

INTERNAL REVENUE SERVICE
District Director
2 Cupania Circle
Monterey Park, CA 91755

DEPARTMENT OF THE TREASURY
Western Key District

CERTIFIED MAIL

Date: NOV 03 1998

Employer Identification Number:
[REDACTED]

Case Number:
[REDACTED]

Person To Contact:
[REDACTED]

Telephone Number:
[REDACTED]

Refer Reply to:
[REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code (Code).

FACTS:

You are organized under a Trust Agreement that was approved on [REDACTED]. Your purpose is to provide funds to individuals for higher education purposes.

The information in your application states that you plan to award scholarships to qualifying dependents of employees of [REDACTED]. [REDACTED] is an analytical laboratory specializing in the analysis of [REDACTED]. Eligible grantees are dependents of employees of [REDACTED] who have a minimum of twelve months service with [REDACTED] and work at least 1,500 hours a year. The grantee must be a full time student with a GPA of 2.5 or better.

The scholarships are available only to dependents of [REDACTED]. Members of the selection committee are employees of [REDACTED] but not stockholders. There are no relatives of the selection committee that are possible recipients of the scholarships. There is no requirement that the recipient accept employment at [REDACTED] upon graduation. The award remains granted even though the employee may terminate his employment after the individual, who is his dependent, has been selected as a recipient. Awards of \$[REDACTED] a semester are granted to a maximum of eight semesters. Grants are given directly to individuals in the form of cashier's checks.

There were [REDACTED] employees of [REDACTED] during [REDACTED] and [REDACTED] during [REDACTED]. [REDACTED] individuals were eligible to apply for a grant in [REDACTED] and [REDACTED] individual were eligible in [REDACTED]. All eligible individuals submitted applications and all applicants, except for one individual, were awarded a scholarship.

ISSUE:

Does the organization qualify for exemption from Federal income tax as an organization described in section 501(c)(3) of the Code?

LAW:

Section 501(c)(3) of the Code describes certain organizations exempt from income tax under section 501(a) and reads in part as follows:

"... (3) Corporation, and any community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of any candidate for public office."

Section 1.501(c)(3)-1(a) of the Income Tax Regulations (Regs) provides that in order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in that section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the Regs provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the Regs provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(a)-1(c) of the Regs defines "private shareholders or individuals" as an individual having a personal and private interest in the activity of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the Regs provides that an organization is not organized and operated exclusively for one or

more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creators, shareholders of an organization or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(3) of the Regs defines the term "educational" as relating to "(a) the 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."

In *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279 (1945), the Supreme Court interpreted the requirement in section 501(c)(3) that an organization be "operated exclusively" by indicating that in order to fall within the claimed exemption, an organization must be devoted exclusively to exempt purposes. The Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly exempt purposes.

In *Copperweld Steel Company's Warren Employee's Trust v. Comm. T.C. Memo 1991-7*, the court found that a trust whose sole purpose was to award scholarships to company employees and their families and that failed to prove that its "exclusive" purpose was educational rather than compensatory, was not exempt under section 501(c)(3) of the Code.

In *Puritan Church of America v. Comm.*, (1953, Dist Col) 209 F2d 3-6, 53-2 USTC section 9601, 45 AFTR 119 cert den (1954) 347 US 975, 9898 L ED 1115, the court found that an organization is disqualified if it serves private rather than a public interest. It must therefore establish that it is not organized or operated for the benefit of private interest such as designated individuals, the creator of the organization or his family, shareholders, or persons controlled (directly or indirectly) by such private interest, and the accomplishment of the exempt purpose must not be accompanied by personal, private or selfish consideration.

Revenue Procedure 76-47, 1976-2 C.B. 670 provides clear guidelines under which company related scholarship programs can meet the requirements of oth Code section 117 and 501(c)(3). These guidelines create a series of conditions and tests aimed at establishing three basic facts:

- 1) the preferential treatment derived from employment does not have any significance beyond that of an initial qualifier.
- 2) the selection of scholarship grantees is controlled and limited by substantial nonemployment related factors, including a selection committee consisting wholly of

individuals independent and separate from the private foundation, its organizer, and the employer concerned.

- 3) there exists only a limited probability that qualified employees or their children will receive scholarship grants. The Revenue Procedure details several tests, giving the alternatives of either granting scholarships to no more than 25% of the applicant considered, granting scholarships to no more than 10% of the total applicants actually shown to be eligible (whether or not they applied), or, if the percentage tests are not met, meeting a facts and circumstances test.

Revenue Ruling 85-175, 1985-2 C.B. 276, provides that a private foundation trust that awards scholarships on a preferential bias to family members of the trust grantor violates the nondiscriminatory rules of section 4945(g) of the Internal Revenue Code. The ruling emphasizes that the part of the trust's grant program that gives preference to family members and relatives of the trust's grantor is not consistent with exempt status under section 501(c)(3) of the Code because it serves a private purpose of the grantor rather than a public purpose. The ruling holds that if the grant program were a substantial part of the foundation's activities, the trust would not be described in section 501(c)(3) of the Code.

ANALYSIS:

All of the preceding Code sections, Regulation sections, Revenue Ruling and Court cases describe the criteria under which an organization may be exempt under section 501(c)(3) of the Code. They also describe the basis for which organizations were denied exemption because of private benefit to members and because the organizations were not organized and operated exclusively for charitable and educational purposes.

Our analysis of your application indicates that you are organized and operated for compensatory rather than educational purposes. Your selection committee are employees of [REDACTED] and indirectly controlled by the owners of the company. The only people who are eligible to apply for your scholarships are the dependents of your employees who number [REDACTED]. You have thus far awarded scholarships to nearly every dependent who has applied for a scholarship. You have not met the percentage requirements of Revenue Procedure 76-47 in the past and cannot foresee meeting the tests in the future. The facts and circumstances surrounding your organization do not lend itself to approval. The group of eligible recipients of your program is not sufficiently broad enough to demonstrate that you are fulfilling a charitable purpose. The awarding of scholarships to nearly every individual that applies for a scholarship is an indication that the awards are compensatory in nature as opposed to educational or charitable.

CONCLUSION:

To be considered for tax exempt status under Code section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in that Code section. Also, its activities must be restricted to those permitted a section 501(c)(3) organization. It is the position of the Internal Revenue Service, based on the information submitted, that you are not entitled to exemption from Federal income tax as an organization described in Code section 501(c)(3), inasmuch as you are not organized and operated exclusively for any of the specified purposes within that Code section but are operated exclusively for the private benefit of your members. Contributions to you are not deductible under section 170 of the Code.

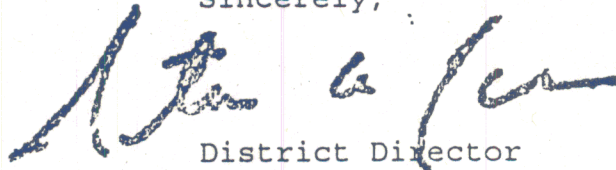
If you are in agreement with this proposed determination, we request that you sign and return the enclosed Form 6018. Please note the instructions for signing on the reverse side of the form.

If you are not in agreement with this proposed determination, we recommend that you request a hearing with our office of Regional Director of Appeals. Your request for a hearing should include a written appeal giving the facts, law, and any other information to support your position as explained in the enclosed Publication 892. You will then be contacted to arrange a date for a hearing. The hearing may be held at the office of Regional Director of Appeals, or, if you request, at a mutually convenient District office.

If we do not hear from you within 30 days from the date of this letter, and you do not protest this proposed determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies and will then become our final determination. Section 7428(b)(2) of the Internal Revenue Code provides, in part, that, "A declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the Court of Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

If you have any questions, please contact the person whose name appears on the heading of this letter.

Sincerely,



District Director
Steven A. Jensen

Enclosure(s)
Form 6018
Publication 892