“Miss Elizabeth” D. Leckie Scholarship Fund v. Commissioner, 87 T. C. 251 (1986)

Scholarship grants can qualify as distributions directly for the active conduct of a private foundation’s exempt activities if the foundation maintains significant involvement in the programs supported by the grants.

Summary

The “Miss Elizabeth” D. Leckie Scholarship Fund sought to be classified as a private operating foundation, which would exempt it from certain excise taxes. The IRS denied this status, arguing that the fund’s scholarships did not constitute qualifying distributions directly for the active conduct of its exempt activities. The Tax Court held that the scholarships were indeed qualifying distributions because the fund maintained significant involvement in its program to alleviate poverty in Butler County, Alabama, by supporting education and encouraging students to return to the area. The court also found that the fund met the endowment test, thereby qualifying as a private operating foundation.

Facts

The “Miss Elizabeth” D. Leckie Scholarship Fund was established to improve the standard of living in Butler County, Alabama, one of the state’s poorest counties. The fund’s primary objective was to provide scholarships to local high school students, encouraging them to return to Butler County after completing their education. The fund was initially endowed with investments worth $135,986. 11, expecting to earn $6,600 annually in interest, with $6,000 allocated for scholarships and $600 for administrative expenses. The fund’s activities included selecting scholarship recipients, assisting them in finding summer employment in Butler County, and promoting the county as a desirable place to live and work. The IRS denied the fund’s application for private operating foundation status, leading to the fund’s petition to the Tax Court for a declaratory judgment.

Procedural History

The IRS issued a determination letter on September 9, 1983, classifying the fund as a private foundation exempt under section 501(c)(3) but not as a private operating foundation under section 4942(j)(3). Following a final adverse ruling on November 29, 1983, the fund exhausted its administrative remedies and filed a petition with the U. S. Tax Court on February 29, 1984, seeking a declaratory judgment regarding its status as a private operating foundation.

Issue(s)

1. Whether the scholarship grants made by the “Miss Elizabeth” D. Leckie Scholarship Fund constitute qualifying distributions directly for the active conduct of the fund’s exempt activities under section 4942(j)(3)(A).

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2. Whether the fund meets the endowment test under section 4942(j)(3)(B)(ii) to qualify as a private operating foundation.

Holding

1. Yes, because the fund maintains significant involvement in its program to alleviate poverty in Butler County by supporting education and encouraging students to return to the area.

2. Yes, because the fund's qualifying distributions exceed two-thirds of its minimum investment return, satisfying the endowment test.

Court's Reasoning

The court applied section 4942(j)(3) and the related regulations, focusing on the requirement that qualifying distributions be made directly for the active conduct of the fund's exempt activities. The court emphasized the qualitative nature of the test for determining whether the fund maintained significant involvement in its exempt activities. It found that the fund's efforts to select recipients based on need, assist them with summer employment, and promote Butler County as a place to return to after education constituted significant involvement. The court rejected the IRS's argument that the fund merely screened and selected applicants, finding instead that the fund's activities went beyond mere selection to direct involvement in the program's success. Additionally, the court interpreted the endowment test to apply broadly, not limited to specific types of organizations, and determined that the fund's annual scholarship expenditures exceeded the required threshold of two-thirds of its minimum investment return.

Practical Implications

This decision clarifies that scholarship grants can be considered qualifying distributions for private operating foundation status if the foundation actively engages in the programs supported by the grants. Legal practitioners should advise clients that maintaining significant involvement in the funded activities is crucial for meeting the requirements of section 4942(j)(3). The ruling expands the potential applicability of the endowment test, suggesting that foundations with various operational models may utilize this test to achieve operating foundation status. This case may influence how other scholarship funds and similar organizations structure their activities to qualify for favorable tax treatment. Subsequent cases might reference this decision when determining the scope of "significant involvement" and the application of the endowment test.

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