NONPROFITS: INTERNAL REVENUE SERVICE

Dodgy Scholarship Scheme Doesn't Get Tax Exemption

06.16.17 | Linda J. Rosenthal, JD

Responding in 2014 to a nightmarish backlog of tax-exemption applications, the Internal Revenue Service came up with a solution: Offer a short and simple alternative form – the Form 1023-EZ – for many small- to mid-size 501(c)(3) start-ups.

The streamlined procedure would have the necessary effect of speeding up the response time from an average 2-year wait down to a few weeks. The trade-off was the miniscule number of questions asked, and dispensing with the requirement to produce bothersome documents like the new organization's articles of incorporation and bylaws. There would be a small sample of applications selected for a more in-depth, upfront review. Otherwise, most applications would sail on through, followed by a more intense audit sometime down the line after exemption was granted.

Indeed, the new application procedure was a quick success insofar as it dramatically reduced the the tax-exemption application turn-around time. But skeptics complained loud and often that the Form 1023-EZ would – and did – result in a mockery of the application screening process:

> *It's easier to get tax-exempt status under Form 1023EZ than it is to get a library card, says Tim Delaney, the President and CEO of the Council of Nonprofits about the new exemption-application alternative for smaller organizations.*

It makes sense that, with such a flimsy review apparatus, any number of organizations not meeting the requirements of 501(c)(3) would slip in under the radar, unnoticed. Some, though, have been caught including a recent case denied tax-exempt status in December 2016. The foundation in question proposed giving college scholarships on a merit basis to highly qualified applicants otherwise meeting certain – ah … ***unusual*** – criteria.

The facts are described in private letter ruling PLR 201652029, which is a highly redacted (for privacy purposes) official explanation of the reasons for denial of the requested 501(c)(3) tax exemption.

As retold by one of several entertaining tax-law commentators, the organization's "purpose was to further education, and it was going to grant scholarships … on merit-based criteria. The organization had two members of a selection committee who expected to spend about one hour per year operating the scholarship program – because it turns out it wouldn't be that difficult to identify qualifying recipients." The only student who could possibly fit these seemingly neutral, but exceedingly narrow parameters was the college-age son of the founder-directors, who also happened to be the sole members of the selection committee.

In a nutshell, a qualified applicant is required to be a National Merit Finalist who happens to be graduating from high school X in the founders' hometown and who plans to attend college Y which is clear across the country, 3000 miles away. Each successive element of this three-pronged criteria test lessened the number of eligible potential applicants down to that one lucky 18-year-old.

Additional details and the specific legal precedent for denial of tax-exempt status are in the private letter ruling; the so-called scholarship program was dressed up in a pretty package to resemble a legitimate philanthropic endeavor for community benefit. But the eagle-eyed folks at the IRS were able to see it for what it was – a rancid bundle of private benefit – despite the limitations of the minimalist Form 1023-EZ application process.

A similar situation was the subject of a 2012 tax-exemption audit. As explained by Peter J. Reilly, the always humorous tax commentator for Forbes Magazine, in his article titled: "Educational Assistance Foundation for The Descendants of Hungarian Immigrants in The Performing Arts – Can't Make This Stuff Up":

> *EAFDHIPA filed Form 990 for the years 2005 and 2006. It took in over two million dollars in contributions and handed out a little over $200,000 in scholarships. Not just anybody can get a scholarship from the Foundation. In order to qualify you have to be a junior or senior in college. You must also have an ancestor who emigrated from the "Hungarian area of Eastern Europe", as defined in the bylaws. The ancestor must have been involved in the performing arts.*

Conclusion

Too much private benefit, not enough pure altruistic educational giving. It's an old (and certainly repeating) story.