

Church Financial Hot Topic

Scholarship Fund or Disguised Tuition Payment Program

Many churches have tried to set up ways to assist members or family members financially that are attending a private school (church sponsored or others), college, or seminary. Though this may seem like a wonderful thought or ministry, it has many difficult obstacles and laws, which if not handled correctly, could result in penalties for donors, recipients, and the church. Unless the church has a large scholarship fund and the scholarship fund benefits a lot of students, as well as numerous contributors, it is probably not advisable to recognize scholarship fund donations for contribution credit. This is especially true if the donor is related to a scholarship recipient.

In order for donations to a scholarship fund to be tax deductible contribution credits, the donations must benefit an “indefinite class” of potential candidates for the scholarship. An “indefinite class,” though not clearly defined by law, should be significant. It is better to maintain a conservative position about the number of potential candidates. For example, if the number of potential candidates is one hundred candidates as opposed to two potential candidates, then the scholarship fund is much more likely to be considered acceptable. Another possible scenario to consider would be that a church scholarship for high school graduates to any university would be more acceptable rather than a scholarship for a particular university. Whether the donations to the scholarship fund are to be considered a charitable gift will depend on the number of possible candidates to be considered and granted scholarships. If the class of possible candidates is limited to few potential applicants, this requirement is not met and the scholarship fund donations are not considered charitable contributions. Scholarship fund donations that benefit a small group of recipients and limit the potential number of candidates too precisely tend to be just that - gifts to individuals; and, therefore, the donations are not charitable contributions.

Churches cannot allow tuition payments to be made through the church to be included on the donor’s annual contribution credit statement when a donor or donor’s relative is the primary or one of the primary recipients. One such proposal or scheme that has surfaced is where the church or parent has a child’s tuition billed to the church and the church pays the bill out of the scholarship fund for which donations were added to the parent’s contribution credit statement. Some churches have even been so untruthful as to stamp the contribution credit statement with the proper wording stating that the parent received nothing in exchange for the contributions except intangible religious benefits. The IRS has called these plans “disguised tuition payment programs” and has set up fines and penalties for violators. The penalties and fines are made against donors for understating taxable income by taking contribution credit for something that was not a contribution, and against churches for assisting in the understatement of income of donors.

Some churches allow donations to a scholarship fund to help students at the private school that is part of the church or have a close relationship to the church. If the donor or a relative will receive a benefit from the donation, it is best to inform the donor (before the church deposits the check) that the donation is not going to qualify for a contribution credit. Also, inform the donor that to protect the church, the church treasurer will have to stamp the donor’s check as a non-qualifying contribution gift. The non-qualifying contribution gift will not be recorded on the donor’s contribution credit statement. This same rule applies if the church and the private school are using the same name and facility. A parent’s payment to his child’s school needs to be specifically documented as tuition payments by the school. The payment should be stamped as a non-qualifying contribution gift. The payment will not be included on the individual’s contribution credit statement from the church. By clearly stamping the tuition payments as a non-qualifying contribution gift to the church-affiliated school, the church’s liability is alleviated should the student’s parent incorrectly claim the contribution gift on his individual income tax return.

Churches can have scholarship funds. The scholarship fund needs to be available to more than just church members (indefinite class of eligible recipients). By the church offering the scholarship to an indefinite class of eligible recipients, this action will help reduce the risk of allowing parents to take a contribution credit for tuition payments or disguised tuition payment programs that put the donor and the church in trouble with the IRS. In addition to having the scholarship fund available to an indefinite class of eligible recipients, the church scholarship fund should have the following guidelines:

- 1) Prepare a written application and have clear documented terms and conditions. This includes limiting conditions for the uses of proceeds to tuition, enrollment fees, books, and supplies.
- 2) Provide academic accountability such as proof of enrollment and transcripts.
- 3) Require the recipient to provide receipts showing that proceeds are used for approved use.
- 4) Request a direct payment to the educational institution rather than directly to the recipient.
- 5) For the scholarship to be a nontaxable scholarship, the recipient must be enrolled in an educational institution that will allow the recipient to be a candidate for a degree.

This document is intended to provide churches, pastors, and staff with current and accurate information about the subjects covered. However, such information is not intended to be sufficient for dealing with a particular legal problem, and the authors and distributors do not warrant or represent its suitability for such purpose. The reader should not rely upon this document as a substitute for independent legal consultation or IRS instructions.