



LEAFFER LAW

LEADERS IN NONPROFIT LAW

Legal Lowdown: Fundamentals for Scholarship Providers

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National Scholarship Providers Association
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Legal Context



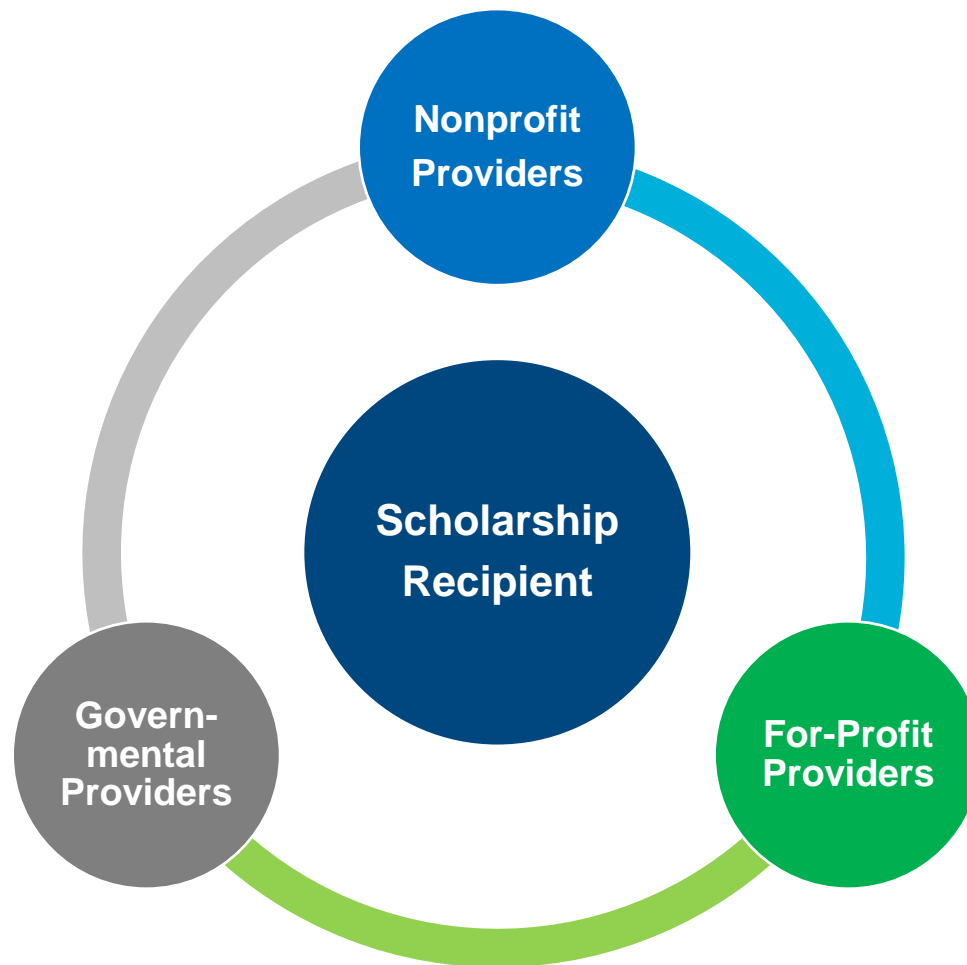
You're All Unique ...



And the IRS Agrees!

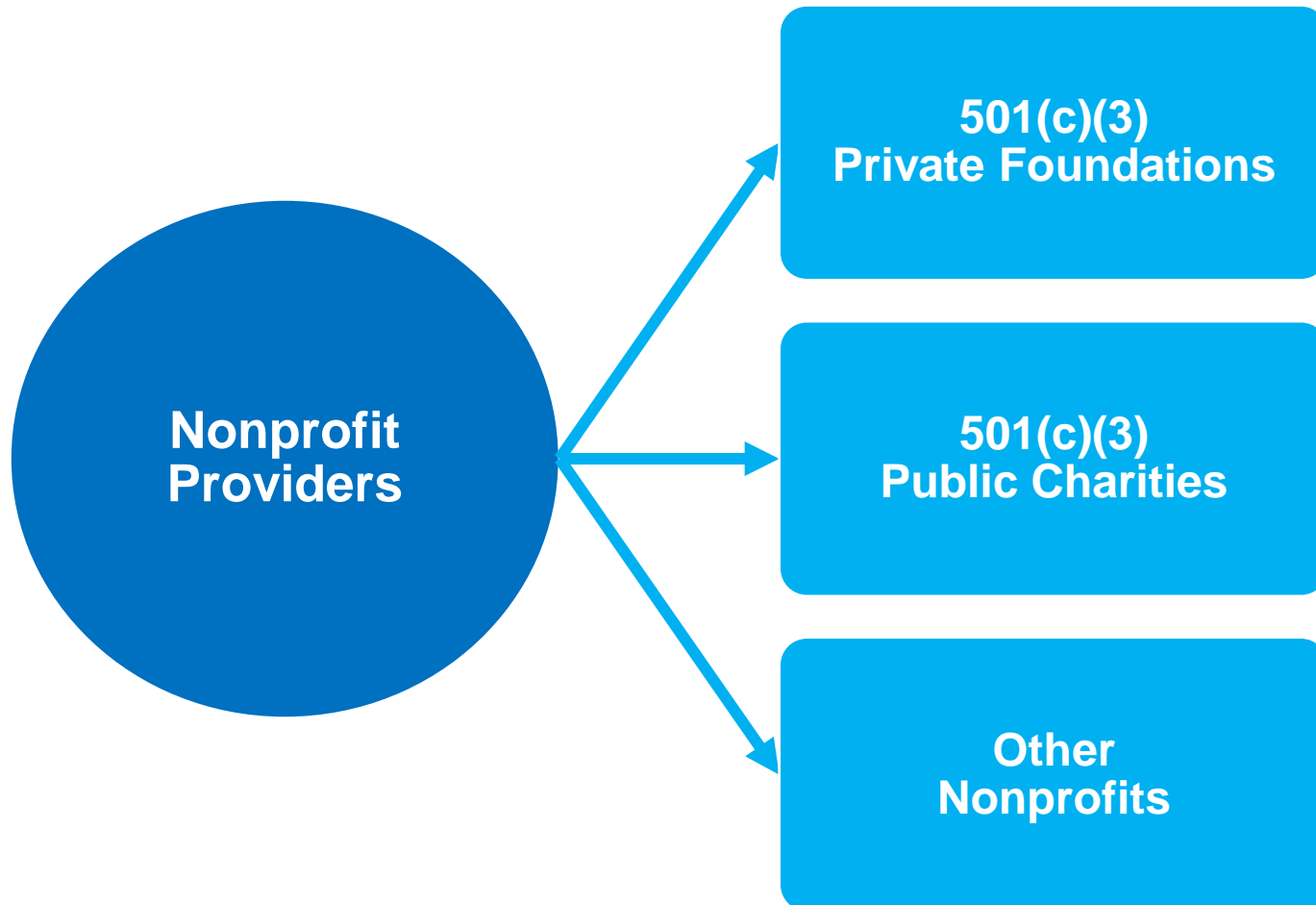


Types of Scholarship Providers:





Types of Nonprofit Providers:





Types of Nonprofit Providers:

Public Charities

- More public involvement
= less IRS oversight
- 501(c)(3) limitations

- Examples:
 - Private colleges
 - University foundations
 - Community foundations
 - Other organizations that rely on many donors

Private Foundations

- Less public involvement
= greater IRS oversight
- 501(c)(3) limitations
+ private foundation rules

- Examples:
 - Endowed foundations
 - Family foundations
 - Company foundations
(e.g., employer-related plans)



Types of Nonprofit Providers:

Other Nonprofits

- Less tax benefits = less IRS oversight
- Some limitations based on tax-exemption category
- Examples:
 - 501(c)(4) providers (social welfare/civic organizations)
 - 501(c)(5) providers (agricultural/horticultural organizations)
 - 501(c)(6) providers (chambers of commerce and trade associations)
 - 501(c)(7) providers (social clubs)



Types of Scholarship Providers:

Question:

What type of scholarship provider are you?



Agenda

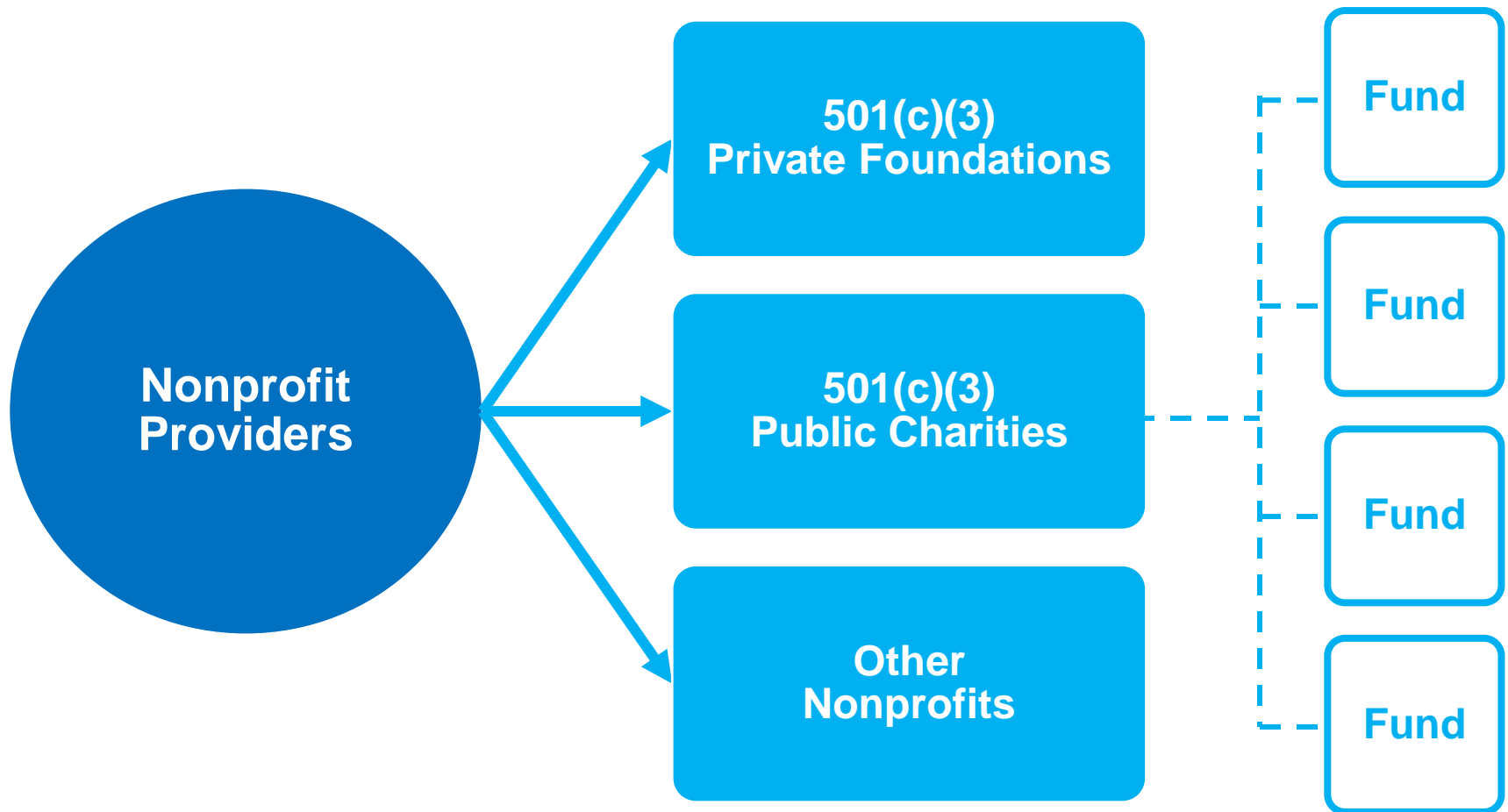
1. Donor Participation in Selection
2. Scholarship Plans
3. Record Collection & Retention
4. Tax Treatment of Scholarships



Donor Participation in Selection



Donor-Driven Scholarship Funds





Donor-Driven Scholarship Funds

Mechanics:

- ✓ Donor(s) establishes separate fund or account with charity
- ✓ Donor(s) “advises” charity in selection process

Examples – Funds Established By:

- Individual donors or families
- Companies and their employees
- University alumni and faculty
- Professional associations and their members
- Civic/service organizations and their members
- Members of faith based organizations



Donor-Driven Scholarship Funds

Benefits to Donor:

- ☺ Current tax deduction
- ☺ Avoid cost and complexity of separate scholarship entity
- ☺ Receive administrative/
back-office support
- ☺ Avoid private foundation rules
(for the most part)
- ☺ Participate in (but not control)
selection process





Donor-Established Scholarship Funds



Historical Abuses:

- ⊖ De facto donor control over selection process
- ⊖ Convert personal gift to charitable donation
- ⊖ Impermissible private benefit



Watch Your Step!

Since 2006,
Donor Advised Funds (DAFs)
have been prohibited
from making scholarships unless
they are structured to meet
stringent criteria of a **Qualified Scholarship Fund!**





Scholarship Prohibition

Penalties for Violation:

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

Rules can snag well-meaning donors and sponsoring charities!



Only Two Ways Around Prohibition:

1. Structure fund to ***avoid*** being considered a DAF.
2. Structure fund to ***qualify*** as Qualified Scholarship Fund.



Donor Advised Fund: Three Elements

Fund is
owned or controlled
by a sponsoring organization

+

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

=

Donor Advised
Fund

+

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



Donor-Advised Fund: Three Elements

1. Fund 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 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 is *separately identified*
by reference to contributions of donor(s)

- Other “multiple donor” funds?
- IRS looks at substance over form



Donor-Advised Fund: Three Elements

3. Donor/advisor * has or expects *advisory privileges* as to distributions because of donor status

- **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)

* Includes related persons



Donor-Advised Fund: Three Elements

3. Donor/advisor has or expects advisory privileges as to distributions because of *donor status*

- **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 has or expects advisory privileges as to *distributions* because of donor status

- **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 *has or expects* advisory privileges as to distributions because of donor status

- **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

Fund is
owned or controlled
by a sponsoring organization

+

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

=

Donor-Advised
Fund

+

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



Only Two Ways Around Prohibition:

1. Structure fund to ***avoid*** being considered a DAF.
2. Structure fund to ***qualify*** as Qualified Scholarship Fund.



Qualified Scholarship Fund: **Four Requirements**

1. Donor/advisor * has advisory privileges in process *only* as member of advisory committee
2. *Entire* advisory committee is appointed by sponsoring charity
3. Donor/advisor* does *not* directly or indirectly control advisory committee
4. Scholarships are awarded pursuant to *pre-approved* scholarship plan (more on this later)

* Includes related persons



Donor Participation - Summary

- Donor-driven funds fill an important, unique space in the scholarship world
- Done well, they represent a win, win, win proposition
 - Good for students, good for donors, good for sponsors
- Done poorly, they create risk and result in penalties
- *Remember, always structure to avoid being a DAF, or to qualify as a Qualified Scholarship Fund!*



Agenda

1. Donor Participation in Selection
- 2. Scholarship Plans**
3. Record Collection & Retention
4. Tax Treatment of Scholarships



Scholarship Plans



Two Questions:

1. Who *must* have a scholarship plan, who *should* have one, and who must approve it?
2. What must a scholarship plan include?





1. Who Must Have a Scholarship Plan?

- **Private Foundations**

- Scholarships are prohibited unless awarded pursuant to plan *pre-approved by IRS*

- **Qualified Scholarship Funds (just discussed)**

- Scholarships are prohibited unless awarded pursuant to plan *pre-approved by sponsor's governing board*

- **Public Charities and Other Nonprofit Providers**

- No requirement, but *should* have board-approved plan



2. What Must the Plan Include?

Scholarship plan must address ...

- Objective and non-discriminatory selection process
- Process for supervising scholarships
- Process for handling jeopardized scholarships
- Record collection and retention



2. What Must the Plan Include?

Objective and Non-discriminatory Selection Process:

- *Eligibility Criteria:*
potential applicant pool = charitable class (broad or indefinite)
- *Selection Criteria:*
related to purposes of scholarship
(e.g., grades, test scores, references, need, interviews)
- *Selection Committee:*
not be in position to benefit privately from selection



2. What Must the Plan Include?

Process for Supervising Scholarships:

- *If Funds are Paid to School:*
School agrees to: (1) use funds to defray student's expenses, or (2) pay funds to student only if enrolled and standing is consistent with purposes of scholarship

- *If Funds are Paid to Student:*
Provider obtains, at least annually, a school-verified transcript of courses taken and grades received for each academic period



2. What Must the Plan Include?

Process for Handling Problem Scholarships:

- *If Funds are Paid to School:*
No additional requirements
- *Funds Paid to Student:*
Provider must investigate and withhold further payments if concerned about proper use of funds or if reports are delinquent; plus take “reasonable and appropriate steps” to recover misused funds



2. What Must the Plan Include?

Record Collection and Retention:

Stay tuned



Scholarship Plan - Summary

- All providers *should* have a scholarship plan
- Private Foundations and Qualified Scholarship Funds *must* have a *pre-approved* plan
- Several required elements, but central is inclusion of objective and non-discriminatory selection process



Agenda

1. Donor Participation in Selection
2. Scholarship Plans
- 3. Record Collection & Retention**
4. Tax Treatment of Scholarships



Record Collection & Retention



Two Questions:

1. What information should a provider collect to meet its tax obligations?
2. How long should it keep that information?





Different Session, Highly Recommend:

“Legal Issues in Collection and Retention of Student Data”

- Required disclosures when collecting information
- Using and sharing information
- Storage of information (including data security requirements)
- Data destruction requirements
- Data breach planning and response

Immediately following this session!



1. What Information Should be Collected?

501(c)(3) Polestar:

Remember, scholarships must be awarded on an objective and nondiscriminatory basis ...

So maintain records that support your compliance with this requirement!



1. What Information Should be Collected?

Private Foundations / Qualified Scholarship Funds

- *Must* collect and keep:
 - All information related to evaluation of applicants
 - Identity of awardees
 - Amount and purpose of each scholarship
 - Any follow-up information obtained in supervising awards

Other Nonprofit Providers

- *Should* collect and keep the same records



1. What Information Should be Collected?

Private 501(c)(3) Schools

- *Must* adopt a racial nondiscrimination policy
- *Must* collect and keep for three years:
 - Records showing racial composition -- student body, faculty and staff -- for each academic year
 - Records showing awards were made on a racially nondiscriminatory basis
 - Copies of brochures and similar items addressing aid
 - Copies of materials used to solicit contributions



2. How Long Should They be Retained?

Our recommendation:

Minimum of **four years, preferably **six years**, after close of calendar year in which studies funded by scholarship are completed**

- *Example: four-year scholarship*
 - Student selected for scholarship during 2014/2015
 - Student begins college in Fall 2015
 - Student graduates from college in May 2019
 - *Keep records until December 31, 2025*



Record Collection & Retention - Summary

- Record collection and retention requirements are fairly minimal under the tax laws
- Specific requirements for Private Foundations and Qualified Scholarship Funds provide good guidance for all providers
- Don't forget, many other federal and state laws cover data privacy and security!



Agenda

1. Donor Participation in Selection
2. Scholarship Plans
3. Record Collection & Retention
4. **Tax Treatment of Scholarships**



Tax Treatment of Scholarships



Two Questions:

1. Is the Scholarship subject to income tax?
2. Does the Provider have to report the Scholarship to the IRS or withhold taxes?





Remember ... you're in this together.





1. Is the Scholarship Subject to Tax?

Scholarships are tax-free *only* if:

- Funds are used for **qualified education expenses**,
- Student is a **candidate for a degree**,
- Student studies at an **educational institution**, *and*
- Award is **non-compensatory**



1. Is the Scholarship Subject to Tax?

Qualified Education Expenses:

- ✓ Tuition and fees *required* for enrollment or attendance
- ✓ Fees, books, supplies and equipment *required* for course work
- ✗ Room and board
- ✗ Travel expenses
- ✗ Optional equipment (e.g., laptop, tablet)
- ✗ Family allowance
- ✗ Anything else!



1. Is the Scholarship Subject to Tax?

Candidate for Degree:

- ✓ Pursues degree at college or university
- ✓ Attends primary or secondary school
- ✓ Attends a non-degree school in program that counts for full credit toward bachelor's degree or higher
- ✓ Attends vocational school

Note: the last two schools must be nationally accredited, and authorized by law to offer the program



1. Is the Scholarship Subject to Tax?

Educational Institution:

- Primary function is presentation of formal instruction,
- Normally maintains a regular faculty and curriculum, *and*
- Normally has a regularly enrolled body of students in attendance at the place where it conducts its educational activities



1. Is the Scholarship Subject to Tax?

Non-Compensatory:

- Scholarship *cannot* be conditioned on performance of teaching, research or other services (past, present or future)

- Limited exceptions:
 - National Health Service Corps Scholarship Program
 - Armed Forces Health Professions Scholarship and Financial Assistance Program



1. Is the Scholarship Subject to Tax?

Non-Compensatory (*cont.*):

- **Relevant Factors for Research Services**
 - Extent of faculty supervision over work schedule
 - Student's ability to direct course of research work
 - Right of student to retain copyrights or patents
 - Extent of reporting requirements
(but reporting requirement alone is not determinative)



1. Is the Scholarship Subject to Tax?

Non-Compensatory (*cont.*):

- ***What about graduate students who teach or conduct research for the provider?***
 - *Example 1:* Graduate student at USC is required to teach intro level chemistry class to undergraduates. *Compensatory?*
 - *Example 2:* Graduate student at SCS is required to conduct chemistry research. *Compensatory?*



1. Is the Scholarship Subject to Tax?

Non-Compensatory (*cont.*):

- ***What if the services are performed for someone else?***
 - *Example 1:* Student is awarded scholarship to Clemson by private foundation, who requires student to teach in South Carolina for three years after graduation. *Compensatory?*
 - *Example 2:* Student at Charleston Law School is awarded scholarship, which requires her to practice public interest law for three years after graduation. *Compensatory?*



1. Is the Scholarship Subject to Tax?

Recap -- scholarships are tax-free only if:

- Funds are used for qualified education expenses,
- Student is a candidate for a degree,
- Student studies an educational institution, and
- Award is non-compensatory

Otherwise, they are taxable!

-- See IRS Publication 970



Two Questions:

1. Is the Scholarship subject to income tax?
2. **Does the Provider have to report the Scholarship to the IRS or withhold taxes?**



2. Reporting & Withholding Obligations?

Provider's obligation to report and withhold taxes depends on ...

- Whether student is **U.S. or foreign**
- Whether scholarship is **compensatory or non-compensatory**



Reporting & Withholding Obligations

U.S. Students:

- *Non-Compensatory Scholarship:*
no tax reporting or withholding required, even if some or all of scholarship is taxable
 - But IRS recommends alerting students of potential taxation
(see IRS Notice 87-31)

- *Compensatory Scholarship:*
tax reporting required, plus withholding for employees
 - Form W-2 (student = employee) or Form 1099 MISC
(student = independent contractor)



Reporting & Withholding Obligations

Foreign Students:

- *Non-Compensatory Scholarship:*
 - If tax free, no reporting or withholding required
 - If taxable, both reporting and back-up withholding required
 - Form 1099/1042-S; withholding rate is generally 14 percent

- *Compensatory Scholarship:*
 - Reporting and withholding required
 - Form W-2 (student = employee) or Form 1099/1042-S (student = independent contractor); different withholding rates apply depending on classification



Reporting & Withholding Obligations

What about undocumented students?

- U.S. taxpayer v. non-U.S. Taxpayer
 - Citizen – born or naturalized in U.S.
 - Permanent resident – greencard
 - Substantial presence test
- DACA v. non-DACA



Taxation of Scholarships - Summary

- Not all scholarships are tax-free!
- Tax reporting and withholding obligations depends on nature of award and identity of recipient
- Tax treaty may change things with foreign students



We're Done ... Thank You!



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