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The Perils of Donor Participation in Scholarship Funds

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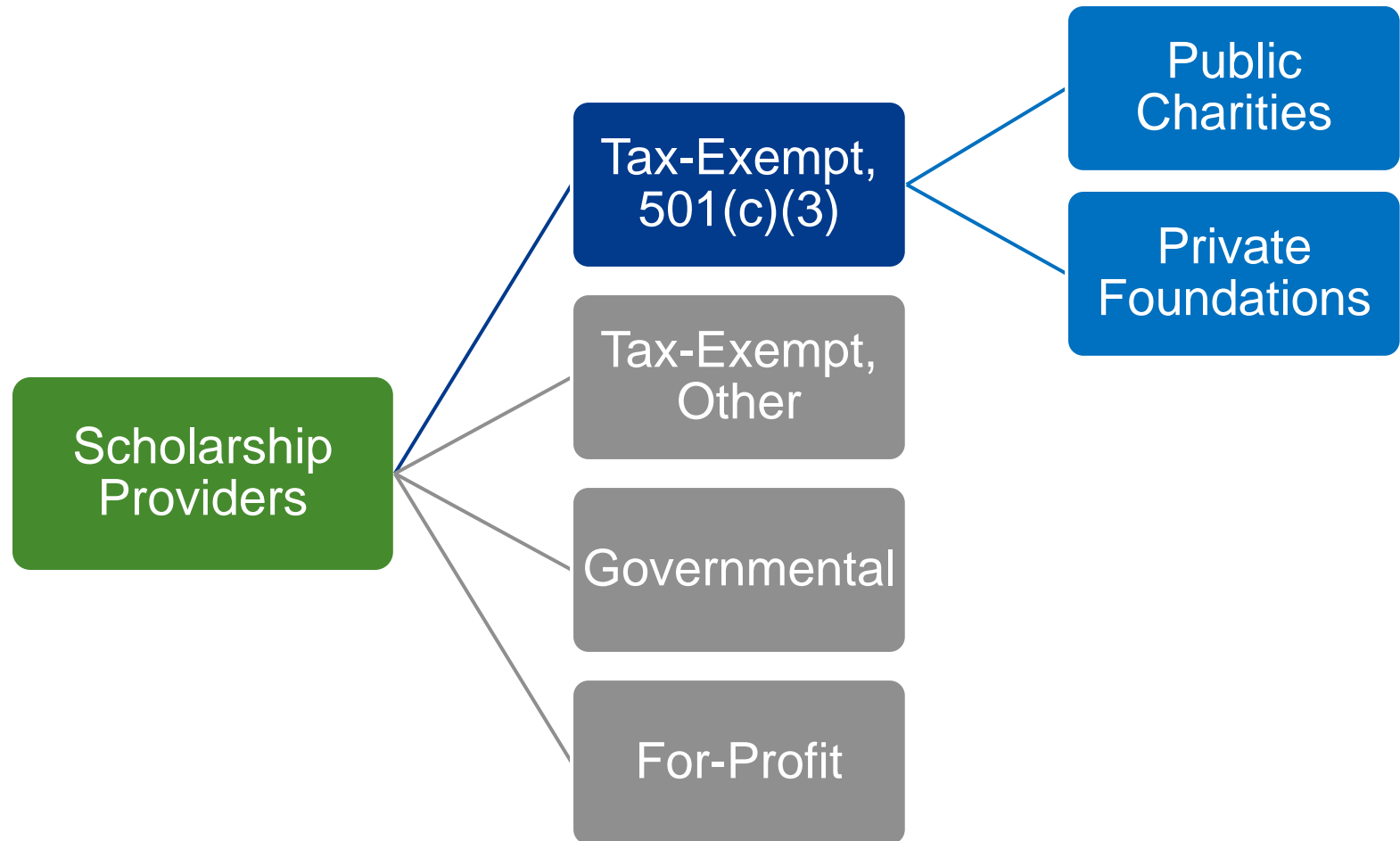
National Scholarship Providers Association
October 15, 2013



Overview

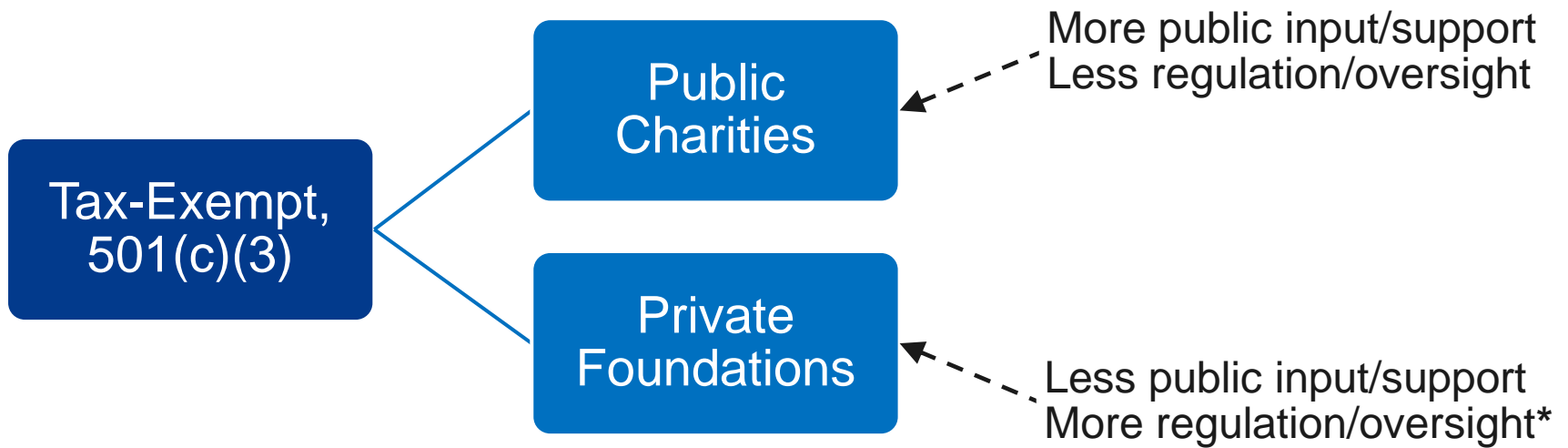


Types of Scholarship Providers





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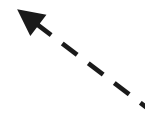


* Special rules for scholarships



Types of Scholarship Providers

Public
Charities



Donor Advised Funds *

* Special rules for
scholarships



Donor-Advised Scholarship Funds

- **Donor-advised funds fill a unique space in charitable world**
 - Current tax deduction (higher limit than private foundations)
 - Avoid cost/complexity of separate entity
 - Receive administrative/back-office support
 - Avoid private foundation rules (for the most part)
 - Donor or his/her designee has advisory role



Donor-Advised Scholarship Funds

- However ...

DAFs are prohibited from making scholarships unless they are structured to meet stringent criteria of “scholarship exception”!



Donor-Advised Scholarship Funds

- **Penalties apply for violation**
 - 20 percent of scholarship against sponsoring charity + correction
 - 5 percent of scholarship fund managers for knowing violation

- **Rules can snag well-meaning donors and sponsoring charities**



Key Questions

Is the scholarship fund a DAF?



If so, does the scholarship exception apply?



If not, scholarships are prohibited!



Is the Scholarship Fund a DAF?



Donor-Advised Fund: Three Elements

Fund or account is owned or controlled by a sponsoring organization

+

Fund or account is separately identified by reference to contributions of donor(s)

=

Donor-Advised Fund

+

Donor/advisor has or expects advisory privileges as to distribution because of status as donor



Donor-Advised Fund: Three Elements

1. Fund or account is owned or controlled by a sponsoring organization

- **Covered:**

- 501(c)(3) public charities
- War veteran organizations
- Fraternal organizations

- **Not Covered:**

- 501(c)(3) private foundations
- Non-501(c)(3) entities
- Governmental entities (including non-501(c)(3) schools)
- Custodial funds



Donor-Advised Fund: Three Elements

2. Fund or account is separately identified by reference to contributions of donor(s)

- **Covered:**

- Fund bears name of donor/advisor
- Fund tracks contributions of specific donor(s)

- **Not Covered:**

- General fund *
- Field of interest fund *

* Funds with multiple donors, contributions pooled



Donor-Advised Fund: **Three Elements**

2. Fund or account is separately identified by reference to contributions of donor(s)

- Other “multiple donor” funds?
(more on this later)
- IRS looks at substance over form



Donor-Advised Fund: Three Elements

3. Donor/advisor (or related person) has or expects advisory privileges as to distributions because of status as donor

- **Covered:**
Advisory privileges
(i.e. donor/advisor makes recommendations; sponsor considers them)
- **Not Covered:**
Gift restrictions
(e.g. donor restricts purpose of fund to scholarships; or establishes eligibility or selection criteria)



Donor-Advised Fund: Three Elements

3. Donor/advisor (or related person) has or expects advisory privileges as to distributions because of status as donor

- **Covered:**
Donor/advisor participates in selection process because of donor's status as a donor
- **Not Covered:**
Donor/advisor participates in selection process because he/she holds certain position
(e.g. officer, director, faculty)



Donor-Advised Fund: Three Elements

3. Donor/advisor (or related person) has or expects advisory privileges as to distributions because of status as donor

- **Covered:**
Recommendation of scholarship recipients
(note: advisory privileges can also extend to investment)
- **Not Covered:**
Recommendation of selection committee,
if based on objective criteria related to expertise
(e.g. department heads, high school principal, etc.)



Donor-Advised Fund: Three Elements

3. Donor/advisor (or related person) has or expects advisory privileges as to distributions because of status as donor

- **Covered:**
 - Privilege arises under written agreement
 - Privilege arises by course of conduct
 - Privilege exists even if not exercised
 - Privilege arises later
- **Not Covered:**
 - No mutual expectation of donor/advisor and sponsor



Donor-Advised Fund: Three Elements

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Donor-Advised Fund

+

Donor/advisor has or expects advisory privileges as to distribution because of status as donor



Of Special Concern: Multiple Donor Funds

- **For example ... scholarship funds established by:**
 - Faculty and alumni groups
 - Service and social clubs
 - Company employees
 - Friends in memory of loved one
 - Giving circles

- **Lack of IRS guidance, so proceed with caution**
 - Separately identified by reference to contributions of donors if named for group? What about relationship between donors?



Of Special Concern: Multiple Donor Funds

- **Key factors for your attorney to consider:**
 - How large is the donor group?
 - How are the donors related? Is fund named after identifiable group?
 - Does anyone dominate or control the group?
 - How is the selection committee comprised and selected?
 - What is the nature of its advisory privilege?
 - Is there a scholarship plan that meets the private foundation rules?
 - To what extent does the sponsor oversee the scholarship activity?
 - How close does the fund come to meeting the scholarship fund exception?



Key Questions

Is the scholarship fund a DAF?



If so, does the scholarship exception apply?



If not, scholarships are prohibited!



Does the Scholarship Exception Apply?



Scholarship Exception: Five Requirements

1. Donor/advisor (and related persons) have advisory privileges only as members of advisory committee
2. Entire advisory committee is appointed by sponsoring charity
3. Donor/advisor (and related persons) do not directly or indirectly control advisory committee
4. Scholarships are awarded pursuant to pre-approved plan of sponsoring charity's governing board
5. Plan is designed to comply with private foundation rules



Scholarship Exception: Five Requirements

1. Donor/advisor (and related persons) have advisory privileges only as members of advisory committee

- **Okay:**
Donor is member of 5-member advisory committee, does not control committee, and votes on candidates as part of committee
- **Not Okay:**
Same facts, except donor pre-selects individuals who will be considered by full committee



Scholarship Exception: Five Requirements

2. Entire advisory committee is appointed by sponsoring charity

- **Okay:**
Sponsoring charity appoints all members of 5-member advisory committee
- **Not Okay:**
Gift instrument designates donor and spouse as members of advisory committee; sponsoring charity appoints remainder



Scholarship Exception: Five Requirements

3. Donor/advisor (and related persons) do not directly or indirectly control advisory committee

- **Okay:**
Advisory committee consists of donor, spouse and three retired college presidents
- **Not Okay:**
Advisory committee consists of donor, spouse, their accountant and two retired college presidents



Scholarship Exception: Five Requirements

4. Scholarships awarded pursuant to pre-approved plan of sponsoring charity's governing board

- **Okay:**
Board adopts “master” procedures applicable to all scholarship funds of sponsoring charity
- **Not Okay:**
Staff determines procedures for each fund



Scholarship Exception: Five Requirements

5. Plan is designed to comply with private foundation rules

- Nondiscriminatory criteria and publicity
- Objective selection process
- Adequate records as to recipients
- Reasonable renewal criteria
- Monitoring of recipients' performance, reports from recipients
- Investigate known diversion of funds
- Special rules for employee scholarships



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Conclusion



Remember . . .

- Any scholarship fund with ongoing donor involvement should be reviewed to determine DAF status
- If scholarship fund is a DAF and does not qualify for scholarship fund exception ... consider your options!



Options:

1. Eventually ... request Treasury Department exemption
2. Modify fund terms to avoid DAF status
3. Modify fund terms to qualify for scholarship fund exception
4. Reorganize fund as supporting organization or private foundation
5. Don't allow scholarship activity



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