

Mastering Foundation Law: Scholarships

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Introduction

Providing scholarships to individuals is a time-honored method of charitable giving in the United States, and programs that provide scholarships are immensely popular with those who donate to charitable organizations. A common motivation prompting people to make these gifts, or to establish scholarship programs, is the desire to invest in someone's future.

Mastering Foundation Law: Scholarships discusses the legal and administrative issues that arise most frequently when a nonprofit, tax-exempt entity under Internal Revenue Code section 501(c)(3)¹ – both public charities and private foundations – designs and implements a scholarship grant program to individuals.² Please note that although this document provides basic legal information, it is no substitute for expert legal advice – especially given the developing areas of the law around permissible restrictions to eligible scholarship recipients.

- ¹ All references to the Code are to the Internal Revenue Code of 1986, as amended. All references to Treasury Regulations are to the applicable Treasury Department regulations promulgated under the Internal Revenue Code. Although IRS private letter rulings ("Priv. Ltr. Rul.") and technical advice memoranda ("TAM") are indicative of the analysis used by the IRS, a private letter ruling or technical advice memorandum may not be relied upon as precedent by anyone other than the taxpayer to whom it was addressed. IRC § 6110(k)(3).
- ² This document includes new content together with updates to the text by Jane C. Nober (*Grants to Individuals by Public Charities*, Revised Edition 2004) and John A. Edie (*Grants to Individuals by Private Foundations*, 1995), both published by the Council on Foundations.

Legal Background

In the United States, an organization qualifies for tax-exempt status under Code section 501(c)(3) if, among other attributes and purposes, it is organized and operated exclusively for “charitable” purposes. For purposes of this document, such organizations will generally be referred to as “charitable organizations” that qualify to receive charitable tax-deductible contributions. For purposes of federal tax law, the term “charitable” is interpreted as having the same meaning as it does under general law. The awarding of scholarships has long been considered charitable since such activities promote and advance education. Accordingly, the granting of scholarships has been recognized as a charitable activity for tax purposes. Indeed, organizations whose only purpose is to award scholarship may qualify as tax-exempt charitable organizations.

Generally, charitable organizations are further classified as either public charities or private foundations. Since the passage of the Tax Reform Act of 1969, each charitable organization is by default a private foundation unless it demonstrates that it is a public charity. To do so, a charitable organization generally either: a) falls within specified categories of public charities (e.g., hospitals, schools, churches); or b) has sufficient broad-based public financial support (i.e., it passes the “public support test”).

Private Foundation or Public Charity?

The distinction between an organization being a public charity or a private foundation is significant because of the comparatively onerous rules applicable to private foundations. For example, private foundations and their managers are subject to penalty taxes for approving “study or travel” grants (for scholarships, fellowships, or research) if they do not obtain advance approval from the Internal Revenue Service (IRS) for the procedures they intend to follow when awarding such grants and monitoring their use.³ Further, “foundation managers” and disqualified persons who engage in a self-dealing transaction are subject to penalty taxes for violating specific statutory prohibitions against self-dealing.⁴ Accordingly, this document generally divides its summary of applicable federal tax rules in providing scholarships to individuals between those applicable to public charities – such as most community foundations – and those applicable to private foundations.

Under the Code and for purposes of this document, scholarships are grants to individuals to assist them in pursuing their education (scholarships, fellowships, and, under certain circumstances, travel grants). Grants to individuals do not include payments to such individuals for services performed for the benefit of the charitable organization in furtherance of its charitable mission;⁵ in general, such disbursements should be treated as administrative expenses and reported as such on the charitable organization’s annual information return and on tax documents supplied to employees and independent contractors. Grants to individuals also do not include payments made by one charitable organization to another charitable organization that, in turn, selects and makes payments to an individual. This document focuses on situations in which a charitable organization selects individual recipients of scholarship grant funds.

³ IRC § 4945.

⁴ IRC § 4941.

⁵ In the private foundation context, “grants” do not ordinarily include salaries or other compensation to employees. For example, “grants” do not ordinarily include educational payments to employees which are includible in the employees’ incomes pursuant to section 61. In addition, “grants” do not ordinarily include payments (including salaries, consultants’ fees, and reimbursement for travel expenses such as transportation, board, and lodging) to persons (regardless of whether such persons are individuals) for personal services in assisting a foundation in planning, evaluating or developing projects or areas of program activity by consulting, advising, or participating in conferences organized by the foundation.” Treas. Reg. § 53.4945-4(a)(2). See also Rev. Rul. 74-125, 1974-1 C.B. 327 (ruling that payments to consultants by a private foundation were not grants when made for services performed in developing model curricula and designing educational materials to aid the foundation in its program activity of assisting educators to employ improved educational methods). Public charities also should not treat expenses of this nature as grants.

Recent Events

A June 2023 Supreme Court decision and some recently filed lawsuits have created uncertainty regarding the permissibility of race-conscious grantmaking, including for charitable organizations providing scholarships. The Supreme Court ruled on June 29, 2023, that colleges and universities may not consider race as a factor in admissions. In doing so, the Court overturned a four-decade precedent that allowed schools to use affirmative action to increase student body diversity. The Court held, among other things, that the admissions processes employed by Harvard University and the University of North Carolina violated the 14th Amendment's Equal Protection Clause.

What is not clear from the decision is its scope: Is it limited to college admissions, or is it applicable to other charitable activities that take race into account, including scholarship programs? For example, will the IRS apply the decision to charitable organizations by taking the position that a charity utilizing race in its activities or decisions violates the "public policy doctrine" described in a 1983 Supreme Court decision? Further, will the various suits being filed across the country against affirmative action and diversity-focused efforts prevail? Accordingly, as of the date of this document, certain information throughout is noted as an unsettled area of the law. Indeed, even for those charitable organizations that have already received the IRS' approval of their programs via a determination letter, the IRS may revoke or modify such approval at any time. Consequently, this area of law should be carefully watched as it develops.

Regardless, the IRS has paid comparatively more attention to scholarship awards than to other types of grants to individuals. As noted earlier, there are rules that apply to scholarship grants to individuals made by charitable organizations broadly, as well as specific rules for private foundations. In the next section, this document discusses the general rules that apply to all charitable organizations and public charities together; in the following section, it reviews rules that apply only to private foundations.

Public Charities Making Scholarship Grants to Individuals

The state and federal rules together with administrative and operational considerations should inform a public charity's evaluation of whether to start and how to operate a program of scholarship grants to individuals. This section describes these rules with a focus on the general rules applicable to all charitable organizations and those applicable to public charities in particular.

Initial Corporate and Governance Considerations

Whether a public charity may make grants to individuals through a scholarship program depends initially on its organizing and governance documents. Generally, if the public charity's formation document or bylaws specify that it may make grants only to other organizations, the public charity may not provide direct scholarship grants to individuals.

For a public charity with such limitations, at least three options exist:

1. SEEK TO REMOVE THE LIMITATION.

A public charity in trust form will generally be required to seek approval from a court for such a change, and the state's attorney general may have to be notified about the proceeding. A corporate-form public charity with such a limitation in its articles of incorporation will have to follow state law procedures for amending the document. Generally, bylaws are comparatively simpler to amend. Procedures for amendment are often set out in the bylaws or, if not, are described in the state's nonprofit corporation statute. The public charity's counsel should ensure the organization's articles of incorporation and bylaws are consistent with one another and with applicable state laws.

2. WORK THROUGH OTHER CHARITABLE ORGANIZATIONS TO PROVIDE INDIVIDUAL SCHOLARSHIP SUPPORT.

A public charity may grant funds to universities and high schools, for example, and allow these institutions to select the individual recipients of scholarships. This is a perfectly appropriate distribution of charitable funds, so long as the grantee institution has complete control over the selection of the individual scholarship recipients.

3. ESTABLISH A SUPPORTING ORGANIZATION THAT ENGAGES IN SCHOLARSHIP GRANTMAKING TO INDIVIDUALS.

Some public charities will discover that there are organizational rules that have been adopted by the governing board as a matter of policy that limit the making of grants to certain qualified organizations. In other words, even though the purposes of the public charity, as stated in its organizing documents, are very broad (e.g., "charitable purposes"), the governing board, as a matter of policy, may have limited the actual operations of the public charity to making grants only to other organizations. In such a case, this policy must be eliminated or modified in order for the officers to be authorized to approve a grant to an individual.

Federal Tax Considerations

There are no specific provisions of the Code or Treasury Regulations that govern a public charity's grantmaking to individuals, which would include the payment of scholarships. However, the IRS has set out legal criteria that are applicable to charitable grants-to-individuals programs in Rev. Rul. 56-304,⁶ and to scholarship programs in particular. In general, the rules require that grants be made for a charitable purpose and that eligible recipients be a class of individuals large enough to constitute a "charitable class," so that private interests are not benefited. Additionally, the public charity must retain adequate records and case histories.⁷ A public charity would be well-advised to develop guidelines regarding the types of individual support it will provide so it is prepared in advance to respond to donors.

⁶ Rev. Rul. 56-304, 1956-2 C.B. 306. See also, Priv. Ltr. Rul. 202248016 (finding that the applicant organization's proposed distributions were unlike those in Rev. Rul. 56-304 because they were not made "on a truly charitable basis, you have not established that your distributions will be for charitable or educational purposes.").

⁷ Rev. Rul. 56-304, 1956-2 C.B. 306.

While private foundations have specific requirements related to making scholarship grants to individuals, the IRS has stated that if a public charity conducts a scholarship program that “conforms to these standards for objectivity and educational character” then the program “will ordinarily be considered to be in furtherance of exempt purposes.”⁸ Except in circumstances involving employer-sponsored scholarships to employees, letter-perfect adherence to the rules governing private foundations is not essential for public charities, but the well-advised public charity manager will stay as close to the private foundation standards as possible.

SCHOLARSHIPS FOR CHARITABLE PURPOSES

A 501(c)(3) organization must engage primarily in activities that further its recognized tax-exempt purposes, including, for example, “charitable” purposes.⁹ The awarding of scholarships has long been considered charitable since such activities promote and advance education.¹⁰ Indeed, organizations whose only purpose is to make scholarship awards may qualify as tax-exempt charitable organizations.¹¹ Importantly, certain type of scholarship grants to individuals will require additional attention than those, for example, paid to a Code Section 501(c)(3) educational organization. Scholarship assistance need not be limited to post-secondary education. Donors may wish to start funds to help students attend private or parochial high schools, elementary schools, and even nursery schools; all of these are generally charitable undertakings.¹²

One type of educational assistance that often raises questions for public charities is scholarship payments to students to attend vocational or technical school. Some of these schools are for-profit institutions, but it is generally considered a charitable activity to enable an individual to attend if this is the most appropriate place to continue the student’s education.¹³

“CHARITABLE CLASS” OF ELIGIBLE SCHOLARSHIP RECIPIENTS

A public charity’s scholarship program for grants to individuals must be open to a “charitable class.” In general, a “charitable class” is a group that is large enough that an indefinite number of individuals may benefit. However, a charitable class may properly consist of a comparatively small number of beneficiaries, provided the class is open and the identities of the individuals to be benefited remain indefinite.¹⁴ If a public charity’s scholarship program limits recipients to a narrowly defined group of individuals, such limitations may cause the program to have an impermissible amount of “private benefit” (described later in this document). At the other end of the spectrum, a scholarship program open to any and all applicants would be the widest possible “charitable class,” since grants would be available to the public in general.

8 Priv. Ltr. Rul. 200332018.

9 Treas. Reg. § 1.501(c)(3)-1.

10 Treas. Reg. § 1.501(c)(3)-1(d)(2). See also Restatement of Trusts 2d § 370; Statute of Charitable Uses of 1601.

11 Rev. Rul. 69-257, 1969-1 C.B. 151 (determining that an organization awarding scholarships based on scholastic ability without regard to financial need still qualifies for tax-exempt status under IRC § 501(c)(3) because the organization was primarily engaged in the charitable activity of advancing education). See also Priv. Ltr. Rul. 201832013 (distinguishing the applicant which sought to provide scholarships to descendants of certain enslaved individuals without regard to scholastic achievement or financial need).

12 Note that not all support enabling a student to seek education will constitute a scholarship. Grants that help a child with disabilities purchase a mechanized wheelchair so the student can navigate school hallways, for example, or funds provided for extra tutoring can certainly qualify as charitable outlays. Similarly, public charities occasionally make grants to low-income families so children can attend summer camp or participate in other enrichment activities (music, dance or art lessons, or sports training), and a public charity may also pay for equipment required to participate in these activities.

13 On the other hand, a public charity generally should not establish a designated fund to provide scholarships at a particular for-profit vocational or technical school.

14 In Rev. Rul. 56-403, the IRS ruled that a foundation set up to award scholarships solely to undergraduate members of a designated fraternity could be exempt under IRC § 501(c)(3) because scholarships would be available not only to present members of the fraternity but also to unknown future members. Rev. Rul. 56-403, 1956-2 C.B. 307.

Additionally, the group must be defined in a manner that does not violate public policy. Importantly, this is a developing and uncertain area of the law as of the date of this publication¹⁵; please see the section regarding private foundations for additional details. For example, if the eligible class is based on race, gender, or ethnic origin, there is a question as to whether it qualifies as discrimination that is contrary to federal public policy.¹⁶

Generally, a scholarship fund can be established for the members and/or the children of members of one church, synagogue, or other religious institution – which, by definition, are often public charities – provided that the group of potential beneficiaries is large enough that there is sufficient “indefiniteness” regarding who will receive benefits. If the congregation itself is not large enough to constitute a charitable class, it may be wise to expand the eligibility criteria to include members of nearby religious institutions of the same denomination.¹⁷

PRE-SELECTED RECIPIENTS

When a proper charitable class is not identified, or when scholarships are granted to pre-selected individuals, the granting public charity will be in violation of the federal tax requirements to maintain its tax-exempt status. Additionally, no income tax deduction is available to individuals or corporations that make a gift to a specified individual.¹⁸ This is true no matter how needy or worthy of aid the individual might be, and it remains true even if the donor channels the contribution through a charitable organization such as a public charity¹⁹. If a contribution is earmarked for a particular individual or family, the IRS is free to disregard the existence of the charitable intermediary and to consider the gift as made directly by one individual to another (earmarking is defined as any oral or written agreement or understanding that funds will be distributed in a specified fashion²⁰). Establishing such a fund could jeopardize a public charity’s tax-exempt status if it falls into a regular pattern of setting up funds for designated individuals, since such funds would be providing impermissible private benefit rather than serving a charitable purpose.²¹

There are many additional pitfalls. A charity would arguably be participating in tax fraud if it led donors to believe they could deduct such contributions from their taxes, and the charity would certainly run afoul of the law if it gave receipts to contributors stating that the contributors had made charitable contributions. Informing donors that their contributions do not qualify as charitable deductions would also be a public relations nightmare, despite the information being legally correct. It invites disputes with family members regarding how donated funds should be spent, and it even tempts lawsuits filed by creditors of benefited individuals. Additionally, a public charity that agreed to create just one of these funds has opened itself up to endless requests for the establishment of similar funds.

PRIVATE BENEFIT, PRIVATE INUREMENT, AND EXCESS BENEFIT TRANSACTIONS

When making scholarship grants to individuals, a public charity must not create an improper private benefit or permit “private inurement.” The Code does not include an explicit restriction against “private benefit;” rather, this concept arises from Treasury Regulations, which state that meeting the exemption requirements under

15 *Students for Fair Admissions, Inc. v. President & Fellows of Harvard Coll.*, 600 U.S. 181 (2023).

16 Please see this document’s section on private foundations rules which includes guidance regarding, in particular, race-conscious criteria for scholarship programs.

17 For example, in Private Letter Ruling 8417092, the IRS approved grantmaking procedures that are “open only to all persons of the Protestant religion” (with Protestant religion being defined as “all persons of the Christian churches resulting from the initial Reformation”). In Private Letter Ruling 8017028, the IRS also approved grantmaking procedures that give preference to Jewish applicants from a particular area.

18 See IRC § 170(c).

19 A practical response to donors who approach a public charity with a proposed fund for a designated individual is to explain the law and provide a list of banks or other institutions that may be willing to establish such funds. The public charity may also wish to consider establishing a general fund that provides assistance in cases of economic hardship.

20 See Treas. Reg. § 53.4945-5(a)(6); Treas. Reg. § 53.4945-4(a)(5).

21 See Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

Code section 501(c)(3) requires an organization establishing that it is not organized or operated for the benefit of private interests. These interests would include (but need not be limited to) the interests of designated individuals, the people who created the public charity or their families, or persons (including corporations) controlled, directly or indirectly, by such private interests.²²

The Code, however, does have an express requirement that “no part of the net earnings of... [the organization] inure to the benefit of any private shareholder or individual....”²³ This provision is not as broad as it might appear, however, and the Treasury Regulations limit its application to “persons having a personal and private interest in the activities of the organization”²⁴ The prohibition on “private inurement” and limitations on “private benefit” are the other side of the statutory requirement that the organization be operated “exclusively” for tax-exempt purposes. There is no prohibition in the Code against making grants to or for the benefit of individuals if, in making such grants, the Section 501(c)(3) organization is furthering one or more charitable purposes.

If a public charity makes a scholarship grant to a disqualified person, the transaction may be an “excess benefit transaction.” An excess benefit transaction is one in which an applicable tax-exempt organization provides an economic benefit directly or indirectly to or for the use of any disqualified person when the value of the benefit exceeds the value of the consideration received for providing the benefit.²⁵ Code section 4958 imposes excise taxes on the charity’s managers of an organization involved in “excess benefit transactions” and on the disqualified person(s) involved. In other words, if a disqualified person receives more in economic benefits than the value of goods or services such person contributes to the organization, an excess benefit transaction may have occurred, and the charity’s directors and managing staff of an organization may be subject to a tax in addition to the disqualified person(s). A disqualified person under this provision is defined as:

- a. any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization;
- b. a member of the family of a person who exercises such substantial influence; or
- c. an entity (including a corporation, partnership, or estate) of which 35 percent is controlled by or benefits the person(s) described in (a) and (b).

Note, however, that the Treasury Regulations under section 4958 provides an exception: An economic benefit provided solely because the recipient is a member of the charitable class the providing tax-exempt organization intends to benefit will be disregarded for the purposes of section 4958.²⁶ This provision suggests that a disqualified person or a family member of a disqualified person **may** receive an award without that award giving rise to an excess benefit transaction – so long as the recipient is a member of a charitable class served by the organization’s charitable programs, and provided that they received the award entirely in that capacity. Despite this exception, many charitable organizations still take a cautious approach and prohibit disqualified persons from receiving scholarships or other individual grants.

²² Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

²³ IRC § 501(c)(3).

²⁴ Treas. Reg. § 1.501(a)-1(c).

²⁵ IRC 4958(c)(1)(a); Treas. Reg. 53.4958-4(a)(1).

²⁶ Treas. Reg. § 53.4958-4(a)(4)(v).

SCHOLARSHIP PROGRAM SUBSTANTIATION REQUIREMENTS

The IRS has long imposed substantiation requirements for all types of charitable organizations that award scholarships²⁷ In addition, when charitable organizations apply for recognition of tax-exempt status on IRS Form 1023, they are asked whether a scholarship program is one of the organization's anticipated charitable activities²⁸ Charitable organizations that have already been recognized but are now starting a new scholarship program should also prepare answers to each of the questions in Form 1023. Thus, **any** charitable organization establishing a program of scholarship grants to individuals should also be prepared to respond to some or all of the following questions:

- The class of eligible individuals, or potential recipients, of the organization's grants, including an indication of whether there are any restrictions or limitations on who the organization will consider as possible recipients.
- Who selects the recipients from the class of eligible individuals. If those selecting recipients are related to the organization, give complete details.
- All criteria used by the selection committee in selecting recipients from the eligible class.
- Whether any grants will be made to spouses, children, descendants, spouses of children or descendants, or other persons who have a close relationship to the organization, its directors, or its officers.
- How the scholarship program will be publicized to ensure that all eligible individuals are reasonably informed of it.
- Whether awards will be restricted to students who will be attending "educational organizations."²⁹
- Whether the organization will provide aid to students both as grants and as loans. If both will be provided, the organization must provide a description of the criteria used to determine who will receive grants and who will receive loans.
- Follow-up procedures that will be used to ensure all scholarship funds are devoted to the stated purposes of the organization.
- The procedures the organization will follow if it discovers a misuse of these funds.
- Whether the funds will be paid to individual students or directly to the school the students will attend.
- When the organization began or will begin giving scholarship aid and how many scholarships have been or will be awarded. If any of the scholarships have been awarded, a list of all grant recipients together with an indication of how much money was received by each recipient is required.

²⁷ See Rev. Rul. 56-304, 1956-2 C.B. 306.

²⁸ IRS Form 1023, Schedule H.

²⁹ IRC § 170(b)(1)(A)(ii) defines an "educational organization" as one that "normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on..."

APPROVAL FROM THE IRS?

In general, a public charity is not required to seek advance approval from the IRS for a scholarship program of grants to individuals,³⁰ though a new organization providing scholarships must describe its scholarship program on Form 1023, Schedule H. If an existing public charity amends its organizational and governing documents in order to undertake a new program, a conformed copy of the amended document must be attached to the organization's next annual information return (Form 990). This attachment, and any other disclosures regarding the scholarship program that the public charity makes on its information return, places the IRS on notice that the organization has undertaken a new charitable activity.

A public charity that is commencing operations and seeking its determination letter should disclose any plans its organizers have regarding making scholarship grants to individuals on its application for exemption on Form 1023, even if the plans are somewhat vague.³¹ The organization will be required to complete and attach Schedule H to its Form 1023, and thus it will need to develop some general policies and guidelines immediately regarding its scholarship program. If the IRS reviewers examining the application ask for further information regarding the proposed program, the public charity may respond that the program is in formation, and precise details of its operation have not yet been established. The disclosure of the program's likely existence puts the IRS on notice that the organization is planning to distribute grants to individuals as part of its charitable operations, meaning the organization's determination letter will be issued with knowledge of these activities.

DONOR INVOLVEMENT IN THE SELECTION PROCESS

The Pension Protection Act of 2006 (PPA) codified the definition of a donor advised fund (DAF) and set out specific rules governing the use of these funds, which permit donors to retain advisory privileges with respect to a fund's distributions or investments. Before passage of the PPA, some foundations allowed scholarship funds to be established as DAFs, which permitted the funds' donors to effectively control the selection process. The PPA added IRC section 4966, which prohibits distributions from DAFs to "any natural person" and imposes an excise tax on these and other defined "taxable distributions."³²

Following the introduction of the DAF rules, community foundations and other public charities administering scholarship funds must take steps to ensure that any donor involvement in the selection process complies with the requirements of section 4966 and that scholarship funds do not fall within the legal definition of a DAF.

Significantly, section 4966(d)(2)(B)(ii) includes an exception to the definition of DAF for certain scholarship funds if they are administered according to specific procedures. A scholarship fund will not be classified as a DAF, even if a donor or fund advisor is involved as a member of the selection committee, if **all** the following are true:

- The sponsoring organization of the fund appoints all members of the committee and the donor's advice is given solely as a member of the committee;
- Neither the donor nor the parties related to the donor control the committee directly or indirectly; and

30 Except in situations where funds for the awarding of scholarships to corporate employees' children are donated by the corporate foundation, a public charity is not required to seek advance approval of its grantmaking procedures.

31 The description of the program should be included in the organization's narrative description where the Form 1023 asks for a detailed narrative description of past, present, and planned activities.

32 IRC § 4966(c)(1)(A).

- All grants are awarded on an objective and nondiscriminatory basis using a procedure that has been approved in advance by the board of directors of the sponsoring organization and that has been designed to ensure that all such grants meet the IRS requirements for scholarship programs found in paragraphs (1), (2), or (3) of section 4945(g) of the IRC.

Appointment of Selection Committee

The fund's sponsoring organization must control the appointment of members to the fund's selection committee. While it is permissible for donors to submit suggestions for membership on the committee, the fund agreement and scholarship policies must make clear that the foundation holds the final authority to accept or reject those suggestions. In order to satisfy the obligation to control the appointment of committee members, it is recommended that the foundation's board review and approve annually the members of all selection committees subject to this rule.

No Donor Control of the Committee

The donor and related parties may sit on a selection committee, but they may not make up a majority of the committee – the majority of the committee must be made up of individuals who are not related parties and who are not designated or appointed by the donor:

- Related parties include relatives and employees of the donor. The donor's attorney will also generally be considered a related party. Under this rule, a fund donor's family cannot constitute the entire selection committee or even a majority of the group (this is also the case if the fund is a memorial fund – the legislative history of the PPA takes the position that since contributions to such a fund are identified with reference to the deceased, family members of the deceased will be considered related parties and may not make up the majority of the selection committee). Where a scholarship fund is established by a corporation, corporate employees may be considered related parties and should not form a majority of the selection committee. In the context of employer-related scholarships, no corporate employees serve on the selection committee.
- The donor may recommend someone who is not a related party for committee membership. If the recommendation is based on objective criteria related to the expertise of the person recommended, that person will not be considered designated or appointed by the donor. The legislative history of the PPA provides an example: If a donor recommends the heads of the science departments at local secondary schools to be on a committee to award grants for the advancement of sciences at those schools, the persons so-recommended will not be considered designated or appointed by the donor.

Procedures for Awards

The foundation's board must approve in advance the procedures for making awards. These procedures must be objective and non-discriminatory, and the grants must meet the requirements that are applicable to private foundations making grants to individuals for travel or study under IRC section 4945(g) paragraphs (1), (2), or (3).

Administrative Considerations and Matters

There are a variety of administrative considerations that public charity managers and boards of directors should contemplate when establishing and running scholarship programs. Initially, a public charity must assess whether the organization has adequate administrative and financial resources to undertake a program of scholarship grants to individuals. Scholarship funds, for example, may be made subject to general guidelines that cover such issues as fund size, selection committee composition, decision-making, recordkeeping, fees,

and investments. Public charities may reduce the administrative burden somewhat by developing common guidelines and procedures for similar funds. Note that these guidelines permit donors a substantial amount of flexibility in such areas as geographic focus, eligibility criteria, and naming of a scholarship fund. A common application form for scholarships may also reduce administrative time and costs. Devising form letters for acknowledgment of applications, awarding of grants, and declinations will not only save time but will also ensure consistency.

The early planning of a scholarship program involves deciding the nature of the assistance, such as grants and/or loans; defining eligible grantees; determining who will make the final selections; developing the criteria for making grants; creating a system for informing eligible individuals about the availability of grants; and implementing, as appropriate, a process for monitoring the use of grant funds. The managers must also decide how the program will be administered. The labor-intensive nature of these decisions foreshadows the heavy staffing and administrative burden that a program of grants to individuals may place on the public charity.

A program of scholarship grants to individuals requires more staff time and attention than most other forms of grantmaking. Before initiating a program of scholarship grants to individuals, the prudent public charity will assess what the administrative costs will be. Some questions to consider:

- How many awards will be made each year?
- How many persons are likely to apply?
- Will the board of the public charity or a variety of special committees review the applications?
- Are community members willing to serve on selection committees (local educators on a scholarship selection committee, for example)?
- If expertise in the subject area of a grant request is not available locally, will funds be available to bring in experts from elsewhere?
- Will finalists need to be interviewed? Who will do this and how much will it cost?
- Will volunteers or paid staff send out the application forms?
- How will the scholarship program be advertised and how much will such marketing cost?
- Does the public charity have sufficient staff to field inquiries from applicants?
- Who will be responsible for keeping records of each grant and application, and what will this recordkeeping cost?
- If board members or others are willing to participate in selection and interviewing, who will coordinate their activities?
- If the scholarship fund or program is being initiated with the understanding that it will seek additional funding, will the public charity be involved in this effort? If so, is the public charity prepared to undertake such an effort?

Funding Minimums, Spending Levels, and Fees

As component funds of a public charity, funds that provide scholarship grants to individuals will generally be subject to organizational policies regarding fund minimums, spending levels, and fees. However, it may be appropriate for the public charity to consider modifying its rules for these scholarship programs. For example, some public charities require a higher initial contribution to ensure that distributions will be significant.

General spending policies that apply to other public charity funds may not be appropriate for a fund that provides scholarships. In some cases, donors may wish to allow the fund to grow for a limited time so it will generate more significant distributions. In other cases, donors may request the public charity make larger-than-normal distributions from contributed funds in order to provide more significant support to grant recipients. These recommendations may be followed if the public charity's staff and board consider them carefully and conclude that they will indeed further the charitable purposes of the foundation.³³ Finally, the fee structure that applies to most of a public charity's funds may not be appropriate for scholarship programs. Some public charities have developed an informal categorization system that is based on the amount of staff attention each fund will require.

³³ See e.g., Priv. Ltr. Rul. 8132051 (approving the decision of a public charity to accumulate income during an "inflationary economy" on some component funds).

Private Foundations Making Scholarship Grants to Individuals

Unlike the comparatively permissive rules applicable to public charities, those applicable to private foundations running a scholarship grant program to individuals require specific actions and approvals.

Initial Administrative Considerations

A private foundation contemplating launching or operating a scholarship program must initially assess whether it has adequate resources to administer such a program. In many cases, it may be more appropriate for the foundation to make the grants to a “public” organization, institution, or agency which in turn will make the payments to qualified individuals.³⁴ The facts and circumstances of each case should be examined to determine which course of action is most appropriate for each private foundation. This document assumes the foundation will choose the individuals qualified to receive scholarship grants.

The initial planning of the program involves deciding the nature of the assistance, such as grants and/or loans; defining the eligible grantees; determining who will make the final selections; developing the criteria for making the grants; creating a system for informing eligible individuals about the availability of grants, and (in some cases) implementing the required process for monitoring the use of grant funds and correcting any misuse of grant funds. The managers must also decide how the program will be administered.

If a private foundation is new and applying for recognition of tax-exempt status, a statement describing the criteria and procedures of its individual grantmaking program should be included as part of the description of program activities in its application to the IRS on Form 1023.

Managers of a private foundation who want to make scholarship grants to individuals must initially design the program in view of the general criteria mandated by the IRS in evaluating such programs. These criteria are applied to the grantmaking programs of all types of charitable organizations, not just private foundations. For all grant programs where the recipient is an individual, the IRS is looking for the grantor organization to maintain adequate records and case histories to show:

- The name and address of each scholarship recipient;
- The scholarship amount distributed to each recipient;
- The purpose for which the scholarship was given;
- The manner in which the scholarship recipient was selected; and
- The relationship, if any, between the scholarship recipient and
 - members, officers, or trustees of the organization;
 - a grantor or substantial contributor to the organization or a member of the family of either; and
 - a corporation controlled by a grantor or substantial contributor.³⁵

Corporate Formation and Governance Requirements

The first legal step in deciding whether a private foundation may make scholarship grants to individuals is to determine whether the governing instruments of the foundation (articles of incorporation, bylaws, trust agreement, etc.) authorize the foundation to make such grants. In some cases, a governing instrument will specify that grants may be made only to “organizations.” In such cases, grants to individuals would not be authorized unless the governing instruments are properly amended to reflect a broader charitable program.

³⁴ A public organization or institution is an organization described in IRC § 509(a)(1), (2) or (3), also referred to as a “public charity.”

³⁵ Rev. Rul. 56-304, 1956-2 C.B. 306. The IRS continues to apply these criteria.

There may also be other foundation rules that have been adopted as a matter of policy by the governing board that limit the making of grants only to certain qualified organizations. In other words, even though the purposes of the foundation, as stated in its articles of incorporation, are very broad (e.g., “charitable purposes”), the governing board, as a matter of policy, may have limited the actual operations of the foundation to making grants only to other organizations. In that case, unless such policy is first modified or changed, the officers would not be authorized to make a scholarship grant to an individual.

Federal Tax Requirements

Private foundation grants to individuals, including scholarships, are regulated in two primary ways. First, there is an outright prohibition on grants to “disqualified persons”³⁶ who include “foundation managers” (trustees, directors, officers, and persons with comparable responsibilities) and members of their families, as well as “substantial contributors” to the foundation (including corporations) and members of their families.³⁷ Second, the making of grants to individuals may subject a private foundation and its managers to penalty taxes if they are deemed to be “taxable expenditures”³⁸ under Section 4945 of the Code. A scholarship grant to an individual may fall into this category if it is found to have been made for noncharitable purposes or – if it is a study or travel grant – not administered in accordance with the IRS-approved procedures discussed below.

If a private foundation makes a taxable expenditure, an initial excise tax of 20% may be imposed upon the foundation and a tax of 5% may be imposed upon any foundation manager who knowingly and willingly agrees to the taxable expenditure.³⁹ If the taxable expenditure is not corrected within the “taxable period,”⁴⁰ a tax of 100% may be imposed upon the foundation and a tax of 50% upon any foundation manager who refused to agree to all or part of the correction. In all cases, the amount of the tax is based on the amount involved in the taxable expenditure.

A private foundation grant to an individual for study or travel is not a taxable expenditure if the grant is awarded on an objective and nondiscriminatory basis pursuant to a procedure approved **in advance** by the IRS **and** certain additional requirements are met to the satisfaction of the IRS.⁴¹ To avoid being treated as a taxable expenditure, a private foundation’s scholarship grant to an individual must constitute either:

- a. A **qualified scholarship or fellowship grant**⁴² and be used for study at an educational institution which maintains a regular faculty and curriculum and has an organized body of students in attendance at the place where the educational activities are regularly held;⁴³
- b. A **prize or award to be used for study or travel purposes**, if the recipient of the prize or award is selected from the general public and other specific requirements are met;⁴⁴ or
- c. A grant whose purpose is to **achieve a specific objective**, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching or other similar capacity, skill or talent of the grantee.⁴⁵

36 Such payments would be considered acts of “self-dealing” and as such would be subject to penalty taxes starting at 5% and escalating to 200% of the amount involved. IRC § 4941. Under extreme circumstances, a pattern of self-dealing may result in the IRS’ terminating the tax-exempt status of the private foundation. See TAM 9230001 (March 12, 1992).

37 IRC § 4946(a).

38 IRC § 4945.

39 IRC § 4945(a)-(b).

40 IRC § 4945(i)(2). The taxable period begins when the foundation makes the expenditure and ends when the IRS mails a notice of deficiency for or assesses the initial tax, whichever is earlier.

41 IRC § 4945(g)(1)-(3); Treas. Reg. § 53.4945-4(a)(3)(ii). See e.g., Rev. Rul. 77-3 80, 1977-2 C. B. 419.

42 IRC § 117. The term “qualified scholarship” means any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.

43 IRC § 4945(g)(1).

44 IRC § 4945(g)(2) which makes cross-reference to IRC § 74(b) (without regard to paragraph 3 thereof). Section 74(b) requires that the recipient be selected without any action the recipient’s part to enter the contest or proceeding and the recipient must not be required to “render substantial services as a condition of receiving the prize or award.”

45 IRC § 4945(g)(3). This is the broadest of three categories under IRC § 4945(g). It is possible for a grant under IRC § 4945(g)(3) to be confused with a

Identical to the requirements applicable to public charities, in making scholarship grants to individuals, a private foundation must not create an improper private benefit or permit “private inurement.” The Code does not include an explicit limitation on “private benefit;” rather, this concept arises from the Treasury Regulations which state that to meet the requirements for exemption as a charitable organization, an organization must establish that it is not organized or operated for the benefit of private interests. These interests would include designated individuals, the person who created the foundation or such founder’s family, or persons (including corporations) controlled, directly or indirectly, by such private interests.⁴⁶

The Code, however, does have an express limitation that “no part of the net earnings of. . . [the organization] inures to the benefit of any private shareholder or individual.”⁴⁷ This provision is not as broad as it might appear, and the Treasury Regulations limit its application to “persons having a personal and private interest in the activities of the organization.”⁴⁸ The concepts of “private benefit” and “private inurement” are the other side of the basic statutory requirement that the organization be organized and operated “exclusively” for charitable or other exempt purposes. There is no prohibition in the Code against making scholarship grants to or for the benefit of individuals if, in making such grants, the private foundation is furthering one or more **charitable** purposes.

A scholarship grant to an individual by a private foundation may be considered made for a noncharitable purpose if it is made for a purpose other than those described in Code Section 170(c)(2)(B)⁴⁹ or if there is an oral or written understanding that the grant is to be used in a way that will violate Section 4945.⁵⁰ Thus, for example, if a private foundation makes a scholarship grant to an individual with the explicit understanding that such individual will be using the funds to work on a public election campaign (a noncharitable activity), the award may be a taxable expenditure. Further, for purposes of scholarships, even if charitable in nature, a private foundation grant to an individual for travel, study, or similar purposes is treated as a taxable expenditure unless certain requirements and procedures are satisfied.⁵¹

A note on the application of private foundation rules to public charities: While the following rules applicable to private foundations making scholarship grants to individuals do not also apply to public charities, an understanding of them can be helpful to public charity managers initiating or administering such programs. Accordingly, this subsection includes comments in italics that discuss how a particular set of private foundation rules may be relevant to public charities.

OBJECTIVE AND NONDISCRIMINATORY BASIS

To establish that scholarship grants to individuals are made on an objective and nondiscriminatory basis, a private foundation must show that they are awarded in accordance with a program which, if it were a substantial part of the foundation’s activities, would be consistent with: (1) the foundation’s tax-exempt status, and (2) the allowance of deductions to individuals for contributions to the foundation. There are three additional requirements that are essential in satisfying the objective and nondiscriminatory requirement rule involving the grantee pool, the selection criteria, and the persons making the selection.⁵²

scholarship or fellowship under § 4945(g)(1). See, e.g., Rev. Rul. 77-44, 1977-1 C.B. 355. *But see*, Priv. Ltr. Rul. 9526020 (distinguishing the applicant from the organization in Rev. Rul. 77-44 because scholarship recipients were not required to provide services as a condition of receiving the scholarship).

46 Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

47 IRC § 501(c)(3).

48 Treas. Reg. § 1.501(a)-1(c).

49 Similar but not identical to Code Section 501(c)(3), Code Section 170(c)(2)(B) sets out the definition of such purposes: “religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals”...

50 Treas. Reg. § 53.4945-4(a)(5)(ii).

51 IRC §§ 4945(d) and (g).

52 Treas. Reg. § 53.4945-4(b)(1). See e.g., Rev. Rul. 76-340, 1976-2 C.B. 370.

Grantee Pool

Ordinarily, selection of grantees on an objective and nondiscriminatory basis requires that the group from which grantees are selected be chosen on the basis of criteria reasonably related to the purposes of the grant.⁵³ In cases where grants provide benefits to an individual (e.g., funding of an individual's education), the pool must be sufficiently broad so the making of grants to members of the group will be considered as furthering a charitable purpose and not merely benefiting private interests. However, selection from a group is not necessary when, taking into account the purposes of the grant, one or more persons are selected because they are exceptionally qualified to carry out these purposes or the selection is particularly calculated to effect the charitable purpose of the grant rather than to benefit particular persons or a particular class of persons. Therefore, a foundation may impose reasonable restrictions on the group of potential grantees.

If a foundation's grant program limits the recipients to a narrowly defined group of individuals, it is then necessary to determine if such limitations cause the grant program to have an impermissible amount of "private benefit." In other words, the eligible recipients must be members of a "charitable class," as defined in the subsection above regarding public charities. In general, a "charitable class" is a group which is large enough so that an indefinite number of individuals may benefit. However, a charitable class may properly be comprised of a comparatively small number of beneficiaries, provided the class is open and the identities of the individuals to be benefitted remain indefinite.⁵⁴ Please note that this document does not explore, beyond the federal tax rules, laws and regulations that may impact a charitable organization's ability to limit its programs or services to a single gender or sex, race, or ethnic group.⁵⁵

Limiting the Grantee Pool Generally

In the interest of permitting "an individual great personal freedom to choose the beneficiaries,"⁵⁶ private foundations are given latitude in placing limits on the pool from which grantees are selected. If the other requirements are met, a grantmaking procedure that limits the grantee pool will not constitute a taxable expenditure as long as the grants are awarded on an "objective and nondiscriminatory basis."⁵⁷ For example, academic scholarships awarded by a private foundation to individuals in a particular city or geographical area are not taxable expenditures.⁵⁸ Likewise, awarding scholarships to people who plan to teach in a particular community does not constitute a taxable expenditure.⁵⁹

Comment: A public charity may include a geographic restriction or a limitation of benefits to graduates of a certain local school in the criteria for a grants program.⁶⁰ Indeed, these are among the most common restrictions on individual scholar-

53 Treas. Reg. § 53.4945-4(b)(2).

54 Please see the Section III, Public Charities Making Scholarship Grants to Individuals, in this document for additional information regarding what constitutes a charitable class.

55 For example, the following laws may impact or govern such activities: Title VI of the Civil Rights Act of 1964 (prohibiting discrimination based on race in programs or activities that receive federal funds); protections under Title IX of the Education Amendments Act of 1972 (prohibiting gender discrimination in educational programs or activities that receive federal funds); Section 1981 of the Civil Rights Act of 1870 (prohibiting racial discrimination in the making and enforcement of contracts by both public and private entities); Section 1983 of the Civil Rights Act of 1871 (restricting a person acting "under the color of the law" from depriving another person of their federally protected rights); and the Equal Protection Clause of the 14th Amendment of the U. S. Constitution (prohibiting racial discrimination by state governments).

56 General Counsel Memorandum ("GCM") 39082 (December 1, 1983) (distinguished by GCM 39792 (July 10, 1989) because, although the organization in this GCM included a restrictive provision that fostered racial discrimination inconsistent with established public policy, the IRS concluded that the organization in GCM 39082 did not have racially restrictive provisions that conflicted with fundamental public policy). Please note that, although these GCMs may be relied upon, this area of the law is unclear and developing in light of a June 2023 Supreme Court ruling discussed in the subsection regarding race in this document.

57 IRC § 4945.

58 See, e.g., Rev. Rul. 76-340, 1976-2 C.B. 370 and Rev. Rul. 79-131, 1979-1 C.B. 368.

59 Rev. Rul. 77-44, 1977-1 C.B. 355

60 See, e.g., Priv. Ltr. Rul. 9630008 (finding that a scholarship program limited to graduates of one high school is eligible for charitable deduction); Priv. Ltr. Rul. 8049101 (approving grantmaking procedures relating to one-time awards to graduates of a specific high school); Priv. Ltr. Rul. 8049080 (approving

ship grant finds. It is important, however, to make sure that the restriction does not reduce the size of the group so much that it no longer constitutes a charitable class. The diversity of eligibility criteria reflects the variety of impulses that motivate donors to create or support scholarship funds. There are numerous funds around the country, for example, for students who have been golf caddies; who are planning on pursuing forestry, jazz, or engineering degrees; who have been in state foster care systems; and who are residents in public housing developments. Restrictions such as these are generally permissible so long as the eligible class created by those restrictions is sufficiently large.

Limitations Based on Gender or Sex

Limitations based on gender or sex do not violate the “objective and nondiscriminatory” test. Such classifications may be direct or indirect. For example, a scholarship fund established to benefit members of a particular college fraternity indirectly excludes female students from the pool of potential grantees, but distributions from the fund are not taxable expenditures.⁶¹ Similarly, grantmaking procedures that earmark funds to assist “outstanding male students in acquiring higher education” have been determined to be “objective and nondiscriminatory,”⁶² as have procedures designed to “encourage female students to obtain a higher education at a certain college.”⁶³

Limitation Based on Race⁶⁴

Grantee pool limitations based on race are an important focus of the “objective and nondiscriminatory” rule. Limiting scholarships based on race poses critical questions and should certainly be discussed with expert legal counsel due to a recent United States Supreme Court decision and subsequent suits filed challenging the use of race in certain programs and activities.

In *Bob Jones University v. United States*, the U.S. Supreme Court upheld the IRS’ denial of tax-exempt status to an educational institution that prohibited interracial marriage and dating.⁶⁵ *Bob Jones University* was decided with *Goldsboro Christian Schools, Inc. vs. United States*, in which the Court considered whether the school’s racially discriminatory admissions policy, which admitted mostly white students, precluded it from maintaining its tax-exempt status.⁶⁶ Both schools asserted that their policies were based on their interpretation of religious doctrine and were protected by the First Amendment of the U.S. Constitution. The Supreme Court disagreed, finding that institutions must show that their operations fall within the tax-exempt guidelines outlined in section 501(c)(3) of the Code and that their activity is not contrary to settled public policy.⁶⁷ This decision gave specific judicial support to the IRS’ position that private schools must follow racially nondiscriminatory policies in order to maintain tax-exempt status as educational institutions.⁶⁸ As a result, racially discriminatory grantmaking procedures can result in the denial of a private foundation’s tax-exempt status.⁶⁹

grantmaking procedures that will award scholarships to high school graduates who are residents of a specific school district and who graduated from a high school in that district).

61 TAM 8613002 (December 12, 1985).

62 See, e.g., Priv. Ltr. Rul. 7935096; Priv. Ltr. Rul. 7824014; Priv. Ltr. Rul. 8031085.

63 Priv. Ltr. Rul. 8029097. The Supreme Court’s decision in the Virginia Military Institute case (*U.S. v. Virginia*, 518 U.S. 515 (1996)) does not directly affect private educational institutions or scholarship programs that discriminate on the basis of sex.

64 Please note that this is a developing and uncertain area of the law as of the date of this document. It is strongly recommended that you seek out legal counsel if a charitable organization is contemplating restricting its scholarship grants to individuals program based on race.

65 *Bob Jones University v. U.S.*, 461 U.S. 574 (1983).

66 *Ibid.*

67 *Ibid.*

68 Rev. Proc. 75-50, 1975-2 C.B. 587 (modified by Rev. Proc. 2019-22 to allow for display of the required nondiscriminatory policy online). See also, Rev. Rul. 71-447, 1971-2 C.B. 230.

69 GCM 39082 (December 1, 1983) (contrasted in GCM 39792 (July 10, 1989) finding that it is possible to include racially restrictive requirements that are not contrary to public policy). Note, however, that these GCMs may no longer be considered settled law given the Supreme Court’s June 2023 decision.

More recently, the U.S. Supreme Court went further in its June 2023 decision by holding that two universities' use of race-conscious admissions programs violated the 14th Amendment of the Constitution and, though the 14th Amendment does not apply to private universities, a violation of the 14th Amendment constitutes a violation of Title VI of the Civil Rights Act of 1964 because the universities received federal funds.⁷⁰ The Court held that the programs violated the Equal Protection Clause of the 14th Amendment because "race may never be used as a 'negative' and... it may not operate as a stereotype"⁷¹ Because some racial groups would be admitted in higher numbers if the admissions program was suspended, the Court found the use of race to be a negative; the ability to obtain preference in the admissions process based on race was held to amount to stereotyping.⁷² Additionally, the Court held that even if the use of race as a negative and as stereotyping was not enough, the admissions program also fatally lacked a logical endpoint.⁷³ In sum, the Supreme Court found that, because the admissions programs at both universities lack sufficiently focused and measurable objectives warranting the use of race, unavoidably employ race in a negative manner, involve racial stereotyping, and lack meaningful endpoints, the programs could not be permitted to continue.⁷⁴

It remains unclear whether the IRS could rely on the Court's recent ruling to take the position that any race-conscious limitations by an exempt organization are contrary to public policy. Regardless, as of the date of this analysis, Treasury Regulations state that a private foundation may provide scholarships that are specifically geared toward racial or ethnic minorities and not be in violation of the objective and nondiscriminatory requirement of Code Section 4945(g). For example, in Treasury Regulations Section 53.4945-4(b)(5), Example 2 recognizes such permissible restrictions: "X company has organized a private foundation which, as its sole activity, provides 100 college scholarships per year to children of X company's employees. It also provides 20 college scholarships per year to a certain ethnic minority group. All members of this ethnic minority group (other than disqualified persons with respect to the private foundation) living in State Z are eligible to apply for these scholarships. It is estimated that at least 400 persons will be eligible to apply for these scholarships each year. Selection of the recipients are based on prior academic performance, performance on certain tests designed to measure ability and aptitude for college works, and financial need. Under these circumstances, the operation of this scholarship program by the private foundation: (1) is consistent with the existence of the private foundation's exempt status under Section 501(c)(3); (2) utilizes objective and nondiscriminatory criteria in selecting scholarship recipients from among the applicants; and (3) utilizes a selection committee which appears likely to make objective and nondiscriminatory selections of grantees."

Yet, even if the awarding of racially restrictive grants does not cause a private foundation to lose its tax-exempt status, an issue remains as to whether such grants are taxable expenditures, either because they are not awarded on a nondiscriminatory basis or because they are a noncharitable expenditure. On this issue, and in light of the June 2023 Supreme Court decision, there is no conclusive answer. If in the future the IRS deems race-conscious decisions or preferences counter to public policy and inconsistent with the organization's charitable tax exemption, charitable organizations should be prepared to adapt to this change.

Comment: Given that this is a developing and unclear area of the law as of the date of this analysis, public charities and private foundations are strongly encouraged to consult with legal counsel when creating or applying race-conscious restrictions to scholarship grant programs for individuals.

70 *Students for Fair Admissions, Inc. v. President & Fellows of Harvard Coll.*, 600 U.S. 181 (2023).

71 *Ibid.*

72 *Ibid.*

73 *Ibid.*

74 *Ibid.*

Limitations Based on Employment

One way in which employer-related private foundations have traditionally sought to limit their grantee pools is by restricting awards to employees and their families. Indeed, the practice of for-profit employers establishing foundation-based scholarship programs for their employees became so prevalent that the IRS issued guidelines for determining when such scholarships constitute taxable expenditures.⁷⁵ These guidelines seek to distinguish between situations in which a scholarship program is provided in a benevolent and disinterested fashion (a charitable undertaking) and when it functions as a recruitment tool, employee retention device, fringe benefit, or otherwise serves a private, noncharitable goal of the related company (a taxable expenditure). The guidelines apply when an employer-related program is limited to some or all of its employees, or to the children of some or all of the employees of a particular employer as a group.⁷⁶ As in non-employer-related programs, the grantee pool must be sufficiently broad to constitute a charitable class. The guidelines impose specific rules in such circumstances.⁷⁷

Comment: The IRS has taken the position that if the funds for an employer-related scholarship fund will be coming from a corporate foundation, the corporate foundation and the public charity must meet all the requirements applicable to private foundations, including securing prior approval of grantmaking procedures and adhering strictly to the percentage tests and other requirements. In other words, just because the corporate foundation works with a public charity to award employer-related scholarships, the corporate foundation is not relieved of its obligations under the relevant rules.⁷⁸ The bottom line for public charities considering whether and how to administer programs of this nature is that adherence to Rev. Proc. 76-47 and the other relevant IRS procedures is necessary if there is a scholarship or comparable benefit provided to company employees and if individuals with a company affiliation are given preference in award decisions.

SELECTION CRITERIA

In order for a foundation's scholarship grants to be made in an objective and non-discriminatory fashion, the criteria used in selecting recipients from the potential grantee pool should be related to the purpose of the scholarship and should be applied equally to all applicants. Proper criteria might include, but need not be limited to, prior academic performance; performance on tests designed to measure ability and aptitude for college (or graduate) work; recommendations from instructors; financial need; and conclusions that the selection committee might draw from a personal interview as to the individual's motivation, character, ability, and potential.⁷⁹ Volunteer activities and demonstrated leadership skills may also be considered, as may an essay or other written submission.

Comment: Note that scholarship criteria need not require that awardees be the top student or top athlete in their respective cohorts. Indeed, there are funds at public charities for students of average and even below-average achievement that are designed to give applicants a second chance to succeed. If the scholarship provides assistance at a particular specialized institution, prior experience and achievement in that field will likely be an appropriate consideration. Many public charities suggest evaluation criteria and methods for their selection committees.

⁷⁵ Rev. Proc. 76-47, 1976-2 C.B. 670. See also, Rev. Proc. 77-32, 1977-2 C.B. 541. Rev. Proc. 85-51, 1985-2 C.B. 717, clarifies Rev. Proc. 76-47 with regard to determining the number of employees' children who can be shown to be eligible recipients of employer-related educational grants for purposes of the ten percent test.

⁷⁶ Rev. Rul. 79-365, 1979-2 C.B. 389 (noting that the application of such guidelines extends to children of deceased or retired employees).

⁷⁷ Publicizing a foundation's employer-related grant or loan program in the employer's newsletter, distributed to all employees of the company, will not violate the requirements of Rev. Proc. 76-47 or Rev. Proc. 80-39 where the foundation is clearly identified as the grantor of the awards. Rev. Proc. 81-65, 1981-2 C.B. 690.

⁷⁸ The IRS' position is set out in Rev. Rul. 81-217, 1981-2 C.B. 217. See also PLR 9349025 (September 15, 1993) (community college administering company scholarship funded by company foundation must comply with all Rev. Proc. 76-47 rules).

⁷⁹ Treas. Reg. § 53.4945-4(b)(3).

PERSONS MAKING THE SELECTIONS

Finally, for a private foundation's scholarship grants procedure to be deemed objective and nondiscriminatory, the foundation must show that the person or group of persons who select recipients are not in a position to derive a private benefit, directly or indirectly, from the selection process.⁸⁰ The selection of members of one's own family is particularly problematic.⁸¹ Therefore, a private foundation's written criteria for the selection process should exclude members of the families of individuals involved in decision-making. If an individual participating in the selection process is a disqualified person in relation to the private foundation, any grant that would provide a direct or indirect benefit to a member of such person's family could be treated as an act of self-dealing.⁸²

Comment: Public charities should follow this rule closely and minimize the possibility of personal benefit. It is prudent for a public charity to adopt policies that bar current members of a selection committee, substantial contributors, the board of the public charity, and its managers from deriving benefits by making these individuals and members of their families ineligible for assistance. In the composition and management of selection committees, the public charity must be equally careful to avoid potential problems. In some cases, a donor may serve on the selection committee, but neither the donor nor such donor's representatives should ever dominate the proceedings (in number or in actions).⁸³ When the donor is a corporation or corporate foundation and the grantees are corporate employees or their families, there should be no representation of the corporation or its foundation. In general, the public charity should strive to create selection committees that represent and are familiar with the community, that include individuals with expertise relevant to the selection process, and that serve as responsible goodwill ambassadors to the community.

IRS ADVANCE APPROVAL

Private foundation scholarship grants to individuals for study, travel, or similar purposes must be made pursuant to a procedure approved by the IRS in advance.⁸⁴ The IRS will only approve such procedure if it: a) awards grants on an objective and non-discriminatory basis; b) is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance (i.e., studies for scholarship grants); and c) requires the grantor foundation to supervise the grant to determine whether recipients have fulfilled the terms of the scholarship.

PAYMENT OF FUNDS AND MONITORING SCHOLARSHIP GRANTS

Generally, a private foundation has two options for payment and monitoring of scholarship and fellowship grants. If payment of scholarship or fellowship funds is made **directly to the individual student**, the private foundation has a duty to monitor the use of the funds and investigate any possible misuse. The private foundation must arrange to receive a verified report of the student's work in each academic period. When a student's course of study at an educational institution is complete, the private foundation must also obtain a final verified report. If a student's studies do not involve taking courses but only preparing research papers or projects, such as the writing of a doctoral thesis, the foundation must secure reports on an annual and a final basis reflecting how the scholarship funds are used and the progress made by the student toward achieving the purposes for which the scholarship was awarded. These reports must be approved by the student's academic supervisor or by another appropriate educational institution official.⁸⁵

⁸⁰ Treas. Reg. § 53.4945-4(b)(4).

⁸¹ Rev. Rul. 85-175, 1985-2 C.B. 276.

⁸² Treas. Reg. § 53.4941(d)-2(f)(2). See also Rev. Rul. 77-331, 1977-2 C.B. 388 (guarantee of loans made to disqualified persons under a student loan guarantee program established by a private foundation for the children of its employees is an act of self-dealing under IRC § 4941).

⁸³ See Priv. Ltr. Rul. 8707073 (holding that under the material restriction rules of Section 507, a private foundation establishing a scholarship at a junior college could have one of three spots on the selection committee).

⁸⁴ IRC § 4945(g). See also, Treas. Reg. § 53.4945-4(d) (describing the required contents of a request for approval of the procedure to make scholarship grants to individuals).

⁸⁵ Treas. Reg. §§ 53.4945-4(c)(2), (3).

When a private foundation has made a scholarship or fellowship payment directly to an individual and it appears that all or any part of a grant is not being used to further the purposes of the grant, the foundation is under a duty to investigate.⁸⁶ While conducting its investigation, the private foundation must withhold further payments to the extent possible until any delinquent reports have been submitted. To avoid taxable expenditure treatment when scholarship grant funds are diverted, a private foundation should (1) take all reasonable and appropriate steps either to recover the grant funds or to ensure the restoration of the diverted funds and the dedication of any unspent grant funds held by the student to the purposes being financed by the grant, and (2) withhold any further payments to the student after the grantor becomes aware that a diversion may have taken place (referred to in this section as "further payments") until it has received the student's assurances that future diversions will not occur and has required that the student take extraordinary precautions to prevent future diversions from occurring.⁸⁷ In addition, the foundation must recover or restore diverted funds prior to making any further payments.⁸⁸

A considerably simpler alternative is for the private foundation to make the payment directly to the scholarship recipient's school.⁸⁹ If payment is made directly to an educational institution and the institution agrees to use the payment to defray the recipient's expenses or to transfer the money (or a portion thereof) to the recipient only if such recipient is enrolled at the school and such recipient's "standing... is consistent with the purposes and conditions of the grant," the monitoring and investigation rules may be considered satisfied.⁹⁰*Comment: Public charities may consider closely following one of the two alternatives for payment and monitoring of scholarship funds to ensure that the granted scholarship funds are being spent properly. Although a public charity is under no specific legal obligation to investigate possible diversions of scholarship and fellowship payments, any public charity that suspects that funds have been misused should pursue information about the transaction and seek repayment if appropriate.*

RENEWALS AND EXTENSIONS OF SCHOLARSHIP GRANTS

A renewal of a grant that originally satisfied the private foundation study or travel requirements will continue to comply with these rules if: (1) the private foundation has no information indicating that the original grant is being used for any purpose other than that for which it was made; (2) any reports due at the time of the renewal decision pursuant to the terms of the original grant have been furnished, and (3) any additional criteria and procedures for renewal are objective and nondiscriminatory. An extension of the period over which a grant is to be paid is not regarded as a grant or a renewal of a grant.⁹¹

⁸⁶ Treas. Reg. § 53.4945-4(c)(4).

⁸⁷ Treas. Reg. §§ 53.4945-4(c)(4).

⁸⁸ If a private foundation is treated as having made a taxable expenditure in a case to which these rules apply, then unless the private foundation meets the requirements, the amount of the taxable expenditure is the amount of the diversion plus the amount of any further payments to the same student. However, if the private foundation complies with the requirements but fails to withhold further payments until the additional requirements are met, the amount of the taxable expenditure is the amount of the further payments. Treas. Reg. §§ 53.4945-4(c)(4).

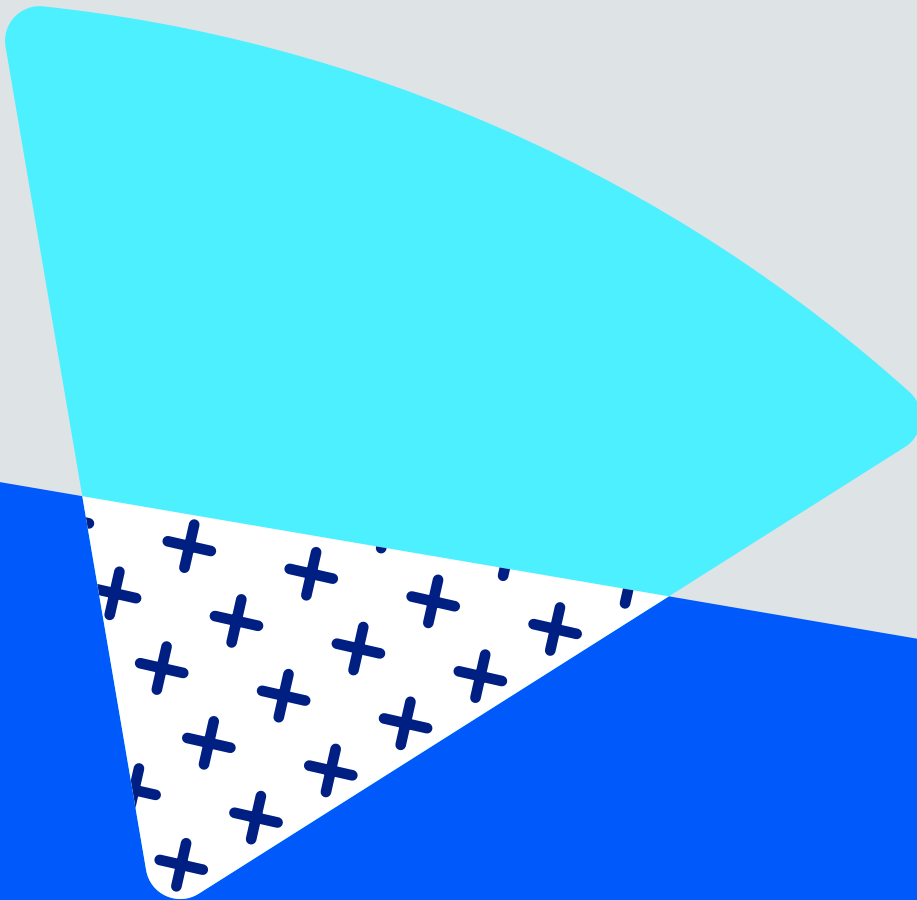
⁸⁹ Treas. Reg. § 53.4945-4(c)(5).

⁹⁰ Treas. Reg. § 53.4945-4(c)(5)(iii). One might assume that grantees should generally be in good academic standing, but it appears that the IRS embraces the possibility that some will be in standings that are other than good.

⁹¹ Treas. Reg. § 53.4945-4(a)(3)(iii).

Additional Consequences for Making Improper Scholarship Grants

When a charitable organization establishes or operates a scholarship grants program to individuals, there are a variety of potential risks.



Lawuits from Unsuccessful Applicants

Some charitable organizations worry that individuals who apply for scholarships but do not receive them will take legal action. As with all grants made by a charitable organization, grants to individuals are gratuitous (voluntary) transfers – no one has a right to expect a charitable organization's support. To protect itself against this risk, a charitable organization may ensure that none of its written or oral communications, including statements by scholarship advisory committee members, ever guarantee an applicant will receive an award. Instead, all conditions should be clearly stated and agreed upon. If the charitable organization has Directors' and Officers' Liability Insurance, this policy may cover any legal costs resulting from a suit in this area.

It is also conceivable that an unsuccessful applicant could accuse the charitable organization of some sort of racial or other discrimination in awarding its grants, especially given the June 2023 Supreme Court decision.⁹² To protect itself against this sort of claim, the charitable organization may strive to ensure that its processes and criteria for selection are objective and non-discriminatory. However, given that this area of law is still under development,⁹³ charitable organizations should seek legal counsel regarding such programs.

Use of Name, Image, and Likeness

Some charitable organizations are concerned that publicity about their scholarship grants-to-individuals programs may invade the privacy of award recipients. To minimize the risk of such issues, charitable organizations may consider including a check-off box and sentence on their scholarship applications that grants the charity the right to use the name, image, and likeness of a successful applicant in publicity materials relating to the charitable organization. Alternatively, such a grant of permission may be included in a scholarship award letter that an applicant must sign and return to receive a check. Importantly, the area of data and privacy law have been evolving quickly, and charitable organizations with specific questions are encouraged to consult with privacy counsel specific questions.

Scholarship Scams

Charitable organizations that publish directories of available scholarships often list scholarships and resources about scholarships that are not offered by the charity itself. Unfortunately, some supposed sources of information and funds are not legitimate.

Unless a charitable organization is able to verify all of its provided information, it should include a notice that states the organization does not endorse any outside organization listed in the directory and applicants should research all such organizations thoroughly. All charitable organizations may wish to provide students with information from the Federal Trade Commission about scholarship scams, available at <https://consumer.ftc.gov/articles/how-avoid-scholarship-financial-aid-scams>.

Impact on Charitable Mission and Reputation

When a charitable organization considers whether or not to establish a scholarship fund for individual grants or a program of such grants, its leaders must ask whether the fund or the program will advance or harm both the organization's charitable mission and its public reputation.

⁹² *Students for Fair Admissions, Inc. v. President & Fellows of Harvard Coll.*, 600 U.S. 181 (2023).

⁹³ *Ibid.*

Making grants to individuals can further a charitable organization's ability to fulfill its charitable mission. Furthermore, good publicity about a charitable organization's scholarship grants program can help create greater awareness of the organization's existence and can generate contributions from diverse segments of the population. Through the act of convening award selection committees, the charitable organization can bring new volunteers into its activities. Even if the amount of money awarded is not large, the impact of making the grant may justify the undertaking.

But the programs may also pose risks to the charitable organization's public reputation. Are there really enough funds available to have a significant impact in the targeted community? How many applicants will be turned down in relation to the number who may apply? Is the donor or institution establishing the fund one with which the charitable organization wishes to be associated? Are there other criteria in the proposed fund or scholarship program that are unacceptable to the charitable organization?

Extensive advance planning before establishing such a scholarship fund or program – including cost analysis and long-term projections – is essential. It will pay off in the future by helping the charitable organization avoid or minimize problems. If the answers to any of these questions are not clear, it is wise to seek advice and counsel from others making similar grants in the same geographic area or under similar circumstances elsewhere.

Alternatives to Conducting a Scholarship Grant Program to Individuals

There are circumstances in which a charitable organization may seek to find an alternative to launching and operating a scholarship grant program. Using an intermediary organization will usually work if the intermediary selects the individual scholarship recipient(s). However, if a private foundation chooses the individual recipient, the study or travel rules cannot be avoided by first sending the scholarship through another charity. The key factor here is whether or not the intermediary organization exercises control, in fact, over the choice of the recipient of the study or travel grant.

For example, when a private foundation scholarship grant to a charitable organization (intermediary) is earmarked for a named individual (or for another named organization), the intermediary grantee may have no control or discretion over its use. Earmarking is defined as any agreement, **oral or written**, between grantor and grantee that funds will be directed in a specific way. Under such circumstances, the ultimate recipient may be treated as the actual grantee of the originating private foundation.⁹⁴ Likewise, if a donor makes a contribution to a private foundation and earmarks the contribution or fund to be used only for the benefit of a particular individual, the contribution may be considered as actually made directly from the donor to such individual, with the foundation acting merely as a conduit. In such a case, the donor will be treated as if the donor made a nondeductible and possibly taxable gift directly to the individual rather than making a charitable contribution to the foundation.

An illustration of the misuse of an intermediary organization was provided in the case of a private foundation that made grants to vocational high schools, all legally classified as educational organizations⁹⁵, in a certain geographic area. The grants were to be used to purchase the basic equipment of a trade for students, enabling the students to learn their trades and enter into those trades upon graduation. However, because the individual grant recipients were selected by representatives of the foundation, rather than by the schools, the grants were deemed to be made directly by the foundation to the individual students.⁹⁶ In general, when the grantee organization exercises control over funds contributed by a donor or private foundation, these problems can be avoided. However, what if the selection of the final recipients is delegated to an educational institution and this institution sets up a selection panel and appoints a foundation director or manager to serve on the panel? Even though the private foundation may not control the selection panel, a disqualified person in relation to the foundation is directly involved in the selection process. It would probably be wise in such a case to get an advance ruling from IRS to be safe.

The rules regarding whether or not a grant is earmarked are specifically articulated in the regulations applicable to study or travel grants by private foundations. A grant made by a private foundation to a charitable organization for such purposes is not regarded as a grant by the foundation to an individual if (1) the foundation does not earmark the use of the grant for any named individual, and (2) there is no written or oral agreement whereby the grantor foundation may cause the selection of the individual grantee by the grantee organization. This non-earmarked status is true even though the foundation has reason to believe that certain individuals will derive benefits from the grant **so long as the grantee organization exercises actual control** over the selection process and actually makes the selection without participation of the private foundation.⁹⁷

94 See Treas. Reg. § 53.4945-5(a)(6); Treas. Reg. § 53.4945-4(a)(4)(ii); Rev. Rul. 81-217, 1981-2 C.B. 217.

95 That is, organizations described in IRC §§ 170(b)(1)(A)(ii) and 509(a)(1).

96 Rev. Rul. 77-212, 1977-1 C.B. 356 (distinguished by Priv. Ltr. Rul. 200341024) (finding that the applicant at issue did not retain authority to select individual grantees as the organization had in Rev. Rul. 77-212).

97 Treas. Reg. §§ 53.4945-4(a)(4)(i), (ii).

Conclusion

A well-run and well-publicized program of scholarship grants to individuals can provide enormous benefits. Activities of this kind not only attract financial support, they generate positive press coverage and community appreciation. However, donors often do not understand the complexity of the laws and regulations that govern scholarship grants to individuals or the labor-intensive nature of such programs. Wise public charity managers should take the time to educate themselves and their donors before they undertake grants to individuals and should enlist the aid of legal counsel with experience in such matters. For private foundations, unlike making grants to well-recognized public charities that have obtained the appropriate determination letter from the IRS, scholarship grants to individuals require extra care, attention, and recordkeeping. In the case of study or travel grants, specific advance IRS approval of the foundation's procedures is required to avoid penalty.

Whatever form of scholarship grant program for individuals is under consideration, advance planning and review by competent legal or accounting advisors is highly recommended.



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