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TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

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Contact Person:

Identification Number:

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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).

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 Indiana by encouraging many of its 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.

(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 renditions 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.

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 awards. 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. Furthermore, this problem is exacerbated by the five-year "look-back" rule of section 4958, which may disqualify individuals and family members for five years after any connection with the community foundation has ended.

Information obtained through N and the R program indicates the magnitude of the problem. A community foundation in northeast P reports that 4 of 15 board members may resign because they do not want to cause their descendants, now in middle school or younger, to be ineligible for future consideration under the O program if it continues. Of 40 community foundations responding to an informal survey, a total of approximately 30 board members have either resigned or announced their intention to do so. The problem also extends to the recruitment of new community foundation board members, with many incumbents discouraging their friends and associates from accepting positions. This trend has the direst consequences for the smaller counties in rural P, where the availability of community volunteers is small, while the need for the program is great. For example, current census data for one such county shows a total population of 9,374, with only 7% of its residents 25 to 34years of age holding a baccalaureate or higher degree (compared to a national average of 27.5%).

The affected community foundation volunteers are "not people who wish to exercise improper influence or to obtain an unfair advantage for their children, grandchildren, or great grandchildren. They do not intend, and never desired, to take any part in the nomination or selection of scholarship recipients when their family members are in the pool of potential recipients. The current tax rules, however, cast a dark pall on their ability to avoid potential excess benefit transaction liability by recusing themselves from the scholarship nomination process, while continuing their voluntary service to their community foundations on other projects as directors or officers. Thus, the possible application of Code section 4958 not only threatens the O program, but may reverse the successes of the community foundation movement in P and M's positive strides through R, S, and other programs."

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. A Scholarship awarded to a Relative of a current or former director, officer, or Nominating Committee member of a community foundation pursuant to the Program Guidelines will not constitute prohibited private inurement or private benefit and will not otherwise jeopardize the tax exempt status of N or any participating community foundation under section 501(c)(3) of the Code.

2. A Scholarship awarded to a Relative of a current or former director, officer, or Nominating Committee member of a community foundation pursuant to the Program Guidelines will not constitute an excess benefit transaction under section 4958(c)(1)(A) of the Code, and therefore will not result in taxes under section 4958.

LAW

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)(1)(ii) of the Income Tax Regulations provides that an organization is not organized or operated exclusively for a section 501(c)(3) exempt purpose unless it serves a public rather than a private interest. Thus, it is necessary that the organization establish that it is not operated for the benefit of private individuals. An organization will not satisfy the operational test if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. See section 1.501(c)(3)-1(c)(2) of the regulations. Under section 1.501(a)-1(c), the term "private shareholders or individuals" refers to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(2) of the 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."

Section 4958 of the Code imposes penalties on disqualified persons who receive excess benefits from a public charity which is tax exempt under section 501(c)(3). A member of a board of directors is automatically a disqualified person under section 53.4958-3(c)(1) of the Foundation and Similar Excise Taxes Regulations. The children and grandchildren, and certain other relatives, of such board members are also automatically disqualified persons. See section 53.4958-3(b)(1) of the regulations. Certain economic benefits are excluded from excess benefits under section 53.4958-4(a)(4). Specifically, section 53.4958-4(a)(4)(v) excludes economic benefits provided to a person because the person is a member of a charitable class that the applicable tax exempt organization intends to benefit as part of the accomplishment of the organization's exempt purpose.

Section 4945 of the Code and the corresponding regulations set forth the criteria for a scholarship program conducted by a private foundation. If these requirements are satisfied, the foundation will not incur a taxable expenditure. While these requirements are not directly applicable to a public charity, nevertheless a scholarship program conducted by a public charity which conforms to these standards for objectivity and educational character will ordinarily be considered to be in furtherance of exempt purposes.

Rev. Rul. 56-403, cited above, holds that a foundation is conducting an educational activity within the meaning of Code section 501(c)(3) when it provides scholarships to members of a national fraternity, where the scholarships are based on academic achievement, character, and service to the particular college or university, and the recipients are "not related by blood or marriage to any of the officers of the trust, trustees or contributors."

Section 53.4958-6 of the regulations sets forth requirements for obtaining a rebuttable presumption that compensation-type benefits provided to officers, directors, trustees and other disqualified persons of a public charity are not excess benefits under section 4958. Section 53.4958-6(a) and (c)(2) provide that the organization must obtain appropriate data as to comparability of the individual's compensation package from one or more outside sources. Section 53.4958-6(a)(1) provides that the organization's board of directors or other authorized body must approve the compensation arrangement. Section 53.4958-6(c)(1) provides that a member of a board of directors will not be treated as such when the board is reviewing the member's compensation package if that member "recuses himself or herself from that meeting and is not present during debate and voting on the compensation arrangement...."

ANALYSIS

The awarding of scholarships contributes to the advancement of education and, as such, may be a "charitable" activity within the meaning of section 501(c)(3) of the Code. See section 1.501(c)(3)-1(d)(2) of the regulations and the holdings in Rev. Ruls. 69-257 and 56-403, cited above.

Concerning N, the Program Guidelines are designed to ensure that no director, officer, or member of a Nominating Committee of a community foundation or of N itself may take advantage of his or her position to benefit from the selection of Scholarship recipients. In awarding Scholarships pursuant to the Program Guidelines (even if some go to Relatives of a community foundation's current or former directors, officers, or Nominating Committee members), N benefits members of a charitable class. Such awards do not result in prohibited private inurement or private benefit to any individual and thus do not contravene the requirements of section 1.501(c)(3)-1(d)(1)(ii) of the regulations. Accordingly, the awarding of Scholarships pursuant to the Program Guidelines should not jeopardize the tax exempt status of N or any participating community foundation.

While we have cited section 4958 of the Code and corresponding regulations, nevertheless we are unable to issue a ruling under this section, as we have explained to your authorized representative. We pointed to Rev. Proc. 2003-4, 2003-1 I.R.B. 123, dated January 6, 2003, which in Section 8.01 states as follows:

> The Service will not issue a letter ruling or determination letter in certain areas because of the factual nature of the problem involved or because of other reasons. The Service may decline to issue a letter ruling or a determination letter when appropriate in the interest of sound tax administration or on other grounds whenever warranted by the facts or circumstances of a particular case.
>
> Instead of issuing a letter ruling or determination letter, the Service may, when it is considered appropriate and in the best interests of the Service, issue an information letter calling attention to well-established principles of tax law.

Based on the foregoing, we are issuing a general information letter with respect to the issue presented under section 4958 of the Code. Section 1.06 of Rev. Proc. 2003-4 states that such a letter "is advisory only and has no binding effect on the Service."

For purposes of the taxes imposed by section 4958(a) and (b) of the Code, the term "disqualified person" includes "any person who was, at any time during the 5-year period ending on the date of such (excess benefit) transaction, in a position to exercise substantial influence over the affairs of the organization", as well as "a member of the family of (such) an individual." See sections 4958(f)(1)(A) and 4958(f)(1)(B). Section 53.4958-3(c) of the regulations provides that the category of disqualified persons under Code section 4958(f)(1) includes (i) the voting directors and certain officers of a public charity and (ii) any other person who, regardless of title, is ultimately responsible for implementing the governing body's decisions or for supervising the management, administration, finances, or operation of the public charity. Section 53.4958-3(b)(1) provides that virtually all family members (including great grandchildren) of an officer, director, or other disqualified person described in Code section 4958(f)(1)(A) are also disqualified persons.

Section 53.4958-4(a)(4)(v) of the regulations carves out the following exception to what is considered an excess benefit transaction: an economic benefit is disregarded for purposes of Code section 4958 if it is provided to a person solely because the person is a member of a charitable class that the public charity intends to benefit in pursuing its exempt purpose.

The Scholarships awarded to relatives of current or former directors, officers, or Nominating Committee members of community foundations pursuant to the Program Guidelines come within the above "charitable class" exception, as explained below. As such, they may be disregarded for purposes of the taxes imposed under section 4958 of the Code.

Scholarships awarded by N are made solely because the recipient is a member of a charitable class that N intends to benefit through the Scholarship Program. This is so whether the nominations for scholarships are made on the basis of "objective" or "subjective" criteria, as described above. Accordingly, a Relative of a current or former director, officer, or Nominating Committee member of a community foundation will be considered as a potential Scholarship recipient solely because he or she is a member of the charitable class that N intends to benefit through the Scholarship Program.

Aside from the charitable class exception discussed above, the Program Guidelines are designed to ensure that community foundation directors, officers, and Nominating Committee members (and, by extension, their Relatives) are not disqualified persons in the first place. At the community foundation level, any person with a Relative eligible for consideration as a Scholarship nominee must recuse himself or herself from the entire nominating process with respect to that pool of potential nominees, including all meetings, discussions, debates, and votes regarding nominations. This recusal is required to be documented. The recusal herein is analogous to the recusal of a board member when his or her compensation arrangement is under consideration. Section 53.4958-6(c)(1) of the regulations provides that a member of a board of directors will not be treated as such when the board is reviewing the member's compensation package if that member "recuses himself or herself from that meeting and is not present during debate and voting on the compensation arrangement...." Finally, N retains the sole and exclusive authority to accept or reject Scholarship nominations submitted by community foundations. N's current and former (within the past five years) directors, officers, and Selection Committee members (and their Relatives) are ineligible to receive Scholarships under the O program.

The above rules remove from the nominating process any individual with a current interest in the results of the nominations. Consequently, should a Scholarship be awarded to a Relative of a current or former director, officer, or Nominating Committee member of a community foundation, the community representative will not have participated in any way in the nomination. Moreover, it is N, and not the community foundations, which makes all final Scholarship decisions. In general, where a family member of a director or officer of a community foundation is selected as a scholarship recipient by an organization which awards scholarships, the transaction will not be considered an excess benefit transaction under section 4958 of the Code so long as the director or officer recuses himself or herself from the selection process in the manner set forth in section 53.4958-6(c)(1) of the regulations.

RULING

1. A Scholarship awarded to a Relative of a current or former director, officer, or Nominating Committee member of a community foundation pursuant to the Program Guidelines will not constitute private inurement or private benefit and will not otherwise jeopardize the tax exempt status of N or any participating community foundation under section 501(c)(3) 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 N'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 N'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