



# Creating a Scholarship Program: Legally Structuring a Lasting Educational Impact

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## Presenter bio

*Ciarra A. Chavarria is the Senior Staff Attorney responsible for Lawyers Alliance's Quality Education program area, which focuses on providing business and transactional legal services to nonprofits that support, deliver, and improve education and increase access to educational opportunities for low-income New Yorkers. Prior to joining Lawyers Alliance in 2017, Ciarra was a senior associate at Covington & Burling LLP. She is also a former Lawyers Alliance extern. Ciarra received a J.D. from the University of Chicago Law School and a B.A. in English Literature from Austin College.*



## Disclaimer


**Please note:** Today's presentation is informational only and is not intended to constitute legal advice. Please consult with appropriate counsel for guidance pertinent to your organization or situation.



# Overview

- Legal structure
- Obtaining tax exempt status for a scholarship program
- Selecting a recipient
- Documenting, monitoring and reporting the scholarship
- Taxability of scholarship grants



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# Legal Structuring

- Public Charity
- Private Foundation
- Donor Advised Fund
- Governing Documents



# Legal Structuring Options – Public Charities vs. Private Foundations

- **Private Foundations**

- Under IRC Section 4945, **private foundations**, which are one sub-category of Section 501(c)(3) organizations, **must obtain pre-approval** from the Internal Revenue Service (the “IRS”) of their procedures for selecting recipients of scholarship grants in order to pay scholarship grants

- **Public Charities**

- **Public charities** are **not** obligated to obtain IRS pre-approval, but public charities generally look to the federal tax rules for private foundation scholarship grants when structuring scholarship grant programs



# Legal Structuring Options – Donor Advised Funds

- **Donor Advised Funds (“DAFs”):** A DAF is a separately identified fund or account that is maintained, operated, and legally controlled by a 501(c)(3) organization, called the sponsoring organization.<sup>1</sup>

## Applicable Law<sup>2</sup>

- Donor has advisory privileges over the distribution of funds from the DAF, but the sponsoring organization must have legal control over the funds in the DAF and the right to disregard the donor’s advice
- Donor can claim a charitable deduction for income-tax, gift-tax or estate-tax purposes only if the donor obtains a written acknowledgment from sponsoring organization stating that it has exclusive legal control over the assets contributed to the DAF

### **BUT**

- IRC Section 4966 prohibits DAFs from granting scholarships to individuals unless they fall within specific exceptions

1. <https://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Donor-Advised-Funds>





# Legal Structuring Options – Donor Advised Funds

## Applicable Law<sup>2</sup>

- IRC Section 4966 outlines types of funds that are excluded from the definition of a DAF
  - The definition of a donor advised fund in the Code does not include any fund which makes grants to individuals for travel, study or other similar purposes if
    - (i) the fund is advised by a committee all the members of which are appointed by the sponsoring organization,
    - (ii) the committee is not controlled by the donor or donor advisor to the fund (or any persons related to the donor or donor advisor), and
    - (iii) all grants from the fund are awarded on an objective and non-discriminatory basis pursuant to a procedure approved in advance by the governing board of the sponsoring organization, provided that the procedure meets the requirements for private foundation grants to individuals for travel, study or other similar purposes
- Therefore, if a fund falls within this exception, scholarship grants to individuals may be paid out of the fund without violating the general prohibition in the Code on donor advised fund distributions to individuals



## Establishing Governing Documents

- The “**purposes clause**” of governing documents must permit the public charity to make scholarship grants to individuals
- Does not have to be explicit, but must be able to infer from the clause that scholarships can be awarded



# Establishing Governing Documents

“Purposes clause” **can be more narrow** than the purposes stated in IRC 501(c)(3):

- ☑ “To grant scholarships to deserving junior college students residing in Gotham City”

“Purposes clause” **must not be broader** than the scope of IRC 501(c)(3):

- ☒ “To provide scholarship assistance to individuals” could include providing assistance to pre-selected individuals
- ☑ “To provide scholarship assistance to individuals” AND “notwithstanding any other provision in this instrument, organization will not further any specified purpose other than those described in IRC Section 501(c)(3)”




# Governing Documents for Existing Public Charities

- Make sure purposes clause allows the granting of scholarships
- If an amendment is required, regulatory approvals may be needed
  - **Attorney General:** a New York not-for-profit corporation must obtain the approval of the NYS Attorney General's Office to amend
  - **Other regulatory agencies** may also require approval and/or notice




- Legal structure



- Obtaining tax exempt status for a scholarship program



- Selecting a recipient



- Documenting, monitoring and reporting the scholarship



- Taxability of scholarship grants



# Obtaining Tax Exempt Status for a Scholarship Program

- Will be required to:
  - Describe scholarship grant program in the narrative portion of Form 1023
  - Respond to specific questions about scholarship grant program in Section I of Schedule H of Form 1023 application



# Obtaining Tax Exempt Status for a Scholarship Program

## Schedule H. Organizations Providing Scholarships, Fellowships, Educational Loans, or Other Educational Grants to Individuals and Private Foundations Requesting Advance Approval of Individual Grant Procedures

### **Section I** *Names of individual recipients are not required to be listed in Schedule H.*

Public charities and private foundations complete lines 1a through 7 of this section. See the instructions to Part X if you are not sure whether you are a public charity or a private foundation.

- 1 a** Describe the types of educational grants you provide to individuals, such as scholarships, fellowships, loans, etc.
  - b** Describe the purpose and amount of your scholarships, fellowships, and other educational grants and loans that you award.
  - c** If you award educational loans, explain the terms of the loans (interest rate, length, forgiveness, etc.).
  - d** Specify how your program is publicized.
  - e** Provide copies of any solicitation or announcement materials.
  - f** Provide a sample copy of the application used.
- 2** Do you maintain case histories showing recipients of your scholarships, fellowships, educational loans, or other educational grants, including names, addresses, purposes of awards, amount of each grant, manner of selection, and relationship (if any) to officers, trustees, or donors of funds to you? If "No," refer to the instructions. ☐ Yes ☐ No
- 3** Describe the specific criteria you use to determine who is eligible for your program. (For example, eligibility selection criteria could consist of graduating high school students from a particular high school who will attend college, writers of scholarly works about American history, etc.)
- 4 a** Describe the specific criteria you use to select recipients. (For example, specific selection criteria could consist of prior academic performance, financial need, etc.)
  - b** Describe how you determine the number of grants that will be made annually.
  - c** Describe how you determine the amount of each of your grants.
  - d** Describe any requirement or condition that you impose on recipients to obtain, maintain, or qualify for renewal of a grant. (For example, specific requirements or conditions could consist of attendance at a four-year college, maintaining a certain grade point average, teaching in public school after graduation from college, etc.)
- 5** Describe your procedures for supervising the scholarships, fellowships, educational loans, or other educational grants. Describe whether you obtain reports and grade transcripts from recipients, or you pay grants directly to a school under an arrangement whereby the school will apply the grant funds only for enrolled students who are in good standing. Also, describe your procedures for taking action if the terms of the award are violated.
- 6** Who is on the selection committee for the awards made under your program, including names of current committee members, criteria for committee membership, and the method of replacing committee members?
- 7** Are relatives of members of the selection committee, or of your officers, directors, or **substantial contributors** eligible for awards made under your program? If "Yes," what measures are taken to ensure unbiased selections? ☐ Yes ☐ No

**Note:** If you are a private foundation, you are not permitted to provide educational grants to **disqualified persons**. Disqualified persons include your substantial contributors and foundation managers and certain family members of disqualified persons.



# Obtaining Tax Exempt Status for a Scholarship Program

## SECTION I of SCHEDULE H

- The types, purposes and amounts of scholarship grants awarded
- How the scholarship grants are publicized
- The eligibility and selection criteria for the scholarship grants
- The composition of the selection committee
- Procedures used to supervise use of the scholarship grants





# Obtaining Tax Exempt Status for a Scholarship Program

- “Charitable class”
  - Sufficiently large and indefinite<sup>3</sup>
  - Cannot benefit a small group of pre-selected or pre-named individuals
  - No magic number


## Examples of qualifying “charitable classes”

- ☑ Students at colleges and universities in New York City
- ☑ High school students from low-income families in California
- ☑ Female students
- ☑ High school students in a particular school or specified geographic area
- ☑ High school seniors graduating in the top 10% of their class

<sup>3</sup> <https://www.irs.gov/pub/irs-pdf/p5781.pdf>



- Legal structure



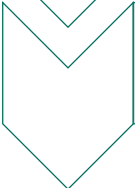
- Obtaining tax exempt status for a scholarship program



- Selecting a recipient



- Documenting, monitoring and reporting the scholarship



- Taxability of scholarship grants



# Objective and Non-Discriminatory Selection Criteria

- Recipients must be selected on an “**objective and non-discriminatory basis**”<sup>4</sup>:
  - Financial need
  - Academic performance/merit
  - Performance on standardized tests (e.g., SAT/ACT)
  - Community involvement and/or extracurricular activities
  - Recommendations from teachers and others in the community
  - Personal interviews

<sup>4</sup> See 26 U.S. Code §4945(g).



# Objective and Non-Discriminatory Selection Criteria

- A public charity **may** consider an applicant's race or national origin
- But **CANNOT** preclude groups that have traditionally faced discrimination from consideration
  - Public charities that are schools will lose federal funding if they discriminate on the basis of race
    - Race-based scholarships to remedy present effects of prior discrimination or to enhance diversity, so long as the scholarships are narrowly tailored to achieve that goal, are constitutional
    - Colleges and universities typically may grant scholarships provided by private organizations if the organizations select the recipients themselves



# Insiders and Scholarship Grants

## NO GRANTS TO INSIDERS

- ☒ Directors, trustees, officers, or senior managers, or their family members
- ☒ Members of selection committee, or their family members
- ☒ Substantial contributors (generally, major donors who are listed on Schedule B of the charity's IRS Form 990 annually), or their family members

- Scholarships for employees of public charities and their family members are permissible, but consult with counsel



## Scholarships to Employees

- **Employees and family members of employees:** Public charities *may* grant awards to its employees and their family members, so long as they are not “insiders” and the grants are limited in number, but consult with counsel
  - Public charities that do not limit the number of scholarships awarded to its employees or their family members run the risk of having the scholarship grant treated as taxable income to the employee
    - Ex: If all, or substantially all, of the applicants (who are employees or their family members) are granted the scholarship, the scholarship program can look like a standard employee benefit/perk that could be taxable to the employee
  - In such cases, though not technically required, charities will use the seven conditions and percentage tests outlined in the applicable IRS revenue procedure for private foundations as general guidance



# Due Diligence for Non-U.S. Citizen Scholarship Grant Recipients

- Check the names of scholarship grant recipients who are foreign citizens against the “Specially Designated Nationals List” (“SDN List”)
  - This is a terrorist watch list maintained by the Treasury Department’s Office of Foreign Assets Control (“OFAC”)
- The search engine for all of the OFAC sanctions lists (including the SDN List) may be found here:  
<https://sanctionssearch.ofac.treas.gov/>



## Written policies and procedures

- All criteria and procedures should be written down
- Also should have written application
  - Eligibility requirements and procedures for selecting recipient may be included
- Ensure that recipient selection complies with your own stated requirements






## Additional considerations

- Consider additional documentation or information you might need to obtain from the recipient:
  - Financial eligibility, if applicable
  - Academic records
  - Test scores
  - Release to use recipient's information/photo




- Legal structure



- Obtaining tax exempt status for a scholarship program



- Selecting a recipient



- Documenting, monitoring and reporting the scholarship



- Taxability of scholarship grants



# Documentation of Scholarship Grants

- Document the terms and conditions of the scholarship grant in a short letter agreement countersigned by the recipient **BEFORE** the funds are disbursed

## TERMS & CONDITIONS

Length of the scholarship grant (e.g., for one year only or renewable)

If the scholarship grant is renewable, the specific conditions for renewal

Specific use of the scholarship grant funds (e.g., tuition and course-related fees, books, supplies and equipment, room and board, other expenses, etc.)

How the scholarship grant funds will be paid (e.g., to the academic institution or to the recipient)

Conditions under which scholarship grant funds need to be repaid by the recipient (i.e., if diverted for a purpose inconsistent with the grant terms)

Reporting obligations (particularly if scholarship grant funds are paid to the recipient)

A statement that the scholarship grant recipient is responsible for any liabilities or obligations incurred in connection with the scholarship grant, including, but not limited to, U.S. federal, state or local income tax obligations



# Monitoring Scholarship Funds after Disbursement

If to Academic Institution	If to Scholarship Grant Recipient
<ul style="list-style-type: none"><li>• Do not need to obtain reports</li></ul>	<ul style="list-style-type: none"><li>• Require recipient to annually report on use of the scholarship grant funds</li></ul>
	<ul style="list-style-type: none"><li>• Require a report in the form of a verified copy of the recipient's transcript and a statement from the recipient that the scholarship grant funds have not been diverted for a purpose inconsistent with the grant terms</li></ul>
	<ul style="list-style-type: none"><li>• Require recipient to submit documentation (e.g., receipts, tuition invoice, etc.) substantiating the use of the scholarship grant funds</li></ul>
	<ul style="list-style-type: none"><li>• If recipient diverted any funds, the recipient must repay the diverted funds</li></ul>



# Reporting of Scholarship Grants on IRS Form 990

IRS FORM 990 REQUIREMENTS	
Domestic Individuals	Foreign Individuals
<ul style="list-style-type: none"><li>An individual who lives or resides in the United States</li></ul>	<ul style="list-style-type: none"><li>An individual, including a U.S. citizen or resident, who lives or resides outside of the United States, <b><u>at the time</u></b> a scholarship grant is paid or distributed to the individual</li></ul>
<ul style="list-style-type: none"><li>Part III of <b><u>Schedule I</u></b> of IRS Form 990</li></ul>	<ul style="list-style-type: none"><li>Part III of <b><u>Schedule F</u></b> of IRS Form 990</li></ul>
<ul style="list-style-type: none"><li>Total number and total amount of scholarship grants paid during the applicable tax year</li></ul>	<ul style="list-style-type: none"><li>Total number and total amount of scholarship grants paid during the applicable tax year <b><u>by specified geographic region (e.g., Europe, East Asia and the Pacific, South Asia)</u></b></li></ul>

# Reporting of Scholarship Grants on IRS Form 990

Schedule I (Form 990) (2019)

Page **2**

**Part III** **Grants and Other Assistance to Domestic Individuals.** Complete if the organization answered "Yes" on Form 990, Part IV, line 22.  
Part III can be duplicated if additional space is needed.

(a) Type of grant or assistance	(b) Number of recipients	(c) Amount of cash grant	(d) Amount of noncash assistance	(e) Method of valuation (book, FMV, appraisal, other)	(f) Description of noncash assistance
1					
2					
3					
4					
5					
6					
7					

Schedule F (Form 990) 2019

Page **3**

**Part III** **Grants and Other Assistance to Individuals Outside the United States.** Complete if the organization answered "Yes" on Form 990, Part IV, line 16.  
Part III can be duplicated if additional space is needed.

(a) Type of grant or assistance	(b) Region	(c) Number of recipients	(d) Amount of cash grant	(e) Manner of cash disbursement	(f) Amount of noncash assistance	(g) Description of noncash assistance	(h) Method of valuation (book, FMV, appraisal, other)
(1)							
(2)							
(3)							
(4)							
(5)							
(6)							
(7)							



## Recordkeeping Requirements

- Records should be maintained for at **least three years** after the filing of the 990 for the year in which the scholarship was given
- Must also maintain a list of scholarship grant applicants that were rejected **within the past three years**
  - Name and address of the declined individual
  - Record of the denial and
  - Reason(s) for the denial



# Recordkeeping Requirements

## RECORDS AND CASE HISTORIES

- The name and address of the scholarship grant recipient
- The amount paid to the scholarship grant recipient
- The purpose of the scholarship grant
- The criteria used to select the scholarship grant recipient
- Any application forms completed by, letter agreement(s) with and reports received from the scholarship grant recipient
- The manner in which the scholarship grant recipient was selected and the relationship, if any, between the scholarship grant recipient and
  - (a) members, officers, directors and/or trustees of the public charity,
  - (b) a grantor or substantial contributor to the public charity or their family members, **OR**
  - (c) a corporation controlled by a grantor or substantial contributor to the public charity





- Legal structure
- Obtaining tax exempt status for a scholarship program
- Selecting a recipient
- Documenting, monitoring and reporting the scholarship
- Taxability of scholarship grants



# Taxability of Scholarship Grants

- Scholarships are **not taxable** to the recipient when it is a **qualified scholarship**: used for **qualified tuition and related expenses** by an individual who is a degree candidate at a defined **educational organization**<sup>5</sup>

## “QUALIFIED TUITION AND RELATED EXPENSES”

- ☒ Tuition and fees required for the enrollment or attendance of the student
- ☒ Course-related fees, books, supplies and equipment

## NOT “QUALIFIED TUITION AND RELATED EXPENSES”

- ☒ Room and board or travel expenses
- ☒ Tuition charged by a degree-granting for-profit school (e.g., University of Phoenix and certain vocational schools)

<sup>5</sup> See Section 117 and 170(b)(A)(ii) of the Internal Revenue Code



# Taxability of Scholarship Grants

Tax Reporting and Withholding	
U.S. CITIZENS and RESIDENT ALIENS	NON-RESIDENT ALIENS
<ul style="list-style-type: none"><li>Generally no need to report payments of scholarship grants</li></ul>	<ul style="list-style-type: none"><li>Report payments of scholarship grants to non-resident aliens to the IRS that do not fall within the definition of “qualified scholarships”</li></ul>
<ul style="list-style-type: none"><li>Generally no need to withhold tax on the scholarship grants</li></ul>	<ul style="list-style-type: none"><li>Do withhold U.S. Federal income tax on such scholarship grants</li></ul>
	<ul style="list-style-type: none"><li>Need to file IRS Form 1042-S</li></ul>
	<ul style="list-style-type: none"><li>Withholding rate is generally 30%, subject to reduction to 14% if the recipient is in the United States under certain visa categories (specifically, “F”, “J”, “M” or “Q”)</li></ul>
	<ul style="list-style-type: none"><li>The public charity will be liable for any tax required to be withheld, independent of the liability of the non-resident alien receiving the scholarship grant</li></ul>
	<ul style="list-style-type: none"><li>See IRS Publication 515 for additional detail</li></ul>



## Takeaways

- Make sure granting scholarships fits your mission
- Scholarship recipients should be selected on an objective and non-discriminatory basis
- Have a written policy for everything
- Maintain good records
- Don't forget about tax rules and reporting requirements



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