



Tax Insights
from Exempt Organization
Tax Services

Treasury and IRS release guidance on new federal scholarship tax credit

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In brief

What happened?

Treasury and IRS, with input from the Department of Education, jointly released guidance ahead of the January 1, 2027, program start date for the new Education Freedom Tax Credit under Section 25F (also known as the Federal Scholarship Tax Credit). The guidance—comprising proposed regulations, temporary regulations, and FAQs—establishes an operational framework that addresses how states may elect to participate, how organizations may qualify as Scholarship Granting Organizations (SGOs), and how individual donors may claim the credit.

Why is it relevant?

This is the first federal tax credit of its kind, providing a direct incentive for individual donors to fund K–12 scholarships through qualifying SGOs. With the program taking effect in the new year, the guidance could help states, SGOs, and donors prepare. It also presents opportunities for public charities considering SGO status, states deciding whether to participate, and individual donors seeking tax-efficient ways to give.

At the same time, the rules impose significant operational and compliance obligations, particularly for SGOs—which face income-based spending requirements, segregated account rules, and IRS reporting requirements—as well as states and donors subject to their own certification and eligibility requirements, underscoring the need for careful planning in the time remaining before the program takes effect.

Actions to consider

Tax-exempt organizations considering SGO status should determine whether they qualify as Section 501(c)(3) public charities, evaluate whether the relevant state has elected to participate, and assess their ability to meet key operating requirements, including the 90% scholarship-spending threshold, segregated account rules, and IRS reporting obligations.

Individual donors should determine if the recipient organization is on the IRS SGO list at the time of contribution, properly designate contributions as qualified at the time of the gift, maintain documentation to support the contribution, and understand how the credit interacts with state tax credits and the charitable contribution deduction.

In detail

Background

Section 25F provides a nonrefundable federal income tax credit for individual taxpayers who make qualified cash contributions to SGOs. The credit generally is capped at \$1,700 per individual taxpayer or up to \$3,400 for married couples filing jointly if each spouse makes qualifying contributions. Unused credits may be carried forward for up to five years.

The provision was added as part of the One Big Beautiful Bill Act (OBBBA) and is effective for tax years ending after December 31, 2026. The temporary regulations apply from September 1, 2026, to October 1, 2029, and establish the administrative infrastructure needed before the program launches, including state participation, SGO registration, and contribution reporting. The proposed regulations set out the broader substantive rules for taxpayers, SGOs, and students. Although open to public comment, the proposed regulations may be relied on for qualified contributions made beginning January 1, 2027, until final regulations are published.

State participation

A state must elect to participate for organizations located in that state to be included on the state's SGO list. A participating state must submit to the IRS a list of SGOs located in the state and certify that the listed organizations meet applicable requirements.

For this purpose, an organization is "located in" a state if it is authorized to do business in the state and complies with generally applicable state charitable organization requirements, including transparency, accountability, and fraud-prevention requirements.

The regulations distinguish between:

- A single-state SGO, which is included on the SGO list of only one covered state; and
- A multistate SGO, which is included on the SGO list of more than one covered state.

A multistate SGO must maintain a separate Section 25F segregated account for each covered state on whose SGO list it appears. Donors may direct how qualified contributions are allocated among the covered-state accounts for which the multistate SGO is listed.

Eligible students and qualified expenses

An SGO must award scholarships only to eligible students. An eligible student generally is an individual who:

- Is eligible to enroll in a public elementary or secondary school; and
- Is a member of a household with prior-year income not greater than 300% of area median gross income, adjusted for family size.

The proposed regulations provide methods for verifying student income eligibility, including direct income verification and certain safe harbors, such as categorical eligibility based on participation in specified needs-based programs.

Scholarships must be used for qualified elementary or secondary education expenses described in Section 530(b)(3)(A). The FAQs describe potentially eligible expenses as tuition, fees, academic tutoring, extended day programs, special education services, books, and supplies.

State nexus of scholarships

The proposed regulations interpret the requirement that scholarships be for students “solely within the State” to refer to the student’s residence, rather than the location of the school or service provider. Accordingly, an SGO listed in one state generally must use its qualified-contribution funds for eligible students who reside in that state.

A taxpayer may make a qualified contribution to any SGO on any state SGO list regardless of the taxpayer’s state of residence.

Key SGO operating requirements

The regulations impose several operating requirements that may be significant for public charities considering SGO status, outlined below.

Income-based scholarship spending requirement. An SGO must spend at least 90% of its income on scholarships for eligible students. “Income of the organization” means total gross receipts from all sources, determined using a cash receipts and disbursements method unreduced by expenses. The funds generally must be spent by the last day of the tax year following the tax year the income is received.

Meeting this requirement may be challenging for established public charities with significant non-scholarship receipts. The proposed regulations include a safe harbor for certain single-state SGOs whose activities are at least 85% scholarship-granting activities. If the safe harbor applies, the 90% spending requirement may be applied at the level of the Section 25F segregated account, rather than to the organization as a whole. For multistate SGOs, the 90% requirement is applied separately to each state-specific segregated account.

Minimum number of scholarships. An SGO must provide scholarships to at least 10 students, not all of whom attend the same school.

Priority rules and no earmarking. An SGO must give priority to:

- Eligible students who received scholarships from the SGO in the prior school year; and

- Eligible students who have a sibling who received a scholarship from the SGO.

Notwithstanding these priority rules, an SGO may not earmark or set aside contributions for scholarships on behalf of any particular student. Donors may not direct qualified contributions to a specific student.

Segregated account. Qualified contributions must be deposited into a Section 25F segregated account. The account must contain only qualified contributions and earnings from those contributions. The SGO must maintain complete books and records for the account.

Once a donor designates a cash contribution as a qualified contribution, that designation is irrevocable.

Donor acknowledgments and IRS reporting

An SGO must provide each donor with a timely written acknowledgment, generally by January 31 of the year following the contribution. The acknowledgment must include:

- The organization's EIN;
- The total amount designated as qualified contributions; and
- The donor's unique donor number.

SGOs also must report donor information to the IRS through the IRS SGO portal, generally by February 28 of the following year.

Donor rules

The federal credit is available only for qualified cash contributions made by individual taxpayers to SGOs. For this purpose, cash includes physical currency, checks, money orders, electronic transfers, and after-tax payroll deductions. Digital assets are not treated as cash.

Key features of the credit include:

- The credit generally equals the taxpayer's qualified contributions, reduced by any state tax credits allowed for those contributions, and capped at \$1,700 per taxpayer.
- Married taxpayers filing jointly are treated as separate taxpayers, allowing a potential combined credit of \$3,400 if each spouse makes qualifying contributions.
- The credit is nonrefundable, so may reduce federal tax liability to zero but will not generate a refund. Unused credits may be carried forward for up to five years.
- A donor may not claim a charitable contribution deduction under Section 170 for the portion of a contribution for which a Section 25F credit is allowed. Donors do not need to itemize deductions to claim the credit.

The takeaway

The Education Freedom Tax Credit creates a significant new federal incentive for K-12 scholarship funding, and the issued guidance sets out the framework for participation and compliance. Organizations, states, and donors that begin preparing before the program takes effect on January 1, 2027, should be well positioned to participate once the credit becomes available.

Let's talk

For a deeper discussion of how these developments may affect your organization, please reach out to your PwC engagement team or a member of our Exempt Organization Tax Services practice:

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