

## N. IRC 4945 -- GRANTS TO INDIVIDUALS

### 1. Introduction

The "taxable expenditure" provisions of IRC 4945 were enacted as part of the Tax Reform Act of 1969, P.L. 91-172, 1969-3 C.B. 10. Prior to the enactment of these provisions, among other problem areas, many private foundations were distributing funds to individuals without conditions and controls adequate to ensure expenditure of the funds exclusively for exempt purposes or to recover the funds in the event of their misapplication. In response to these problems, Congress enacted IRC 4945, which defines five types of taxable expenditures. IRC 4945(d) provides that:

The term "taxable expenditure" means any amount paid or incurred by a private foundation--

- (1) to carry on propaganda, or otherwise to attempt, to influence legislation, within the meaning of IRC 4945(e),
- (2) except as provided in IRC 4945(f), to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive,
- (3) as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of IRC 4945(g),
- (4) as a grant to an organization (other than an organization described in paragraph (1), (2), or (3) of IRC 509(a)), unless the private foundation exercises expenditure responsibility with respect to such grant in accordance with IRC 4945(h), or
- (5) for any purpose other than one specified in IRC 170(c)(2)(B).

IRC 4945(a) and (b) impose a two-level tax on these expenditures; an initial ten percent tax to be paid by the private foundation, and an additional 100 percent tax if the expenditure is not timely corrected. Also, a 2 1/2 percent tax is imposed

on any foundation manager knowingly agreeing to the making of a taxable expenditure, and a 50 percent tax on any foundation manager who refuses to agree to part or all of the correction. This article will focus in on IRC 4945(d)(3) and IRC 4945(g), relating to grants to individuals.

## 2. Background

The legislative history to IRC 4945(d)(3) provides a good explanation of its need and intended purpose. S. Rep. No. 91-552, 91st Cong., 1st Sess. 47 (1969), 1969-3 C.B. 440, 455, states:

It also was called to the committee's attention that existing law does not effectively limit the extent to which foundations can use their money for "educational" grants to enable people to take vacations abroad, to have paid interludes between jobs, and to subsidize the preparation of materials furthering specific political viewpoints.

The committee has concluded that more effective limitations must be placed on the extent to which tax-deductible and tax-exempt funds can be dispensed by private persons and that these limitations must involve more effective sanctions. Accordingly, the committee has determined that a tax should be imposed upon expenditures by private foundations for activities that should not be carried on by exempt organizations (such as lobbying, electioneering, and "grass roots" campaigning). The committee also believes that granting foundations should take substantial responsibility for the proper use of the funds they give away.

In general, the committee's decisions reflect the concept that private foundations are stewards of public trusts and their assets are no longer in the same status as the assets of individuals who may dispose of their own money in any lawful way they see fit. (Emphasis added.)

Additionally, at 1969-3 C.B. 440, 456, the Senate Report states:

The House bill also imposes sanctions upon the making of grants to individuals by private foundations unless the grantees are chosen in open competition or on some other objective and nondiscriminatory basis, in accordance with procedures approved in

advance by the Internal Revenue Service. This approval procedure does not contemplate specific approval of particular grant programs but instead one-time approval of a system of standards, procedures, and follow-up designed to achieve the intended degree of objectivity. Where the grants take the form of scholarships there will normally be available the relatively independent supervision of schools and colleges. Prizes or awards that qualify under existing law (sec. 74(b)) for exclusion from income also may be made if the recipient is selected from the general public. Otherwise, the bill requires that any grant by a private foundation be directed toward the production of a specific product (a book, paper, or other study, or a scientific development or useful process), the achievement of a specific objective or the improvement or enhancement of a literary, artistic, musical, scientific, or other similar capacity, talent, or skill.

The Committee added "teaching" to this list of skills. The scholarships, prizes, and other individual grants that a private foundation may make must meet the standards described at the beginning of the preceding paragraph.<sup>19</sup> ...A grant, but not a contract for services, is limited by this provision...

<sup>19</sup> Even if it qualifies under these standards, any individual grant also must be tested by the standards described above in "Prohibitions on Self-Dealing."

See also H.R. Rep. No. 91-413, 91st. Cong., 1st Sess. 31 (1969), 1969-3 C.B. 200, 221.

### 3. IRC 4945(d)(3) - Which Grants Must Satisfy the Requirements of 4945(g)

IRC 4945(d)(3) applies only to "a grant to an individual for travel, study, or other similar purposes by such individual." While this may seem clear, many complicated issues have arisen in interpreting this language. Three basic questions must be answered: (1) Is the payment a grant?; (2) Is it to an individual?; and (3) Is it for travel, study, or other similar purposes by such individual?

(1) The term "grant" is broadly defined in Reg. 53.4945-4(a)(2) as including scholarships, fellowships, internships, prizes, and awards.

A scholarship generally includes any amount paid to a student in pursuing his or her studies. It would include tuition, matriculation and related fees, and any family allowances provided. Fellowships and internships include similar payments to individuals who may or may not necessarily be "students" to aid in the pursuit of the recipient's studies. Prizes and awards are generally grants made to individuals in recognition for some past accomplishment.

Very often the prize or award is made in recognition for some accomplishment in an educational, literary, artistic, or scientific field. Also, an expenditure to enable a "grantee" to produce a report or similar product, or to enhance his or her skills may constitute a grant for purposes of IRC 4945(d)(3). An example of such a grant would be the payment of funds by a foundation to enable an individual to write a book under circumstances where the grantee is not providing personal services to the foundation. Grants also include loans to students for educational purposes. See Rev. Rul. 77-434, 1977-2 C.B. 420, discussed in section 5c below.

On the other hand, grants do not include salaries or other compensation to employees of the foundation. Similarly, grants do not include payments such as consultants' fees and reimbursement for expenses to persons assisting a foundation in planning, evaluating, or developing projects by consulting, advising, or participating in conferences organized by the foundation. This issue is illustrated in Rev. Rul. 74-125, 1974-1 C.B. 327, which holds that payments to consultants by a private foundation for personal services performed in the development of model curricula and the design of educational materials to aid the foundation in its program activity of assisting educators to employ improved educational methods are not grants within the meaning of IRC 4945(d)(3).

(2) The second question, whether the grant is made to an individual, arises when a private foundation makes a grant to another organization with the understanding that the grantee organization will in turn award grants to individuals. Depending on the nature of the initial grantee organization and the extent of the grantor private foundation's control over the selection of the ultimate individual grantee, these payments may constitute taxable expenditures under IRC 4945(d)(3).

The general rule set forth in Reg. 53.4945-4(a)(4)(i) is that where a private foundation awards a grant to another organization that uses the award to make grants to individuals for educational purposes, these latter grants will not be considered as having been made by the private foundation to the individual

grantees if the foundation does not earmark the use of the original grant for any named individual and there is no agreement whereby the grantor foundation may cause the selection of the individual grantee by the grantee organization. The fact that a grantor foundation has reason to believe that certain individuals would derive benefits from its grant to the grantee organization will not change the result so long as the grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independent of the grantor private foundation.

This general rule is subject to two exceptions that involve special types of intermediate grantee organizations. The first exception, described in Reg. 53.4945-4(a)(4)(ii), comes into play when the intermediate grantee organization is a "public charity" described in IRC 509(a)(1), (2), or (3). Under these circumstances, the grantor private foundation may participate to a limited extent in the selection of the individual grantee (such as through the suggestion of candidates for grants) subject, however, to the condition that the grantee public charity remains in control of the selection process and that there is an objective manifestation of such control by it.

The second exception applies when the intermediate grantee organization is a governmental agency described in IRC 170(c)(1). Under these circumstances, the grant will not be subject to IRC 4945(d)(3) even though the grantor private foundation exercises considerable control over the selection of individual grantees provided the governmental agency meets certain requirements set forth in Reg. 53.4945-4(a)(4)(iii).

This issue is illustrated in Rev. Rul. 77-212, 1977-1 C.B. 356, which considers a program of a private foundation under which it makes grants to vocational high school students in a certain geographical area. The grants are used to supply selected students with the basic tools of their chosen trades to enable them better to learn their trades and to enter into those trades upon graduation. The vocational schools purchase the tools for the students chosen by the foundation's selection committee with grant funds paid by the private foundation.

While the private foundation makes grants to the vocational schools rather than to the individual students, the foundation through its representatives selects the individual grant recipients. Thus, under Reg. 53.4945-4(a)(4)(ii), the grants are deemed to be made directly to the individual students, and are subject to IRC 4945(d)(3).

The question of whether a grant is made to an individual is also present in the following hypothetical situation:

A foundation makes a grant to an IRC 509(a)(1) organization to fund a number of scholarships for children. The IRC 509(a)(1) organization evaluates the interested high school students in various communities according to its own criteria including performance on a national test, academic record, leadership qualities, and recommendations. Applicants with the highest ratings are classified as finalists. The private foundation requires that its funds be used only to make scholarship grants to finalists who are children of the employees of particular company. Arguably, in this circumstance, while the IRC 509(a)(1) organization chooses the particular individuals who will receive grants, it does not make the selection "completely independently" of the foundation, nor does it truly "control" the selection process. It appears, then, that the grants would fall within IRC 4945(d)(3), and are considered as made by the private foundation to the individuals.

The question can also arise where a grant is made to an individual who then transfers grant funds to other individuals. This often occurs with respect to grants for scientific research, where the initial grantee uses a portion of the grant to hire research assistants. In this circumstance, it appears that the salaries paid to such assistants, selected independently of the foundation, would not constitute grants made by the foundation.

(3) The third question deals with the intended use of the grant by the grantee. To fall within IRC 4945(d)(3), the grant must be for travel, study, or other similar purposes. This question is dealt with in a series of revenue rulings: Rev. Rul. 75-393, 1975-2 C.B. 451; Rev. Rul. 76-460, 1976-2 C.B. 371; Rev. Rul. 76-461, 1976-2 C.B. 371, and Rev. Rul. 77-380, 1977-2 C.B. 419.

Rev. Rul. 75-393 holds that an award by a private foundation to the person who has written the best work of literary criticism during the preceding year, whether it is an article, essay, treatise, or book, is not a taxable expenditure within the meaning of IRC 4945(d)(3). The award is granted in recognition of past outstanding achievement in the literary field, and is not intended to finance any activities; and no conditions are imposed on the manner in which it may be expended by the recipient.

Rev. Rul. 76-460 holds that an unconditional and unrestricted grant by a private foundation to the winner of a competition conducted among students

attending schools specializing in teaching a special craft is not a taxable expenditure within the meaning of IRC 4945(d)(3). The Rev. Rul. also notes that even if a grant to an individual is for a purpose not described in IRC 4945(d)(3), it may still be a "taxable expenditure" if it does not meet the requirements of IRC 4945(d)(5).

Rev. Rul. 76-461 holds that an award by a private foundation to a high school senior whose exhibit receives top honors in a local science fair, which is conditioned on the student's agreeing to use the award for educational activities, is subject to the provisions of IRC 4945(d)(3), and will constitute a taxable expenditure unless the foundation's grant-making procedures satisfy the requirements of IRC 4945(g).

Rev. Rul. 77-380 is extracted below:

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**Private foundation grants.** Grants made by a private foundation primarily in recognition of past achievement, with the funds being unrestricted, or earmarked for subsequent travel or study and meeting the requirements of section 4945(g) of the Code, are not taxable expenditures within the meaning of section 4945.

**Rev. Rul. 77-380**

Advice has been requested whether the grants to individuals made by the private foundations in the situations described below are taxable expenditures within the meaning of section 4945 of the Internal Revenue Code of 1954.

*Situation 1.* Private Foundation M is a trust created for the purpose of encouraging excellence in the art of journalism. Each year, the foundation awards its net income to the person whose work represents the best example of investigative reporting on matters concerning the Federal government.

Journalists throughout the United States are eligible for the award. The recipient is chosen by a majority vote of a selection committee comprised of three working newsmen who otherwise have no relationship with Private Foundation M and who have an established reputation for competence in the field of journalism. Each member of the selection committee is appointed by the foundation's trustees for a three-year term. The terms are staggered so that one new judge is selected each year.

Each year, news organizations throughout the United States voluntarily submit to the committee samples of the work of journalists in their employ. These submissions consist of articles, published by the submitting newspapers, magazines, or other news media during the past year, that were written in the ordinary course of the journalists' professional employment.

No journalist prepares or produces any material specifically for submission to the selection committee. The selection committee is not restricted to consideration of actual submissions, and submission is not a condition to eligibility for the award. The committee makes an attempt to review major publications in which eligible works may have appeared.

The award is granted in recognition of past achievement in this particular field of journalism, and is not intended to finance any specific activities of the recipient nor are any conditions imposed on the manner in which it may be expended by the recipient. The recipient is not required to render any substantial future services as a condition to receiving the award. The grants are awards within the meaning of section 74(b) of the Code and are excludable from the recipient's gross income.

*Situation 2.* Private Foundation N is also a trust created for the purpose of encouraging excellence in the art of journalism. It has received advance approval of its grant-making procedures. The operations of Private Foundation N are identical to those of Private Foundation M, above, except that its annual award is to be used for financing a three-month trip throughout the United States designed to further the recipient's understanding of the operations of the Federal government.

*Situation 3.* Private Foundation P is also a trust created for the purpose of encouraging excellence in the art of journalism. It has received advance approval of its grant-making procedures. The operations of Private Foundation P are identical to those of Private Foundation M, above, except that its annual award is to be used for study at an institution described in section 170(b)(1)(A)(ii) of the Code and is a "scholarship" within the meaning of section 117(a).

Section 4945 of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(3) of the Code provides that the term "taxable expenditure" includes any amount paid or incurred by a



private foundation as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of section 4945(g).

Section 4945(d)(5) of the Code provides that the term "taxable expenditure" includes any amount paid or incurred by a private foundation for any purpose other than one specified in section 170(c)(2)(B), that is, other than for an exclusively religious, charitable, scientific, literary, or educational purpose, or to foster national or international amateur sports competition (not involving the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.

Section 4945(g) of the Code provides that section 4945(d)(3) shall not apply to an individual grant awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Service, if it is demonstrated that--

(1) the grant constitutes a scholarship or fellowship grant which is subject to the provisions of section 117(a) and is to be used for study at an educational institution described in section 170(b)(1)(A)(ii),

(2) the grant constitutes a prize or award which is subject to the provisions of section 74(b), if the recipient of such prize or award is selected from the general public, or

(3) the purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

Section 53.4945-4(a)(3)(i) of the Foundation Excise Tax Regulations states that a grant to an individual for purposes other than those described in section 4945(d)(3) of the Code is not a taxable expenditure within the meaning of section 4945(d)(3).

In each of the three situations described above, the grants by the private foundation must be made for purposes within the scope of section 170(c)(2)(B) of the Code. See Rev. Rul. 76-460, 1976-2 C.B. 371. In all three situations, this requirement is met, and therefore, the grants are not taxable expenditures within the meaning of section 4945(d)(5).

In *Situation 1*, the grants made by Private Foundation M are awards made primarily in recognition of past achievement.

They are not intended to finance any future activity of the recipient. There are no conditions or requirements to be met subsequent to receiving the grants. Thus, the awards are not grants to individuals for travel, study, or other similar purposes by such individuals. See Rev. Rul. 75-393, 1975-2 C.B. 451. Accordingly, the grants made by Private Foundation M are made for purposes other than those stated in section 4945(d)(3) of the Code and they are not taxable expenditures within the meaning of section 4945.

In *Situation 2*, the grants made by Private Foundation N are also awards made primarily in recognition of past achievement, but they are designed to pay for subsequent travel by the recipients of the awards. Because they are so earmarked by the foundation, they represent grants to an individual for travel within the meaning of section 4945(d)(3) of the Code and would be taxable expenditures but for the fact that they satisfy the requirements of section 4945(g). The grants by Private Foundation N are awards made on an objective and nondiscriminatory basis under procedures for which advance approval has been granted. The grants constitute awards subject to the provisions of section 74(b) and the recipients are selected from the general public within the meaning of section 4945(g)(2). Accordingly, the grants made by Private Foundation N are not taxable expenditures within the meaning of section 4945.

Similarly, in *Situation 3*, while the grants made by Private Foundation P are awards made primarily in recognition of past achievement, they are designed to pay for subsequent study by the recipient of the award. Because they are so earmarked by the foundation, they represent grants to individuals for study within the meaning of section 4945(d)(3) of the Code but are not taxable expenditures because they satisfy the requirements of section 4945(g). The grants by Private Foundation P are awards made on an objective and nondiscriminatory basis under procedures for which advance approval has been granted. The grants constitute scholarships subject to the provisions of section 117(a) and they are to be used for study at an educational institution described in section 170(b)(1)(A)(ii). Accordingly, the grants made by Private Foundation P are not taxable expenditures within the meaning of section 4945.

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As is seen in the four revenue rulings, grants made in recognition of past achievement, whether for literary, artistic, scientific or other areas of achievement, with no conditions or requirements to be met subsequent to receiving the awards, are not subject to IRC 4945(d)(3). However, such awards must be made for a

charitable purpose within the scope of IRC 170(c)(2)(B), as required by IRC 4945(d)(5).

#### 4. IRC 4945(g) Requirements

Once it is determined that a grant falls within the ambit of IRC 4945(d)(3), it must then be determined if the grant satisfies the requirements of IRC 4945(g). IRC 4945(g) provides that any individual grant must be awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary, and must:

(1) constitute a scholarship or fellowship grant which is subject to the provisions of IRC 117(a) and is to be used for study at an educational organization described in IRC 170(b)(1)(A)(ii),

(2) constitute a prize or award which is subject to the provisions of IRC 74(b), if the recipient of such prize or award is selected from the general public, or

(3) be for the purpose of achieving a specific objective, producing a report or other similar product, or improving or enhancing a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

##### a. Requirement of Advance Approval

To satisfy IRC 4945(g), a foundation must get advance approval of its grant-making program. Grants awarded prior to receiving approval constitute taxable expenditures under IRC 4945(d)(3) even if all the other requirements are met. The procedures for requesting advance approval are given in Reg. 53.4945-4(d). Once approval is given, it is effective so long as the foundation makes no material changes in its procedures.

Of highest importance is IRM 7666.3, which requires that when an organization, applying for recognition of exemption under IRC 501(c)(3), appears to be a private foundation and has a grant-making program requiring advance approval under IRC 4945(g), key districts will not make a determination of the organization's exempt status. All such cases should be forwarded to the National Office. These instructions apply whether or not the organization has requested advance approval of its grant making procedures. The purpose of this requirement,

of course, is to help insure that organizations will get advance approval of their procedures. Because many organizations are not familiar with the requirements of IRC 4945(g), and because of the harsh consequences of not getting advance approval, it is best to treat the application for exemption and advance approval together. Also, often all of the information needed to secure approval is contained in a foundation's Form 1023.

A number of special rules affect the advance approval requirement:

(1) Transitional Rules

Reg. 53.4945-4(e)(2) provides special treatment for grants awarded before January 30, 1973, and paid within 48 months after the award of the grant. Generally, such grants are deemed approved under IRC 4945(g).

(2) 45-Day Rule

Reg. 53.4945-4(d)(3) provides that:

If by the 45th day after a request for approval of grant procedures has been properly submitted to the Internal Revenue Service, the organization has not been notified that such procedures are not acceptable, such procedures shall be considered as approved from the date of submission until receipt of actual notice from the Internal Revenue Service that such procedures do not meet the requirements of this section. If a grant to an individual for a purpose described in section 4945(d)(3) is made after notification to the organization by the Internal Revenue Service that the procedures under which the grant is made are not acceptable, such grant is a taxable expenditure under this section.

In a number of similar cases, the 45-day rule has been applied in the following situation: An organization has filed Form 1023 after 1969, including a description of its grant-making procedures. Subsequently, an exemption letter was issued containing no mention of the organization's grant-making procedures. Some years later, it was discovered during an audit that the organization had never received written advance approval under IRC 4945(g). In this circumstance, the 45-day rule has been held to apply, so that any grants made after the Form 1023 was filed are considered approved until either 1) there is a material change in the

grant-making procedures, or 2) the organization receives actual notice whether its procedures are acceptable. This example illustrates the importance of IRM 7666.3

On the other hand, the 45-day rule will not apply where the existence of a grant-making program is acknowledged by an agent during an audit, but the organization fails to make any written request for advance approval. The oral statements made to the agent would not constitute a request for advance approval.

Another issue that has arisen is whether grants considered approved under the 45-day rule may be renewed after the Service notifies the organization that its procedures do not satisfy IRC 4945(g). Generally, Reg. 53.4945-4(a)(3)(iii) provides that the renewal of a grant originally awarded under an approved procedure shall not be treated as a grant. However, where the original grant was permissible only because of the 45-day rule, rather than because of actual approval, Reg. 53.4945-4(a)(3)(iii) appears to be inapplicable. Thus, a renewal will be treated as a new grant that is subject to IRC 4945(d)(3). On the other hand, if a grant of a set amount is considered approved under the 45-day rule, but is to be paid in installments, the payment of any remaining installments after the foundation has received actual notice that its procedures are not approved will not constitute taxable expenditures. Payment of the remaining installments will not be considered to be the awarding of new grants, but merely the satisfaction of the foundation's obligation under the grants that were deemed approved.

b. Requirement of a Proper Procedure

In order to receive advance approval of its grant-making procedures, a foundation must demonstrate that:

(1) Its grant procedure includes an objective and nondiscriminatory selection process;

(2) Such procedure is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance; and

(3) The foundation plans to obtain reports to determine whether the grantees have performed the activities that the grants are intended to finance.

No single procedure or set of procedures is required. Procedures may vary depending upon such factors as the size of the foundation, the amount and purpose of the grants, and whether one or more recipients are involved.

The procedural requirements are given in detail in Reg. 53.4945-4(b) and (c).

#### (1) Objective and Nondiscriminatory Basis

This requirement concerns whether the grants are awarded in a manner that is consistent with exempt status under IRC 501(c)(3) provisions and relates to who is eligible for the grants, how the grantee is chosen, and who makes the selection. Ordinarily, the group from which the grantee is chosen must be large enough to constitute a charitable class. On the other hand, if the grant is intended for a particular purpose, such as scientific research, that only a small group of persons is qualified to undertake, selection from such a small group is permissible.

Secondly, selection of the grantee from among the candidates should be related to the purposes of the grant. For example, criteria for choosing a scholarship recipient can include academic performance, performance on college entrance exams or similar tests, recommendations, financial need, and personal qualities. The National Office is currently considering whether random selection from a group of qualified candidates is acceptable.

Finally, the persons selecting the grantee should not be in a position to derive a private benefit from the selection. Such benefit could arise if the persons choose their relatives to receive the grant. Similarly, if the program is a company-related program, awarding of a disproportionate number of grants to highly-compensated employees or their children could violate this provision.

The National Office is currently considering whether racial, religious, ethnic, or sexual restrictions are compatible with the requirements of IRC 4945(g).

#### (2) Other Procedural Requirements

The other procedural requirements under IRC 4945(g) are intended to insure that a private foundation's grants are used for their intended purpose. The foundation's procedures must include a follow-up mechanism to review the use of the grant and investigate any misuse of funds. See Reg. 53.4945-4(c).

Special rules apply to scholarship and fellowship grants. If the award is made directly to the student, the foundation must receive a report of his/her courses and grades from the educational institution at least once a year. If the individual is not attending school, a yearly progress report must be made. Similarly, yearly reports must be obtained for grants under IRC 4945(g)(3).

When a foundation pays a scholarship directly to an educational institution that agrees to supervise the use of the grant, the foundation need not adopt the type of procedures discussed above. Reg. 53.4945-4(c)(5).

The procedural requirements are illustrated in Rev. Rul. 76-340, 1976-2 C.B. 370.

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**Private foundation; scholarship grants; taxable expenditures.** Scholarship grants made to individuals by a private foundation on the basis of academic standing, financial need, personal history, the cost of the programs of study to be pursued, and the likelihood that the recipients will be able to finance the balance of the cost of their education, are not taxable expenditures within the meaning of section 4945(d)(3) of the Code.

**Rev. Rul. 76-340**

Advice has been requested whether grants to individuals made by a private foundation in the manner described below are taxable expenditures within the meaning of section 4945(d)(3) of the Internal Revenue Code of 1954.

The private foundation is a testamentary trust recognized as exempt from Federal income tax under section 501(c)(3) of the Code. It was created to provide college scholarship grants to students attending a high school in a certain locality within a city. The grants constitute scholarships which are excludable from the gross income of the recipients under section 117(a), and which are to be used for study at educational institutions described in section 151(e)(4).

A selection committee, made up of three high school principals and the director of the city's recreation center in that part of the city, selects the recipients based on information submitted on an application form and gained from personal interviews. Criteria used in selecting a recipient include academic standing, financial need, personal history, the cost of the program of study to

be pursued by the applicant, and sources of income available to the applicant other than the trust's scholarship grant. The committee gives preference to those applicants who are likely to be able to finance the balance of the cost of their education.

Section 4945 of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(3) of the Code defines the term "taxable expenditure" to include any amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of section 4945(g).

Section 4945(g) of the Code provides, in part, that grants to an individual for travel, study, or other similar purposes will not be considered as "taxable expenditures" if they are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary or his delegate, and if it is demonstrated that the grant constitutes a scholarship which is subject to the provisions of section 117(a) and is to be used for study at an educational institution described in section 151(e)(4).

Section 53.4945-4(b) of the Foundation Excise Tax Regulations provides, in part, that in order for a foundation to establish that its grants to individuals are made on an objective and nondiscriminatory basis, the grants must be awarded in accordance with a program which, if it were a substantial part of the foundation's activities, would be consistent with the existence of the foundation's exempt status under section 501(c)(3) of the Code and would require that the criteria used in selecting grant recipients from the potential grantees be related to the purpose of the grant.

A trust for educational purposes is charitable although the persons to be educated are not limited to the poor. The fact that recipients of scholarships are selected on the basis of scholastic ability without regard to financial need does not preclude exemption under section 501(c)(3) of the Code. See Rev. Rul. 69-257, 1969-1 C.B. 151.

The committee selects recipients on the basis of scholastic ability as well as other criteria which are related to the educational purposes of the trust. One such criterion is the cost of the program the applicant proposes to pursue, and whether the applicant is likely to be able to finance it with the foundation's assistance. By including such a factor in its consideration, the committee attempts



to assure that the foundation's grants are likely to see the recipient through to the completion of an educational program.

By operating in the manner described above, the foundation has demonstrated that its scholarship grants are made on an objective and nondiscriminatory basis within the meaning of section 4945(g) of the Code. It has also demonstrated that its grants constitute scholarships which are subject to the provisions of section 117(a) and are to be used for study at an educational institution described in section 151(e)(4). Accordingly, the foundation's scholarship grants are not "taxable expenditures" within the meaning of section 4945(d)(3).

Even though a private foundation considers its grant making program within the scope of this Revenue Ruling, it must request advance approval of its procedures in accordance with section 53.4945-4(d) of the regulations.

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### (3) Requirement that Grants be Described in IRC 4945(g)(1), (2), or (3).

In addition to requiring advance approval of an objective and nondiscriminatory grant making procedure, the grants must fall within the categories enumerated in IRC 4945(g)(1), (2), or (3). These additional requirements are discussed in Part 5 of this article.

## 5. IRC 4945(g)(1), (2), and (3) Requirements

### a. Scholarships and Fellowship Grants - IRC 4945(g)(1)

The first category of grants acceptable under IRC 4945(d)(3) are scholarships or fellowship grants that are subject to the provisions of IRC 117(a), and are to be used for study at an educational organization described in IRC 170(b)(1)(A)(ii). IRC 4945(g)(1) is illustrated in Rev. Rul. 76-340, 1976-2 C.B. 370, and Rev. Rul. 77-380, Situation 3, 1977-2 C.B. 419, both extracted above. This article will not consider the requirements of IRC 117 or 170(b)(1)(A)(ii) in any detail.

A number of special rules have been developed with respect to employer-related grant programs. An employer-related program is a program that treats some or all of the employees, or children of some or all of the employees, of a particular employer as a group from which grantees of some or all of the foundation's

educational grants will be selected. Usually, foundations having such programs were created and funded by the employer in question. The rules for determining whether grants made in such a program constitute scholarships or fellowship grants under IRC 117 are contained in Rev. Proc. 76-47, 1976-2 C.B. 670.

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**Rev. Proc. 76-47**

**SECTION 1. PURPOSE.**

A grant by a private foundation to an individual for travel, study, or other similar purpose by such individual is a "taxable expenditure" by the private foundation for purposes of the tax imposed by section 4945 of the Internal Revenue Code of 1954 unless such grant satisfies the requirements of section 4945(g) of the Code. Section 4945(d)(3). Such a grant, awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance, by the Secretary or the Secretary's delegate, may satisfy the requirements of section 4945(g)(1) if it is demonstrated to the satisfaction of the Secretary or the Secretary's delegate that the grant is a scholarship or fellowship grant that is subject to the provisions of section 117(a) and is to be used for study at an educational institution described in section 151(e)(4).

Ruling requests seeking advance approval of procedures are to be submitted to Assistant Commissioner (Employee Plans and Exempt Organizations), Attention: E:EO:T, Washington, D.C. 20224, and should include the statements described in section 53.4945-4(d) of the Foundation Excise Tax Regulations.

The purpose of this Revenue Procedure is to provide guidelines to be used in determining whether a grant made by a private foundation under an employer-related grant program to an employee or to a child of an employee of the particular employer to which the program relates is a scholarship or fellowship grant subject to the provisions of section 117(a) of the Code.

If the private foundation's educational grants are not scholarships or fellowship grants subject to the provisions of section 117(a) of the Code and do not otherwise qualify under the provisions of section 4945(g)(2) or (3), they would be "taxable expenditures" within the meaning of section 4945(d), and might, depending upon the circumstances, lead to a loss of the private foundation's exempt status. As hereinafter explained, grants made by a foundation under an employer-related grant program to

employees, or to children of employees, of the particular employer to which the program relates could fail to be section 117 scholarships or fellowship grants because, for example, the purpose of the program is to provide extra compensation, an employment incentive, or an employee fringe benefit for the employees generally or a particular class of employees. Such a purpose would not be consistent with the foundation's exempt purpose or the allowance of deductions under section 170 for contributions to it.

The guidelines are directed only to the foregoing question of qualification under section 117 of the Code. For example, they are not directed to whether the private foundation's employer-related grant program meets the rules of section 53.4945-4(b) of the regulations requiring that the foundation's program be consistent with its exempt status and the allowance of deductions to individuals under section 170 for contributions to the foundation and that the group from which grantees are selected is a "charitable class." The guidelines assume that those requirements have been met except insofar as that conclusion may be affected by the failure of the educational grants to be scholarships or fellowships subject to the provisions of section 117(a) and the reason for such failure.

Thus, for example, these guidelines assume that the group of employees, or children of employees, from which grantees are to be selected is sufficiently broad so that the awarding of grants to members of such a group could be considered consistent with the fulfillment of a purpose described in section 170(c)(2)(B) of the Code and the group could be considered to be a charitable class.

In addition, these guidelines are not directed to whether or not, if programs permit disqualified persons to receive grants, such grants constitute taxable expenditures under section 4945 of the Code or subject the disqualified persons to tax under section 4941.

## SEC. 2. APPLICATION OF GUIDELINES.

These guidelines apply to educational grants made on or after January 1, 1970, by a private foundation under an employer-related grant program to individuals who are employees, or the children of employees, of the employer to which the program relates.

An employer-related program is a program that treats some or all of the employees, or children of some or all of the

employees, of a particular employer as a group from which grantees of some or all of the foundation's educational grants will be selected, limits the potential grantees for some or all of the foundation's grants to individuals who are employees, or children of employees, of a particular employer, or otherwise gives such individuals a preference or priority over others in being selected as grantees of such grants.

These guidelines apply only to cases in which the group of employees, or children of employees, of the particular employer to which the program relates, from which grantees are to be selected, is sufficiently broad so that the awarding of grants to members of such a group could be considered consistent with the fulfillment of a purpose described in section 170(c)(2)(B) of the Code and the group could be considered to be a charitable class.

### SEC. 3. BACKGROUND.

Section 117 of the Code provides that gross income does not include any amount received as a scholarship or as a fellowship grant at an educational institution (as defined in section 151(e)(4)). Section 1.117-3 of the Income Tax Regulations states that a scholarship generally means an amount paid or allowed to, or for the benefit of, a student to aid that student in pursuing studies. A fellowship grant is defined as an amount paid or allowed to, or for the benefit of, an individual to aid the individual in the pursuit of study or research.

Section 1.117-4(c) of the regulations explains that any amount paid or allowed to, or on behalf of, an individual to enable that individual to pursue studies or research is nevertheless not a scholarship or a fellowship grant for purposes of section 117 of the Code if such amount represents compensation for past, present, or future employment services or if such studies or research are primarily for the benefit of the grantor. In the context of section 1.117-4(c), "benefit" is not limited to monetary gain. See Jerry S. Turem, 54 T.C. 1494 (1970). It may include anything that furthers a noneducational purpose of a grantor. By contrast, a grant made for the relatively disinterested purpose of financially assisting an individual to pursue an education for that individual's own benefit may qualify as a section 117 scholarship or fellowship. The determination must, of course, be made in light of all the relevant facts and circumstances.

When educational grants are made available by an employer to its employees on a preferential basis, the employer-

employee relationship is immediately suggestive that the grant is compensatory. See *Bingler v. Johnson*, 394 U.S. 741 (1969), 1969-2 C.B. 17. Such preferential grants by an employer to the children of employees suggests a purpose to compensate or otherwise provide an employment incentive to the employee-parents. These suggestions are not dispelled simply because the grantor is an independent third party (for example, a foundation). The employer-related preferential treatment does not, of itself, further in any way the requisite (under section 117 of the Code) disinterested purpose of simply making it financially possible for individuals to obtain an education for their own personal benefit, and suggests the presence of a contrary purpose to provide extra compensation, an employment incentive, or an employee fringe benefit. If a grant program by a private foundation is designed or administered to that end, the grants made under it to the employees or their children will not be scholarships or fellowship grants subject to the provisions of section 117(a).

The Internal Revenue Service will not, however, treat a private foundation's program as designed or administered for such a purpose if the availability of grants to employees of their children fall outside the pattern of employment. In order to be outside the pattern of employment, the availability of grants to employees or their children under the program must be controlled and limited by substantial nonemployment related factors to such an extent that the preferential treatment derived from employment does not continue to be of any significance beyond an initial qualifier. Such qualification must not lead to any significant probability that employment will make grants available for a qualified employee or his or her children interested in applying for one. The Service will treat the grants as scholarships or fellowship grants subject to the provisions of section 117(a) of the Code if (1) the availability of the grants falls outside the pattern of employment, and (2) the grants do not otherwise represent compensation for past, present, or future services rendered or to be rendered the foundation or employer by the employees or their children, and (3) the grants are not for studies or research undertaken primarily for the benefit of the foundation or the employer or for some other purposes not sanctioned by section 117.

#### SEC. 4. GUIDELINES.

If a private foundation's program satisfies the seven conditions set forth in sections 4.01 through 4.07, below, and meets the percentage test described in section 4.08 applicable to grants to employees' children, or to grants to employees, or to both,

as the case may require, the Service will assume the grants awarded under the program to employees, or their children, or to both (if the percentage test is met for each category) will be scholarships or fellowship grants subject to the provisions of section 117(a) of the Code.

If a private foundation's program does not satisfy one or more of the seven conditions set forth in sections 4.01 through 4.07, the Service will not issue a ruling that the grants awarded are scholarships or fellowship grants under section 117 of the Code.

If a private foundation's program satisfies the seven conditions set forth in sections 4.01 through 4.07 below, but does not meet the percentage test of section 4.08 applicable to grants to employees' children or to grants to employees, as the case may be, the question whether the grants, awarded to individuals in the category (children or employees) in respect of which the percentage test was not met, are scholarships or fellowship grants subject to the provisions of section 117(a) of the Code will be determined on the basis of all the facts and circumstances. In making this determination, the Service will consider as a substitute for the percentage test of section 4.08 all the relevant facts and circumstances to determine whether the primary purpose of the program is to provide extra compensation or other employment incentive, or whether the primary purpose is to educate recipients in their individual capacities. These facts and circumstances will be considered in the context of the probability that a grant will be available to any eligible applicant.

Such relevant facts and circumstances could include the history of the program (such as the source of the program's funding), the courses of study for which the grants are available, any eligibility requirements imposed by the program (other than employment of the applicants or their parents and the age and grade level prerequisites for the studies for which the grants are available), the publicity given the grant program, the degree of independence of the selection committee, the particular standards used for selection, the specific means used to determine whether those standards have been met, the precise nature of the employee limitation or preference, the number of grants available, the number of employees or their children who would be eligible for them, the percentage of eligible employees or their children applying for grants who normally (e.g. on an average basis), receive grants under the program, and whether and how many grants are awarded to individuals who do not qualify as employees or children of employees.

### .01 Inducement

The programs must not be used by the employer, the private foundation, or the organizer thereof, to recruit employees or to induce employees to continue their employment or otherwise follow a course of action sought by the employer.

### .02 Selection committee

Selection of grant recipients must be made by a committee consisting wholly of individuals totally independent (except for participation on this committee) and separate from the private foundation, its organizer, and the employer concerned. An individual who is a former employee of either the foundation or the employer concerned will not be considered totally independent. Such committees preferably should consist of individuals knowledgeable in the education field so that they have the background and knowledge to properly evaluate the potential of the applicants. The forwarding of the selections by the independent selection committee to the employer or private foundation for the sole purpose of verifying the eligibility requirements and selection criteria followed by the committee in considering the candidates and in making its selection will not disqualify the program. Any public announcement of the awards, however, must be made by the selection committee or by the foundation. Grants must be awarded solely in the order recommended by the selection committee. The number of grants to be awarded may be reduced but may not be increased from the number recommended by the selection committee. Only the committee may vary the amounts of the grants awarded.

### .03 Eligibility requirements

The program must impose identifiable minimum requirements for grant eligibility. Such requirements must be related to the purpose of the program and in the case of scholarships must limit the independent selection committee's consideration to those employees, or children of employees, who meet the minimum standards for admission to an educational institution (as defined in section 151(e)(4) of the Code) for which the grants are available. No persons will be considered eligible if they would not reasonably be expected to attend such an institution, however, even if they meet such minimum standards. If an employee must have been employed for some minimum period by the employer to which the program relates to be eligible to

receive a grant, or to make that employee's children eligible to receive a grant, the minimum period of employment may not exceed three years. Moreover, eligibility must not be related to any other employment-related factors, such as the employee's position, services, or duties.

#### .04 Objective basis of selection

Selection of grant recipients must be based solely upon substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business. Such standards as, but not limited to, prior academic performance, performance on tests designed to measure ability and aptitude for higher education, recommendations from instructors or other individuals not related to the potential awardees, financial need, and conclusions drawn from personal interviews as to motivation and character, may be utilized.

#### .05 Employment

A grant may not be terminated because the recipient or the recipient's parent terminates employment with the employer subsequent to the awarding of the grant regardless of the reason for such termination of employment. If a grant is awarded for one academic year and the recipient must reapply for a grant to continue studies for a subsequent year, the recipient may not be considered ineligible for a further grant simply because that individual or the individual's parent is no longer employed by the employer. If a grant is awarded for a period of more than one academic year, subject to renewal, the standards for renewal must be based solely upon nonemployment related factors such as need and maintenance of scholastic standards. Renewal may not be denied because the recipient or parent has previously terminated employment with the employer. In such case, the recipient or parent met the employment requirement at the time the grant was first awarded, and no further employment requirement can be effected at the time of each renewal.

At the time the grant is awarded or renewed, there must be no requirement, condition or suggestion, express or implied, that the recipient or parent is expected to render future employment services for the foundation or the employer, or be available for such future employment, even though such future employment is at the discretion of the foundation or the employer.

#### .06 Course of study



The courses of study for which grants are available must not be limited to those that would be of particular benefit to the employer or to the foundation. If the courses of study for which grants are available include one or more that would be of such particular benefit, a grant may not be conditioned on the recipient choosing such a course of study; the recipient must have a free choice to use the grant in the pursuit of a course of study for which the grant is otherwise available that is not of particular benefit to the employer or to the foundation.

#### .07 Other objectives

The terms of the grant and the courses of study for which grants are available must meet all other requirements of section 117 of the Code and the regulations thereunder, and must be consistent with a disinterested purpose of enabling the recipients to obtain an education in their individual capacities solely for their personal benefit and must not include any commitments, understandings or obligations, conditional or unconditional, suggesting that the studies are undertaken by the recipients for the benefit of the employer or the foundation or have as their objective the accomplishment of any purpose of the employer or the foundation (even though consistent with its exempt status) other than enabling the recipients to obtain an education in their individual capacities and solely for their personal benefit.

#### .08 Percentage test

In the case of a program that awards grants to children of employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to such children does not exceed 25 percent of the number of employees' children who, (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of grants in that year, or 10 percent of the number of employees' children who can be shown to be eligible for grants (whether or not they submitted an application) in that year. In the case of a program that awards grants to employees of a particular employer, the program meets the percentage test if the number of grants awarded under that program in any year to such employees does not exceed 10 percent of the number of employees who, (i) were eligible, (ii) were applicants for such grants, and (iii) were considered by the selection committee in selecting the recipients of grants in that year. For the purpose of meeting these percentage tests, an

employee or child of an employee will be considered eligible only if the individual meets all of the eligibility requirements imposed by the program and such requirements satisfy the conditions of section 4.03 of this Revenue Procedure. Renewals of grants awarded in prior years will not be considered in determining the number of grants awarded in a current year. Grants awarded to children of employees and those awarded to employees will be considered as having been awarded under separate programs for purposes of all of the requirements of this Revenue Procedure whether or not they are awarded under separately administered programs.

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Briefly, these rules are intended to insure that the grant-making program does not exist for the purpose of providing extra compensation, an employment incentive, or an employee fringe benefit. This is done by separating the operation of the program from the company involved, and by providing percentage limitations on the number of grants that can be awarded. The percentage limitations are presented in Sec. 4.08 of the Rev. Proc.

Of particular interest is the alternative allowing grants to ten percent of the number of eligible children of employees, whether or not they submit an application. To use this alternative, a foundation must develop a methodology to determine the number of eligible children. This could be accomplished, for example, by an annual survey to all employees of the company. On the other hand, the ten percent test cannot be satisfied by the use of a statistical approach to merely infer that the test is met by comparing the number of grants to the total number of employees.

The question has arisen whether an employer-related educational grant program created pursuant to a collective bargaining agreement can qualify under Rev. Proc. 76-47 and IRC 117. It appears that the existence of a collective bargaining agreement would conclusively establish the lack of disinterested motivation that is a prerequisite to qualification under IRC 117. See Bingler v. Johnson, 394 U.S. 741 (1969). Secondly, it must be questioned whether an organization created pursuant to a collective bargaining agreement could qualify for exemption under IRC 501(c)(3). The organization could be viewed as operating to serve the private interests of the creating employer or employers.

Related to this issue is the question of whether any employer-related grant program that cannot meet the requirements of Rev. Proc. 76-47, and thus cannot

qualify under IRC 4945(g)(1), could fall under IRC 4945(g)(3). It appears that at least where the program is initially funded by the employer, the payment of compensatory educational grants to its employees would not be consistent with exempt status under IRC 501(c)(3). Thus, such a program could not be approved under any provision of IRC 4945(g).

A different result could be reached if the compensatory grants were consistent with charitable purposes. This could occur where the recipients of the grants were employees of a charitable organization, and the grants were used to educate the employees in areas useful in their jobs. For example, a grant program for employees of a public library for studies in library administration could qualify under IRC 4945(g)(3), even though it failed under Rev. Proc. 76-47.

Rev. Proc. 76-47 is illustrated in Rev. Rul. 79-131, 1979-1 C.B. 368, and Rev. Rul. 79-365, 1979-45 I.R.B. 15. Rev. Rul. 79-131 considers a private foundation that was created and funded by a for-profit company that grants scholarships, based on objective standards, for the education of children of a particular community, regardless of whether the parents are employed by the company. The scholarship program is not an "employer-related" grant program subject to the guidelines of Rev. Proc. 76-47. Rev. Rul. 79-365 holds that a private foundation's scholarship program for children of deceased or retired employees is an "employer-related" grant program subject to the guidelines of Rev. Proc. 76-47.

Prior to the issuance of Rev. Proc. 76-47, a number of employer-related grant programs were approved under IRC 4945(g)(1) that did not conform to the guidelines of Rev. Proc. 76-47. Rev. Proc. 77-32, 1977-2 C.B. 541, provides that foundations could rely on such rulings only until March 31, 1978. Thus, any organization operating a program not complying with Rev. Proc. 76-47 should have requested a new ruling under IRC 4945(g)(1) prior to that date. If this has not been done, any grants awarded after March 31, 1978, could constitute taxable expenditures under IRC 4945(d)(3).

#### b. Prizes and Awards - IRC 4945(g)(2)

The second category of grants acceptable under IRC 4945(d)(3) are prizes or awards that are subject to the provisions of IRC 74(b). The recipient of such prize or award must be selected from the general public. IRC 74(a) provides that, except as provided in IRC 74(b) and IRC 117, gross income includes amounts received as prizes and awards. IRC 74(b) provides that gross income does not include amounts received as prizes and awards made primarily in recognition of religious,

charitable, scientific, educational, artistic, literary, or civic achievement, but only if the recipient was selected without any action on his part to enter the contest or proceeding, and the recipient is not required to render substantial future services as a condition to receiving the prize or award. This provision is illustrated in Rev. Rul. 77-380, Example 2, which is excerpted above.

c. IRC 4945(g)(3)

The third, and final, category of grants acceptable under IRC 4945(d)(3) are grants to achieve a specific objective, produce a report or similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee. For example, Rev. Rul. 77-434, 1977-2 C.B. 420, holds that long-term, low-interest educational loans are individual grants subject to IRC 4945(g)(3). Also, Rev. Rul. 77-44, 1977-1 C.B. 355, holds that grants to students who acknowledge that they plan to teach in a particular state after graduation are grants under IRC 4945(g)(3).

The Service is currently considering publication of a Revenue Procedure to provide guidelines for employer-related loan programs similar to the guidelines contained in Rev. Proc. 76-47, relating to employer-related educational grant programs.

While dealing with educational loans, Rev. Rul. 77-331, 1977-2 C.B. 388, raises an important issue with respect to all grants under IRC 4945(g). Rev. Rul. 77-331 holds that the guarantee of loans made to disqualified persons under a student loan guarantee program established by a private foundation constitutes an act of self-dealing under IRC 4941. Similarly scholarships or fellowship grants, as well as prizes or awards, made to disqualified persons could constitute acts of self-dealing under IRC 4941. See Reg. 53.4945-4(a)(1). See also Rev. Rul. 77-161, 1977-1 C.B. 358, which holds that a loan to a disqualified person may not constitute a taxable expenditure under IRC 4945(d)(5).

Additionally, grants made under IRC 4945(g)(3) will generally constitute taxable income to the recipient unless excludable under IRC 117, subject to the limitations of IRC 117(b)(2). This issue is illustrated in Rev. Rul. 72-168, 1972-1 C.B. 37, and Rev. Rul. 74-86, 1974-1 C.B. 36.

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## **Section 117.--Scholarships and Fellowship Grants**

*26 CFR 1.117-1: Exclusion of amounts received as a scholarship or fellowship grant.*

*(Also Sections 61, 102; 1.61-2, 1.102-1.)*

Grants-in-aid by an exempt foundation to selected creative writers to pursue their artistic talents are not gifts excludable under section 102 of the Code but are excludable fellowship grants under section 117.

### **Rev. Rul. 72-168**

Advice has been requested whether, under the circumstances described below, grants-in-aid by a foundation to creative writers are excludable from gross income as gifts under section 102 of the Internal Revenue Code of 1954, or as scholarships or fellowship grants under section 117 of the Code.

The foundation, which is exempt from Federal income tax under section 501(a) of the Code as an organization described in section 501(c)(3), initiated a program to foster the cultural development of our society by providing assistance in the form of grants-in-aid to selected creative writers including novelists, poets, and playwrights.

Under the program nominators from all over the country are asked to name possible candidates for the grants-in-aid. The nominators are scholars, editors and writers known for their broad cultural interests and critical acuity. A central advisory committee composed of eminent men of letters, after reading the published works and manuscripts of the writers nominated and after intensive discussions within the committee, reduces the field of potential candidates and invites applications from a small percentage of those nominated. The writers finally selected for the grants are not candidates for degrees and range from well established novelists, poets, and playwrights of the highest reputation to young and talented people who are all but unknown.

The purpose of the grants is to give assistance, both financial aid and psychological support, at a time it can make a significant impact on the writer's career, thus enabling the recipients to pursue their artistic talents in contributing to the

cultural development of society and to prevent such talents from becoming atrophied as a result of the artists having to devote their energies to earning a living in other pursuits.

The following features are characteristic of all grants-in-aid to individuals selected under the program:

1. The sole purpose of the grants is to enable an individual of demonstrated capacity to produce creative work in the arts and to devote himself to such work exclusively and uninterruptedly, without concern for making a living.

2. The foundation exercises no control over the grantee's choice of subject matter, and no direction or supervision over his work, and requires no report from the grantee other than a brief informal accounting statement showing how the funds have been spent.

3. All rights of ownership in writings, or other work produced by the grantee during the period of the grant belong to the grantee exclusively.

4. The grants are not compensation for any past, current or future employment services of the grantee.

Section 61 of the Code provides that, unless otherwise excluded by law, gross income means all income from whatever source derived, including but not limited to compensation for services.

Section 102(a) of the Code provides that gross income does not include the value of property acquired by gift, bequest, devise or inheritance. Section 1.102-1(a) of the Income Tax Regulations provides, in part, that section 102 of the Code does not apply to scholarships and fellowship grants.

Subject to certain qualifications and limitations, section 117(a) of the Code provides that gross income of an individual does not include any amount received as a scholarship at an educational institution or as a fellowship grant.

Whether an amount received by an individual is excludable from his gross income under section 117 of the Code depends upon the facts and circumstances under which the payment is made. The exclusion provision applies only to scholarship or fellowship grants. A scholarship or fellowship grant is an amount paid or allowed to an individual for the primary purpose of furthering the education and training of the recipient in his individual capacity.

Section 117(b)(2) of the Code and 1.117-2 of the regulations limit the exclusion provided for by section 117(a), in the case of an individual who is not a candidate for a degree, to \$300 per month for the number of months during which amounts are received under the grant, limited to a lifetime exclusion of 36 months, whether or not consecutive.

Section 1.117-1(a) of the regulations provides, in part, that the exclusion from gross income of an amount which is a scholarship or fellowship grant is controlled solely by section 117 of the Code and that to the extent a scholarship or fellowship grant exceeds the limitations of section 117(b) of the Code, it is includable in the gross income of the recipient, notwithstanding the provisions of section 102 of the Code relating to the exclusion from gross income of gifts.

Section 1.117-4(c) of the regulations provides, in part, that any amount or amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research shall not be considered to be an amount received as a scholarship or fellowship grant if such amount represents compensation for past, present, or future employment services, if such amount represents payment for services which are subject to the direction or supervision of the grantor, or if such studies or research are primarily for the benefit of the grantor. Any of these conditions will negate the existence of a scholarship or fellowship grant as defined in these regulations.

In the case of *George Winchester Stone, Jr., et ux. v. Commissioner*, 23 T.C. 254 (1954) acquiescence, C.B. 1957-1, 5, the taxpayer, a teacher, was awarded a grant in 1950 by the John Simon Guggenheim Memorial Foundation which enabled him to devote full time for a year to a project involving a study of Eighteenth Century Dramatic Performances in London. The taxpayer planned to publish the results of his findings in eight volumes. The Tax Court of the United States held the \$1,000 grant was a gift and therefore excludable from gross income under section 22(b)(3) of the 1939 Code (section 102 of the 1954 Code).

Revenue Ruling 57-286, C.B. 1957-1, 497, discussed the Stone case and considered its effect on section 117 of the 1954 Code, stating that while the 1939 Code contained no provisions concerning the taxable status of scholarships and fellowship grants, section 22(b)(3) of the 1939 Code excluded from gross income amounts received as gifts. However, Revenue Ruling 57-286 concluded by stating that "Fellowship grants made for taxable years governed by the Internal Revenue Code of 1954 will be

controlled by section 117 thereof which provides rules for determining the extent to which amounts received as scholarships or fellowship grants are to be excluded from the recipients' gross income."

Revenue Ruling 57-50, C.B. 1957-1, 74, relates to a grant under the 1952 Rockefeller Public Service Award Program made to Princeton University and administered by the University for the academic year beginning in September 1953 and ending in May 1954. The Revenue Ruling held that the portion of the fellowship grant received in 1953, was a gift excludable from the gross income of the recipient under the provisions of section 22(b)(3) of the 1939 Code, but that the portion received in 1954 was subject to the provisions of section 117(b)(2) of the 1954 Code and was excludable from gross income to the extent provided by that section.

Revenue Ruling 57-50 was distinguished in Revenue Ruling 61-92, C.B. 1961-1, 11, after a new Rockefeller Public Service Award Program was instituted placing a different emphasis on the award, thus meeting the requirements of section 74(b) of the 1954 Code. However, Revenue Ruling 57-50 and the principles upon which it was based were not otherwise affected.

Revenue Ruling 61-66, C.B. 1961-1, 19, holds that where an individual transfers an amount of money to a university to be disbursed by it to a teacher, not a candidate for a degree, specifically designated by the donor to enable the teacher to engage in independent research, such amount is not excludable from the gross income of the recipient as a fellowship grant under section 117 of the Code. However, such amount is, under certain conditions, excludable from the gross income of the recipient as a gift under section 102 of the Code.

In Revenue Ruling 61-66 the grant did not qualify for exclusion under section 117 of the Code since the grantor was not a qualified grantor under section 117(b)(2)(A) of the Code. Since the grant did not qualify for exclusion under section 117 of the Code, there was no impediment to the application of section 102 of the Code. In the instant case, the situation is distinguishable from that in Revenue Ruling 61-66, since the grantor is an organization described in section 501(c)(3) of the Code which is exempt from tax under section 501(a) of the Code, and is therefore a qualified grantor under section 117(b)(2)(A)(i) of the Code, and the awarding of grants is a reason for its existence.



The principles stated in Revenue Ruling 57-286 and Revenue Ruling 57-50 are equally applicable to the grants-in-aid in the instant case since the grants have definite scholarship or fellowship characteristics and therefore properly fall within section 117 of the Code and not section 102 of the Code.

Accordingly, the grants-in-aid made by the Foundation are not gifts excludable under section 102 of the Code. However, they are excludable from gross income as fellowship grants under section 117(a) of the Code, subject to the limitations contained in section 117(b)(2) of the Code.

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### **Section 117.--Scholarships and Fellowship Grants**

*26 CFR 1.117-1: Exclusion of amounts received as a scholarship or fellowship grant.*

**Research grant; recipient not degree candidate.** A research grant received by a recipient, not a candidate for a degree, from an exempt organization unrelated to his employer to enable him to travel, study, and consult with people in foreign countries concerning his chosen field of work was not compensation for employment services, did not benefit his employer or the grantor organization, and is excludable from the recipient's gross income under section 117(a)(1) of the Code.

### **Rev. Rul. 74-86**

Advice has been requested whether a grant received by a taxpayer is excludable from his gross income under section 117(a) of the Internal Revenue Code of 1954, under the circumstances described below.

The taxpayer, who was not a candidate for a degree, was awarded a grant by an organization described in section 501(c)(3) of the Code, that is exempt from tax under section 501(a). His selection, by a committee appointed by the organization, was based on professional ability and leadership potential rather than on educational qualifications. The purpose of the grant was to enable the recipient to travel, study, and consult with people in foreign countries, thereby providing him with an opportunity to broaden his experience by exposure to techniques and problems in his chosen field and allowing him to make inquiries along whatever lines he believed to be most useful to him and to his work.

The grant is for three to six months of interviews, professional consultation, and field trips in foreign countries. It is intended to pay the cost of travel to, from, and in the host countries, plus a reasonable allowance for living expenses, but is not restricted to such purposes. As a condition to receiving the grant, the taxpayer was obligated to submit a report of his experience to the grantor within one month after his return to the United States. The taxpayer's proposed study had direct application to his work and responsibilities as an executive with a state youth authority. However, the taxpayer's employer and the grantor organization were unrelated and the employer had no right to select the grant recipient or to control his itinerary once he was selected. Furthermore, the purpose of the grant was not to benefit the taxpayer's employer. In addition, no money was furnished to the grantor organization by the employer in connection with the grant.

Upon receiving the grant, the taxpayer spent three months in foreign countries studying current mental health and correctional issues related to organizational and social change, the effectiveness of recent rehabilitation programs, and new ways of coping with crime and delinquency.

Section 117(a)(1) of the Code excludes from gross income any amount received as a scholarship at an educational institution or as a fellowship grant, including the value of contributed services and accommodations. Section 117(a)(2) excludes any amount received to cover expenses for travel, research, clerical help, or equipment, that are incident to such a scholarship or a fellowship grant, but only to the extent that the amount is so expended by the recipient. Section 1.117-1(b) of the Income Tax Regulations provides, in part, that to be excludable from the recipient's gross income under section 117(a)(2) amounts received to cover such specified expenses incidental to a scholarship or fellowship grant must be specifically designated to cover such expenses and so expended.

Section 117(b)(2) of the Code provides, in part, that the amount of a scholarship or fellowship grant that may be excluded from the gross income of an individual who is not a candidate for a degree is limited to \$300 a month for a period (whether or not consecutive) not to exceed 36 months. This section further requires, in the case of a recipient who is not a candidate for a degree, that the grantor qualify under one of four designated classifications, including an organization described in section 501(c)(3) which is exempt from tax under section 501(a).

Whether an amount received by an individual is excludable from his gross income under section 117 of the Code depends upon the facts and circumstances under which the payment is made. The exclusion provision applies only to scholarship or fellowship grants. Section 1.117-3(a) and (c) of the regulations provides, in part, that a scholarship or fellowship grant is an amount paid or allowed to or on behalf of, an individual to aid him in pursuing studies or research.

Section 1.117-4(c) of the regulations provides, however, that any amount paid or allowed to or on behalf of an individual shall not be considered to be a scholarship or fellowship grant if the amount represents compensation for past, present, or future employment services, payment for services that are subject to the direction or supervision of the grantor, or payments to enable the recipient to pursue research or studies primarily for the benefit of the grantor.

The facts of the instant case indicate that the purpose of the grant to the taxpayer was to aid him in the pursuit of his studies or research, and was not paid to him as compensation for services or payment for services subject to the direction and supervision of the grantor, or payments to enable him to pursue studies or research primarily for the benefit of the grantor. Although the grantor required the taxpayer to submit a report at the end of his participation, the report was not a means of making the results of the taxpayer's research available to the grantor, but was a means of assisting the administration of the grant program. See Rev. Rul. 61-65, 1961-1 C.B. 17.

Accordingly, it is held that the amount received by the taxpayer is excludable from his gross income as a fellowship grant under section 117(a)(1) of the Code, subject to the limitations contained in section 117(b)(2).

While the grantor intended that the grant would offset the taxpayer's expenses of travel, including meals and lodging while traveling, neither the taxpayer's application nor the grant award specifically designated that any or all of the amount awarded was to be used for the purposes specified in section 117(a)(2) of the Code. Accordingly, none of the amount awarded is excludable under section 117(a)(2).

Compare Rev. Rul. 71-344, 1971-2 C.B. 94, which holds, under the facts in that case, that a supply allowance award was

specifically designated to cover the taxpayer's expenses of travel, research, and equipment incidental to his fellowship.

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## 6. Imposition of Tax and Correction

As discussed above, the first-level tax of IRC 4945(a) will be imposed when a private foundation makes a grant described in IRC 4945(d)(3), unless the foundation has received advance approval under IRC 4945(g). The first level tax should be imposed even where the sole defect in the foundation's grant program is a failure to request advance approval. See Reg. 53.4945-1(a) for general rules on the first level tax.

Following the imposition of the first-level tax, correction should be sought. Reg. 53.4945-1(d)(1) provides that, in general, correction of a taxable expenditure shall be accomplished by recovering part or all of the expenditure to the extent recovery is possible and, where full recovery cannot be accomplished, by any additional corrective action which the Commissioner may prescribe. Special rules for IRC 4945(d)(3) cases are given in Reg. 53.4945-1(d)(3). These provide that correction can be accomplished, where there was solely a failure to obtain advance approval, by (1) obtaining approval of present procedures and (2) establishing that no grant funds have been diverted from their intended use, that the procedures would have been approved if advance approval had been properly requested, and that advance approval will be requested in the future whenever it is required. Specific procedures for agreed and unagreed cases are found in IRM 7(10)62.6 and 7(10)62.7.

Delegation Order No. 139 (Rev. 5), 1979-46 I.R.B. 23, delegates to the District Directors and the Regional Directors of Appeals the authority to extend the correction period under IRC 4945.

In some circumstances, a taxpayer can receive advance approval of the proposed correction. See IRM 7(10)62.8.

## 7. Conclusion

The above article has considered the various requirements of IRC 4945(d)(3) and 4945(g). While much of the responsibility for these sections lies in the National Office, which must give advance approval under IRC 4945(g), it is

important to keep these provisions in mind while considering a Form 1023 Application, and during an audit.

As discussed above, when an application reveals that the organization appears to be a private foundation, and has a grant-making program requiring approval under IRC 4945(g), IRM 7666.3 requires that the application be forwarded to the National Office.

During an audit, it should be determined whether the organization has made any grants to individuals subject to IRC 4945(d)(3) and, if so, whether the organization has received advance approval of its procedures. Where an organization has received advance approval, it should be determined whether the organization has actually followed the approved procedures in all material aspects. Particular scrutiny should be given to the percentage tests of Rev. Proc. 76-47 to verify that the organization has not exceeded the percentage limitations. Finally, the taxability of any grant to the recipient should be considered. Where the grant may constitute taxable income, appropriate action should be taken to insure that the income was properly reported.