

Employer-Related Tax-Exempt Scholarship Funds — Issues in Structure and Operation

by Jack A. Rosenbloom

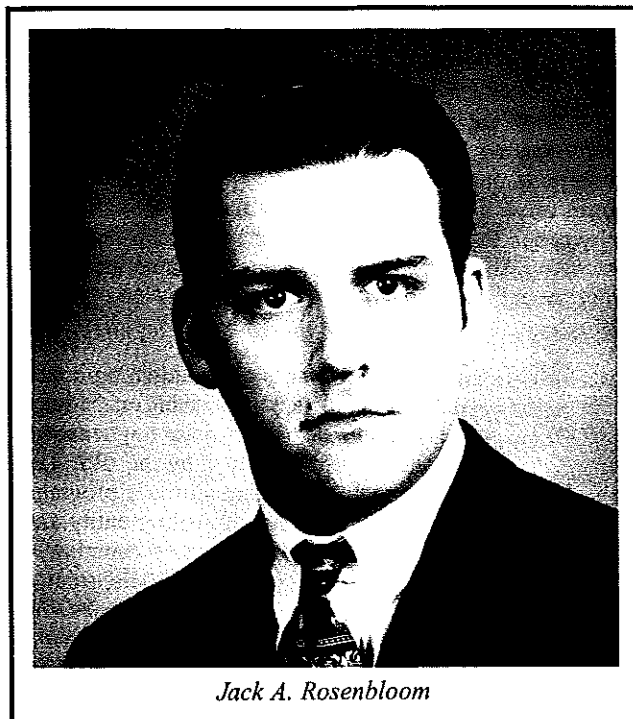
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I. Introduction

With the increase in the cost of post-secondary education over the past decade, working families have been forced to expend a greater portion of their income on higher education. As of 1995, the average cost for tuition, room, and board for a private four-year college represented 42 percent of median family income.¹ As of the 1997-1998 academic year, the average four year college cost \$11,227 per year compared to \$5,964 per year during the 1986-87 academic year.² The average two-year college cost \$5,075 during the 1997-1998 academic year compared to \$3,295 only 10 years earlier.³

Many education experts expect similar rates of increase or higher ones during the next decade.⁴ Therefore, the burden on families to finance a post-secondary education will be even greater in the future. The federal government has recognized this burden and has instituted the Education Individual Retirement Account (IRA)⁵ to provide a tax break to families who save for education. Numerous states have created tuition savings programs and prepaid tuition programs to assist in the cost of post-secondary education.⁶

The financial benefit of tax-incentive programs offered by the federal and state governments, although helpful, helps pay only a small portion of the cost a post-secondary educa-



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tion. Most families will still need to rely on traditional methods of financing college, such as federal financial aid and private educational loans.

Scholarships are another method of defraying the cost of financing a college education. Scholarships may come from varied sources, including colleges, corporations, private organizations, foundations, or other charitable entities. However, the availability of most scholarships is limited and most are highly competitive; awarded to a few select individuals. Therefore, many individuals seeking post-secondary education are left searching for other options.

Another less common, but beneficial, source of aid for individuals seeking post-secondary education is an employer-provided scholarship. When structuring benefit packages for employees, employers often overlook the value of creating a scholarship program designed to benefit employees and their family members. Many employers might believe instituting a scholarship program would be too costly and could force the employer to reduce or eliminate other benefit programs. However, a scholarship program not only creates a significant benefit to the employee, it also can create a significant benefit to the employer.

¹National Center for Education Statistics (visited April 22, 2000) <http://nces.ed.gov/pubs/ce/c9712a01.html>. The average tuition, room, and board at public four year colleges represented 15 percent of the median family income as of 1993.

²National Center for Education Statistics (visited April 22, 2000) <http://nces.ed.gov/fastfacts/isplay.asp?>

³*Id.*

⁴Deloitte & Touche LLP (visited March 20, 2000) <http://dtonline.com/edfund/edcost.html>. A study by Deloitte & Touche LLP predicts that the average annual cost for a private university will reach \$42,804 by the year 2015, assuming a 4-percent inflation rate. Assuming the same inflation rate, the cost of a public university will rise to \$20,846 by the year 2015, according to the same study.

⁵Section 530(b) (defining the education individual retirement account).

⁶Both prepaid tuition plans and college savings plans are qualified state tuition programs under section 529. Both plans allow earnings to be federally tax deferred until the beneficiary enters college. Earnings are then taxable at the beneficiary's tax rate, which is typically lower than that of the contributor's. Most states exempt earnings from state income tax, and some states even allow a full or a partial deduction from state income taxes for contributions.

If structured properly, a scholarship program can benefit an employer by generating significant tax deductions as well as by fostering employee and community goodwill. From the employee's perspective, a properly structured scholarship program assists in financing a post-secondary education without creating any additional taxable income to the employee.

If an employer decides to implement an employee scholarship program, several issues must be resolved prior to awarding any scholarships. First, the employer must determine whether to create a separate tax-exempt entity to conduct the scholarship program. If the employer elects to establish a separate tax-exempt entity, it must be structured, funded, and pre-qualified, with the Internal Revenue Service in accordance with the individual grant guidelines in section 4945 and reg. section 53.4945-4, and the employer scholarship guidelines in Rev. Procs. 76-47⁷ and 85-51.⁸ Finally, the program must be operated in accordance with such rules. Employer-funded scholarship programs must closely follow these rules and guidelines if the employer wants the scholarships to be qualified under section 117 as non-taxable qualified scholarships.⁹

This article analyzes the process of establishing a tax-exempt employer-related scholarship by focusing on the steps and key issues that need to be resolved to implement a scholarship program that will be approved by the IRS. The article discusses the alternatives for structuring a program, the establishment of a tax-exempt grant-making entity and the rules surrounding them, and then focuses on compliance with IRS guidelines. Finally, throughout the article, sample clauses are provided that may be included in scholarship documents.

II. Alternatives for Structuring an Employer-Related Scholarship Program

When determining the appropriate structure for a scholarship program, an employer may choose from several alternatives. First, the employer may simply provide additional funds to the employee or the employee's children and designate the dollar amounts to be given for a scholarship. No selection process or requirements need be utilized and awards may be granted on an entirely arbitrary basis. This plan would require virtually no tax compliance and would not invoke any IRS scrutiny regarding scholarships. In fact, this type of program is not really a scholarship, but merely represents a compensation bonus to the employee.¹⁰ The tax treatment of this arrangement would be as follows: (1) deductible to the employer who makes the payment, whether it is paid directly

to the employee or to the institution on behalf of the employee and (2) taxable to the employee.¹¹ As such, the employer is not creating a qualified scholarship within the meaning of section 117.¹² The IRS considers these payments to be preferential payments, similar to bonuses, and not payments made to a charitable class of individuals, thereby suggesting that they are compensatory in nature.¹³ A disadvantage of this type of program is that it does not allow the employer to establish an endowment fund to accumulate funds for making scholarship awards.¹⁴ Instead, all awards must be paid out of current income. For example, in the event the corporation elects not to award scholarships in a particular year, the funds designated for scholarships may still earn income and accumulate tax-free, if placed in a tax-exempt entity. Also, without an endowment fund, the employer does not have a vehicle that might allow potential benefactors to make tax-deductible contributions to the fund.

By creating a separate entity to operate a scholarship program, the employer retains virtually all of the advantages of the outright scholarship grant, but eliminates key disadvantages. Under this alternative, the employer would form a tax-exempt private foundation to serve as the scholarship grant-making entity.¹⁵ Forming a private foundation enables the employer to create a separate entity that will house all of the employer's scholarship activities, as well as any other charitable activities it might perform in the future.

III. General Rules Pertaining to Private Foundations

Private foundations may qualify as exempt organizations described under section 501(c)(3).¹⁶ Utilizing a private foundation as the grant-making entity creates several benefits to both the employer and the employee. First, any contributions made by the employer to a private foundation are tax deductible, subject to certain limitations.¹⁷ Second, funds contributed to a private foundation accumulate tax-free while in the foundation. Thus, the employer can create an endowment that can earn interest, tax-free. Depending upon the appreciation of the assets in the fund, this endowment may then be used to make scholarship grants. As previously stated, without a private foundation, the employer would most likely have to make these payments out of current income. Finally, if structured in accordance with IRS regulations, grants to employees made by the private foundation, will be deemed qualified scholarships, and would not be taxable to the employee.¹⁸

¹¹The payment made by the employer would be classified as an ordinary and necessary business expense under section 162(a). The payment to the employee would be deemed section 61(a)(1) gross income from compensation.

¹²*Supra* note 9.

¹³*Bingler v. Johnson*, 394 U.S. 741 (1969).

¹⁴*Infra* note 25.

¹⁵Section 4945.

¹⁶Section 509(a) (describing and defining a private foundation).

¹⁷Section 170(b) (discussing the percentage limitations for deductions on contributions made to charitable organizations).

¹⁸Reg. section 53.4945-4(b) (discussing the requirements for a private foundation).

⁷1976-2 C.B. 670.

⁸1985-2 C.B. 717.

⁹A qualified scholarship is defined as an "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." Section 117(b)(1).

¹⁰Section 61(a)(1). Such additional payments would be classified merely as additional compensation for services performed by an employee.

Beyond the initial scholarship program, establishing a private foundation enables the organization to have considerably more flexibility if it decides to ultimately engage in other charitable activities. For example, the foundation may be used to promote other charitable activity through charitable giving to other tax-exempt entities and to create informational programs that serve a charitable purpose.¹⁹ Regardless of whether the foundation does or does not expand its purpose, contributions to the section 501(c)(3) foundation are still tax-deductible to the employer.

A. Definition of Private Foundations

The Internal Revenue Code classifies charitable organizations as either public charities or private foundations. A public charity is a charitable organization that is broadly supported by the general public or functions primarily to support one or more public charities.²⁰ The code does not provide a specific definition of a private foundation, but instead describes all of the tax-exempt organizations that are not private foundations.²¹ Therefore, if an organization does not fall under one of these specific categories, it is not a public charity, and is instead a private foundation, by default.²² The IRS presumes that every tax-exempt organization is a private foundation, unless the organization can rebut the presumption by proving that it should be classified differently.²³

Unlike a public charity, a private foundation ordinarily receives most or all of its support from a single source. Whether this source is a person, another organization, or a corporation, is irrelevant to the determination of whether an organization is a private foundation. The fact that the support is not coming from members of the general public is all that is relevant.²⁴ A private foundation often receives its ongoing funding in the form of investment income and makes grants to other charities or those that qualify as a charitable class of individuals. A private foundation operates much like an endowment fund.²⁵

¹⁹For example, The Princeton Review (standardized test preparation) maintains a tax-exempt entity called the Princeton Review Foundation. The foundation was established in 1988 and is used to provide scholarships for test preparation, but is also used to enhance the organization's community reputation and serves as a vehicle to promote Princeton Review's products.

²⁰Section 509(a)(2)(A)(i), (ii). Ordinarily, if a tax-exempt organization receives more than one-third of its support in each taxable year from the general public, as computed under these sections, it is classified as a public charity.

²¹Section 509(a)(1)-(4).

²²Section 509.

²³*Id.*

²⁴Bruce R. Hopkins, *The Law of Tax Exempt Organizations*, section 11.1, at 242 (7th ed. 1998).

²⁵An endowment fund is usually established by an institution to accept the transfer of a gift of money or property for a particular purpose. *Black's Law Dictionary* 527 (6th ed. 1990).

B. Formation of Private Foundations

To be classified as a private foundation, an organization must be both organized and operated for one or more permissible charitable purposes.²⁶ This standard has given rise to two specific tests: the *organizational* test and the *operational* test. If the organization fails to satisfy either or both of these tests, the organization will not qualify as a tax-exempt organization.

Generally, to be considered *organized* for a permissible charitable purpose, the organizing document of a charitable organization (e.g., articles of organization, articles of incorporation, etc.) must limit the purpose of the organization to one or more tax-exempt purpose(s).²⁷ Only an insignificant portion of the organization's activities may be in furtherance of activities that are unrelated to the organization's tax-exempt purpose. The organization's organizing document must also contain specific provisions requiring the organization to make distributions of a certain percentage of its funds in order to comply with rules prohibiting self-dealing, retaining excess business holdings, making jeopardizing investments, or making taxable expenditures.²⁸

With respect to the second prong of the test, the organization must be *operated* exclusively for one or more tax-exempt purpose(s) and only if it operates primarily to engage in such purpose(s).²⁹ The "organization's resources must be devoted to the purposes that qualify as exclusively charitable within the meaning of section 501(c)(3) and the applicable regulations."³⁰ An organization will not be considered as operated exclusively for one or more of its exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.³¹

C. Funding a Private Foundation

Once the foundation is formed it must be funded if it intends to grant scholarships. Numerous options for funding a foundation exist and virtually any type of property may be contributed to a foundation including cash, securities, art, real estate, and other property. In recent years, non-cash funding has become extremely popular, because of the additional tax benefits. For example, when funding a foundation with cash, the contributor would be entitled to a charitable tax deduction on the property contributed, subject to certain charitable deduction limitations.³² If the contributor funded the foundation with appreciated securities, with a fair market value equal to the aforementioned cash contribution, he would receive the same charitable deduction. An additional tax benefit would also accrue to the foundation because it could sell the securities without incurring any capital gains tax liability,

²⁶See Hopkins, *supra* note 24, section 4.3, at 54.

²⁷Reg. section 1.501(c)(3)-1(d).

²⁸Section 508(e)(1).

²⁹See Hopkins, *supra* note 24, section 4.5, at 66-71.

³⁰Rev. Rul. 72-369, 1972-2 C.B. 245.

³¹*Id.* at 66.

³²Section 170(b).

whereas the contributor would owe capital gains tax on the sale of such property.³³

The IRS is not concerned with the subject matter of the contribution to the foundation, but is concerned with the source of the funding. Furthermore, the IRS imposes restrictions upon those who provide the foundation's funding; they are classified by the code as *disqualified persons*³⁴ and subject to certain restrictions with respect to their relationship to the foundation.

A disqualified person is defined generally as any natural person, corporation, or artificial entity that has an intimate or influential relationship with the organization.³⁵ There are several types of disqualified persons: a *substantial contributor*³⁶ is any person who contributes an aggregate amount of \$5,000 to the private foundation, if the amount is more than 2 percent of the total contributions received by the foundation in any particular taxable year.³⁷ A *foundation manager*³⁸ is any officer, director, trustee, or an individual having powers or responsibilities similar to one of those persons. The third type of disqualified person is any person who is a 20-percent owner.³⁹

As disqualified persons, these individuals are subjected to some restrictions in their dealings with the foundation. For example, the IRS is particularly concerned about any transactions between a disqualified person and the foundation that may create a substantial benefit for the disqualified person. In certain transactions between a disqualified person and a private foundation, the IRS may even impose an excise tax on the foundation for engaging in self-dealing.⁴⁰ So, creators of an employer-related scholarship program should be careful to identify any potential disqualified persons to avoid any possibility of self-dealing when awarding scholarships.

IV. Forming a Scholarship Fund

A. Applicable Rules

Unless specifically qualified as a scholarship program, a grant made by a private foundation to an individual for travel, study, or similar purpose is classified as a *taxable expenditure* for purposes of the tax imposed by section 4945.⁴¹ However, if such a scholarship grant satisfies the requirements of section 4945(g) and the foundation has obtained the necessary IRS rulings in advance of awarding scholarships, the grant may

³³Victoria B. Bjorklund, *Charitable Giving Techniques: Charitable Giving to a Private Foundation and the Alternatives*, SC74 ALI-ABA 69, 74 (May 7, 1998).

³⁴Section 4946.

³⁵*Id.*

³⁶Sections 4946(a)(2), 507(d)(2).

³⁷Section 507(d)(2)(A).

³⁸Section 4946(b).

³⁹Section 4946(a)(1)(C).

⁴⁰Section 4941 (defining the excise tax on self-dealing and explaining upon whom it is imposed).

⁴¹Section 4945(d)(3).

be classified under section 117 as a qualified scholarship, and not be taxable to the recipient.⁴² To be classified as a qualified scholarship, it must first satisfy the individual grant requirements of section 4945 and reg. section 53.4945-4 and then strictly comply with the requirements of Rev. Proc. 76-47. Rev. Proc. 76-47 is the primary source of guidance on structuring these programs to receive qualified scholarship status and Rev. Procs. 80-39 and 85-51 further clarify portions of the ruling.

B. Section 4945 and Reg. Section 53.4945-4

Ordinarily, grants made to individuals by a private foundation are classified as taxable expenditures.⁴³ However, if such grants are awarded through an objective and nondiscriminatory procedure approved in advance by the IRS and it is demonstrated to the IRS that: (1) the grant constitutes a scholarship or fellowship grant that would be subject to the provisions of section 117(a) and is to be used for study at an educational organization described in section 170(b)(1)(A)(ii); and (2) such grant constitutes a prize or award for which the recipient is selected from the general public; or (3) the purpose of the grant 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 grantor, such grants will be excluded from the provisions of section 4945(d).⁴⁴ Under those circumstances, the grants would be non-taxable to the recipient.

C. Rev. Proc. 76-47

To satisfy the *objective and non-discriminatory* standard outlined in reg. section 53.4945-4, the scholarship program must adhere carefully to the requirements of Rev. Proc. 76-47. This revenue procedure applies specifically to employer-related scholarship programs. It describes applicable programs as those that "treat some or all of the employees, or children of some or all of the employees, of a particular employer as a group, from which, grantees of some or all of the foundation's educational grants will be selected, and limits the potential grantees for some or all of the foundation's grants to individuals who are employees, or children of employees, of a particular employer, or otherwise gives such individuals a preference or priority over others in being selected as grantees of such grants."⁴⁵

The ruling is comprised of seven separate guidelines. The scholarship fund must adhere to these guidelines when creating its procedures and organizing documents for the IRS to consider the procedures to be objective and nondiscriminatory. Each of the seven steps requires careful attention and

⁴²Section 4945(g).

⁴³Section 4945(d)(3). Grants made to individuals "for travel, study, or other similar purposes by such individual" unless such grant satisfies the requirements of subsection (g)(3).

⁴⁴Section 4945(g) and reg. 53.4945-4(a)(3).

⁴⁵*Supra* note 7. (Describing the application of Rev. Proc. 76-47).

drafting when preparing scholarship procedures. Each of the steps is discussed separately below.

1. Inducement

"The programs must not be used by the employer, the private foundation, or the organizer thereof, to *recruit* employees or to *induce* employees to continue their employment or otherwise follow a course of action sought by the employer."⁴⁶

This first step presents problems for almost every employer attempting to institute a scholarship program. There is no bright-line rule or test for employers to determine whether a scholarship program is being used to induce or recruit employees. To a potential or current employee, the prospect of receiving a non-taxable scholarship is inherently beneficial. Scholarship programs may also be advertised to employees or potential employees as a benefit of employment, which might influence a prospective employee when making his/her decision.

Under these circumstances, the IRS will not look specifically at the actual use of the program as an inducement or recruiting tool, but will instead consider the fairness of the overall scholarship process. The IRS prefers to see the program structured in such a way that the child of a particular individual is not offered preferential treatment merely because the employer would like to recruit that child's parent. For example, the IRS might have problems if a particular employee's compensation package included a scholarship benefit for that employee's child, without that child first going through an objective and non-discriminatory process to receive the award.

The employer should include a disclaimer in the scholarship documents to prevent this first step of the test from becoming an issue. The disclaimer could state the following:

The CFG scholarship is available to all eligible children of employees of CFG Corporation. The scholarship was created and operates solely for the benefit of the children of employees and is not intended to be used as an inducement or recruitment device for existing or prospective employees.

2. Selection Committee

The selection of all scholarship recipients must be made by a committee consisting solely of "independent" individuals.⁴⁷ These individuals must be completely unrelated to the private foundation, its organizers, and the employer. Former employees of the scholarship fund or the employer are not considered totally independent, and may not serve on the committee.⁴⁸ The selection committee oversees the entire scholarship process from selection, to interviewing (if desired), to administering the program.

Generally, an employer that forms a scholarship fund would like to have control over where and to whom the funds are disbursed. However, maintaining this level of control over the scholarship process would likely be fatal to IRS qualification of a scholarship fund under the guidelines. To be approved, the scholarship fund must be operated free from influence or the potential influence of the employer, the organizers, or the foundation. The IRS is particularly concerned about the objectivity of the committee, especially if it is comprised of individuals with competing interests that may be influenced by a lack of objectivity. Thus, appointing completely independent individuals eliminates the potential problem of partial committee members.

Although the independent selection committee must ultimately determine who will receive scholarships, the employer and/or the board of the foundation may authorize the total funds available for scholarship.

For example, a scholarship foundation is funded with \$100,000. Although the board cannot influence how that sum is divided and distributed to scholarship grant recipients, it can authorize the total dollar amount available for scholarships. Thus, if the board wants to make only \$50,000 of the \$100,000 available for scholarships, it may do so without jeopardizing the fund's status as a tax-exempt qualified scholarship fund, as long as it plays no role in determining how that \$50,000 is distributed.

Although not required by the IRS, the selection committee should consist of individuals knowledgeable in the education field so that they have the background to properly evaluate the potential of the applicants.⁴⁹ Utilizing education professionals lends credibility to the selection committee and may also help to facilitate the evaluation process.

The selection committee is permitted to interact with the foundation and the employer, as long as that interaction does not involve input on which applicants should receive scholarships. Any interaction should serve only to verify that information received by the committee regarding scholarship applicants is true and correct.⁵⁰

For example, CFG scholarship committee has made its selections for scholarship awards. Prior to finalizing the awards, the scholarship committee forwards its selections to the directors of the CFG foundation and the officers of CFG, Inc. (the employer) to verify that all of the information the committee used to make its decision was correct. This type of interaction is permissible under the IRS guidelines, and would not jeopardize the grant's status as a qualified scholarship. But if the employer decided to change, or even comment on, any of the selections, the qualified scholarship status of the grant could be jeopardized.

Further, under the selection committee step, any public announcement of the scholarship awards must be made by the selection committee or by the foundation, not the em-

⁴⁶*Id. ra.*

⁴⁷*Id.*

⁴⁸Rev. Proc. 76-47, at 1.

⁴⁹Rev. Proc. 76-47, at 2.

⁵⁰*Supra* note 4 at 4.

ployer. The selection committee also maintains responsibility for determining the amount, size, number, and order in which scholarship grants are disbursed. The employer does have the power to reduce the number of scholarships to be awarded as determined by the scholarship committee, but may increase the number recommended by the selection committee.

3. Eligibility Requirements

To be classified as a qualified scholarship program, the scholarship program must impose a set of minimum requirements for scholarship eligibility. Eligibility requirements will vary depending upon the type of scholarship and the desired class of individuals for whom the scholarship is designated. Therefore, the IRS has not created specific rules for eligibility but instead offers guidelines for structuring eligibility requirements.

Any eligibility requirements must satisfy two standards: (1) they must be related to the *purpose* of the scholarship; and (2) limit the independent selection committee's consideration to those employees, or children of employees, who meet the *minimum standards* for admission to an educational institution for which the grants are available.⁵¹ Generally, a scholarship program may not discriminate on race, gender, or religion of an employee or a child of an employee when creating eligibility classifications for a scholarship.⁵² The IRS has not specifically ruled if these requirements apply to an employer-related scholarship program that is structured to provide scholarships to a particular minority or group of persons.⁵³

Requiring an employee to work a minimum period of time before his/her family member may become eligible for a scholarship is not required by the IRS. It is permissible, however, provided that the minimum period of time does not exceed three years.⁵⁴ Eligibility for scholarships cannot be related to any other employment-related factors, such as the employee's position, services, or duties.

By instituting these eligibility guidelines, the IRS has shown its concern for potential abuses of the scholarship process, particularly favoritism toward individuals who may otherwise be unqualified for a scholarship and potential discrimination against others who may be more qualified.

4. Objective Basis of Selection

The selection of scholarship grant recipients must be based solely upon an identifiable set of objective standards. The

standards must be completely unrelated to the employment of the recipients or their parents and to the employer's line of business. Some examples of permissible objective standards include, but are not limited to: prior academic performance, performance on aptitude tests (SAT, LSAT, MCAT, etc), recommendations from instructors or other individuals not related to the potential recipients, financial need, and personal interviews dealing with motivation and character.⁵⁵

The IRS requires the selection committee to utilize an objective standard for scholarship selection, in order to reduce or eliminate the possibility of subjectivity when selecting scholarship recipients.⁵⁶ The tax-exempt qualified scholarship is designed to award scholarships to a select group of individuals from a charitable class. The selection process is intended to be based upon standards that afford the entire charitable class an equal opportunity to receive a scholarship grant. Utilizing subjective standards jeopardizes this balance by favoring certain qualities for some and not for others. Once different sets of subjective standards are applied to members of the same charitable class, it becomes extremely difficult to gauge the fairness and objectivity of the selection process. It is this lack of objectivity that concerns the IRS. The IRS looks at scholarship programs to see if they are operated according to charitable guidelines. If the organization acts subjectively when evaluating applicants, the IRS will likely presume that the grants are compensation, rather than qualified scholarships.

5. Employment

If a grant is awarded for a period of more than one academic year, subject to renewal, the standards for renewal must be based solely on non-employment-related factors such as need and maintenance of scholastic standards. The fact that the recipient or his/her parent is no longer employed by the employer or the foundation must not weigh into the decision as to whether the scholarship will be renewed.⁵⁷ The rationale behind this requirement is that the recipient or parent met the employment requirement when the grant was first awarded, and no further employment requirement is necessary for renewal.⁵⁸

A qualified scholarship may not be terminated because the recipient or the recipient's parent terminates employment.

This is one of the most often overlooked steps in creating a qualified scholarship. A qualified scholarship may not be terminated because the recipient or the recipient's parent terminates employment with the employer subsequent to the

⁵¹Section 151(e)(4) (describing the minimum standard for admission to an academic institution).

⁵²Title VI of the Civil Rights Act of 1964 prohibits direct or indirect racial discrimination in the provision of financial aid to individuals. 45 C.F.R. section 80.3 (1973).

⁵³Although discrimination against minorities is not permitted in education and scholarships, programs that favor minorities are permissible, subject to specific limitations. Such programs must select recipients on an "objective and nondiscriminatory basis," reg. section 53.4945-4(b).

⁵⁴Rev. Proc. 76-47.

⁵⁵Rev. Proc. 76-47.

⁵⁶*Id.*

⁵⁷*Id.*

⁵⁸Rev. Proc. 76-47, at 5.

awarding of the grant regardless of the reason for such termination of employment.⁵⁹

This provision is particularly important if the scholarship involves an annual award that requires re-application by the scholarship recipient. Under these circumstances, the recipient may not be considered ineligible for a further grant simply because that individual or the individual's parent is no longer employed by the employer. In many circumstances, the recipient relied upon the scholarship money for further education. By making the individual ineligible to apply in future years, the employer may cause that individual to be without the funds needed to continue his or her education. Employers must carefully consider this factor when determining the length of a scholarship award. The longer the award, the greater the risk that an employee may no longer be working for the employer, yet the employer would still be required to pay for the post-secondary education of the former employee's child.

An employer considering creating a college scholarship that will cover the entire post-secondary education of an employee's child should consider making the scholarship into a series of one-year scholarships that require annual re-applications. For example, Techno, Inc. decides to award two four-year college scholarships in 2001. The selection committee selects two students for the awards. Instead of making a commitment to pay a certain sum over a four-year period, Techno then makes a one-year commitment to each student that may be continued for subsequent years if the applicants reapply for additional scholarships through the selection committee. Techno has made the standards for re-selection identical to the standards for maintaining the scholarships on an annual basis. As a result, as long as the two students satisfy the current standards to keep a scholarship, they should be able to continue to receive awards. However, if the employer or the foundation no longer employs one of the student's parents, the employer would probably no longer be required to pay scholarship funds to that recipient.

6. Course of Study

The courses of study for which grants are available must not be limited to those that would be of particular benefit to the employer or to the foundation. If the courses of study do include one or more that would be of benefit to the employer or the foundation, a grant may not be conditioned on the recipient's pursuing such a course of study. The recipient must have an uninhibited choice to use the scholarship to pursue a course of study that is not of particular benefit to the employer or the foundation.⁶⁰

7. Other Objectives

Both the scholarship and the courses of study for which grants are available must meet all other requirements of section 117 and the regulations thereunder, and must be

consistent with a disinterested purpose of enabling the recipients to obtain an education in their individual capacities solely for their personal benefit.

A scholarship program cannot include any "commitments, understandings, or obligations, conditional or unconditional, suggesting that the studies are undertaken by the recipients for the benefit of the employer or the foundation or have as their objective the accomplishment of any purpose of the employer or the foundation (even though consistent with its exempt status) other than enabling the recipients to obtain an education in their individual capacities and solely for their personal benefit."⁶¹

Also, at the time the grant is awarded or renewed, there must be no requirement, condition, or suggestion, express or implied, that the recipient or parent is expected to render future employment services for the foundation or the employer, or be available for future employment, even though such future employment is at the discretion of the foundation or the employer.⁶²

D. The Percentage Test

Once the seven steps of Rev. Proc. 76-47 have been sufficiently satisfied, a scholarship must meet yet another standard to be qualified by the IRS.⁶³ A scholarship program must satisfy a *percentage test*.⁶⁴ A scholarship will satisfy the percentage test if the scholarships awarded to employee's children do not exceed either of the following two criteria:

- (i) the number of grants awarded under that program in any year to such children does not exceed 25 percent of the number of employees' children who, (a) were eligible, (b) were applicants for such grants, and (c) were considered by the selection committee in selecting the recipients of grants in that year; or
- (ii) 10 percent of the number of employees' children who can be shown to be eligible for grants (regardless of whether they submitted an application) in that year.⁶⁵

Although the test appears to be relatively straightforward on its surface, the application is much more difficult. For example, if the employer identifies 1,000 eligible children of employees and 500 children actually submitted applications for a scholarship, the foundation may award 125 scholarships (25 percent x 500 eligible applicants = 125). However, if the employer only received 300 applications for scholarships, the foundation could award only 100 scholarships (10 percent x 1,000 eligible children = 100) because this amount exceeds

⁶¹*Id.*

⁶²*Id.*

⁶³Rev. Proc. 76-47, at 7.

⁶⁴*Id.*

⁶⁵*Supra* note 63 at 6. The child of an employee is only considered eligible if the child meets all eligibility requirements imposed by the employer. A person cannot be considered "eligible" if he/she would not reasonably be expected to attend an educational institution defined in section 170(b)(1)(A)(ii). Rev. Proc. 76-47, 1976 C.B. 670, section 4.03.

⁵⁹Rev. Proc. 76-47, at 5.

⁶⁰*Id.*

the 75 scholarships that may be awarded under the alternative test (25 percent x 300 eligible applicants = 75).⁶⁶

The rationale behind the imposition of this test is to prevent abuses by the employer by awarding too many scholarships. Awarding scholarships to all employees' children undermines the status of the scholarship as an award and creates the appearance that the scholarship was available to all children of employees merely as a compensation bonus. Under those circumstances the grant would be taxable.

The most problematic aspect of the percentage test is determining what portion of the employees' children may be classified as *eligible* under the 10-percent test. Many private foundations have difficulty determining the exact number of children who are eligible for scholarships. Generally, the private foundation may include as eligible only those children who can be shown to, by a written questionnaire, survey, or other written validation: (i) meet the eligibility requirements established by the foundation; and (ii) be enrolled or have already completed a course of study preparing them for admission to an educational institution at the level for which the scholarships or loans are available, have applied or intend to apply to such an educational institution, and expect, if accepted, to attend such an educational institution in the next academic year; or (iii) currently attend an educational institution for which the scholarships or loans are available, but not be in the final year for which such an award may be made.⁶⁷

This standard for eligibility creates a disadvantage for smaller employers, who have a lower population of eligible children who may actually apply for a scholarship.

This standard for eligibility creates a disadvantage for smaller employers, who have a lower population of *eligible* children who may actually apply for a scholarship. Many employers may be limited to making single scholarship awards if there are only 10 eligible children. In TAM 8838007,⁶⁸ the IRS addressed this issue when an employer in a small company was unable to meet the 10-percent test. In this case, the employer created a private foundation for the purpose of providing employer-related scholarships and loans. During an IRS audit, the employer indicated that it did not meet the rigid application of the 10-percent test, but made the argument that the scholarship program it had created satisfied the legislative intent behind the test. The employer indicated that to award a single scholarship, the employer would need to have at least 10 eligible applicants. The employer also indicated to the IRS that it was the practice of the scholarship selection committee to choose one qualified

applicant in a year where only eight applicants applied. The IRS rejected this position, on the grounds that *mere intent to comply* did not constitute compliance with the percentage test. Under this standard, if an employer has only three children of employees who are eligible for scholarships, the employer would be unable to award a single scholarship under both the 25-percent test and the 10-percent test. Therefore, a small employer must structure the scholarship program with an extremely broad *eligibility* requirement in order to include the largest possible number of eligible children to give the scholarship the best chance of passing the percentage test. For example, the eligibility clause for a small employer that is seeking to create the largest class of eligible applicants for a post-secondary education scholarship could read as follows:

A scholarship is available to one or more children of CFG, Inc. employees who, at the time of their applications for scholarships, are either high-school seniors, or have graduated from high school and have not commenced post-secondary education, or have completed no more than three full years of post-secondary education.

Some employers may be unable to determine which children are eligible for scholarships, because in many cases, employers do not maintain accurate information on the families or family size of employees. Or, in other cases, employers and employees may be separated geographically in the United States or internationally. The IRS has not ruled on whether children of employees who are non-U.S. citizens may be included in the class of eligible children. The IRS has ruled that when an eligible class for a scholarship could not be determined with certainty, it was impossible for that scholarship to meet the percentage test of Rev. Proc. 76-47.⁶⁹

E. Facts and Circumstances

If an employer-related scholarship program satisfies the seven steps, but does not satisfy the percentage test, which is often the case with small employers, it may still qualify as a scholarship program under a *facts and circumstances* analysis. Under this analysis, the IRS may qualify an employer-related scholarship program if, in light of all relevant facts and circumstances, the primary purpose of the scholarship program is to educate recipients and not to provide additional compensation to employees.⁷⁰ Relevant facts and circumstances could include: (1) the history of the program (such as the source of the program's funding); (2) the courses of study for which scholarships are available; (3) any eligibility requirements (other than employment of the applicants or their parents and the age and grade level prerequisites for the studies for which the scholarships are available); (4) the publicity given the scholarship program; (5) the degree of independence of the selection committee; (6) the particular standards used for selection and the specific means used to

⁶⁶Michael I. Sanders and Celia Roady, "Private Foundations — Taxable Expenditures," *BNA Tax Management Portfolio Number 298-3rd* (1999) at A-35.

⁶⁷Rev. Proc. 85-51, 1985-2 C.B. 717.

⁶⁸TAM 8838007 (Sept. 23, 1988).

⁶⁹PLR 8422088 (1984). Despite the indeterminable class size, the IRS granted this program qualified scholarship status by utilizing the "facts and circumstances" analysis described in Rev. Proc. 76-47, 1976-2 C.B. 670.

⁷⁰Rev. Proc. 76-47, 1976-2 C.B. 670, section 4.

determine whether those standards have been met; (7) the precise nature of the employee limitation or preference; (8) the number of scholarships available and the number of employees or their children who would be eligible for them; (9) the percentage of eligible employees or their children applying for grants who normally (e.g., on an average basis) receive scholarships under the program; and (10) whether and how many scholarships are awarded to individuals who do not qualify as employees or children of employees.⁷¹

In PLR 8222063, the IRS ruled favorably on the qualified scholarship status of a grant-making entity utilizing the facts and circumstances test. In this ruling, several private foundations entered into a relationship with a corporation that granted undergraduate scholarships to high school students based upon their academic records. The students were children of employees of an entity that was related to the foundation. No applications were required for the scholarships; instead the foundation would only award scholarships to those students designated as *finalists*. As a result, neither the private foundation nor the employer could determine the number of eligible applicants. The scholarship recipients were selected by a selection committee comprised of independent members who were completely unrelated to the private foundation of the employer. In all other respects, the structure of the scholarship program satisfied the seven parts of Rev. Proc. 76-47.

Since the number of *eligible applicants* was indeterminate, the scholarship program could not satisfy either the 25-percent or the 10-percent test under Rev. Proc. 76-47. Therefore, the only way for the scholarship to become qualified was to satisfy the facts and circumstances test. In its favorable ruling, the IRS emphasized the following factors as the justification for its ruling: (1) no scholarship application was required; (2) before being considered for the award, the students already had to be designated as *finalists*, thereby already demonstrating academic achievement; (3) the scholarship recipients were chosen by an independent scholarship committee; (4) the amount of the scholarship award was determined by the grant making entity in advance of making

the award; (5) there were no limitations on the course of study for which the scholarship may be used; and (6) the number of grants made could not exceed the number of children who qualified as finalists. In consideration of these factors, the IRS concluded that the child of an employee being selected for the primary purpose of additional compensation was insignificant in light of the structure and goals of the scholarship program.⁷²

V. Procedure for IRS Approval

The foundation must receive advance approval from the IRS prior to making any scholarship grants.⁷³ To obtain such advance approval, the foundation must file a ruling request on a Form 1023 Application for Exemption.⁷⁴ The form requires any organization seeking tax exemption to provide information about its activities, programs, directors, and officers, as well as current and proposed financial data. Organizations that intend to grant scholarships must complete an additional schedule⁷⁵ and a detailed description of the scholarship program, the bylaws of the scholarship program, as well as any scholarship applications or questionnaires. The organization must also pay a \$500 user fee when submitting the application.⁷⁶ The evaluation process usually takes anywhere from three to six months for a response, depending on the complexity of the program.

VI. Conclusion

If structured in accordance with the IRS guidelines, an employer-related scholarship can generate benefits for both the employer and the employee. However, most employers are unaware that making the decision to create a scholarship for employees is only the initial step in the process. Beyond that decision, the employer must structure and operate the program in strict compliance with IRS guidelines. The guidelines, while complicated, provide numerous safeguards that protect the employer and the employee in the event of an IRS audit or other examination.

⁷¹Rev. Proc. 76-47, 1976-2 C.B. 670.

⁷²PLR 8222063 (1982). See also Rev. Rul. 86-90, in which the IRS granted qualified scholarship status, based on the "facts and circumstances" analysis, to a private foundation that awarded a single scholarship each year to a child of the related company's employees. The IRS used reasoning similar to that of PLR 8222063 (1982).

⁷³Rev. Proc. 83-36, 1983-1 C.B. 763, section 5.

⁷⁴Form 1023 is used by organizations when applying for tax-exempt status.

⁷⁵Scholarship grant making entities must complete Schedule E of Form 1023.

⁷⁶See Rev. Proc. 97-8, 1998-1, IRB 225, for a complete discussion of fees.

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