

Taxation of College Financial Aid

This article summarizes the federal income tax rules that apply to the most common types of financial aid received by college-age students. If you have any questions about these rules, or need our help in any other way, please call us.

The Basics

The first thing to keep in mind is that the economic characteristics of financial aid, rather than how it is titled, determine how it's treated for federal income tax purposes. In particular, the terms *scholarship*, *fellowship*, and *grant* are often used loosely. Strictly speaking, scholarships, fellowships, and grants are awards of "free money" and come to students as nontaxable financial assistance. However, these terms are also sometimes used to describe arrangements involving obligations to provide services, in which case the payments are compensation for employment. Also, an award that is really a free-money scholarship, fellowship, or grant will sometimes be called an *allowance*.

Some "tuition reduction" arrangements are actually employee benefits provided to students whose parents are employees of the college. On the other hand, a tuition reduction granted to a student for reasons unrelated to anyone's employment status is free money and therefore treated the same as a scholarship, fellowship, or grant for tax purposes.

With some exceptions, the IRS generally is not concerned with the source of student aid. It may originate with federal, state, or local governments or come from private nonprofit or for-profit organizations.

Scholarships, Fellowships, and Grants

Scholarships, fellowships, and grants are awarded based on the student's financial need (for example, federal Pell grants) or are based on scholastic achievement and merit (for example, grants provided by colleges themselves and by corporations and other organizations).

For federal income tax purposes these awards are nontaxable as long as (1) the recipient is a degree candidate, (2) the award does not exceed the recipient's "qualified tuition and related expenses" (tuition and enrollment fees, books, supplies, and equipment required for courses, but *not* room and board or incidental expenses) for the year, (3) the agreement does not expressly designate the funds for other purposes (such as room and board or incidental expenses) or prohibit the use of the funds for qualified education expenses, and (4) the award is not conditioned on the student performing services (teaching, research, or anything else). However, special rules apply to amounts received under the National Health Service Corps Scholarship Program or Armed Forces Health Professions Scholarship and Financial Assistance Program. In this case, amounts received for teaching, research and other services are not taxable.

The recipient must establish that the money was actually used for the intended purposes. This does require the student to trace the actual use of awards. The funds are automatically assumed to be used for qualified tuition and related expenses up to the net amount of such expenses paid by the student (after reduction for other awards and any tuition reductions). Awards in excess of the student's net qualified tuition and related expenses count as taxable income. To ensure tax-free treatment, students should keep records of their outlays for qualified tuition and related expenses.

If financial aid is described as a scholarship, fellowship, or grant, but is conditioned on the student performing services (and is not part of one of the previously mentioned exempted programs), the amount that represents payment for such services is taxable income. Such payments can also take the form of tuition reductions. It makes no difference whether the services are to be performed before, during, or after the scholastic period to which the aid relates. It also makes no difference whether the service requirement applies to all students or is necessary for attaining a degree. The provider of the financial aid is responsible for determining the proper amount treated as a taxable payment for services and reporting it to the student (on Form W-2 or Form 1099).

Tuition Reductions

As explained earlier, an award of free money may be described as a tuition reduction. If so, the preceding rules for scholarships, fellowships, and grants apply.

Tuition reductions are also commonly provided to employees of educational institutions as an employee benefit. Special rules apply in this context. The tuition reduction is tax-free if (1) it is restricted to education below the graduate level (with one exception discussed later), (2) the tuition reduction program does not discriminate in favor of highly-compensated employees, and (3) it does not represent payment for services. (As mentioned earlier, tuition reductions that are actually payments for teaching, research, or other job-related activities are taxable income.)

Provided the three requirements are met, tuition reductions are tax-free even if they benefit the employee's spouse or dependent children or offset tuition at a school other than where the employee works. For example, Big College could have an agreement to reduce the tuition of students who are children of teachers employed by Large University, and vice versa.

A tuition reduction arrangement for graduate study is tax-free only if it meets the above requirements and benefits school employees who are graduate students engaged in teaching or research activities (for example, a graduate assistant or teaching assistant). In other words, tax-free treatment is not available for tuition reductions that benefit the graduate student-employee's spouse or dependent children.

Work-study Arrangements

Work-study programs are a form of financial aid in which students are given jobs to help pay for their college education. Students typically work for the school they're attending. However, they could work for other employers under the auspices of a work-study program.

Sometimes the work is integrated with the curriculum, sometimes not. Regardless, of the nature of the work-study program, though, the student's earnings count as taxable compensation for federal income tax purposes.

Student Loans

Naturally, student loan proceeds are not taxable income because the borrowed amounts must be paid back. However, some college education loans are subsidized to allow borrowers to pay reduced interest rates. For example, with a subsidized Stafford Loan, the federal government pays interest to the lender (or a subsequent purchaser of the loan) while the student is in school and for certain periods of interest deferral. The IRS has ruled that college loan interest subsidies are nontaxable to the same extent as if they were provided in the form of an outright scholarship, fellowship, or grant.

An above-the-line deduction (i.e., available whether or not the borrower itemizes) of up to \$2,500 is allowed for interest expense paid by a taxpayer on a loan to fund qualified higher education expenses. It doesn't matter if the interest rate is discounted or a portion of the interest has been deferred under a subsidized student loan program. This break is phased out for taxpayers with adjusted gross income (normally the number at bottom of page one of a Form 1040) of between \$125,000 and \$155,000 for joint filers and between \$60,000 and \$75,000 for singles. Only individuals legally responsible for repaying a loan can take the deduction, and then only if they aren't claimed as a dependent on someone else's return. So, if the loan is in the student's name, he or she (rather than the parents) can claim the write-off, but only if the student is not a dependent on the parents' return.

For interest expense that doesn't qualify under above rule, taxpayers who itemize can generally claim a deduction for the expense if the interest is paid on a home equity loan used to finance college expenses (up to a debt limit of \$100,000 or net equity in the residence, whichever is lower). However, the deduction is completely disallowed in computing the alternative minimum tax.

Unfortunately, college loan interest that doesn't fit into either of the above two categories is completely nondeductible.

What Happens When Financial Aid Isn't Tax Free?

Even though some forms of financial aid are taxable, this doesn't necessarily mean a student will owe any federal income tax. Fortunately, taxable scholarships, fellowships, and grants, and taxable compensation from employment (for example, via a work-study program) count as earned income. Single taxpayers who are not dependents can offset earned income with their personal exemption (\$3,900 for 2013) and standard deduction (\$6,100 for 2013). Together these two breaks can shelter up to \$10,000 of 2013 earned income. However, a student is much more likely to owe taxes when taxable financial aid is received while the student is still claimed as dependent on another person's return (typically a parent's). In this case, the student is *not* entitled to a personal exemption. Also, the student's standard deduction is limited to the greater of (1) \$1,000 or (2) earned income plus \$350 up to the \$6,100 maximum for a single taxpayer. Since, taxable scholarships, fellowships, grants, compensation count as earned income; they increase the student's standard deduction.

Taxable financial aid in excess of what can be offset by the student's personal exemption (if any) and standard deduction is usually taxed at only 10%. (For 2013, 10% bracket for single taxpayers applies to taxable income up to \$ 8,925.)

Warning: The Kiddie Tax rules may cause investment income (such as interest, dividend, and capital gains) received by students who are under age 24, to be taxed at the parent's higher rates instead of at the student's lower rates. The student's earned income (including taxable scholarships, fellowships, grants, and compensation) is not subject to the Kiddie tax rules.

Conclusion

If your college-age child is or will be receiving financial aid, congratulations. We hope this article helps you understand more about the income tax implications. If you have some questions or want more information, please give us a call.