Legal Fundamentals for Scholarship Providers

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Agenda

• Overview
• Taxation of Scholarships
• Donor Participation in Scholarship Process
• Scholarship Plans
• Charitable Solicitations
• Record Collection & Retention
Overview

Taxation of Scholarships
Donor Participation in Scholarship Process
Scholarship Plans
Charitable Solicitations
Record Collection & Retention
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
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
Many Types of Scholarship Providers

What type of scholarship provider are you?
Overview

Taxation of Scholarships

Donor Participation in Scholarship Process
Scholarship Plans
Charitable Solicitations
Record Collection & Retention
Two Questions

1. Is the scholarship taxable or tax-free?
2. Is tax reporting or withholding required?
Scholarships are tax-free *only* if:

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

Otherwise, they are taxable!  
– See IRS Publication 970
Is the scholarship taxable or tax-free?

a. Funds are used for **qualified education expenses**:

- Tuition and fees *required* for enrollment or attendance
- Fees, books, supplies and equipment *required* for course work
- **Room and board**
- **Travel expenses**
- **Optional equipment (e.g., laptop, tablet)**
- **Family allowance**
- **Anything else!**
Is the scholarship taxable or tax-free?

b. Student is a candidate for a degree:

- Pursues degree at college or university
- Attends primary or secondary school
- Attends school with program that counts for full credit toward bachelor’s degree or higher, even if student him/herself is not seeking a degree
- Attends vocational school

*Note:* the last two schools must be nationally accredited, and authorized by law to offer the program
c. Student studies at an educational institution:

» Primary function is presentation of formal instruction,
» Normally maintains a regular faculty and curriculum, and
» Normally has a regularly enrolled body of students in attendance at the place where it conducts its educational activities
Is the scholarship taxable or tax-free?

d. Award is **non-compensatory**:

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

   » Limited exceptions, e.g.:
      - National Health Service Corps Scholarship Program
      - Armed Forces Health Professions Scholarship Program

   **Non-compensatory v. Compensatory (Relevant Factors)**
      - Extent of faculty supervision over work schedule
      - Student’s ability to direct course of work
      - Right of student to retain copyrights or patents
      - Extent of reporting requirements (but reporting requirement alone is not determinative)
1 Is the scholarship taxable or tax-free?

What about graduate students who teach or conduct research for the provider?

» Example 1: Graduate student is required to teach intro level chemistry class to undergraduates. *Compensatory?*

» Example 2: Graduate student is required to conduct chemistry research. *Compensatory?*

What if the services are performed for someone other than provider?

» Example 1: Scholarship provider requires student to teach in rural area for three years after graduation. *Compensatory?*

» Example 2: Scholarship provider requires law graduate to practice public interest law for three years after graduation. *Compensatory?*
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*Otherwise, they are taxable!*
– See IRS Publication 970
Two Questions

1. Is the scholarship taxable or tax-free?
2. Is tax reporting or withholding required?
Requirement to report to IRS and withhold taxes depends on whether:

a. Student is **U.S.** or **foreign** taxpayer, *and*
b. Scholarship is **compensatory** or **non-compensatory**
2 Is tax reporting or withholding required?

U.S. Students:

» **Non-Compensatory Scholarship:** no tax reporting or withholding is required; but IRS recommends alerting students of potential taxation

» **Compensatory Scholarship:** tax reporting required, plus withholding for employees

Foreign Students:

» **Non-Compensatory Scholarship:** no tax reporting or withholding is required for tax-free scholarships; tax reporting and back-up withholding (generally 14%) for taxable scholarships

» **Compensatory Scholarship:** tax reporting and withholding required
What about undocumented students?

» **U.S. Taxpayer = U.S. Student**
  - Citizen, born or naturalized in U.S.
  - Permanent resident—green card
  - Substantial presence test

» **DACA v. Non-DACA Student**
  - DACA students: requirements for DACA qualification likely meet substantial presence test
  - Non-DACA students: further due evaluation required
Requirement to report to IRS and withhold taxes depends on whether:

- a. Student is **U.S.** or **foreign** taxpayer, *and*
- b. Scholarship is **compensatory** or **non-compensatory**

Tax treaty may change outcome for foreign students
Overview

Tax Treatment of Scholarships

Donor Participation in Scholarship Process

Scholarship Plans
Charitable Solicitations
Record Collection & Retention
Review … IRS World View: Three Types of Scholarship Providers

- 501(c)(3) Public Charities
- 501(c)(3) Private Foundations
- Other Providers

Scholarship Recipient
Public Charities: Types of Providers

501(c)(3) Public Charities

<table>
<thead>
<tr>
<th>More public involvement = less IRS oversight</th>
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<td>501(c)(3) limitations</td>
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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

Select Recipient

Name Scholarship

Advise
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 in a fund/account becomes too great, it may 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

» Penalties for violation are severe!
If Donor Participation is Allowed, 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 allowed
  - If no, scholarships are allowed
  - If no, scholarships are prohibited
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
Qualifying Scholarship Fund

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 control advisory committee.

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

5. Plan is designed to comply with private foundation rules.
Summary

Donor participation:
» Structured well, represents a win, win, win proposition (good for students, donors and sponsors)
» Structured poorly, creates risk and results in penalties

Remember to always evaluate if:
» If donor participation creates a DAF
» And if so, whether the DAF meets the requirements for a Qualifying Scholarship Fund
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Two Questions

1. Who must have a scholarship plan?
2. What must a scholarship plan include?
1. Who must have a scholarship plan?

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

**Qualifying Scholarship Funds (just discussed)**
Scholarships are prohibited unless awarded pursuant to a plan *pre-approved by sponsor’s governing board*

No requirement for Other Public Charities or Providers, though a plan is recommended
Scholarships plan must address:

a. Objective and non-discriminatory selection process
b. Process for supervising scholarships
c. Process for handling jeopardized scholarships
d. Record collection and retention
2. What must a scholarship plan include?

a. Objective and non-discriminatory selection process

» *Eligibility Criteria:*
  potential applicant pool = charitable class
  (broad or indefinite)

» *Selection Criteria:*
  related to purposes of scholarship
  (e.g., grades, test scores, references, need, interviews)

» *Selection Committee:*
  not be in position to benefit privately from selection
b. Process for supervising scholarships

» *Funds paid to school:*  
School agrees to: (1) use funds to defray student’s expenses, or (2) pay funds to student only if enrolled and standing is consistent with purpose of scholarship

» *Funds paid to student:*  
Provider obtains, at least annually, a school-verified transcript of courses taken and grades received for each academic period
2. What must a scholarship plan include?

c. Process for handling problem scholarships

> **Funds paid to school:**
> No additional requirements

> **Funds paid to student:**
> Provider must investigate and withhold further payments if concerned about proper use of funds or if reports are delinquent; plus, take “reasonable and appropriate steps” to recover misused funds
What must a scholarship plan include?

d. Record collection and retention:

» Stay tuned … covered under Record Collection and Retention
Private Foundations and Qualifying Scholarship Funds must have a pre-approved plan.

But all providers should have a scholarship plan.

Several required elements, but central is inclusion of objective and non-discriminatory selection process.
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40 States Regulate Charitable Solicitations
Charitable Solicitations Laws

» Laws require organizations to register before soliciting charitable contributions in a state

» Laws vary by state, though common principles apply

» Laws are intended to:
  • Protect citizens and charitable sector from fraud
  • Bolster public confidence by boosting transparency, accountability
Charitable Solicitations Laws

“Charitable Solicitation” is very broadly defined

- Charitable = any eleemosynary purpose (not limited to 501(c)(3) purposes)
- Solicitation = direct or indirect request for contribution on basis that contribution will be used for charitable organization or purpose, whether oral, written or electronic.
Charitable Solicitations Laws

» Exemptions may apply, though they vary by state:
  • Small organizations (e.g., raise < $25,000 per year)
  • Limited solicitations (e.g., solicit < ten persons per year)
  • Religious institutions, hospitals, educational institutions, PTA organizations
  • Trade associations, veterans associations

» Filing proof of exemption may be required
Charitable Solicitations Laws

» Initial registration typically requires:
  • Background information (similar to IRS Form 1023)
  • Governing documents
  • Financial documents (e.g., federal tax filings)
  • IRS determination letter
  • Board or officer signature
  • Fee

» Annual renewal is typically required

» Registrations are typically public information
Charitable Solicitations Laws

» Professional solicitors/fundraisers:
  - May also require registration (contract may need to be filed)
  - Exemptions (e.g., paid employees) also apply, though they vary by state
  - Organization should confirm registrations are made
Charitable Solicitations Laws

» Charitable solicitations laws are grounded in consumer fraud laws

» Non-compliance can mean big trouble:
  • Significant penalties (up to $25,000 in some states)
  • Potential criminal charges
  • Prohibition of solicitations in state
  • Return of contributions
Of Special Concern: Internet Solicitations

» Some states adhere to the **Charleston Principles**: registration by out-of-state organizations is required only if:

  • Contributions are solicited through **interactive** website and organization either: (1) specifically targets people in state or (2) receives contributions from people in state on a repeated/ongoing basis or substantial basis through the website.

  • Contributions are solicited through **non-interactive** website and organization either: (1) invites further offline activity to complete contribution or (2) establishes other contacts with state (e.g. emails that promote website)

» Some states are more aggressive!
Summary

When in doubt, reach out:

• Complex area of law, which varies significantly among states
• Review/refresh applicable law in each state where soliciting
• Err on the side of registration

Help is available for multi-state filing:

• States are attempting Uniform Registration Statement effort (with limited success)
• Until then, specialized firms offer support in this area
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1. What information should a scholarship provider collect to meet its tax obligations?

2. How long should it keep that information?
What information should be collected?

Guiding Principle:
501(c)(3) Scholarship Providers must award scholarships on an objective and nondiscriminatory basis …

So maintain records that support your compliance with this requirement!
1. What information should be collected?

Private Foundations / Qualifying Scholarship Funds

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

Other Nonprofit Providers

» *Should* collect and keep the same records
Private 501(c)(3) Schools

» **Must** adopt a racial nondiscrimination policy

» **Must** collect and keep for three years:
  • Records showing racial composition—student body, faculty and staff—for each academic year
  • Records showing awards were made on a racially nondiscriminatory basis
  • Copies of brochures and similar items addressing aid
  • Copies of materials used to solicit contributions
Our recommendation:
Minimum of **four years**, preferably **six years**, after close of calendar year in which studies funded by scholarship are completed

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

» Record collection and retention requirements are fairly minimal under tax laws

» Specific requirements for Private Foundations and Qualifying Scholarship Funds provide good guidance for all providers

» Don’t forget, many other federal and state laws cover data privacy and security!
Thank you! We’re done …

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