WHAT IS THE FEDERAL SCHOLARSHIP TAX CREDIT?



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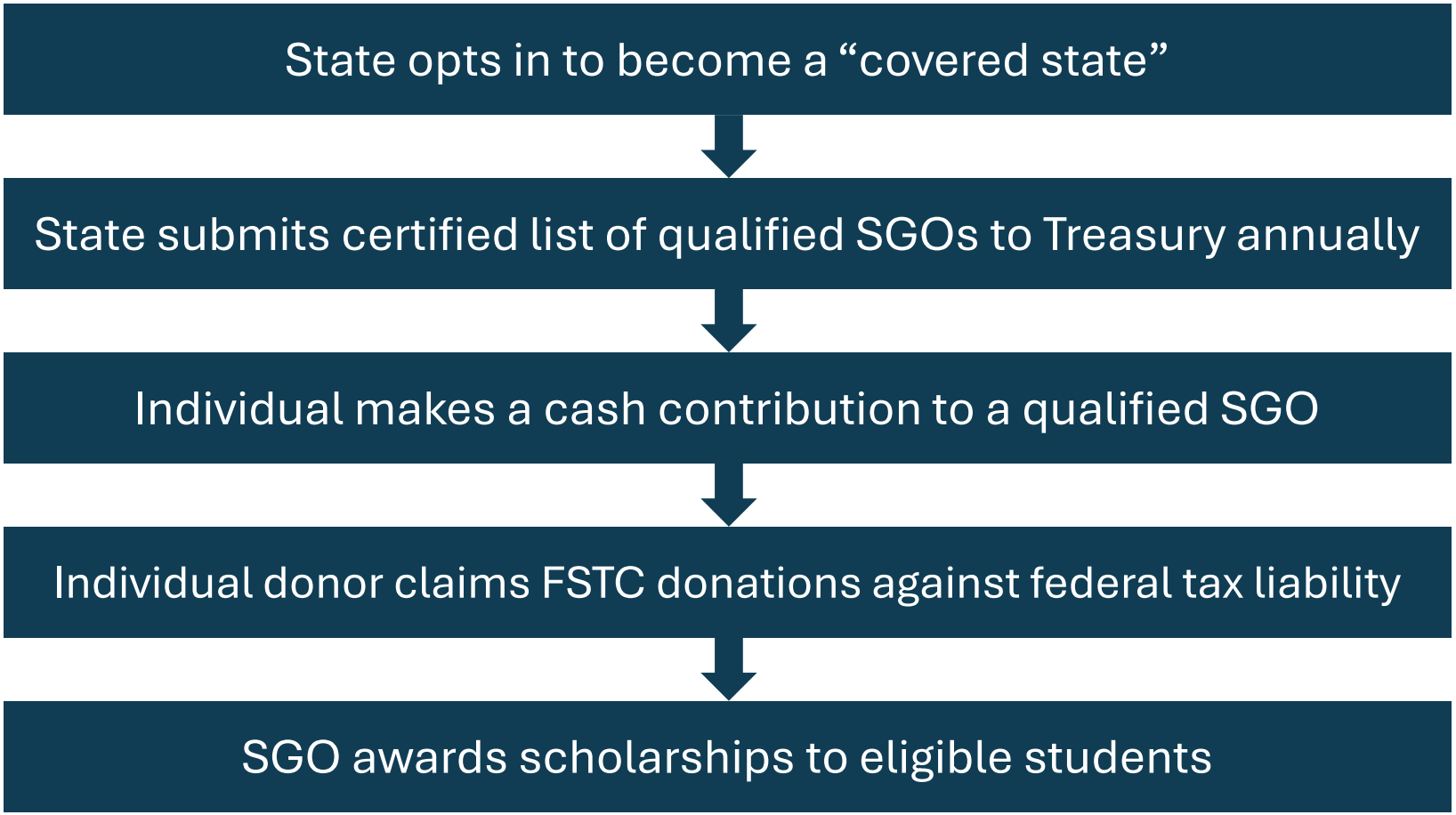
- **Internal Revenue Code (IRC) § 25F. Congress last year created the Federal Scholarship Tax Credit ("FSTC")**

- **$1,700 Credit.** Starting in 2027, the FSTC is a nonrefundable, 100% tax credit, for cash contributions made by a taxpayer to scholarship granting organizations ("SGOs"). **Joint filers may claim $3,400** (if both taxpayers donate $1,700)

- **SGOs.** IRC § 501(c)(3) organizations on a "covered" state's certified list can raise qualified contributions and award scholarships to K-12 students for qualified education expenses

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How the FSTC Works



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Eligible Students

Students must:

- Come from households ≤ 300% of area median gross income
- Be eligible for elementary or secondary public school enrollment
- School definitions from Coverdell, IRC section 530, per state definition
  - Section 530 guidance is forthcoming before end of year
- Reside in the covered state of the SGO (i.e., a participating state)
  - Two exceptions: students of a military family or live on tribal lands
- Not be related to a "disqualified person"
  - Substantial contributors to the SGO or to the 25F segregated account
  - Officers, directors, or trustees of the SGO, including individuals with similar powers and responsibilities
  - Anyone who participates in selecting scholarship recipients, including as a member of a selection committee
  - Family members of any of the persons above

Note: Scholarships are not taxable income to recipients

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Qualified Elementary or Secondary Education Expenses

Permissible Uses of Scholarship Funds

Included under IRC section 530(b)(3)(A):

- Tuition and fees
- Tutoring and special needs services
- Books, supplies, and equipment
- Room and board
- Transportation and uniforms
- Educational technology and internet access
- Extended day programs and supplemental expenses

Note: Treasury and the IRS have noted this a separate, high-priority regulatory project

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State Opt-In Requirements

"Covered State" Defined

- States must affirmatively elect to participate for its resident students to benefit
- Advance election process
  - File Form 15714
  - **Year 1 form must be submitted by Jan. 1, 2027**
  - Submit form for future year election by Sept. 30 of the prior year; or with SGO list simultaneously by Jan. 1
  - **"Perfected" (SGO list) year 1 form by Feb. 15, 2027 (first year only)**
  - Future years by Jan. 1

Voluntary election ("opt-in") to participate made by:

- Governor, or
- Other authorized state official/entity

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Who Can Claim the FSTC?

Donor Eligibility:

- Individuals only (not partnerships or S-Corps.)
- Only citizens or residents of the U.S.

Credit limited by:

- $1,700 annual cap ($3,400 joint filers)
- Donor's federal income tax liability
  - Carryforward of unused credit
  - State credit applies first: If you receive the state credit, it reduces the amount of the federal credit on the same donation dollars
- No double dipping
  - State credits and charitable contribution deductions cannot occur on same dollars

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Credit Carryforward Scenario

Example: Joint filers in 2028 have a $700 FSTC carryforward from 2027.

- In 2028, joint tax filers make a new $3,400 cash contribution to an SGO
- 2028 federal income tax liability (before credit): $4,000
- The $1,700 annual cap applies regardless to each individual taxpayer
- Five-year limitation applies

Credit applied (FIFO):

- First: $700 carryforward from 2027 is applied
- Then: $2,700 of new 2028 credit is applied (reaching $3,400 cap)
- Remaining $700 from 2028 credit carries forward to 2029

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What Is a Scholarship Granting Organization (SGO)?

An SGO must:

- Be tax-exempt under IRC §501(c)(3)
- Meet statutory operational requirements
- Maintain separate accounts for qualified contributions
  - State-by-state basis
- Be listed on a covered state's annual certified SGO list
- **Provide annual audits and reports to donors & IRS**

An SGO must NOT:

- Be a private foundation

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SGO Operational Requirements (1 of 3)

An SGO must:

- Award scholarships to at least 10 eligible students that do not all attend the same school
- Spend ≥90% of income on scholarships for eligible students (the “90/10 Rule”) by end of following tax year from which the income was received
    - Income = total gross receipts from all sources, unreduced by expenses (cash method)
- Safe Harbor: more narrowly define "income" as qualified contributions in the SGO's segregated account if:
    - 85% of its activities be focused on scholarship granting activities: administrative, fundraising, governance, investment, compliance, outreach and other activities that are in support of scholarship granting activities
- Prohibit donor earmarking for specific students
- Prohibit scholarships to dependents and relationships to disqualified persons

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SGO Operational Requirements (2 of 3)

An SGO must:

- Prioritize awards to prior-year recipients and their siblings
  - For scholarships awarded for individual tutoring or special needs services, prior-recipient and sibling preferences may not apply; priority can also be based on need for the services
  - Sibling includes brothers and sisters, adopted siblings, foster siblings, half-siblings, and step-siblings
- Verify household income (≤ 300% of area median gross income) and family size
    - Family size is the number of persons who are part of a household
    - Foster children automatically qualify and are not subject to household income verification

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SGO Operational Requirements (3 of 3)

- Household income includes only cash sources for verification including child support and alimony

  - Does not include imputed income from assets

- There are many options to verify and some safe harbors:
  - Direct income – Form 1040, W2, etc.
  - Category – SNAP Section 8 Housing
  - Safe harbor for tutoring and special needs
    - School is in a qualified census tract (QCT)
    - Or 80% live in a QCT
- 300% of area median gross income is a ceiling, not a requirement -- SGOs may focus on lower-income students and still qualify

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State and SGO Registration

State Opt-in Requirements

- Special purpose identification number from the IRS portal
- Transmit state election (including advanced), state SGO list, changes to the state SGO list, and annual certifications to IRS
- For all SGOs, states must provide on the SGO list:
  - EIN, address, telephone number, and tax-exempt status
  - Certify that each listed organization meets the requirements to be an SGO
  - Certify it reviewed the annual programmatic and financial audits

SGO Certification Requirements

- SGOs must register though the IRS SGO portal as soon as possible and preferably before they appear on any State list
- Information required to complete registration:
  - Contact information for the two state designated officials to interact with the portal
  - "Perfection" of advanced election by submitting SGO certified list
  - Provide SGO list and certifications that they meet the requirements for: new SGOs can rely on organizing documents for the first year; and existing SGOs

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SGO Registration Requirements

State SGO listing of organizations, incl. pending IRS tax-exempt applications

- A state may include pending-application organizations on its State SGO list if it includes *all* organizations that seek inclusion & have applications pending with the IRS
- For each pending organization, the State must comply with the same requirements that apply to any organization on the State SGO list
- Make the required certifications regarding the organization's tax-exempt status:
  - The organization has applied for recognition as a section 501(c)(3) public charity
  - If granted, the organization's tax-exempt status will be effective retroactively to a date on or before Jan. 1 of the year for which the State SGO list applies
- The State SGO list must indicate that the organization's tax-exempt status is pending IRS recognition
- The IRS will add the organization to the IRS SGO list once it:
  - Determines the organization qualifies for tax-exempt status as a section 501(c)(3) public charity, and
  - Confirms the organization consents to inclusion on the IRS SGO list

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Multistate SGO Interactions

Located in a State

- An organization must be authorized to do business in the State and be in compliance with applicable state laws to operate as a charitable organization

Operational thresholds applied:

- State-by-state
  - SGO can be multistate, but needs to meet the operational requirements on a state-by-state basis, e.g., audits, 25F accounts, etc.

Recordkeeping and Reporting

Compliance Framework Requirements

- Annual IRS reporting
  - An SGO must certify that it meets the requirements

- Basics
  - Register on portal → mandatory as soon as possible
    - Name, EIN, address, telephone number, year of form, person to contact (bind or power of attorney), and tax year
  - SGO receives unique donor number instructions
  - Normal report to donor and unique donor number, January 31st of year following qualified contribution(s)

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Recordkeeping and Reporting

SGO information to the IRS

1. Certify annually by February 28th:
   - Generally meets SGO requirements (90/10 rule, no comingling, etc.)
     - Plus programmatic and financial audit
   - Single and Multistate
     - Verified proper use of scholarships (eligible students, expenses, etc.)
     - 85% rule if applicable
2. Report annually by May 15th or with submission of IRS Form 990:
   - Information about the scholarship and students
     - How many applied for and how many awarded scholarships
     - Scholarship amounts (highest, lowest and average)
     - Process for awarding scholarships
     - Data on revenue and expenditures; percentage spent on scholarships
   - To states
     - Programmatic and financial audit by independent CPA (less than $500,000 in income is a different process)

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Treasury, IRS Request Comments

Scholarships and expenses

- Definition of qualified digital wallet
- Safe harbor for verification that scholarships are being used for eligible expenses

Activities

- Further guidance on measuring SGO activities, 85% activity threshold, 501(c)(3) interactions with 25F

Programs

- Eligibility under the categorical eligibility verification method, state certifications for a multistate SGO

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For more information, please contact

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