

[Home](#)

What Should I Do About My Scholarship Funds?

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The Pension Protection Act of 2006 (PPA) includes the first comprehensive regulation of donor-advised funds, and it directly affects scholarship funds with donor involvement. Community foundations that have the following funds will need to review the operations of these funds to determine whether they will be considered donor-advised funds under the new law:

- Donor-advised scholarship funds
- Alumni group scholarship funds
- Memorial scholarship funds
- Company scholarship funds
- Professional group scholarship funds
- Scholarship funds established by churches or other charities

Grants and distributions to individuals now prohibited for donor-advised funds

Beginning at the start of the first tax year following the August 17, 2006, enactment of the law (January 1, 2007, for foundations on a calendar year), scholarship funds that are deemed to be donor-advised are prohibited from making grants to individuals. Only scholarship funds that meet certain requirements may continue to make these grants. At the very least, you need to make any necessary changes to your scholarship procedures before you begin your selection process.

What is considered a donor-advised fund?

The PPA bars distributions from donor-advised funds to individuals. For a fund to be a donor-advised fund the following must be true:

- The fund must be separately identified with reference to the contribution of a donor or donors.
- The fund must be owned and controlled by a sponsoring organization (the community foundation).
- The donor or a person appointed by the donor must have, or must reasonably expect to have the privilege of providing advice with respect to the fund's investments or distributions.

Distributions from a donor-advised fund to an individual will be deemed "taxable expenditures" and subject the community foundation to a 20 percent tax on the amount of the expenditure. In addition, foundation managers who knowingly approve the distribution could be subject to a 5 percent tax on the grant, not to exceed \$10,000 per taxable expenditure. A grant to an individual includes a grant to university for the benefit of a designated student, so this penalty may not be avoided by making a scholarship check payable to a school rather than an individual.

It's clear that donor-advised funds established by a family and advised by members of that family would be considered donor-advised funds. The legislative history of the PPA suggests that memorial funds to which family members of the deceased provide advice on distributions may also be considered donor-advised funds. Similarly, funds established by professional or alumni groups for

which members of the group serve as the advisory board will also be considered donor-advised funds. Funds established by corporations with advisory boards consisting of corporate employees may also be deemed donor-advised funds.

Does this mean that none of these kinds of funds can make scholarship grants? Fortunately, the law includes a provision under which these groups may award scholarships, but they will most likely have to alter their procedures to take advantage of the rule.

How to continue to award scholarships

The PPA does not consider a scholarship fund to be a donor-advised fund, even if a donor or fund advisor is a member of the selection committee, if all of the following are true:

- The sponsoring organization (the community foundation) appoints all of the members of the committee and the donor's advice is given solely as a member of the committee
- Neither the donor nor the parties related to the donor control the committee directly or indirectly
- All grants are awarded on an objective and nondiscriminatory basis using a procedure that has been approved in advance by the board of directors of the sponsoring organization and that has been designed to ensure that all such grants meet the requirements of paragraphs (1), (2), or (3) of section 4945(g).

Let's take these requirements in order and see how they will affect some of the most common scholarship fund arrangements. Remember that a donor can be a living, breathing person, a deceased person, a charity or other nonprofit, or a corporation or other type of business.

Community foundation appointment of selection committee members

The community foundation must appoint the members of the selection committee. While an advisor may certainly suggest some members of the committee, the community foundation must have the power to accept or reject any suggestions. Community foundations will probably have to review and approve annually the members of all selection committees subject to this rule.

No donor control of committee

The donor and related parties may sit on a selection committee, but they may not make up a majority of the committee. The majority of the committee must be made up of individuals who are not related parties and who are not designated or appointed by the donor. Related parties include relatives and employees of the donor. The donor's attorney will generally be considered a related party. The donor may recommend for membership on the committee someone who is not a related party. If the recommendation is based on objective criteria related to the expertise of the person recommended that person will not be considered designated or appointed by the donor. The legislative history of the PPA provides an example: if a donor recommends the heads of the science departments at local secondary schools to be on a committee to award grants for the advancement of sciences at those schools, the persons so recommended will not be considered to be designated or appointed by the donor.

This provision clearly bars the board of a professional or alumni group, church, or other public charity that has established a scholarship fund from serving as the entire selection committee. Members of the board may serve on the committee but the majority of the committee must be made up of other individuals who are not related parties (such as school officials, other educators, or community foundation representatives). Similarly, a fund donor's family cannot constitute the entire selection committee or even a majority of the group. This is also the case if the fund is a memorial fund. The legislative history of the PPA takes the position that since contributions to such a fund are identified with reference to the deceased, family members of the deceased will be considered related parties and may not make up the majority of the selection committee.

Where a scholarship fund is established by a corporation, corporate employees may be considered related parties and should not form a majority of the selection committee. Indeed, the Council recommends that no corporate employees serve on the selection committee. This will

help ensure compliance with the rules for making employer-related scholarships.

Before appointing the members of a selection committee, the community foundation should be given basic information about why each individual being appointed is qualified to be on the committee—for example, he or she is a high school principal, a church leader, or a community representative. Donors should be asked to disclose any family or employment relationships they have with other committee members so that the community foundation can determine that the donor does not control the committee.

Procedures for awards

The PPA requires the community foundation board to approve in advance the procedures for making awards. These procedures must be objective and non-discriminatory and the grants must meet the requirements that are applicable to private foundations making grants to individuals for travel or study.

The Council has drafted a **sample set of procedures** [pdf] [doc] for scholarship programs that are designed to meet the requirements of the Pension Protection Act of 2006 and help community foundations continue to make scholarships and other grants to individuals from funds with donor involvement. Please read the **cover memo** [pdf] [doc] in conjunction with the sample procedures so that you can fully understand what they do—and do not—cover. We also drafted a **sample board resolution** [pdf] [doc] that relates to these procedures.

Board pre-approval of procedures

It's not clear from the text of the PPA how closely the community foundation board must review the procedures for each scholarship award. The Council believes that Congress intended community foundation boards to perform the role that the IRS plays in the pre-approval of private foundation scholarship procedures. According to the Internal Revenue Manual (the IRS's manual of procedures for its agents) the IRS's responsibility in these instances is to review a submission from the foundation that includes:

1. A statement describing the selection process
2. A description of the terms and conditions under which the foundation ordinarily makes such grants that is sufficient to enable the IRS to determine whether the grants awarded under such procedures would meet the requirements of IRC 4945(g)(1), (2), or (3)
3. A detailed description of the private foundation's procedure for exercising supervision over grants
4. A description of the foundation's procedures for review of grantee reports, for investigation in case diversion of grant funds from their proper purposes is indicated, and for recovery of diverted grant funds

The manual does not contemplate a series of separate approvals of particular grant programs. Once a private foundation's grant procedures are approved by the IRS, such grantmaking procedures apply to a new grant program as long as the procedures do not materially change. It is possible that the community foundation board could approve a general set of guidelines for committee selection, applicant processing and selection, follow-up, and investigation of misspent funds that would cover most scholarship funds. This would not absolve the community foundation from appointing committee members as discussed above. The Council will likely seek guidance on this issue shortly.

Objective and non-discriminatory procedures

Community foundations should already be familiar with the requirement that procedures relating to scholarship awards be "objective and non-discriminatory." A thorough review of this topic is contained in the Council's *Grants to Individuals by Community Foundations* .

Compliance with paragraphs (1), (2), or (3) of section 4945(g)

Like private foundations, community foundations must now ensure that their grants to individuals for travel, study, or similar purposes fit into one of the three categories set out in these provisions of the Tax Code:

1. Paragraph (1) allows grants that are scholarships and fellowships. These are grants that pay for tuition, books and other expenses.
2. Paragraph (2) sanctions grants that are prizes or awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. If the recipient is chosen from the general public, he or she must be selected without any action on his or her part to enter a contest or proceeding, and the recipient must not be required to provide services as a consequence of receiving the award.
3. Paragraph (3) permits grants to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific or other similar capacity, skill, or talent of the grantee. This is the broadest category and covers, for example, awards to artists to create works of art and some scholarships that do not fit under paragraph (1).

To sum up: if your community foundation has a scholarship fund that would be considered a donor-advised fund under the Act, you need to make sure that it can qualify for the scholarship exception. You will need to ensure that the selection committee is not donor-controlled and that your community foundation has approved the membership of the committee. You will also need to have your board approve the procedures for the selection committee's work. These actions must be taken prior to the commencement of your selection process for any scholarships or awards that will be paid after the date that the law's provisions start to apply to your organization.

How should changes to a fund's operations or documents be made?

In some cases you will find that the documents relating to a scholarship fund do not refer to donor involvement and that the donor's role has evolved over time. In other cases, the fund agreement will specifically discuss the donor's role. In all cases, you will need to determine what changes are necessary to ensure that the fund is in compliance with the new rules. You will no doubt want to communicate to your donors the importance of compliance and discuss alternatives that may be available. If you have scholarship fund agreements that include references to donor involvement that would prevent the funds from taking advantage of the scholarship exception, it will probably be necessary for your board to exercise its variance power to make changes to these funds. Keep records of the changes that your board has approved with the records for each affected fund. We generally do not recommend that you execute a new or amended fund agreement with the donor to make any necessary changes. Because the donor has made a completed gift to you, it is the board's duty to alter arrangements that are no longer practicable (because they would subject all participants to penalty taxes).

When do the provisions of the law start to apply?

The provisions of the PPA that relate to scholarship grants apply to organizations holding such funds in the first tax year following the year in which the PPA was passed. For community foundations on a calendar year, the first day on which these rules will apply is January 1, 2007. For community foundations on a fiscal year the effective date will vary. Depending on the organization's year, the effective date could be as early as September 1, 2006, or as late as August 1, 2007. As of the effective date, a community foundation may not make a distribution to an individual from a donor-advised fund.

Payment of awards approved before August 17, 2006

When the law was passed, it contained no provision that exempted from the ban payments that were approved before the prohibition but were made after the law's provisions applied. Community foundations with multi-year scholarship commitments were concerned that payments made after the law became applicable to them could be subject to penalty if the selection process through which the award was made did not comply with the new standards. In response to the Council's request for relief in this area, the IRS on December 4, 2006, released [Notice 2006-109](#). It exempts payments on educational grants awarded prior to August 17, 2006, from the ban on distributions to individuals from donor-advised funds. Scholarships are eligible for this special treatment if:

- The award was made on an objective and nondiscriminatory basis and is of a reasonable amount in light of the purposes of the scholarship.
- The recipient is not the fund's donor, donor advisor, or someone related to them (see

Changes in Intermediate Sanctions for Donor-Advised Funds and Supporting Organizations for information about which persons are considered to be related to a donor or advisor).

- On or before August 17, the sponsoring charity had records or copies of correspondence with the recipient, showing:
 - The name of the recipient
 - The nature of the grant (e.g., scholarship)
 - The amount of the grant
 - The date on which the grant was awarded
 - The grant period

Records must be kept for at least three years following the close of the taxable year in which the last payment is made. There can be no material change in the amount or conditions of the award or it will become ineligible for the exemption. The notice states that a material change includes "a required reapplication for the grant." We do not believe that the process of checking that a student continues to meet the eligibility requirements for a scholarship is a "required reapplication." Provided the scholarship meets the requirements outlined above, there is no deadline by which payments must be complete.

The information provided here is based on our continuing analysis of the bill. Every effort has been made to ensure accuracy of these documents. Please understand, however, that due to the complexity of the bill and the fact that many of these provisions introduce issues that are new to the Internal Revenue Code, this information is subject to change. The information is not a substitute for expert legal, tax or other professional advice and we strongly encourage grantmakers and donors to work with their counsel to determine the impact of this legislation on their particular situations. This information may not be relied upon for the purposes of avoiding any penalties that may be imposed under the Internal Revenue Code.

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