The main laws affecting the awarding of scholarships are the laws relating to private foundations and non-profit organizations. For example, section 4945(g)(1) of the Internal Revenue Code specifies that amounts paid as a scholarship or fellowship grant to an individual for travel or study will not be considered a taxable expenditure if the grant is awarded on an objective and nondiscriminatory basis and is to be used for study at an educational institution described in Section 170(b)(1)(A)(ii) of the code. Generally, a private foundation that awards scholarships should request advance approval from the IRS of the procedures it uses in managing the scholarship program, to ensure that the scholarships are not considered taxable expenditures. Section 4946 of the code specifies a list of "disqualified persons" who are not eligible to receive the grants. Similarly, for an award to be excludable from gross income, it must comply with the provisions of section 117(a) of the code.

This yields the following requirements for scholarships:

- The scholarship must be awarded on an objective and nondiscriminatory basis.
- No grants may be awarded to an officer, manager or trustee of the organization, nor to a member of the selection committee, nor to a substantial contributor, nor to certain US government officials.
- Family members of these individuals are also not eligible to receive grants.
- The group of applicants from which the recipients are selected must be sufficiently broad as to be considered a charitable class.

A charitable class must be sufficiently large and indefinite so that assisting members of the charitable class benefits the community as a whole. Earmarking scholarships to help a particular pre-selected student would violate this requirement. The donor of a scholarship cannot take a charitable deduction for a scholarship that is earmarked for the benefit of a specific individual, not even if that individual is unrelated to the donor. Moreover, donors may not circumvent this restriction by tightly delineating the selection criteria. Examples of valid charitable classes include 9/11 victims, lower income students, female students, students graduating in the top 10% of their class, all graduating seniors of a particular school, and even baton twirlers. Each of these examples is broad and indefinite.

Scholarships do not need to be based on financial need in order to be considered charitable. A scholarship whose recipients are selected on the basis of academic merit without regard to financial need may still be exempt under section 501(c)(3) of the IRC. (See Revenue Ruling 69-257, 1969-1 C.B. 151.)

A family cannot take a charitable deduction for a contribution to a tax exempt foundation if the contribution is earmarked by the family for the education of a specific individual, regardless of whether that individual is a relative or not. Such "contributions" fail the IRS's non-discriminatory test. (Note, however, that amounts paid directly to an educational institution for the education of a particular individual are not subject to gift taxes.)

Aside from the provisions of the Higher Education Act of 1965 concerning the awarding of federal student aid, and the provisions of The Internal Revenue Code relating to specific tax benefits for education, scholarships and fellowships (see IRS Publication 970), the only other laws relating to scholarships are the College Scholarship Fraud Prevention Act of 2000 and the US Supreme Court rulings on affirmative action.
The IRS has a variety of rules concerning scholarship grants by private foundations. IRS Revenue Procedure 76-47, 1976-2 C.B. 670 establishes guidelines that can be used to determine whether a grant under an employer-related scholarship program is considered a taxable expenditure (and might lead to a loss of the foundation's exempt status).

To be non-taxable, the grant must satisfy the following seven conditions and certain percentage tests paraphrased from the revenue procedure. Please refer to the actual revenue procedure for details.

- **Use as inducements prohibited.** The program may not be used to recruit employees, induce employees to continue their employment, or follow any other course of action sought by the employer. The scholarships may not represent compensation for past, present or future services to the foundation/employer.

- **Independent selection committee.** The selection committee must be totally independent of the foundation/employer. Former employees are not considered independent. Grants may be awarded only in the order and amounts recommended by the selection committee. The number of grants may be reduced but not increased from the number recommended by the committee.

- **Minimum eligibility requirements.** The program must have a set of minimum eligibility requirements that are related to the purpose of the program. These eligibility requirements must limit the selection committee to considering only those employees (or children of employees) who meet the minimum standards for admission to a qualifying educational institution. If the employee must have been employed for a minimum period, the minimum period may not exceed three years. Eligibility must not be related to other employment-related factors, such as position, services or duties.

- **Objective basis for selection.** Selection of recipients must be based solely on substantial objective standards that are completely unrelated to the employment of the recipients or their parents and to the employer's line of business. Examples of objective standards include prior academic performance, performance on tests designed to measure ability and aptitude for higher education, recommendations from instructors and other individuals not related to the potential awardee, financial need, and conclusions based on personal interviews as to motivation and character. The program must be controlled and limited by substantial non-employment-related factors. The members of the selection committee should not derive a benefit from the selection (e.g., recipients may not be related to members of the selection committee or disproportionately affiliated with management or highly compensated employees of the company).

- **Eligibility not contingent upon continued employment.** Grants may not be terminated because of termination of employment subsequent to the awarding of the scholarship. Likewise, for renewable awards, the standards for renewal should be based solely on nonemployment-related factors such as financial need and maintenance of scholastic standards. Renewal may not be denied because of termination of employment. At the time of award or renewal there cannot be any requirements, conditions or suggestions, express or implied, that the recipient (or parent) is expected to render future employment services or be available for such future employment.

- **Course of Study.** The course of study may not be limited to those that are of particular benefit to the foundation/employer. If the courses of study includes one or more of benefit to the foundation/employer, the scholarship may not be conditioned on the recipient choosing that particular course of study. The recipient must have a free choice as to pursuit of a course of study.

- **Other objectives.** The scholarships and courses of study supported by the scholarships must be consistent with a disinterested purpose of enabling the recipients to object an education solely for their personal benefit. There may not be any commitments, understandings or obligations -- conditional or unconditional -- suggesting that the studies or research are undertaken for the benefit of the employer/foundation or have as their objective the accomplishment of any purpose of the employer/foundation other than enabling the recipient to obtain an education for their personal benefit. For example, collectively bargained scholarship plans for employees' children are not considered charitable and hence are not exempt under IRC 501(c)(3). A private foundation funded by a for-profit company that grants scholarships for children of a particular community is nontaxable, regardless of whether the parents are employed by the company.
(Revenue Ruling 79-131). A private foundation's scholarship program for children of deceased or retired employees is subject to Revenue Procedure 76-47, as it is considered an employer-related grant program (Revenue Ruling 79-365).

The percentage tests are satisfied if

- The number of grants awarded to children of employees of a particular employer does not exceed 25% of the number of employees' children in that year who were eligible applicants considered by the selection committee in selecting the recipients in that year OR if the number of grants does not exceed 10% of the number of children of employees who were eligible for a grant in that year (regardless of whether or not they submitted an application).
- The number of grants awarded to employees of a particular employer does not exceed 10% of the number of employees in that year who were eligible applicants considered by the selection committee in selecting the recipients in that year.

(There is a proposal before Congress to increase the percentages to 35% and 25% if the foundation awarding the grants provides a comparable number and aggregate amount of grants during the year to individuals who are not employees, children/dependents of employees or otherwise affiliated with the employer.)

When two or more foundations make grants to a single employer, the combined number of grants should not exceed these percentage tests.

If the percentage tests are failed but the other seven conditions are satisfied, the IRS will review the facts and circumstances before issuing a ruling whether the grants are considered scholarships subject to the provisions of IRC section 117(a).

There is an exception when an employee is killed or seriously injured in a qualified disaster (IRS Revenue Ruling 2003-32).

Revenue Procedure 80-39 is similar, but concerns whether educational loans made by a private foundation under an employer-related loan program are considered taxable expenditures.

The Pension Protection Act of 2006 (P.L. 109-280) bans donor-advised funds from making grants to designated individuals. Donors may serve on a scholarship selection committee but may not directly or indirectly control the selection process. This restriction includes the donor, members of the donor's family, people who serve as advisers to the donor (e.g., lawyers and accountants), people who are employed by the donor (including officers and directors of a donor that is a business or corporation), and committee members selected or appointed by the donor. These people may not represent a majority of the members of the selection committee. Selection of recipients must be on an "objective and nondiscriminatory basis" (see the relevant discussion of IRC section 4945 above). In addition, the donor may not derive a more than incidental benefit from the grant program.

**Don't Ask for Social Security Numbers**

If you do not have a legitimate reason for asking for the applicant's social security number, don't ask for it on the application form. Assign your own ID number to each applicant instead.

Not only do you not have the right to request the social security number, but the social security number is a badly designed personal identifier. For example, if you transpose two digits in someone's social security number, you'll likely to yield someone else's social security number.
Minimize Displacement

Displacement occurs when a school has to reduce the need-based portion of a student's financial aid package because the student received an outside scholarship. Although many schools have favorable outside scholarship policies that reduce loans before grants, to some extent the outside scholarship is benefiting the school (or more accurately, other students at the school) than the student selected by the sponsor.

You can minimize the impact of displacement on your recipients by allowing them to use the award for "educational expenses" (or even room and board) and not just "tuition".

Writing the check directly to the student as opposed to the school is ineffective, because the student is required to report all outside scholarships to the financial aid office. Failing to report outside scholarships can have serious consequences for the student when the outside award is eventually discovered by the school.

Paying the scholarship as wages or a honoraria to the student or parent would reduce the financial aid impact somewhat, since it would be treated as income instead of as a resource. Student income is assessed at a rate of 50% instead of the 100% reduction associated with resources. However, the family would be able to use the money for any purpose whatsoever, not just for educational expenses, and the income would be subject to federal and state income tax and FICA. (If the "wages" were restricted for educational purposes, they would be treated as a resource. If it looks like a scholarship and acts like a scholarship, it is a scholarship.)

If your scholarships are tenable only at a specific college, try entering into an agreement with the school whereby the school will first apply the scholarship to unmet need, and then reduce loans before grants in overaward situations involving your scholarship program.

Spreading the award over all four years of college will allow for more opportunities for the money to reduce unmet need and loans instead of grants.

Another way to minimize the impact is to establish a 529 college savings plan or prepaid tuition plan that names the student as the beneficiary. If the account owner is neither the parent nor the student, it will have no impact on federal student aid. If the account owner is the parent, it will have a minimal impact on federal student aid, as it will be treated as a parent asset and not as a resource.

http://www.finaid.org/educators/awarddesign.phtml