

Tax Treatment of Scholarships

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This document identifies several flaws in the tax treatment of scholarships, grants and fellowships and proposes fixes for these flaws.

Current Law

From 1954 to 1980, scholarships, grants and fellowships for degree candidates were entirely tax-free, including amounts used for tuition & fees, textbooks, equipment, travel and research. The tax-free status of scholarships, grants and fellowships was essentially unlimited.

Gift aid includes money that does not need to be repaid, including scholarships, grants and fellowships. Although the terms grant and scholarship are often treated as synonyms, they generally differ according to whether the funds are awarded based on financial need or merit.

- A scholarship is a type of gift aid provided to an undergraduate student, usually based on merit, such as academic, athletic or artistic talent.
- A grant is a type of gift aid provided to a student, usually based on demonstrated financial need.
- A fellowship is a type of gift aid provided to a graduate or professional school student, usually based on merit.

Since then, several amendments to 26 USC 117 began taxing scholarships, grants and fellowships for the first time, significantly narrowing the tax-free status. These amendments ended the tax-free status for several types of scholarships, grants and fellowships, including:

- **Scholarships, grants and fellowships that represent fees for services.** However, exceptions were added for teaching and research assistantships and for certain federal student aid programs, such as the National Health Service Corps Scholarship Program and the Armed Forces Health Professions Scholarships and Financial Assistance Program.
- **Scholarships, grants and fellowships that are awarded to students who are not degree candidates.**
- **Scholarship and fellowship amounts that are used to pay for or that are earmarked for living expenses.**
- **Scholarship and fellowship amounts used to pay for travel and research expenses.**

These changes reflect a perspective that considers scholarships, grants and fellowships to be a form of employee compensation, as opposed to a form of generosity. Yet, the majority of scholarships, grants and fellowships are not awarded to employees or the dependents of employees. This includes most

private scholarships, state grant, scholarship and fellowship programs, institutional grant, scholarship and fellowship programs, the Federal Pell Grant program and other federal grant and fellowship programs.

Why Does this Matter?

There are several harmful consequences of the government taxation of scholarships, grants and fellowships. The harmful impact affects the ability of students to complete their education and graduate. Taxing financial aid prevents students from making full use of their scholarships, fellowships and grants. Scholarships, fellowships and grants are the only form of generosity that is taxed by the federal government.

- **Taxing generosity.** Scholarships, grants and fellowships are the only form of charitable giving where the beneficiary is subjected to a tax liability, despite the donor receiving no benefit from the donation. For example, donations to a homeless shelter or soup kitchen are tax-free to the beneficiaries, while college scholarships that cover room and board are treated as taxable income to the beneficiary (student).
- **Displacement.** Taxing scholarships makes them less effective at improving outcomes for scholarship recipients, such as increasing retention and graduation rates. In effect, taxation displaces part of the scholarship that otherwise could be used to pay for college costs.
- **Causes a shortfall.** Because the tax liability offsets part of the value of the scholarship, the student does not benefit from the full value of the scholarship. However, IRS coordination restrictions are based on the before-tax value of the scholarship, leaving the student with a gap if he or she relies on scholarships to pay for college costs.
- **Disincentive for expansion of scholarship and fellowship programs.** Private scholarship providers are reluctant to create new scholarship and fellowship programs and to expand existing programs because taxation makes the programs less effective than other charitable purposes.
- **Burden on low-income students.** About half of the cost of enrolling in college is associated with living expenses, such as room and board and transportation to/from campus. Not only are private scholarship providers less likely to cover these costs because of the tax liability, but the tax liability can also represent a significant burden for low-income students.
- **Blocks emergency aid programs.** Emergency aid programs provide small grants to students to eliminate unanticipated obstacles that cause some students to drop out of college. These grants might be considered taxable income to the student under current law.
- **Giving with one hand while taking back with the other.** All or part of the Federal Pell Grant and state/institutional gift aid might be considered taxable income to the recipient if they are enrolled at a low-cost institution where tuition and textbooks are covered by the American Opportunity Tax Credit (AOTC) and institutional aid. So, the federal government taxes its own college grants.

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The most serious repercussions on students involve a reduction in the amount of gift aid available to pay for college costs. Most scholarships do not pay for the living expense portion of college costs because of concerns over the tax liability. The money that students do receive is partially displaced by taxes, making it less effective at improving college affordability. As a result, charitable organizations are less likely to create new scholarship programs or expand existing scholarship programs.

The federal government should restore tax-free status to scholarships, grants and fellowships to encourage a public-private partnership in paying for college. Scholarships, grants and fellowships help students graduate from college. The federal government benefits financially from the increased federal income tax revenue attributable to higher educational attainment. So, it is in the federal government's best financial interest to stop displacing scholarships, grants and fellowships through taxation.

Recommended Changes

The following recommendations will address the flaws in the current exclusion from income for qualified scholarships, such as scholarships, grants and fellowships.

- Clarify that the recipient of a qualified scholarship can be pursuing a certificate or other recognized educational credential, not just an academic degree.
- Replace the definition of qualified tuition and related expenses with a definition of qualified higher education expenses by cross-reference to the definition of cost of attendance in section 472 of the Higher Education Act of 1965 [20 USC 1087II]. This will ensure that qualified scholarships are available to pay for the full cost of education, as determined by an eligible college or university. This will allow scholarships to be used, tax-free, to pay for room and board, transportation to and from college, and disability- and other college-related expenses.
- Consistent with the limitation of qualified higher education expenses to the cost of attendance, eligible educational institutions should be limited to Title IV institutions that are eligible to receive Title IV federal student aid.
- Limit eligibility to students who satisfy the requirements of section 484(a)(1) of the Higher Education Act of 1965 [20 USC 1091(a)(1)], limiting eligibility to regular students enrolled at a postsecondary institution that is eligible for Title IV federal student aid.
- Clarify that college grants to students are also excluded from income. The current language refers to "scholarship or fellowship grant" without any definition of the terms. The phrasing is a little ambiguous. This should be replaced with "scholarships, grants or fellowships." Generally, a scholarship refers to gift aid provided to an undergraduate student based on merit, a fellowship refers to gift aid provided to a graduate or professional school student based on merit, and a grant refers to gift aid provided to a student based on demonstrated financial need.

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- Streamline the language concerning payment for teaching and research services, which are effectively nullified in current law through several exceptions, by striking paragraphs (c) and (d)(5) in 26 USC 117.
- To address the concerns of the IRS about the potential for self-dealing, add restrictions that the scholarship, fellowship or grant must be awarded on an objective and nondiscriminatory basis. Require that the group of applicants from which the recipients are selected must be sufficiently large and indefinite as to be considered a charitable class. Prohibit recipients from including anyone who is involved in selecting recipients or funding the award, or their family members. This will prevent the scholarship, fellowship or grant from being earmarked by the donor for the benefit of a particular individual.

About NSPA

The National Scholarship Providers Association (NSPA) is the leading professional association dedicated to supporting the needs of scholarship providers in colleges and universities, non-profits, foundations, and businesses. NSPA provides networking opportunities, professional development, and scholarship program resources all with a goal of advancing the collective impact of scholarship providers and the scholarships they award. Our membership represents over 1,500 individuals from over 500 organizations across the U.S., Canada, and abroad. For more information, visit www.scholarshipproviders.org.

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