

Tax treatment of scholarships

Scholarships and fellowships are generally tax-free, whether for elementary or high school students, for college or graduate students, or for students at accredited vocational schools. It makes no difference whether the scholarship takes the form of a direct payment to the individual or a tuition reduction.

However, for the exemption to apply, certain conditions must be satisfied. The most important are that the scholarship must be used for tuition and related expenses (and *not* for room and board) and that it must not be compensation for services.

Tuition and related expenses. A scholarship is tax-free only to the extent it is used to pay for (1) tuition and fees required to attend the school or (2) fees, books, supplies, and equipment required of all students in a particular course. For example, if a computer is recommended but not required, buying one would not qualify. Other expenses that do not qualify include the cost of room and board, travel, research, and clerical help.

To the extent a scholarship is used for nonqualifying items, it is taxable. The recipient is responsible for determining how much of the scholarship was used for qualified tuition and related expenses so as to be tax-free. You should maintain records (e.g., copies of bills, receipts, cancelled checks) that reflect the use of the scholarship money.

Scholarship can't be payment for services. A scholarship isn't tax-free if the payments are linked to services that your child performs as a condition for receiving the scholarship, even if those services are required of all degree candidates. Thus, a stipend your child receives for required teaching, research or other services is taxable, even if the money is used for tuition or related expenses.

Returns and records. If the scholarship is tax-free and your child has no other income, the scholarship doesn't have to be reported on a return. However, any portion of the scholarship that is taxable as payment for services is treated as wages, and tax is withheld accordingly. Estimated tax payments may have to be made if the grantor doesn't withhold enough tax.

Your child should receive a Form W-2 from the grantor of the scholarship showing the amount of these "wages" and the amount of tax withheld on them. However, any portion of the scholarship that is taxable must be reported, even if no Form W-2 is received.

Related tax issues. Your child's scholarship can have an impact on these tax issues:

1. **Dependency exemption.** Your dependency exemption for your child should not be threatened by the scholarship. To claim an individual as your dependent, you must provide more than 50% of his support. Since education is a support item, to the extent that education costs are paid by an outside source, the amount of support you are providing could fall below 50%. However, a special rule provides that educational costs covered by a scholarship for a dependent who is a child of the taxpayer (but not for other dependents) are not included in the calculation of total support.

Example. Ellen's parents provide \$8,000 towards her support and she receives a \$10,000 college scholarship. If the scholarship were included in Ellen's total support, the parents' \$8,000 would not constitute more than 50% of her support (\$18,000) and they would not qualify to claim her as their dependent. However, since the scholarship is not included in her support, the parents qualify.

2. Taxable scholarship as "earned income." As noted above, to the extent awarded funds are spent on room, board, or other nonqualifying expenses, the scholarship is taxable. However, it is treated as "earned income." This means if the student is being claimed as a dependent by his parent, and using the standard deduction he may qualify for a higher standard deduction.

If an individual is a dependent, his standard deduction is limited (in 2002) to the greater of (a) \$750, or (b) the sum of \$250 plus the individual's earned income. But the standard deduction can't be more than the regular standard deduction (\$4,700 for single taxpayers for 2002). So even though part of a scholarship is taxable, it may be "covered" by the standard deduction.

Example. Tim is a dependent of his parents. His only income is \$3,000 he received as part of a scholarship which is taxable because it was applied to cover his costs of room and board. Since the \$3,000 is treated as earned income, Tim is entitled to a \$3,250 standard deduction which reduces his taxable income to zero.

3. Hope and Lifetime Learning credits for higher education costs. You or your child may be able to claim the HOPE credit or the Lifetime Learning credit. The amount of higher education expenses taken into account in computing the HOPE or Lifetime Learning credits must be reduced by any tax-free scholarships and fellowships used to pay the expenses.

4. Deduction for interest on qualified education loans. You or your child may be able to take an above-the-line deduction for interest due and paid on qualified higher education loans (in general, loans to pay qualified higher education expenses). In computing the amount of the interest that is deductible, the qualified higher education expenses must be reduced by the amount of any tax-free scholarships and fellowships.

5. Deduction for higher education expense. Starting in 2002, you or your child may be able to claim a deduction for higher education expenses. The amount of higher education expenses taken into account in computing the deduction must be reduced by any tax-free scholarships and fellowships used to pay the expenses.