

TAXATION OF SCHOLARSHIPS

Frank Sommerville, JD, CPA

Most churches want to honor students from their congregation and encourage them to attend college. Sometimes, a church will want to honor a member who has been called into the ministry but lacks the necessary education to be ordained. The solution to both of these situations is to award scholarships to high school students and members wanting to go to seminary. Frequently, churches fail to appreciate the tax consequences of the scholarships. This article will explain the tax rules that govern scholarships.

What is a Scholarship?

A qualified scholarship is exempt from income taxes. The Internal Revenue Code (“IRC”) Section 117 contains a specific definition for a “qualified scholarship.” According to the IRC, the term “qualified scholarship” means any 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. “Tuition and related expenses” includes tuition, required fees, books, supplies, and equipment that is required for specific classes. The recipient of the scholarship must be a **candidate for a degree** at a **qualified educational organization**. A “qualified educational organization” is an organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The IRS has interpreted this definition to include only those schools, colleges, and universities that are accredited.

The term “qualified scholarship” does not include any amount received that represents payment for **teaching, research, or other services** by the student that are required as a condition for receiving the qualified scholarship. This means that employees may not receive a qualified scholarship.

What Authorizes the Church to Grant a Scholarship?

A church is authorized to pursue charitable purposes. This means that the church may only benefit those who are members of a charitable class. The IRC defines charitable classes to include children, needy individuals, sick and infirmed individuals, and those under distress.

Applying this standard to scholarships, the church may award qualified scholarships to anyone under the age of 18, anyone who cannot afford to attend college, anyone who is handicapped or ill, and anyone who is distressed. Beyond these basic guidelines, the church has great flexibility in determining the criteria for awarding scholarships.

As a caveat to the above criteria, the courts and the IRS have decided that a charitable class must be broad enough to be “indefinite” in size. This means that a church may not draft its criteria for applying for the scholarship so that very few individuals will qualify for the qualified scholarship. For example, if a church decided to award a scholarship to all children of staff

members, this requirement creates too small a class of individuals to qualify as a charitable class. In smaller churches, the church will frequently award scholarships to all graduating seniors. Again, since only a few individuals will be eligible for the qualified scholarship, this group will not qualify as a charitable class.

If the church defines the group eligible for the qualified scholarship too narrowly, the IRS and the courts have decided that the church has provided a private benefit to those individuals. If a church provides material private benefits, the IRS may revoke its tax exempt status.

I suggest that churches define the group eligible for the qualified scholarship broadly so that this does not become an issue. For example, the church could make everyone in their community eligible to apply for the scholarship, with a priority given to youth that are active in their church.

Practical Application

The church should adopt a written policy governing the award of scholarships. The policy should define the charitable class of potential recipients and the criteria that will be used to award the scholarship. The scholarship award committee should be composed of individuals who are not related to the potential recipients. The church should approve a written application form that will be used by all applicants. The application should be drafted to secure information from the applicants that will confirm that they are part of the charitable class defined in the policy and information about the criteria being used to evaluate the applicants. A copy of the applicant's college transcript should be attached to the application. If the scholarship is awarded to graduating high school seniors, the application should be accompanied by a letter of acceptance from the college or university where the applicant intends to attend. The application should be signed by the applicant with the applicant verifying that the facts contained in the application are true and correct.

The church should pay the scholarship amounts directly to the college or university where the successful applicant(s) will attend. The payment should be accompanied by a letter from the church instructing the school to apply the payment to the tuition and required fees of the successful applicant(s). The letter should also request that the school confirm in writing that the student is enrolled in the school and participates in a degree program.