



## Nonprofits: The Do's and Don'ts of Granting Scholarships

College acceptance letters arrive every April with a question for students and parents. They ask, how do we pay for this? For many, the answer includes seeking scholarships from nonprofits.

Your charity may already have a scholarship program in place or may be thinking about starting one. Whatever your status, it is very important to administer scholarship programs in a certain way to ensure your donors receive deductions. The rules also vary if your organization is a public charity or a private foundation.

### Are There Limits on How We Can Choose Scholarship Recipients?

Your scholarship cannot benefit a particular person or family, but you can put reasonable restrictions on the group of applicants. As a rule, the applicant pool should be big enough to benefit the greater community, and you should not be able to identify all of the eligible recipients ahead of time. Your applicant pool can be very small only if your charitable goal is similarly narrow (e.g., sponsoring a top Ph.D. candidate in a small scientific field when your organization is devoted to curing a rare disease).

All scholarships should be awarded on an objective and nondiscriminatory basis. Excellent metrics to consider include prior academic performance, test scores, recommendations, or financial need. You can also interview candidates to evaluate their character. Family members of officers, directors, major contributors and members of any scholarship selection committee should be disqualified from receiving scholarships.

Some nonprofits also consider an applicant's race or national origin. These are, however, potentially problematic criteria to use, especially if the result is to eliminate groups that have traditionally faced discrimination. Schools must be especially careful in this area because they can lose access to federal loan programs and other forms of support if they discriminate based on race. A much less contentious way to further narrow the applicant pool, and one that will prompt fewer possible legal issues, is screening for applicants whose pursuits align with your charitable mission (e.g., sponsoring local student musicians when your organization promotes the arts in Boston).

### What Form Can the Scholarship Take?

Any scholarship that you give directly to an individual student must meet special rules so the money does not count as taxable income for them. The student will have to verify that the scholarship is spent only on tuition, fees, or supplies. Also, the student must be pursuing a degree at their college or university. Scholarships may also be paid directly to the student's school.

### Specific Rules for Public Charities

First, no member of your selection committee can benefit in any way from choosing the scholarship recipients (e.g., committee members can not have relatives in the applicant pool).

Second, you may donate money to a 501(c)(3) school and recommend that they grant scholarships to certain applicants. But, the school must have the final say on which students actually receive scholarships.

Third, you must ensure that any non-U.S. citizen who receives a scholarship is not on a published "Specifically Designated Nationals" terrorism watch list.

#### **Additional Rules for Donor-Advised Funds:**

If you operate a donor-advised fund and want to make scholarship grants out of that fund, additional rules apply. The portion of the fund that will grant scholarships must be set up solely to distribute scholarships, and the money must be paid directly to a domestic 501(c)(3) school that uses the money exactly as you instruct. You must also appoint a selection committee. The original donor may serve on the committee if they have no other advisory privileges or control over the committee and if there are also at least two other independent committee members. Before awarding scholarships, the committee must create an objective and nondiscriminatory selection procedure.

If your committee restricts the applicant pool, the limits must be reasonable, they must benefit the greater community, and they cannot predetermine the eligible recipients.

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## Specific Rules for Private Foundations

Your foundation must meet the guidelines above plus additional strict requirements. Failure to comply with these rules can result in penalties ranging from a 20% excise tax on scholarships granted (and revocation of the scholarships) to complete revocation of your tax-exempt status.

### **If you give scholarships to selected students:**

You must obtain pre-approval of your selection procedure from the IRS by submitting a request for pre-approval at least 45 days before you make your first award. People who can profit from choosing the scholarship recipients are ineligible to serve on the selection committee.

### **If you fund scholarship programs at educational institutions:**

You may suggest scholarship recipients to the school, provided the school makes the final choice. If the grant is conditioned on certain students receiving scholarship funds, the rules that apply to scholarship awards to selected students described above apply.

### **If your foundation is affiliated with a business entity:**

If employees of the business or their children are eligible for scholarships, your program must strictly follow a number of additional rules. For example, business-related foundation scholarships must be awarded by a completely independent selection committee - no business or foundation employees or board members, not even former employees. Selection must be based on objective standards unrelated to the recipients' (or their parents') continued employment except as an initial qualifying matter. Only a small percentage of eligible recipients may actually be awarded scholarships. Recipients cannot be required to choose an area of study that primarily benefits the business.

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## In Summary

A wide variety of nonprofits give scholarships for a wide variety of reasons. Whatever their type or reason, it is crucial that they precisely follow rules and processes that do the most good without creating a costly tax consequence.

Take care, for example, to be objective and arm's length, avoiding unfair advantages or discrimination. Remember as well that the manner in which a gift is made will have a tax impact on the recipient and donor alike.

As with anything tax-related, granting scholarships is a complex undertaking with many potential risks. Take care to get counsel experienced in this area of the law.

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## For More Information

Contact your Hemenway & Barnes attorney or the author of this advisory:

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