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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: MAY 13 2003

Contact Person:

Identification Number:

Telephone Number:

WIL:
4942.03-05
4945.00-00

T:EO:BR4

Employer Identification Number:

Legend:

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Dear Sir or Madam:

We have considered the ruling request dated March 7, 2003, submitted on behalf of M and N by their authorized representatives, with respect to a State-wide scholarship program, O, funded by M and administered by N.

FACTS

M is a nonprofit corporation formed in 1937 under the laws of the State of P. It is exempt from federal income tax as an organization described in section 501(c)(3) of the Internal Revenue Code and is classified as a nonoperating private foundation under section 509(a) of the Code.

N is a nonprofit corporation which is tax exempt under section 501(c)(3) of the Code. It is classified as other than a private foundation because it is a "supporting organization" described in section 509(a)(3) of the Code. N's exempt purpose is to benefit, perform the functions of, and carry out the public purposes of its 31 member nonprofit colleges and universities by, *inter alia*, conducting and sponsoring workshops, publications, and other services that promote higher education in the State of P, performing research, and administering various grant and scholarship programs.

In 1998, M began a collaboration with N and community foundations representing all the counties in the State of P to address a critical problem – P's consistent ranking near the bottom of the 50 States in the percentage of its residents who hold at least a baccalaureate degree. The O program was designed to address this problem at the local level by utilizing the energy, ideas, and initiatives of community foundations from around P in awarding scholarships to deserving graduates from P high schools who attend a college or university in P, and in tracking the early career and life choices of the scholarship recipients. The O program challenges community leaders to attack head-on the problem of low educational achievement, and to replace it with a "culture of hope, vision, and personal achievement through education for the entire State, including some of the smallest, poorest, and most distressed counties in the nation."

The O program currently provides recipients with scholarships for full tuition, required fees, and a special allocation of up to $800 per year for required books and required equipment for four years of full-time undergraduate study leading to a baccalaureate degree at any P public or private college or university accredited by Q. For the 2003-2004 academic year, the O program is open to any P resident who (1) will have graduated by the end of June, 2003, with a diploma from an accredited P high school, and (2) has been accepted to pursue a full-time baccalaureate course of study at an accredited public or private college or university in the State of P.

M established the O program primarily to raise the level of educational attainment in P by encouraging many of P's most talented students to attend one of P's institutions of higher learning. The O program complements and builds upon a number of M sponsored initiatives focused on bettering the lives of P residents, including:

> (1) R – Beginning in 1990, M embarked on an ambitious program to support and to develop community foundations in the State of P. Through five phases of challenge and asset-building grants from M, the number of community foundations in P has grown from about a dozen 10 years ago to over 65 community foundations covering all of P's counties (some are multi-county foundations). Their combined assets, estimated at about $100,000x when R started, are now at approximately $1,000,000x.
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> (2) S – At M's behest, community foundations in 44 counties developed strategies to identify and address their areas' most compelling educational needs, and M has awarded $186,000x in S grants since year 2000 to support these efforts. The projects supported through S have included community learning centers, early childhood programs, classroom and technology upgrades, and "exciting partnerships with higher education to use college and university resources, faculty, and students to touch the lives, and imaginations, of elementary and high school youth around P."

An underlying theme of the above initiatives, as well as with the O program, is that the problems facing P and its residents often are best identified and addressed locally, with real commitment demonstrated through the financial support, time, and efforts of those closest to the

problems. M is "convinced that without changes in attitude, culture, and understanding by P's citizens and leaders, all the money in the world will not bring lasting and sustainable relief from many individual hardships that start with pre-school (or the lack thereof), and last lifetimes."

M has seen significant success and promise among the scholarship recipients who were awarded under the prior versions of the O program. In the first year of the program, community foundations from around the State were invited to identify at least one candidate from each county in P (based on population) to receive a full tuition scholarship to pursue a baccalaureate degree at any accredited public or private P college or university. N received grants from M and administered the O program, providing invaluable technical expertise, oversight, and consistency to the project. But just as important, the leaders of P community foundations, through their direct participation in the scholarship selection process, "came to realize more directly and tangibly the role that education can play in isolating local problems and mobilizing resources to improve conditions in their communities."

You maintain that the scholarships that have been awarded since the O program began "have more than fulfilled every expectation." Of the first group of recipients who entered college in the fall of 1998, 86 have graduated, and most of the remainder are scheduled to graduate this year. Because of this success, M increased the number of scholarships that it would fund per county to at least three (based on population), so that, to date, 1,320 students have received awards. Only 28 students have left the program, to study elsewhere or for other reasons. The scholarship awardees attend colleges or universities in every corner of P. You have furnished a chart listing the number of scholarship recipients who have attended, or are attending, each P college or university and the program dollars that have been spent at each school. The total scholarship payments for the last five years exceed 70,400x dollars.

You have submitted a few sample copies of the hundreds of articles, reports, and letters documenting how the O program has touched and changed the lives of many people. M and N firmly believe that "the involvement of local citizens, through the community foundations, has been critical to finding the right students to receive the scholarships and to furthering the overall objectives of the O program."

As indicated above, the participation of volunteer community leaders, through the community foundations, has been a major factor in the success of the O program. The community foundations provide "credibility, exposure, and local excitement" to the process. High school students want to represent their counties as M scholarship recipients. Volunteers who serve as community foundation directors, officers, and community members are more engaged than ever, helping to identify local students who may get the opportunity to attend a college or university in their home State and who may have more incentive to use that education in future careers closer to home. The community foundations are also indispensable in maintaining contact with the awardees after graduation to determine if the program has any impact on the "brain drain", whereby P's top graduates often go elsewhere to live and work. The ability to follow the individuals who benefit from the scholarships is a critical tool in gauging the effectiveness of the O program.

Recent changes in the law governing excess benefit transactions with the disqualified persons of a public charity (such as a community foundation) and corresponding regulations "have cast a disturbing cloud over the involvement of the community foundations in identifying nominees" to receive the O program scholarships. In several counties, dedicated community volunteers have resigned from positions on the boards and committees of their community foundations because they fear that the excess benefit transaction restrictions of Code section 4958 and the general private benefit limitations of section 501(c)(3) might disqualify their children, grandchildren, or other relatives from consideration as nominees to N for scholarships, regardless of the degree of their personal involvement in the identification of potential scholarship recipients.

In light of the foregoing, M and N have reconfigured the O program with respect to the community foundation nominating process to prevent even the possibility of the abuses that the excess benefit transaction and private benefit rules are designed to proscribe. You describe the O program planned for the upcoming school year as follows:

M provides grants to N to pay the scholarships and for the costs of administration, follow-up, and research relating to the program. N collaborates with eligible community foundations in P (each of which must be exempt from federal income tax under section 509(a)(1), 509(a)(2), or 509(a)(3)) to nominate, monitor, and maintain contact with scholarship recipients. In many cases, proposed scholarship recipients will be nominated, and their names submitted to N, by the Board of Directors of a community foundation or a separate Nominating Committee created by the community foundation.

N maintains its own Selection Committee, which makes final selections of scholarship recipients or recommends recipients for ultimate approval by N's Board of Directors. In addition, N is charged with making the appropriate scholarship payments to the colleges and universities that the recipients attend, making special administrative and promotional grants to community foundations, e.g., to cover the costs of the local nomination process, paying book and equipment allocations to the scholarship recipients, and providing administrative services for the program.

N is authorized to award scholarships to any or all nominees that are identified by community foundations, provided that the procedures utilized by the community foundations are consistent with applicable law and the overall goals of the O program. The scholarship nomination criteria and procedures are developed by each community foundation and submitted to N for approval. In some cases, nominations are based on objective criteria, such as the identification of the three graduating seniors with the highest grade point average in a particular county and who plan to attend a P college or university. In other cases, the community foundation considers subjective criteria, such as an evaluation of written essays, community service activities, and/or personal interviews. But in all instances, scholarship recipients are finally chosen by N.

Whenever a community foundation's pool of potential scholarship nominees includes a family member (including spouse, brothers and sisters by whole or half blood, ancestors, children, grandchildren, and great grandchildren, referred to hereinafter as a "Relative") of a

community foundation's director, officer, or Nominating Committee member at the time of nomination, N requires the recusal of such director, officer, or Nominating Committee member from the entire scholarship nominating process for that pool, including all meetings, discussions, debates, and votes regarding nominations. N also requires the community foundation to document such recusal.

In all cases, the sole and exclusive authority to make final scholarship selections from the nominations submitted by community foundations remains with N. Individuals who are (or within the past five years have been) directors, officers, or Selection Committee members of N, as well as the Relatives of such individuals, are ineligible to receive scholarships under the program.

Each community foundation is expected to assist N with the ongoing administration of the O program by (1) providing to N all scholarship application forms and proposed scholarship nomination criteria and procedures; (2) maintaining annual contact with each scholarship recipient nominated by the community foundation while he or she is in college; (3) reporting to N on the academic progress of each such recipient each year; (4) conducting an annual follow-up with each such recipient for at least ten years after graduation; and (5) reporting to N on the progress of each such recipient annually for at least ten years after graduation.

At all times, N will be responsible for the overall administration and proper use of the grant funds provided by M for the O program. Each year, N makes final scholarship selections and notifies M of the total amount of scholarship funds needed for the O program in the coming academic year. Finally, N reports to M on the progress of the scholarship recipients and the general administration and financial aspects of the program.

The various features of the O program described above, including the recusal requirements for community foundation directors, officers, and Nominating Committee members whose Relatives are eligible for scholarships, will be referred to as the "Program Guidelines."

RULINGS REQUESTED

1. Grants made by M to N to fund Scholarships pursuant to the Program Guidelines constitute qualifying distributions under section 4942(g)(1)(A) of the Code.

2. Grants made by M to N to fund Scholarships under the Program Guidelines do not constitute taxable expenditures under either section 4945(d)(4) or 4945(d)(5) of the Code.

LAW

Section 4942(a) of the Code imposes on the undistributed income of a private foundation for any taxable year, which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year (if such day falls within the taxable period), a tax equal to 15 percent of the amount of such income remaining undistributed at the beginning of such second (or succeeding) taxable year. Section 4942(c) defines the term "undistributed

income" as the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made before such time out of such distributable amount.

Section 4942(d)(1) of the Code provides that the term "distributable amount" means, with respect to any foundation for any taxable year, an amount equal to (1) the sum of the minimum investment return plus the amounts described in subsection (f)(2)(c), reduced by (2) the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and section 4940.

Section 4942(g)(1) of the Code defines a "qualifying distribution" as (a) 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 by the foundation or one or more disqualified persons or (ii) a private foundation which is not an operating foundation, except as otherwise provided; or (b) any amount paid to acquire an asset used directly in carrying out one or more purposes described in section 170(c)(2)(B).

Section 53.4942(a)-3(a)(2) of the Foundation and Similar Excise Taxes Regulations defines the term "qualifying distribution", in relevant part, to mean any amount (including program related investments and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in Code section 170(c)(1) or 170(c)(2)(B), other than any contribution to a private foundation which is not an operating foundation or to an organization controlled (directly or indirectly) by the contributing private foundation or one or more disqualified persons with respect to such foundation.

Section 170(c)(2)(b) of the Code defines the term "charitable contribution" to include a contribution to or for the use of a corporation, trust, or any community chest, fund, or foundation, organized and operated exclusively for charitable, educational, or other specified purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated "exclusively" for religious, charitable, educational, or other specified exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which does not engage in proscribed legislative or political activities.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" is used in Code section 501(c)(3) in its generally accepted legal sense, and includes the advancement of education.

Section 1.501(c)(3)-1(d)(3) of the regulations provides that the term "educational" includes the instruction or training of the individual for the purpose of improving or developing his capabilities or the instruction of the public on subjects useful to the individual and beneficial to the community. Example (1) is an organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Rev. Rul. 69-257, 1969-1 C.B. 151, holds that a nonprofit organization formed and operated to award academic scholarships to students for college and university studies qualifies for tax exemption under section 501(c)(3) of the Code. The ruling emphasizes that the selection of scholarship recipients on the basis of scholastic ability, irrespective of financial need, does not preclude tax exempt status under section 501(c)(3).

Rev. Rul. 56-403, 1956-2 C.B. 307, holds that the awarding of scholarships by a foundation solely to undergraduate members of a designated fraternity will not preclude it from qualification under section 501(c)(3) of the Code as an educational organization. The ruling notes that the limitation of scholarships to a particular group does not vitiate tax exemption because there is no specific designation of persons eligible for scholarships and the purposes of the foundation are "not so personal, private, or selfish in nature as to lack the elements of public usefulness and benefit which are required of organizations qualifying for exemption under section 501(c)(3) of the Code."

Sections 4945(a)(1) and 4945(b)(1) of the Code impose excise taxes to be paid by a private foundation that makes a taxable expenditure, as defined in section 4945(d).

Sections 4945(a)(2) and 4945(b)(2) of the Code impose excise taxes to be paid by a foundation manager who agrees to the foundation's making of an expenditure "knowing" that it is a taxable expenditure, unless such agreement is not willful and is due to reasonable cause.

Section 4945(d)(4) of the Code defines the term "taxable expenditure" to include any amount paid by a private foundation to another organization unless (i) such organization is described in Code section 509(a)(1), (2), (3), or is an exempt operating foundation, or (ii) the private foundation exercises expenditure responsibility with respect to the amount paid in accordance with section 4945(h).

Section 4945(d)(5) of the Code defines the term "taxable expenditure" to mean any amount paid or incurred by a private foundation for other than the exempt purposes described in Code section 170(c)(2)(b).

Section 53.4945-5(a)(1) of the regulations defines the term "taxable expenditure" generally to include any amount paid by a private foundation as a grant to an organization (other than an organization described in Code section 509(a)(1), 509(a)(2), or 509(a)(3)) unless the private foundation exercises expenditure responsibility with respect to the grant.

Section 53.4945-6(a) of the regulations defines the term "taxable expenditure" to include any amount paid or incurred by a private foundation for any purpose other than one specified in Code section 170(c)(2)(B).

Section 53.4945-5(a)(6)(i) of the regulations provides that a grant by a private foundation to a grantee organization which the grantee organization 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 it has given the grant. A grant described herein shall not be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grants so long as the original grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independent of the private foundation.

Section 53.4945-6(b)(1) of the regulations provides, in part, that, funds used in furtherance of purposes described in section 170(c)(2)(B) of the Code ordinarily will not be treated as taxable expenditures under section 4945(d)(5).

Section 53.4945-6(b)(1)(v) of the regulations provides that the term "taxable expenditure" does not include payments which constitute "qualifying distributions" under Code section 4942(g).

ANALYSIS

A private foundation's expenditures will be treated as "qualifying distributions" under Code section 4942(g)(1)(A) only if they are made to further religious, charitable, educational, or other purposes stated in section 170(c)(2)(B). These purposes, which are also stated in section 501(c)(3), include the "advancement of education", which is defined as a charitable purpose in section 1.501(c)(3)-1(d)(2) of the regulations. The advancement of education may be accomplished by the awarding of academic scholarships to students for use in attending a college or university. See the holdings in Rev. Ruls. 69-257 and 56-403, cited above.

The O program provides P residents with four-year scholarships covering the cost of tuition, fees, and required books and equipment in full-time programs of undergraduate study leading to baccalaureate degrees at accredited colleges and universities (public or private) in the State of P. These scholarships advance education and therefore further a charitable purpose within the meaning of Code sections 170(c)(2)(b) and 501(c)(3). See section 1.501(c)(3)-1(d)(2) of the regulations and the two revenue rulings cited in the previous paragraph.

Relatives of a community foundation's current or former directors, officers, or Nominating Committee members who receive Scholarships pursuant to the Program Guidelines will receive any such scholarships solely as members of the broad charitable class benefited by the O program. Whenever a community foundation's pool of potential scholarship nominees includes a Relative of any director, officer, or Nominating Committee member, N requires the recusal of such director, officer, or Nominating Committee member from the entire nominating process for that pool, as detailed above. Furthermore, N is a public charity that is not controlled by M or by any disqualified persons with respect to M. Accordingly, Scholarships awarded to such Relatives pursuant to the Program Guidelines serve charitable and educational purposes, as do all other Scholarships awarded under the O program. Therefore, M's disbursements to support the O program should be treated as qualifying distributions under section 4942(g)(1)(A) of the Code.

N is not a private foundation because it is a supporting organization described in section 509(a)(3) of the Code. N uses its grants from M under the O program to award Scholarships in collaboration with P community foundations and to administer the O program. Inasmuch as the community foundations act in a nominating capacity only, M's grants to N should not be regarded as earmarked grants to the community foundations. N exercises complete and independent control of the Scholarship selection process and actually makes such selections completely independent of M and the community foundations. See section 53.4945-5(a)(6)(i) of the regulations. Moreover, M does not earmark its grants to N for use by specific community foundations or individual Scholarship recipients, and no agreement exists whereby M may cause N to select secondary grantees. Accordingly, M's grants to N do not constitute taxable expenditures under section 4945(d)(4).

A payment by a private foundation that constitutes a qualifying distribution under section 4942(g) of the Code ordinarily will not be treated as a taxable expenditure by the foundation under section 4945(d)(5). See section 53.4945-6(b)(1)(v) of the regulations. As set forth in the analysis under section 4942, M's grants to N further charitable and educational purposes and therefore constitute qualifying distributions under section 4942(g)(1)(A). Consequently, such grants do not constitute taxable expenditures under section 4945(d)(5).

RULINGS

1. Grants made by M to fund Scholarships for the O program pursuant to the Program Guidelines constitute qualifying distributions under section 4942(g)(1)(A) of the Code.

2. Grants made by M to N to fund Scholarships for the O program pursuant to the Program Guidelines do not constitute taxable expenditures under either section 4945(d)(4) or 4945(d)(5) of the Code.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon M's tax status should be reported to the Tax Exempt and Government Entities (TE/GE) Customer Service Office. The mailing address is: Internal Revenue Service, TE/GE Customer Service, The telephone number there is

We are sending a copy of this ruling to the E/GE Customer Service Office. Because this letter could help resolve any questions about M's tax status, you should keep it with your permanent records.

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

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.

Thank you for your cooperation.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4