of advanced computer and communications systems to connect the college community, the incubator, and the individuals and businesses that participate in Program activities. W envisions that the systems will encourage significant collaboration among its faculty and students, incubator staff and businesses, fellows, and interns. The computer system will include super-computing capabilities adapted to high-technology research and production. The communications system will connect the incubator sites and the main campus at W with telephone, video-conferencing, distance learning, and other communication facilities. The entire W campus will have access to and will benefit from these enhanced resources.

The final component of the Program is a venture capital fund that will provide loans to, or equity investments in, early-stage product development, marketing, and business planning efforts of enterprises associated with the incubator or other W projects. W proposes to dedicate approximately one-third of V's grant to the venture capital fund. With the fund, the college will invest "seed venture capital" in qualifying businesses, especially in the early stages of proving technical feasibility, assessing the potential of inventions, and underwriting the cost of new product development, marketing, and business planning. By furnishing seed capital, W hopes to attract and retain successful entrepreneurs to the incubator on the conviction that such individuals and businesses will settle where the prerequisites for research, education, and business development prevail. In this last phase of the Program, W may incur greater than average risk to foster worthwhile start-ups developed in earlier stages of the Program and to offer research, educational, and career opportunities to W's students, faculty, and graduates. Compared to W's existing endowment, the proposed venture capital fund will represent less than 7 percent of the college's total investment portfolio.

V seeks rulings that disbursement of the portion of its grant proceeds targeted for W's venture capital fund:

1. Will not be treated as a taxable expenditure under section 4945(d)(4) or (5) of the Code; and
2. Will constitute a qualifying distribution that satisfies the requirements of section 4942(g).

LAW

Section 4945(d)(4) of the Code defines the term "taxable expenditure" to include amounts paid by a private foundation -- as a grant to an organization unless--

(A) such organization is described in paragraph (1), (2), or (3) of section 509(a) or is an exempt operating foundation (as defined in section 4940(d)(2)), or

(B) the private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection (h) . . . .

Section 53.4945-5(a)(6)(i) of the Foundation and Similar Excise Taxes Regulations explains that a grant by a private foundation to a grantee organization which the grantee uses to make payments to another organization (the secondary grantee) shall not be regarded as a grant by the private foundation to the secondary grantee if the

foundation does not earmark the use of the grant for any named secondary grantee and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the secondary grantee by the organization to which the foundation makes the grant. To avoid earmarking to the secondary grantee, the original grantee organization must exercise control, in fact, over the selection process and actually make the selection completely independently of the private foundation.

Section 4945(d)(5) of the Code states that a taxable expenditure is any amount paid by a private foundation "for any purpose other than one specified in section 170(c)(2)(B)." Among the purposes recognized as exempt and described in section 170(c)(2)(B) are "exclusively . . . religious, charitable, scientific, literary, or educational purposes."

Section 4942(g)(1) of the Code defines the term "qualifying distribution" as "any amount . . . paid to accomplish one or more purposes described in section 170(c)(2)(B), other than any contribution to (i) an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons . . ., or (ii) a private foundation which is not an operating foundation."

Section 53.4945-6(b)(1)(v) of the regulations states that an expenditure that "constitutes a qualifying distribution under section 4942(g) [of the Code]" ordinarily will not be treated as a taxable expenditure.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations defines the term "charitable" in its generally accepted legal sense to include the "advancement of education or science."

Section 1.501(c)(3)-1(d)(3) of the regulations defines the term "educational" to include "(a) [t]he instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) the instruction of the public on subjects useful to the individual and beneficial to the community."

Section 1.501(c)(3)-1(d)(5)(i) of the regulations provides that a scientific organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest and is organized and operated in the public interest. The term 'scientific', as used in section 501(c)(3), includes the carrying on of scientific research in the public interest.

Section 1.501(c)(3)-1(d)(5)(ii) of the regulations specifies that scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, or the designing or construction of equipment, etc.

Section 1.501(c)(3)-1(d)(5)(iii) provides that scientific research will be regarded as carried on in the public interest (a) if the results of such research (including patents, copyrights, processes, or formulae resulting therefrom) are made available to the public on a nondiscriminatory basis; (b) if such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or (c) if such research is directed toward benefiting the public.

Section 1.501(c)(3)-1(d)(5)(iv) of the regulations provides that "an organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under section 501(c)(3) as a "scientific" organization, if: (a) such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3), or (b) such organization retains (directly or indirectly the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make such patents, copyrights, processes, or formulae available to the public. For purposes of this subdivision, a patent, copyright, process, or formula shall be considered as made available to the public if such patent, copyright, process or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the

exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public. In such a case, however, research from which the patent, copyright, process, or formula resulted will be regarded as carried on in the public interest (within the meaning of subdivision (iii) of this subparagraph) only if it is carried on for a person described in subdivision (iii)(b) of this subparagraph or if it is scientific research described in subdivision (iii)(c) of this subparagraph."

Rev. Rul. 74-587, 1974-2 C.B. 162, held that an organization formed to relieve poverty, eliminate prejudice, reduce neighborhood tensions, and combat community deterioration through a program of financial assistance in the form of low-cost or long-term loans to, or the purchase of equity interests in, various business enterprises in economically depressed areas was exempt under section 501(c)(3) of the Code. The loans and purchases of equity interests were "not undertaken for purpose of profit or gain but for the purpose of advancing the charitable goals of the organization and are not investments for profit in the traditional business sense." The ruling also noted that the activities were no less charitable because some of the benefiting businesses would not have otherwise qualified for charitable assistance; the businesses were merely the instruments through which the charitable purposes were accomplished.

Rev. Rul. 79-323, 1979-2 C.B. 106, held that amounts paid to an industrial commission established by a state legislature, the purpose of which was to maintain existing industries and to invite and attract additional industries to an area to diversify the area's industrial base, were used for exclusively public purposes and were, therefore, deductible as charitable contributions. The commission, by promoting the general economic health of the region and by maintaining and attracting industry, benefited the residents of the region. In addition, there was "no indication that gifts to the commission will inure to the benefit of private interests except indirectly in the course of advancing the public purposes of promoting the economic health and stability of the area."

Rev. Rul. 85-109, 1985-2 C.B. 165, considered the United States District Court decision in St. Luke's Hospital of Kansas City v. United States, 494 F. Supp. 85 (W.D. Mo. 1980). The Court held that a tax-exempt hospital's performance of diagnostic laboratory testing upon patient specimens from staff physicians did not constitute an unrelated business under section 513(a) of the Code. The ruling declined to accept the Court's reasoning that the testing was for the convenience of "members" under section 513(a)(2), but did adopt the Court's alternative position that the testing furthered the hospital's exempt educational purpose. The ruling accepted the "holding that a teaching hospital which conducted non-patient laboratory testing on specimens needed for the conduct of its teaching activities was not engaged in an unrelated trade or business where the outside testing services contributed importantly and substantially to the hospital's teaching program."

Rev. Rul. 68-373, 1968-2 C.B. 206, addressed whether a nonprofit entity that engaged in testing drugs for commercial pharmaceutical companies qualified for exemption as a scientific research organization under section 501(c)(3) of the Code. The founder and principal investigator of the testing organization was approved as a qualified investigator for the Food and Drug Administration. The ruling denied the exemption, citing section 1.501(c)(3)-1(d)(5)(ii) of the regulations and concluding, "Clinical testing is an activity ordinarily carried on as an incident to a pharmaceutical company's commercial operations . . . [which] does not constitute scientific research within the meaning of section 1.501(c)(3)-1(d)(5)(i) of the regulations."

Rev. Rul. 69-632, 1969-2 C.B. 120, denied section 501(c)(3) status to a nonprofit association composed of members of a particular industry that was created to develop new and improved uses for existing industry products. The association's research projects may result in new products and processes that benefit the public, but such benefit is secondary to that derived by the association's members. The

association's members select research projects in order to increase their sales by creating new uses and markets for their product. Therefore, it is held that the primary purpose of the association's research is to serve the private interests of its creators, rather than the public interest.

ANALYSIS

W is a traditional educational institution providing engineering, science, and mathematics training to undergraduate and graduate students. It fulfills all of the criteria of section 170(b)(1)(A)(ii) of the Code and, thus, is an organization described in section 509(a)(1). W will use the venture capital fund to make loans to or equity investments in organizations that are not exempt themselves, but which will be the means for W to further its educational, scientific, and other exempt purposes. No part of the grant will be earmarked for particular secondary grantees or other recipients, and W will make all investment and similar decisions completely independently. Therefore, V's proposed grant to W for the venture capital fund will not be a taxable expenditure under section 4945(d)(4)(A) of the Code, even though V will not exercise expenditure responsibility under sections 4945(d)(4)(B) and 4945(h).

Under section 4945(d)(5) of the Code, V would incur taxable expenditure liability on amounts paid or incurred for any purpose other than one specified in section 170(c)(2)(B). As an integral part of W's greater effort to continue offering a world-class engineering, science, and mathematics education to its students, the Program will provide W's students hands-on, team-oriented research and educational work experiences with innovative individuals and businesses. The Program will allow W's faculty to continue their professional development while remaining on campus to fulfill their teaching, research, and administrative responsibilities. W will extend its educational reach to businesses and other participants in the incubator or in other Program activities. Furthermore, the Program will provide community benefit by contributing to the general economic development of the depressed Y area. Therefore, the Program generally advances scientific, educational and charitable purposes described in section 170(c)(2)(B) of the Code.

In addition, the venture capital fund specifically is intended, and will be operated, to further the scientific purposes of W. The enterprises located in the research and business incubator will provide the apparatus for study and advanced knowledge in both the fundamental and applied sciences taught at the college. W's faculty will transfer ideas from the classroom into laboratories, computer simulations, and production facilities. W's students will apply the theories discussed in lectures to actual physical, chemical, electrical, and engineering problems. Inventions discovered in the process of teaching and learning will be refined and developed for public dissemination and use.

These activities fit into the category of "scientific research in the public interest" described in the regulations. The research conducted by and for incubator companies that are supported by venture capital funds will immediately and directly aid "in the scientific education of college or university students" by creating an enhanced research environment on and around W's campus. In addition, faculty and student participation in venture capital businesses will allow them to observe and develop "scientific information . . . [for publication] in a treatise, thesis, . . . or . . . other form that is available to the interested public." Treasury Regulations section 1.501(c)(3)-1(d)(5)(iii)(c)(2). Their participation also may result in the development of processes or formulae "made available to the public on a nondiscriminatory basis." Regulations section 1.501(c)(3)-1(d)(5)(iii)(a).

The venture capital fund additionally furthers W's scientific research goals by "aiding a community or geographical area by attracting new industry to the community or area [and] . . . by encouraging the development of, or retention of, an industry in the community or area." Regulations section 1.501(c)(3)-1(d)(5)(iii)(c)(4). This result supports venture capital fund investments even with respect to high-technology businesses in Z that may not have a physical presence at the incubator.

Scientific research does not include activities "ordinarily carried on as an incident to commercial or industrial operations," such as ordinary product testing and designing or constructing equipment or buildings. Unlike the private drug-testing company in Rev. Rul. 68-373 or the trade association in Rev. Rul. 69-632, however, W is an accredited college of engineering, science, and mathematics that supports and conducts research to advance education and science. W's venture capital activities are related to that research and thus will further scientific purposes described in section 170(c)(2)(B) of the Code.

Additionally, the venture capital fund will further broader educational purposes. The venture capital pool will be used both (i) to create a better environment in which to instruct students and to support faculty "for the purpose of improving or developing [their] . . . capabilities," and (ii) to provide general public instruction on "subjects useful to the individual and beneficial to the community." Treasury Regulations section 1.501(c)(3)-1(d)(3). W is a teaching institution. The educational opportunities created directly through venture capital businesses located at the research and business incubator will contribute "importantly and substantially to the [college's] teaching program." See Rev. Rul. 85-109.

W will invest primarily in companies and ideas that further its educational mission of exposing students and faculty to cutting-edge, high-technology science and business endeavors. Any private benefit to the companies in which W invests will be indirect and incidental "in the course of advancing the public purposes" of the college and the community at large. See Rev. Rul. 79-323. The investments will be the last step along a continuum of activities, from classroom study through practical commercial application, necessary to fulfill W's educational mission. Thus, the venture capital fund contributes importantly and directly to carrying out W's exempt purposes.

Similarly, W's investments will help provide economic opportunities to the depressed Y areas and promote professional specialty occupations, including high-technology careers in Z. The Program will increase Y's ability to attract new industry and provide useful products and services that support economic growth, new jobs, and expanding businesses which will foster the development of an innovation economy in Z. The Program will contribute to the benefit of the citizens of Z and to the community of Y in particular.

Furthermore, like the organization in Rev. Rul. 74-587, W's venture capital investments generally will not generate profits in the traditional business sense. Although W hopes to use the venture capital fund to invest in companies that will become successful and thus create a revolving fund to support the Program or increase W's general assets, a return on investment will be only a secondary goal of the fund.

For the reasons discussed above, W's use of the venture capital fund furthers scientific, educational, and charitable purposes under section 170(c)(2)(B) of the Code and thus satisfies the initial requirement of section 4942(g)(1)(A). Neither V nor any of its disqualified persons exercise control, directly or indirectly, over W, and W is not a private foundation. Therefore, the second requirement of section 4942(g)(1)(A) is met. Accordingly, V's support of W's venture capital project constitutes a qualifying distribution by V.

Based on the information you have submitted and as the distributee organization is recognized as exempt under section 501(c)(3) of the Code, under the facts described above we rule:

1. The disbursement of the portion of its grant proceeds targeted for W's venture capital fund will not be treated as a taxable expenditure under section 4945(d)(4) or (5) of the Code; and

2. The disbursement of the portion of its grant proceeds targeted for W's venture capital fund will constitute a qualifying distribution that satisfies the requirements of section 4942(g).

We are informing your key District Director of this ruling. Because this ruling could help resolve future questions about your federal income tax status, you should keep it in your permanent records.

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This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Group 4