

## Internal Revenue Service

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Washington, DC 20224

Person to Contact:

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Refer Reply To:

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Date:

December 23, 2003

Dear \*\*\*:

This letter is in response to your request dated October 29, 2002, for a general information letter pursuant to Rev. Proc 2002-4, sec. 1.06. This letter is issued pursuant to that section. Under this procedure, this letter "is advisory only and has no binding effect on the Service."

You state that many \* \* \* community foundations are struggling with the following issue:

Community foundations are public charities established to help donors create a permanent legacy with their communities. Donors are encouraged to establish endowment funds within their community foundation for many different charitable purposes. Sometimes, donors establish donor-advised scholarship funds within their local community foundation. Recipients are chosen by selection committees that cannot award a grant or scholarship to any close relative of a donor or a member of the selection committee.

In addition, the foundation itself awards some scholarships. For this purpose, the foundation establishes a selection committee. No member of the selection committee, or any close relative of a member, may receive a scholarship from the foundation fund.

Each community foundation ensures that the donors establish objective criteria with a sufficiently broad class of eligible recipients for the scholarships. Each community foundation also ensures that no member of any selection committee has a conflict of interest with the applicants by having them sign a conflict of interest statement to that effect. Each selection committee must submit in writing to the board of directors of the community foundation the names of its scholarship recipients.

The board of directors of the foundation cannot add names to the list of scholarship recipients. The function of the board is to ensure that each selection committee has followed applicable conflict of interest and other legal requirements in making its selections. Only if the board of directors determines that such requirements have not been met will the board disapprove one or more recipients. In making such decisions, any board member who has a conflict of interest—e.g., if a family member of a director of the foundation would be affected by the decision—would not participate in the board deliberations or decision.

If a family member of a director of the community foundation is selected as a scholarship recipient by a donor advised scholarship selection committee, may the board of directors approve this scholarship without the transaction constituting an excess benefit? Our response is as follows:

Section 4958 of the Internal Revenue Code provides for sanctions on disqualified persons who receive excess benefits from a public charity exempt under Section 501(c)(3). A member of a board of directors is automatically a disqualified person under Section 53.4958-3(c)(1) of the Regulations. The children and grandchildren, and certain other relatives, of such board members are also automatically disqualified persons. Section 53.4958-3(b)(1) of the Regulations. Certain economic benefits are excluded from excess benefits under Section 53-4958-4(a)(4) of the Regulations. Specifically, Section 53.4958-4(a)(4)(v) excludes economic benefits provided to a person solely because the person is a member of a charitable class that the applicable tax-exempt organization intends to benefit as part of the accomplishment of the organization's exempt purpose.

Section 4945 of the Code provides that certain scholarship programs must satisfy certain requirements in order to satisfy certain private foundation statutes and regulations. In general, these requirements are spelled out in Section 53.4945-4 of the Regulations. While these requirements are not directly applicable to public charities, if the standards set forth therein for objectivity and educational character are followed, the scholarships will constitute a part of the accomplishment of the exempt purposes of a public charity.

Rev. Rul. 56-403, 1956-2 C.B. 307 held that a foundation that was a public charity under Section 501(c)(3) conducted an exempt educational activity when it provided scholarships to members of a national fraternity, where the scholarships were based on scholarship, character and service to the institution, and "the recipients . . . [were] not related by blood or marriage to any of the officers of the trust, trustees or contributors."

Section 53.4958-6 of the Regulations provides requirements for obtaining a rebuttable presumption that compensation-type benefits provided to officers, directors, trustees and other disqualified persons of a public charity are not excess benefits under Section 4958. Sections 53.4958-6(a)(2) and (c)(2) provide that the organization must obtain appropriate data as to comparability of the individual's compensation package from one or more outside sources. Section 53.4958-6(a)(1) provides that the organization's board of directors or other authorized body must approve the compensation arrangement. Section 53-4958-6(c)(1)(i) provides that a member of a board of directors will not be treated as such when the board is reviewing the member's compensation package if that member "recuses himself or herself from the meeting and is not present during debate and voting on the compensation arrangement. . . ."

The scholarship plan of the community foundations is somewhat similar to the compensation setting and approval plan set forth in the above intermediate sanction regulations. Indeed, the scholarship plan provides more barriers to a prohibited conflict

of interest. Since no relatives of selection committee members may receive scholarships, and the foundation's board of directors may only veto a selection on grounds of illegality or failure to follow proper procedures. Even on such veto matters, members of the board of directors who would be benefited by the veto decision must recuse themselves in the same manner as members of boards of directors benefited by compensation decisions under Section 53.4958-6(c)(1)(i) of the Regulations..

Accordingly, we conclude that if a family member of a director of the community foundation is selected as a scholarship recipient by a donor-advised selection committee, the board of directors may approve this scholarship without the transaction constituting an excess benefit, so long as the board member whose family member is benefited by the scholarship recuses himself or herself in the manner set forth in Section 53-4958-6(c)(1)(i) of the Regulations..

Very truly yours,

Marvin Friedlander  
EO Technical Group 1