The Heart of It: Allowing Donor Participation in the Scholarship Process

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National Scholarship Providers Association | October 11, 2016
Overview: Why Does Donor Participation Matter?
Our World View: Many Types of Scholarship Providers, One Common Goal

- Private Foundations
- Public Charities
- Community Foundations
- Colleges and Universities
- Corporate Programs
- Other Providers

Scholarship Recipient
IRS World View: Three Types of Scholarship Providers, Each Uniquely Regulated

501(c)(3) Public Charities → Scholarship Recipient → 501(c)(3) Private Foundations

Others
Public Charities v. Private Foundations

501(c)(3) Public Charities

More public involvement = less IRS oversight

501(c)(3) limitations

501(c)(3) Private Foundations

Less public involvement = greater IRS oversight

501(c)(3) limitations and private foundation rules
Public Charities: Types of Providers

501(c)(3) Public Charities

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

For example:
- Charities with scholarship focus
- Community foundations with scholarship funds
- College/university foundations and alumni groups
Public Charities: Donor Participation

501(c)(3) Public Charities

Donate

Establish Criteria

Name Scholarship

Advise

Select Recipient
Public Charities: Donor Participation

**Warning:** when a public charity allows donor participation in the scholarship process, take pause, because we’re in sensitive territory!
Public Charities: Donor Participation

- If donor participation becomes too great, fund/account may be considered a Donor Advised Fund (DAF)

- Donor Advised Funds (DAFs) are prohibited from making scholarships, unless they satisfy stringent requirements for a Qualifying Scholarship Fund!
Public Charities: Donor Participation

» Complex rules can snag well-meaning scholarship providers and their donors

» Penalties are severe:
  - 20% of scholarship amount for sponsoring charity (plus “correction”)
  - 5% of scholarship amount for fund managers (for knowing violation)
So, if There is Donor Participation, Ask Yourself …

- **Does the donor participation create a DAF?**
  - **If yes, is the DAF a Qualifying Scholarship Fund?**
    - **If yes, scholarships allowed**
    - **If no, scholarships are prohibited**
  - **If no, scholarships are allowed**
Does the Donor Participation Create a DAF?
DAF Definition

1. Is fund/account owned or controlled by a sponsoring organization?

2. Is fund/account separately identified by reference to contributions of donor(s)?

3. Does donor/advisor have or expect advisory privileges as to distributions or investments because of donor status?

= Donor Advised Fund
DAF Definition: Sponsoring Organization

1. Is fund/account 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
- Custodial funds
DAF Definition: Separately Identified

Is fund/account 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*
- Other “multiple donor” funds* (more later)

* Multiple donors, contributions pooled
DAF Definition: Advisory Privileges

Covered:
- Advisory privileges as to distributions or investments
  (donor/advisor makes recommendations; sponsor considers them)

Not Covered:
- Gift restrictions
  (e.g. donor restricts purpose of fund to scholarships; or establishes eligibility or section criteria)

3 Does donor/advisor have or expect advisory privileges as to distributions or investments 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 a certain position (e.g. officer, director, faculty)
DAF Definition: Distributions/Investments

Covered:
• Recommendation of scholarship recipients
• Recommendation of investments

Not Covered:
• Recommendation of selection committee, so long as based on objective criteria related to expertise (e.g. department heads, high school principal, etc.)

Does donor/advisor have or expect advisory privileges as to distributions or investments because of donor status?
DAF Definition: Have or Expect

3

Does donor/advisor have or expect advisory privileges as to distributions or investments because of donor status?

Covered:
• Privilege arises under written agreement
• Privilege arises by course of conduct
• Privilege exists even if not exercised
• Privilege that arises later

Not Covered:
• No mutual expectation of donor/advisor and sponsor
DAF Definition

1. Is fund/account owned or controlled by a sponsoring organization?

2. Is fund/account separately identified by reference to contributions of donor(s)?

3. Does donor/advisor have or expect advisory privileges as to distributions or investments because of donor status?

= Donor Advised Fund
Of Special Concern: Multiple Donor Funds

For example … scholarship funds established by:

» Faculty and alumni groups
» Service and social clubs
» Company employees
» Friends in memory of loved one
» Giving circles

Lack of IRS guidance, so proceed with caution

» Separately identified by reference to contributions of donors if named for group? What about relationship between donors?
Of Special Concern: Multiple Donor Funds

Key factors for your attorney to consider:

» How large is the donor group?
» How are the donors related? Is fund named after identifiable group?
» Does anyone dominate or control the group?
» How is the selection committee comprised and selected?
» What is the nature of its advisory privilege?
» Is there a scholarship plan that meets the private foundation rules?
» To what extent does the sponsor oversee the scholarship activity?
» How close does the fund come to meeting the scholarship fund exception?
If There is Donor Participation, Ask Yourself …

- Does the donor participation create a DAF?

  - If yes, is the DAF a qualifying scholarship fund?
    - If yes, scholarships are allowed
    - If no, scholarships are prohibited
  - If no, scholarships are allowed
Is the DAF a Qualifying Scholarship Fund?
## Qualifying Scholarship Fund: Five Requirements

<table>
<thead>
<tr>
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<th>Requirement</th>
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<tbody>
<tr>
<td>1</td>
<td>Donor/advisor (and related persons) have advisory privileges only as members of advisory committee</td>
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<tr>
<td>2</td>
<td>Entire advisory committee is appointed by sponsoring charity</td>
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<tr>
<td>3</td>
<td>Donor/advisor (and related persons) do not directly or indirectly control advisory committee</td>
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<td>4</td>
<td>Scholarships are awarded pursuant to plan pre-approved by sponsoring charity's governing board</td>
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<td>5</td>
<td>Plan is designed to comply with private foundation rules</td>
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Qualifying Scholarship Fund: Five Requirements

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

**Okay:**
Donor is member of 5-member advisory committee, does not control committee, and votes on candidates as part of committee.

**Not Okay:**
Same facts, except donor pre-selects individuals who will be considered by full committee.
Qualifying Scholarship Fund: Five Requirements

2

Entire advisory committee is appointed by sponsoring charity

Okay:
Sponsoring charity appoints all members of 5-member advisory committee

Not Okay:
Gift instrument designates donor and spouse as members of advisory committee; sponsoring charity appoints remainder
Qualifying Scholarship Fund: Five Requirements

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

Okay:
Advisory committee consists of donor, spouse and three retired college presidents.

Not Okay:
Advisory committee consists of donor, spouse, their accountant and two retired college presidents.
Qualifying Scholarship Fund: Five Requirements

Okay:
Board adopts “master” procedures applicable to all scholarship funds of sponsoring charity

Not Okay:
Staff determines procedure for each fund
Qualifying Scholarship Fund: Five Requirements

Plan is designed to comply with private foundation rules

5

• Nondiscriminatory criteria and publicity
• Objective selection process
• Adequate records as to recipients
• Reasonable renewal criteria
• Monitoring of recipients’ performance, reports from recipients
• Investigate known diversion of funds
• Special rules for employee scholarships
Qualifying Scholarship Fund: Five Requirements

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

2. Entire advisory committee is appointed by sponsoring charity

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

4. Scholarships are awarded pursuant to plan pre-approved by sponsoring charity’s governing board

5. Plan is designed to comply with private foundation rules
Conclusion
Recap:

**Warning:** any scholarship fund/account administered by a public charity, which permits donor participation, should be reviewed to determine DAF status.
What if …?

Does the donor participation create a DAF?

If yes, is the DAF a qualifying scholarship fund?

If yes, scholarships allowed

If no, scholarships are prohibited

If no, scholarships are allowed
Options:

» Modify donor participation to avoid DAF status
» Modify fund terms to satisfy criteria for Qualifying Scholarship Fund
» Reorganize fund as supporting organization or private foundation
» Eventually … request Treasury Department exemption
» Consider alternative to scholarship activity
We’re Done!

Visit our blog at http://leafferlaw.com/resource_type/blog-post/!
Thank you.

Karen Leaffer | Leaffer Law Group

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