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Caution when using private foundations to provide educational benefits

Tax-free scholarships to employees or their kids provided through employer-related 501(c)(3) private foundations aren't new. Additionally, they aren't limited to companies with deep pockets. Your scholarships can be as modest as you choose. All you need to do is e-file an application for tax-exempt status, set up the foundation, fund the scholarship and establish the rules for recipients.

However, setting the rules for granting scholarships can be tricky. If done wrong, your foundation can lose its tax-exempt status, and those scholarships may become taxable income to employees and the company.

Good thing, where have you gone?

The qualities that make a good employee—enthusiasm, leadership, efficiency, dedication, and wanting the company to succeed—are not the benchmarks employer-related foundations should use to decide who gets scholarships.

Case in point: Employees had to meet certain job performance standards, including the above criteria, to receive a scholarship from an employer-related foundation. Applications were preselected by employees' managers, with a board of directors making the final decision.

The foundation was audited. During the closing conference, had concerns that the foundation was granting scholarships to retain employees. Instead of denying it, the treasurer responded, "Well, isn't that a good thing?"

Well, no. The revenue agent recommended that the foundation lose its tax-exempt status. *IRS:* The scholarships are compensatory in nature and provide a substantial private benefit to the foundation and the employer.

Unaddressed by this ruling is the related issue of whether the scholarships were taxable. Although the tax status of the scholarships would need to be evaluated separately and by a different auditor, they would likely be fully taxable because of the employer-employee relationship.

Back to school

To pass muster, foundations providing employer-related scholarships must satisfy these conditions:

- No one involved—the employer, the foundation, or anyone else—can use a scholarship program to recruit or retain employees or to induce employees to follow a course of action sought by the employer.
- The selection of scholarship recipients is made by a committee independent of the foundation and the employer.
- Recipients' selection is based on substantially objective standards, including prior academic performance, performance on tests measuring ability and aptitude for higher education, recommendations from instructors or others not related to the potential recipients, financial need, and conclusions drawn from personal interviews.

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- The scholarships continue even if employees terminate their employment.
- The courses of study don't particularly benefit the employer or the foundation.
- The scholarship and the courses of study meet the requirements of IRC § 117—it's limited to tuition and related expenses.
- Scholarships to employees' children don't exceed 25% of the number of children who are eligible and were considered by the selection committee or 10% of the number of scholarships awarded to children, regardless of whether they applied, or to 10% of the number of employees who were eligible and were considered by the selection committee.

Get smart

Employees value education benefits. If you want to offer an education benefit, offer an IRC § 127 educational assistance plan. These plans are easier to administer since you don't need to set up any foundation to do it, but employee benefits are limited.

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