

## SCHOLARSHIPS AND FELLOWSHIPS TAXATION GUIDE

For tax purposes, scholarships are amounts that benefit an undergraduate student attending an educational institution in pursuit of a degree. Fellowships are amounts paid for the benefit of an individual in the pursuit of study or research. In both cases, benefits that qualify for tax exclusion are those that are used to pay for qualified expenses of a degree candidate. So, whether the benefits are denominated as scholarships or as fellowships, their taxability depends on whether the beneficiary is a candidate for a degree, and how the benefits are spent. These tax regulations went into effect with the Tax Reform Act of 1986.

### **Tax-Free Scholarships and Fellowships**

The general conditions that must be met in order for your scholarships or fellowships to be tax-free are that:

- You must be a candidate for a degree at an eligible educational institution, and
- You must use the benefits of the scholarship or fellowship to pay for what are considered qualified education expenses.

### **Candidate for a Degree**

You are considered a candidate for a degree, for tax purposes, if you are:

- Attending primary or secondary school (leading to a high school diploma),
- Pursuing a degree at a college or university (bachelor's degree, master's degree, doctor's degree)
- Attending an accredited educational institution in a program that is acceptable for full credit toward a bachelor's or higher degree (two-year colleges or community colleges leading to an associate' degree), or
- Attending an accredited education institution in a program of training that prepares students for gainful employment in a recognized occupation (trade, vocational, and technical schools).

### **Eligible Educational Institution**

An eligible educational institution, for tax purposes, is an institution that maintains a regular faculty and curriculum, and a regularly enrolled body of students at a place where educational activities are carried out.

### **Qualified Education Expenses**

In order to be able to exclude scholarship and fellowship benefits from your taxable income, they must be used to pay qualified education expenses, including:

- Tuitions and fees required to enroll and attend an eligible educational institution
- Course-related expenses, such as books, supplies, and equipment used in the course, and any special fees. These expenses must be required of all the students in the course.

In order to qualify as tax-free, the scholarship or fellowship cannot require that it be used to pay for other expenses such as room and board.

### **Expenses that Do Not Qualify**

Expenses that do not qualify include:

- Room and board
- Travel
- Research
- Clerical help
- Equipment and other expenses not required for attendance

Therefore, if a scholarship or fellowship is used to pay for both qualified and unqualified expenses, part of the benefits are tax-free and part are taxable.

### **Taxable Portion of Scholarships and Fellowships**

If you are not a candidate for a degree, the entire amount of your scholarships or fellowships is generally taxable. If you are a candidate for a degree, the part of a scholarship or fellowship that is used to pay anything other than qualified education expenses is taxable. This is true even if the expense is required for attendance. If it is not for tuition and fees, or course-related expenses, it is taxable.

Although these payments represent taxable income to the recipient, **the College does not have any specific reporting or withholding requirements, unless paid to a non-resident alien (reported on 1042-S)**. However, students should be aware of their reporting requirements when receiving these types of payments.

### **Payment for Services**

Any payment for services is generally taxable. This applies even if all students must perform the services as a condition for obtaining a degree. To the extent these services are compensated, the compensation would be taxable income. But there are certain exceptions.

If part of your scholarship or fellowship is payment for teaching, research, or other services you perform under the following programs, you are a candidate for a degree, and you use that compensation to pay for qualified education expenses, your compensation is not taxable:

- National Health Services Corp. Scholarship Program
- Armed Forces Health Professions Scholarship and Financial Assistance Program

### **Future Services**

If you receive a grant that has a condition requiring you to perform future services, the entire amount of the grant is taxable, even though you are a candidate for a degree and the grant is being used to pay your education expenses.

## **Reporting Scholarship or Fellowship Income on Your Tax Return**

If your only income is a scholarship or fellowship that is tax-free, based on the above rules, you do not need to file a tax return.

### **Do You Need to File?**

If part or all of your scholarship or fellowship is taxable, you will need to check the filing requirements for your filing status and level of income to see if you have to file a return. If you can be claimed as a dependent on someone else's tax return (such as your parents), and you have unearned income such as dividends, interest, or capital gain distributions in addition to your scholarship or fellowship income, you should check the special requirements for filing a return in those circumstances. You can find these requirements in Internal Revenue Service (IRS) Publication 501, Exemptions, Standard Deductions, and Filing Information, or in the instructions for Form 1040EZ, 1040A, or 1040. These forms, instructions, and publications are available in the IRS website.

If part of your benefits include compensation for services or work you performed, and income tax was withheld, it may be to your advantage to file, if too much tax has been withheld and you are due a refund.

### **Eligibility for Other Tax Benefits for Education**

You should also see whether you qualify for any of the tax benefits available for education, including the tuition and fees deduction, which is an adjustment to gross income, and the Hope and Lifetime Learning Credits, which are credits that directly reduce your tax.

### **Where to Report**

If you have taxable scholarship or fellowship income to report and you receive a Form W-2 reporting your income, you should include this amount in the line for "Wages, salaries, tips, etc." on Form 1040EZ, 1040A, or 1040. If you do not receive a Form W-2 but you have taxable amounts, you should report them on the same line, and write "SCH" on the dotted line next to the amount.

### **Independent Contractor**

If part of your scholarship or fellowship included compensation for your work as an independent contractor, you will have self-employment income. In this case, you will have to file Schedule SE and pay self-employment tax, in addition to federal income tax, on your earnings. As an independent contractor, you may also have related business expenses and could file Schedule C, Profit or Loss from Business.

### **Other Educational Assistance**

Fulbright Grants, Pell Grants and other need-based education grants are treated as scholarships for purposes of determining whether they are taxable, and are subject to the

same rules described above. Appointments to a United States military academy are not considered scholarships, and the income you receive as a cadet or midshipman is taxable compensation for personal services and will be reported on Form W-2.

### **Veterans' Benefits**

Veterans' benefits you receive for education, training, or subsistence are not taxable. You may need to take these benefits into consideration in determining the amount of any tax benefits for education for which you may qualify. You may have to reduce the amount of education expenses eligible for the tax benefit by the amount of tax-exempt veterans' benefits you receive.

### **Qualified Tuition Reduction**

This is a reduction in tuition granted by the educational institution. Whether or not it is tax-free depends on whether it is for education at or below the graduate level. And, in order to be tax-free, the tuition reduction must not represent compensation for personal services.

### **Below Graduate Level**

Education below the graduate level includes primary and secondary education, and undergraduate college or university studies. The qualified tuition reduction is tax-free if it is provided to the following individuals:

- A current employee of the educational institution
- A former employee of the education institution, who retired or is disabled
- A widow or widower of a former employee
- A dependent child or spouse of any of the above

Owners, officers, and highly compensated employees can take advantage of tax-free qualified tuition reductions only if the benefits are not discriminatory and are made available to all members of a group of employees.