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September 10, 2026 • Updates

Treasury and IRS Propose New Section 501(c)(3) Racial Nondiscrimination Rules for Private Schools

Key Updates

- Treasury and the IRS have proposed regulations that would make racial nondiscrimination an express Section 501(c)(3) requirement for covered private schools, colleges, universities and professional or trade schools.
- The proposal would reach beyond admissions to scholarships, loans, educational policies, athletics and other school-administered or school-supported programs, with applicability proposed for taxable years beginning after May 31, 2027.

Why It Matters

- For private educational institutions, this means race-conscious policies or programs could raise institution-level tax-exemption concerns, even as key questions remain about materiality, cure rights, affiliated foundations, legacy gifts and donor-restricted funds.
- Tax-exempt financing for impacted schools could be at risk.

Next Steps

- Potentially affected institutions should assess applicability, identify scholarships and programs that may use covered criteria, review legacy obligations and evaluate whether comments are needed before the November 3, 2026 public comment deadline.

The Treasury Department and IRS have proposed new regulations (REG-119986-25) that would establish an express regulatory standard governing racial nondiscrimination at tax-exempt private schools, colleges and universities.

The proposed regulations would add a new Treasury Regulation Section 1.501(c)(3)-2 providing that a covered private school is not operated exclusively for exempt purposes, and therefore, does not qualify under Section 501(c)(3), if it adopts, maintains or enforces any policy or practice that discriminates based on race, color, or national or ethnic origin.

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Related Capabilities

- Nonprofit Organizations
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The proposal reaches well beyond admissions. It expressly covers scholarships and loans, educational policies, athletics and other school-administered or school-supported programs. The proposed regulatory text also provides that prohibited discrimination includes discrimination on a covered basis "for any purpose."

Although the regulations remain proposed and may change before finalization, private educational institutions should understand their potential scope. The proposal raises several significant questions that are not answered by the regulatory text and may require institutions to examine programs and arrangements extending well beyond the admissions office.

Who Would Be Directly Subject to the Proposed Rule?

The proposed regulations would not apply to every Section 501(c)(3) organization or every educational institution.

They would apply to a "private school," defined as an organization that is:

- Described in Section 501(c)(3); and
- Classified as an educational organization under Section 170(b)(1)(A)(ii).

This generally encompasses qualifying private primary and secondary schools, colleges and universities, and professional and trade schools.

The proposed rule expressly excludes governmental units, their agencies and instrumentalities, and organizations owned or operated by such agencies or instrumentalities. Accordingly, public colleges and universities generally would not be directly subject to this new Section 501(c)(3) requirement. That exclusion is limited to the proposed federal tax rule and does not alter separate nondiscrimination obligations that may apply under Title VI, the Equal Protection Clause or other federal or state law.

Likewise, a private foundation, community foundation, charitable trust, independent scholarship organization or other non-school Section 501(c)(3) organization ordinarily would not fall within the proposed definition merely because it is tax-exempt. However, the proposal leaves important unanswered questions regarding separately organized foundations and other entities that administer or fund programs connected with a covered school. The proposal also does not resolve how existing Section 501(c)(3) public-policy principles or other nondiscrimination laws may apply independently to those organizations.

The proposal is also relevant for organizations outside the rule's direct scope. Affiliated foundations, scholarship arrangements and overlapping federal nondiscrimination requirements may still warrant attention depending on the organization and the facts.

What Would Change?

The proposal would provide that a covered private school fails the Section 501(c)(3) operational requirement if it adopts, maintains or enforces a discriminatory policy or practice in the administration of its educational policies; admissions; scholarships and loan programs; athletics; or other school-administered or school-supported programs.

The preamble states that the rule is intended to encompass racial discrimination regardless of its intent or legality, including discrimination defended as serving remedial or diversity-related objectives.

Treasury and the IRS would also modify Rev. Proc. 75-50 by eliminating provisions that historically permitted certain preferences for racial minority groups when designed to promote a school's racially nondiscriminatory policy.

The proposal does not prohibit schools from maintaining religious missions or using genuinely religious selection criteria. It also recognizes that organizations may continue efforts to eliminate prejudice and discrimination, provided those efforts do not themselves discriminate on the basis of race, color, or national or ethnic origin.

If finalized as proposed, the regulations would apply to taxable years beginning after May 31, 2027.

Important Questions Remain

The proposed regulations establish a broad standard but leave institutions with significant questions about how that standard would operate in practice.

1. Can one program create an institution-level exemption issue?

The proposed text refers to "any policy or practice," but provides no express materiality threshold, *de minimis* rule, correction period or other cure procedure. That omission is particularly significant because the potential consequence under the proposed rule attaches to the institution's Section 501(c)(3) qualification, rather than merely to the program at issue.

For private higher education institutions, an actual loss of Section 501(c)(3) status could have consequences extending into charitable giving and fundraising; qualified Section 501(c)(3) bond financings and other credit arrangements; and potentially, the institution's classification as a nonprofit institution for federal student-aid purposes. The proposal does not explain whether an isolated scholarship or program at an otherwise compliant institution could create consequences of that magnitude, particularly where the institution discovers and promptly corrects the issue.

2. What counts as a "school-supported" program?

The proposed regulations do not define "school-supported." For colleges and universities, that leaves uncertainty regarding programs involving separately incorporated foundations, alumni organizations, student organizations, outside scholarship providers and other affiliates or third parties.

The degree of institutional funding, governance, control, branding or participation necessary to bring a program within the rule remains unclear.

3. What about existing scholarships, fellowships and multi-year commitments?

The proposal does not expressly grandfather multi-year scholarships, fellowships or other commitments awarded before the regulation becomes applicable. It also does not explain whether continuing payments under a preexisting award after the applicability date would constitute "maintaining" or "enforcing" the underlying policy, or how annual renewals and other continuing eligibility determinations would be treated.

4. What happens to donor-restricted funds?

Treasury recognizes that existing race-restricted scholarship funds may require institutions to work with donors or their heirs to revise eligibility criteria.

However, not every charitable restriction can be modified administratively. The proposal does not provide a clear transition rule for funds requiring donor consent, state-law modification procedures, court approval or other relief before their terms can be changed.

5. Where is the line between permissible race-neutral criteria and an impermissible proxy?

The proposal creates a potential tension concerning race-neutral eligibility criteria. In the preamble's economic analysis, Treasury and the IRS contemplate alternatives such as income, geography and first-generation status and assume that demographic changes may be limited because those criteria can correlate with race or ethnicity. Those observations do not appear in the proposed regulatory text, which creates no safe harbor or authorization to use facially neutral criteria as substitutes for prohibited racial classifications. Separate DOJ guidance for recipients of federal funding cautions that facially neutral criteria may be unlawful proxies when intentionally selected because they correlate with, replicate or substitute for protected characteristics.[1]

That also makes the decision-making record important: contemporaneous documents explaining why replacement criteria were selected may become relevant to whether those criteria were intended as substitutes for race.

6. How will the rule apply to foundations and other affiliated organizations?

Although non-school Section 501(c)(3) organizations are generally outside the direct scope of the proposed regulation, many schools operate through separately incorporated foundations and other affiliates. The proposal provides little guidance on when the activities of those entities may be treated as "school-supported" activities of the educational institution.

Why Does Section 501(c)(3) Status Matter?

1. **Ripple Effects**. The consequences of a violation would not necessarily stop with the particular program at issue. If the IRS were ultimately to revoke an institution's Section 501(c)(3) status, the institution could lose its federal income tax exemption and face broader ripple effects involving charitable giving and donor relationships, financing arrangements, contractual obligations and other regulatory regimes that depend on continued federal tax-exempt status. How far those consequences reach will depend on the institution and the facts.
2. **Tax-Exempt Financing**. Many private schools utilize financing vehicles (such as bonds), the interest on which is exempt from federal income taxation, providing those borrowers with more favorable cost of capital that can be achieved through traditional financing. Only private schools that are also Section 501(c)(3) organizations are eligible for tax-exempt financing and a critical requirement for maintaining such tax-exempt status is that the borrower (here, the private school) maintain its status as a Section 501(c)(3) organization. The proposed rule provides no guidance on the impact of a school's revocation on outstanding tax-exempt financing. If revocation of status results in the interest on outstanding tax-exempt financing becoming taxable to the holders thereof, the market impact would be significant. It could also cause required early prepayment of debt or defaults under the school's debt documents, which could have severe and negative impacts on the school's liquidity and financial condition. Future unavailability of tax-exempt financing would also create higher future borrowing costs and capital project costs for impacted schools.

What Should Organizations Consider Now?

Because the regulations are still proposed, institutions should be measured about making significant changes before the rulemaking process is complete. At the same time, waiting until final regulations are issued may leave insufficient time to address complicated arrangements, particularly legacy gifts and multi-year programs.

Written or electronic comments and requests for a public hearing are due November 3, 2026. Comments submitted to the public docket will be publicly available. Treasury and the IRS have indicated that they expect to finalize the regulations, with any modifications resulting from the comment process, before May 31, 2027.

Potentially affected organizations may want to consider taking the following steps now:

1. **Assess applicability.** Determine which entities within an institutional structure would be directly subject to the proposed rule and which foundations or affiliates warrant separate analysis.
2. **Identify potentially affected arrangements.** Institutions can begin identifying scholarships, fellowships, admissions practices, student programs and donor-restricted funds that use race, color, or national or ethnic origin as an eligibility or selection criterion, including programs for which alternative criteria may be under consideration. Where appropriate, counsel can help structure that review to preserve applicable privilege and work-product protections.
3. **Review legacy obligations.** Existing multi-year commitments and donor-restricted funds may require more lead time than ordinary institutional policies, particularly where modification depends on a donor, governing instrument or applicable state law.
4. **Evaluate the comment opportunity.** Institutions and associations should consider whether the unanswered questions in the proposal affect their existing arrangements and whether providing comments could help obtain needed clarification, transition relief or workable standards before the regulations are finalized.

Looking Ahead

The proposal is still just that — a proposal. However, it gives private schools, colleges and universities a reason to look beyond admissions and consider how scholarships, student programs, affiliated entities and legacy gifts may fit within the rule if finalized. For foundations and other organizations in the education sector, the proposal is also worth watching for its potential ripple effects and interaction with broader federal nondiscrimination requirements.

The details will matter, and the analysis may look very different depending on the organization, the program involved, how a scholarship or fund was established and the role of affiliated organizations.

Polsinelli's Nonprofit Organizations and Tax-Exempt Organizations team is closely monitoring the proposed regulations and related federal developments affecting educational institutions and other tax-exempt organizations. We are available to assist with evaluating whether and how the proposal may apply, reviewing potentially affected programs and arrangements, developing comments to Treasury and the IRS, and preparing for any final regulations.

If your institution, foundation or other organization is evaluating how these proposed regulations may affect its programs or operations, please contact the author or another member of Polsinelli's Nonprofit Organizations and Tax-Exempt Organizations team.

[1] Memorandum from Pamela Bondi, Attorney General, to All Federal Agencies, *Guidance for Recipients of Federal Funding Regarding Unlawful Discrimination* (July 29, 2025), https://www.justice.gov/ag/media/1409486/dl.