

March 25, 2019

### **Legal Alert: Creating a Scholarship Program**

Nonprofits may wish to provide scholarship grants to individuals, either as their primary purpose or as a part of achieving their charitable purpose. To ensure that tax-exempt dollars are not being used to benefit private individuals, the Internal Revenue Service (IRS) has strict rules regarding how and to whom tax-exempt organizations may award scholarships. This legal alert discusses some of the steps and considerations for both establishing and administering scholarship programs that tax-exempt organizations should consider to ensure compliance with IRS requirements.

#### **Establishing the Scholarship Program**

A tax-exempt organization can be established for the purpose of offering scholarships, or an already-existing organization may decide to provide scholarships as one part of its charitable activities.

##### *Newly-forming organizations*

When drafting the governing documents of a new 501(c)(3) organization that will make scholarship grants to individuals, the “purposes clause” in the Certificate of Incorporation or equivalent document must permit the organization to make scholarship grants to individuals. While this need not be made explicit, you must be able to infer from the clause that scholarships can be awarded. Further, the purposes clause cannot be broader than the scope of what is permissible activity for tax-exempt organizations by IRC Section 501(c)(3).

Once the organization has been formed, it will need to apply for tax-exempt status from the IRS. Scholarship grant programs should be included in the narrative portion of the Form 1023 application. In addition, there are specific questions relating to scholarship programs in Section I of Schedule H, which will need to be completed. Some of the information that must be included on Schedule H include: the types, purposes, and amounts of scholarship grants awarded, how grants are publicized, eligibility and selection criteria, composition of the selection committee, and procedures used to supervise use of the grants.

##### *Already-established organizations*

For a nonprofit organization that already exists, but would like to begin granting scholarships to individuals as part of its charitable mission, the nonprofit organization should ensure that their existing purposes clause permits such activity. If an amendment is required, regulatory approvals may be required (e.g., New York nonprofits must obtain approval from the New York State Attorney General’s office to amend its purposes clause).

If an existing nonprofit organization would like to start granting scholarships, it is not required to re-submit or amend its Form 1023; however, it is required to submit information about any individual grants above \$5,000 on Schedule I of their Form 990, which effectively provides notice to the IRS that the organization is now engaging in this type of activity.

## **Administering the Scholarship Program**

### *Eligibility criteria*

The IRS sets forth several requirements for eligibility and selection criteria used by tax-exempt organizations for scholarship programs. The first step is in defining the charitable class that is to benefit from the program. While there is no specific definition, the IRS has provided some guidance as to what can constitute a “charitable class”.<sup>1</sup> A charitable class must be large enough or sufficiently indefinite that the community as a whole, rather than a pre-selected group of people, benefits when a charity provides assistance. There is no magic number of potential applicants that definitively makes a class large and indefinite enough.

### *Selecting recipients*

**Objective and non-discriminatory basis:** Within the charitable class identified, the IRS requires that the ultimate recipients of grants be selected on an “objective and non-discriminatory” basis. Some factors that are often considered are financial need, academic performance/merit, performance on standardized tests, community involvements or extracurricular activities, letters of recommendation, and personal interviews. There is no particular set of factors that must be considered—because advancing an individual’s education is a charitable purpose in and of itself, there is no legal requirement that an applicant demonstrate financial need for a scholarship to further charitable or educational purposes; therefore, scholarships granted by a public charity on the basis of academic merit alone are permissible. A public charity *may* consider an applicant’s race or national origin, but *cannot* preclude groups that have traditionally faced discrimination from consideration.<sup>2</sup>

**Grants to insiders and employees:** Public charities may not award scholarships to its directors, trustees, officers, or senior managers, or their family members<sup>3</sup>, or to members of its selection committee, or their family members. Public charities should also not award scholarships to substantial contributors (generally, major donors who are listed on Schedule B of its annual Form 990), or their family members. These individuals are collectively referred to as “insiders”. Public charities can grant awards to its employees and their family members, so long as they are not insiders and the grants are limited in number (i.e., they are not granted to all employees, which would instead be considered a taxable employee benefit).

**Non-U.S. citizen recipients:** Minor additional diligence is required for scholarship grants that will be made to foreign citizens. The organization must check the names of scholarship grant recipients who are foreign citizens against the Specially Designated Nationals List, which is a terrorist watch list

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<sup>1</sup> For further discussion, see [IRS Publication 3833](#).

<sup>2</sup> 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. However, note that public charities that are schools will lose federal funding if they discriminate on the basis of race. Colleges and universities may grant scholarships provided by private organizations if the organizations select the recipients themselves.

<sup>3</sup> Note that for these purposes, “family members” include spouses or domestic partners, siblings, children, and grandchildren, as well as spouses or domestic partners of siblings, children, and grandchildren.

maintained by the Treasury Department's Office of Foreign Assets Control (OFAC). Organizations may search all OFAC sanctions lists [online](#).

### *Documentation*

Applicants should submit appropriate documentation and information to ensure that the recipients are selected in accordance with the organization's stated selection criteria. For example, depending on the selection criteria, applicants may be required to submit financial eligibility forms or evidence, academic records, etc. Organizations should also consider including with the application a release for the ability to use grant recipients' stories, names, and/or photographs in publicity materials.

Prior to disbursement of any funds, recipients should sign a short agreement documenting the terms and conditions of the scholarship grant. Typical provisions would include the term of the grant (e.g., a one-time grant, a renewable grant, etc.), conditions for renewal (if applicable), permitted uses of the scholarship funds, how funds will be paid (e.g., directly to an academic institution or to the recipient), conditions under which funds need to be repaid by the recipient (e.g., if diverted for a purpose inconsistent with the grant terms), any reporting obligations by the recipient, and a statement that the recipient is responsible for any liabilities or obligations incurred in connection with the grant, including, but not limited to, U.S. federal, state, or local income tax obligations.

### *Monitoring, reporting, and recordkeeping*

**Monitoring:** Nonprofits making grants should pay careful attention to making sure the funds it grants are being properly used by the recipient. If scholarship money is granted directly to an individual (as opposed to the academic institution), the organization should ask the recipients for evidence that the funds have been used appropriately. If the organization believes grant funds have not been used for their intended purpose, it should investigate the use of the funds and, if any funds have been diverted and not used for their intended purpose, require the scholarship grant recipient to repay the diverted funds.

**Reporting:** Tax-exempt organizations will also need to report scholarship grants to domestic individuals in Part III of Schedule I and grants to foreign<sup>4</sup> individuals should be reported in Part III of Schedule F of its annual Form 990. In either case, the names of individual recipients need not be reported; instead the total number and total amount of scholarship grants paid during the applicable tax year should be reported.

**Recordkeeping:** The IRS generally requires that public charities maintain certain records and case histories when making scholarship grants. Specifically, nonprofits should retain the name and address of the recipient, amount paid, purpose of the grant, criteria used for selection, any application materials, letter agreements and reports received from the recipient, any potential insider relationships, and details on the selection process. Records should be maintained for at least three years after the filing of the 990 for the year in which the scholarship was given. Organizations

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<sup>4</sup> For these purposes, a "domestic individual" is an individual who lives or resides in the U.S. and a "foreign individual" is an individual, including a U.S. citizen or resident, who lives or resides outside of the United States, at the time a grant is paid or distributed to the individual.

must also maintain records of grant applicants that were rejected within the past three years, including their name and address, a record of the denial, and reason(s) for the denial.

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