

## *Tax Treatment of Scholarships*

If your student was awarded a scholarship, congratulations to both of you!

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 scholarship to be tax-free, certain conditions must be satisfied. The most important are that the award 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 wouldn't qualify. Other expenses that don't qualify include the cost of room and board, travel, research, and clerical help. To the extent a scholarship award is used for non-qualifying items, it is taxable. The recipient is responsible for determining how much of the award 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 awards 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 award, 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 child uses the money for tuition or related expenses.

***Returns and records.*** If the scholarship is tax-free and your child has no other income, the award doesn't have to be reported on a return. However, any portion of the award that is taxable as payment for services is treated as wages, and the payor should withhold accordingly. Estimated tax payments may have to be made if the payor doesn't withhold enough tax. Your child should receive a Form W-2 showing the amount of these 'wages' and the amount of tax withheld, but any portion of the award that is taxable must be reported, even if no Form W-2 is received.

Your child's award can have the following impact on these related tax issues:

(1) You should still get dependency exemption. Your dependency exemption for your child shouldn't 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 (or fellowship) for a dependent who is a child of the taxpayer (but not for other dependents) aren't 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

wouldn't be more than 50% of her support (\$18,000) and they wouldn't qualify to claim her as their dependent. However, since the scholarship isn't included in her support, the parents qualify.

(2) Any taxable scholarship amounts should increase your child's standard deduction. As noted above, to the extent scholarship funds are spent on room, board, or other non-qualifying expenses, the award 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 or she may qualify for a higher standard deduction.

If an individual is a dependent, his or her standard deduction is limited (in 2004) to the greater of (a) \$800, 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 (\$4,850 for single taxpayers for 2004). 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) The tax-free scholarship may limit other higher education tax benefits you or your child may be entitled to. If your child receives a tax-free scholarship and his or her higher education expenses also qualify for any of the following credits, deductions, and exclusions, the expenses taken into account in computing any of these other benefits must first be reduced by the tax-free amounts used to pay the expenses:

- Hope and Lifetime Learning credits.
- Deduction for higher education expense.
- Deduction for interest on student loans
- Coverdell ESA distribution exclusion.
- Qualified tuition (529) plan distribution exclusion.
- Savings bond interest exclusion.

In other words, neither you nor your child may claim a credit, deduction, or exclusion based on expenses paid with tax-free scholarship funds.

### **Qualified tuition programs – “529 plans”**

If you have a child (or a grandchild) who is going to attend college in the future, you have probably heard about qualified tuition programs, also known as 529 plans (for the Internal Revenue Code section that provides for them), which allow prepayment of higher education costs on a tax-favored basis.

There are two types of programs: prepaid plans, which allow you to buy tuition credits or certificates at present tuition rates, even though the beneficiary (child) won't be starting college for some time; and savings plans, which depend on the investment performance of the fund(s) you place your contributions in.

You don't get a federal deduction for the contribution, but the earnings on the account aren't taxed while the funds are in the program. You can change the beneficiary or roll over the funds in the program to another plan for the same or a different beneficiary without tax consequences.

Distributions from the program are tax-free if they don't exceed the student's qualified higher education expenses. If the program was established by a private education institution (rather than a state), the distributions are tax-free beginning in 2004.

Qualified higher education expenses include tuition, fees, books, supplies, and required equipment. Reasonable room and board is also a qualified expense if the student is enrolled at least half-time. Distributions in excess of qualified expenses are taxed to the beneficiary to the extent that they represent earnings on the account. A 10% penalty tax will also be imposed.

Accredited colleges, junior colleges, and area vocational schools are qualified to participate in the tuition program. Accredited post-secondary schools offering credit towards a bachelor's degree, an associate's degree, a graduate or professional degree, or another recognized post-secondary credential, are also eligible to participate, as are certain proprietary institutions and post-secondary vocational schools.

The contributions you make to the qualified tuition program are treated as gifts to the student, but the contributions qualify for the annual gift tax exclusion, which is \$11,000 for 2004. If your contributions in a year exceed the exclusion amount, you can elect to take the contributions into account ratably over a five-year period starting with the year of the contributions. Thus, assuming you make no other gifts to that beneficiary, you could contribute up to \$55,000 for each beneficiary in 2004 without gift tax. (In that case, any additional contributions during the next four years would be subject to gift tax, except to the extent that the exclusion amount increases.) You and your spouse together could contribute \$110,000 per beneficiary, subject to any contribution limits imposed by the plan.

A distribution from a qualified program isn't subject to gift tax, but a change in beneficiary or rollover to the account of a new beneficiary is.

529 Plans can work well, but they must be considered as part of your financial plan. Although the tax benefits appear to be substantial, the ROI generated by the fiduciary along with the tuition locks must be carefully evaluated.

We can help you create and manage your college funding goals.. Please contact us if you would like more information about our services.