IRS Denies Exemption to Local Fraternity Foundation Providing Scholarships to Chapter Members

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The IRS ruled that a foundation formed to provide tuition and room and board scholarships to members of a local fraternity chapter is **not entitled** to exempt status as a Section 501(c)(3) educational organization. In the past the IRS has ruled that a fraternity foundation **could** award scholarships solely to undergraduate members of a designated fraternity or fraternity chapter. The facts surrounding the administration of the scholarship program at issue provide important guidance as to what activities are exempt, and what activities are not.

In this case, the IRS took issue with the method by which scholarship recipients were selected and the potential number of recipients in relation to the number of applicants. The criteria for awarding scholarships were financial need, academic excellence, or both. Scholarship recipients were chosen based on a ranking system whereby the applicants were ranked based on grade point average and financial need. The foundation then began at the top of the list and granted scholarships as far down the list as its resources allowed. The foundation estimated that between 10 and 14 of the chapter's 31 members received scholarships in a typical year. The IRS noted however, that in some years, all of the chapter members could potentially win scholarships if the foundation's fundraising efforts were particularly successful.

The IRS also took issue with the relationship between the foundation and the local house corporation owning the chapter house. In this case, all of the trustees of the foundation were members of both the fraternity and the local house corporation. The foundation planned to solicit funds from members of the house corporation, which, due to its ownership of the chapter house, had a vested interest in scholarships for room and board expenses.

Based upon these circumstances, the IRS determined the foundation was not exempt. The principal reason for the IRS determination was that the class of beneficiaries was too restricted to confer the public benefit required by Code Section 501(c)(3). In other words, the foundation's benefits were overly directed toward a narrowly designated group.

Moreover, there was an unacceptably high level of pre-selection of scholarship recipients such that members of the house corporation donating to the foundation would know, in advance, that their donations would assist only those applicants from a small pre-identified pool.

Finally, the fact that some or all of the room and board portion of the scholarships would be paid to or for the benefit of the house corporation resulted in a significant private benefit to the house corporation.

This ruling should not be read as establishing a hard-line rule precluding exemption for local fraternity foundations that award scholarships solely to members of the local chapter. The ruling does, however establish some guidelines. **AVOID:**

1. the implementation of a ranking system for selection of scholarship recipients;
2. a system which results in a possibility of awarding scholarships to all or a high percentage of the chapter members and
3. a significant overlap between local house corporation and/or alumni association board members and foundation board members