COUNCIL on FOUNDATIONS

Legal Background on Scholarship Grantmaking by Foundations

Foundations are charities, as described in §501(c)(3) of the Internal Revenue Code. Foundations provide leadership, subject-matter expertise, innovation, and financial support in the form of grants to organizations serving the common good across the country and the world. Among foundations, there are two primary legal classifications: a private foundation[1] or a community trust.[2] A private foundation—which receives a majority of its annual revenue from the investment income of an endowment—is subject to stricter limitations on its activities than other 501(c)(3) organizations. A community trust (more commonly referred to as a "community foundation")—which both holds endowments and fundraises annually[3]—has more flexibility in terms of its activities than a private foundation does. The policy rationale for this is that the donations to a community foundation are more broadly-based than a private foundation and serve as a sort of referendum of public opinion on the foundation's activities—acting as a "check-and-balance" that holds the foundation accountable to the needs of the population it serves. Regardless, both types of **foundations are bound to follow their charitable mission**.

A common grantmaking practice of foundations is to provide *scholarships*[4] to students pursuing technical certifications or degrees of higher education. *Both private and community foundations are permitted by law to engage in this type of grantmaking activity but must comply with certain rules and regulations depending on which type of foundation they are*. For community foundations, grants to individuals in the form of scholarships are considered an activity that furthers a stated "charitable purpose."[5] As such (except for rules governing donor advised funds[6]), there are no specific restrictions in the Code or Treasury Regulations—beyond those that community foundations are generally subject to—that limit scholarship grantmaking.[7] In general, 501(c)(3) charitable organizations may only make grants to further "the [charitable] purposes for which they are organized,"[8] and may not engage in any activity that results in the private inurement or private benefit of a disqualified person.[9] Such activities which would result in inappropriate benefit (which are commonly referred to as **excess benefit transactions**[10]) are subject to intermediate sanctions or possible revocation of the organization's tax-exempt status. The initial penalty is a tax of 25% of the excess benefit amount that is imposed on the disqualified person that receives the inappropriate benefit. If the violation is not corrected, an additional tax of 200% is imposed on the disqualified person. Additionally, in certain cases where a foundation manager knowingly and willfully participated in the excess benefit transaction without a reasonable cause, a tax of 10% of the excess benefit

1 IRC §509(a).
2 IRC §170(b)(1)(A)(vi) and Treasury Regulations section 1.170A-9(f)(10).
3 As described by the "public support test." IRC §509(a)(1).
4 IRC §117.
5 IRC §501(c)(3).
6 Since the Pension Protection Act of 2006, donor advised funds are subject to an excise (penalty) tax on any distribution made to or for the benefit of an individual. IRC §4966(c)(1)(A)
7 However, the IRS has set out general criteria that are applicable to all charitable grants to individuals in Revenue Ruling 56-304, 1956-2 C.B. 306.
8 Ibid.
9 A "disqualified person," as it relates to excess benefit transactions, is defined as any person (including certain family members of said person) who is in a position to exercise substantial influence over the affairs of the organization at any time in the five-year period prior to the occurrence of the excess benefit transaction (i.e. officers, directors, and key employees). IRC §4958(f)(1)(A); Treasury Regulations §53.4958-3(a).
10 IRC §4958.

(not to exceed $20,000 with respect to any specific excess benefit transaction) is imposed on a foundation manager in his or her personal capacity.[11]

Private foundations (*which include most corporate foundations*) face tighter restrictions and harsher penalties when it comes to making scholarship grants. If a private foundation engages in an activity that results in the private inurement or private benefit of a disqualified person,[12] it is considered a **self-dealing transaction**.[13] In general, self-dealing activities between a private foundation and a disqualified person (which follows a more expansive definition for self-dealing transactions than it does for excess benefit transactions), where the purpose or benefit is not directly related to or necessary for carrying out a charitable purpose, include: (1) the sale/exchange of property; (2) lending of money/extension of credit; (3) furnishing of goods, services, or facilities; (4) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (5) certain payments of money or property to a government official. The initial penalty for such transactions is a tax of 10% of the amount involved that is imposed on the disqualified person and a tax of 5% on any foundation manager who knowingly and willfully participated in the transaction. If the act of self-dealing is not corrected, the tax penalty is increased to 200% for the disqualified individual and 50% for the foundation manager. *Additionally*, private foundations must adhere to a separate set of rules that govern which types of expenditures do and do not align with a charitable purpose and are otherwise subject to penalties.[14] One type of activity that is considered a **taxable expenditure** is "a grant to an individual for travel, study, or similar purposes" (which would include scholarships) unless made in accordance with a procedure that is pre-approved by the Secretary of Treasury. As such, private foundations must secure advanced approval of scholarship programs to ensure that grants are "awarded on an objective and non-discriminatory basis" in accordance with Treasury Regulations.[15] In general, the rules require that grants be made for a charitable purpose and that eligible recipients are a class of individuals large enough to constitute a "charitable class" so that private interests are not benefited. If a private foundation is found to be in violation of any of these rules, an initial tax of 20% of the amount of the expenditure is imposed on the private foundation and a tax of 5% is imposed on any foundation manager who knowingly and willfully participated in the expenditure. If the taxable expenditure is not corrected, the tax is increased to 100% for the foundation and 50% for the foundation manager.

In summary, **there are an abundance of rules governing how foundations may award scholarship grants** to individuals. Foundations are very familiar with the laws and regulations for this type of activity and have worked throughout the years to implement organizational policies and procedures to ensure compliance. The Workforce Development Through Post-Graduation Scholarships Act would simply allow foundations to administer post-graduation scholarship programs, **subject to all the same requirements and restrictions as traditional scholarships are under current law**.

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11 IRC §4958(d)(2). Taxes imposed may be abated if certain conditions are met. §4961 and 4962.

12 A "disqualified person," as it relates to self-dealing transactions, includes substantial contributors, foundation managers (officers, directors, trustees, or individuals having similar powers or responsibilities), owners of more than 20% of a business enterprise that is a substantial contributor, family members of the persons previously described, business entities (including corporations, partnerships, trusts, and estates) in which persons described above own more than 35 percent of the voting power, and certain government officials. IRC §4946.

13 IRC §4941. Taxes imposed may not be abated.

14 IRC §4945. Taxes imposed may be abated if certain conditions are met. §4961 and 4962.

15 Treasury Regulations §53.4945-1 through -6.