

Are scholarships tax-free or taxable?

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COVID-19 is changing the landscape for many schools this fall. Many children and young adults are going back, even if it's just for online learning, and some parents will be facing tuition bills. If your child has been awarded a scholarship, that's cause for celebration! However, there may be tax implications.

Scholarships (and fellowships) are generally tax-free for students at elementary, middle and high schools, as well as those attending college, graduate school or accredited vocational schools. It doesn't matter if the scholarship makes a direct payment to the individual or reduces tuition.

Tuition and related expenses

Nevertheless, for a scholarship to be tax-free, certain conditions must be satisfied. A scholarship is tax-free only to the extent it's used to pay for:

- Tuition and fees required to attend the school; and
- 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 isn't used for qualifying items, it's taxable. The recipient is responsible for establishing how much of an award is used for tuition and eligible expenses. Maintain records (such as copies of bills, receipts and cancelled checks) that reflect the use of the scholarship money.

Award can't be payment for services

Subject to limited exceptions, 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 the services are required of all degree candidates. Accordingly, 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.

What if you, or a family member, is an employee of an education institution that provides reduced or free tuition? A reduction in tuition provided to you, your spouse or your dependents by the school at which you work isn't included in your income and isn't subject to tax.

Returns and recordkeeping

If a scholarship is tax-free and your child has no other income, the award doesn't have to be reported on a tax return. However, any portion of an award that's taxable as payment for services is treated as wages. 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, and any portion of the award that's taxable must be reported, even if no Form W-2 is received.

These are just the basic rules. Other rules and limitations may apply. For example, if your child's scholarship is taxable, it may limit other higher education tax benefits to which you or your child are entitled. As we approach the new school year, best wishes for your child's success in school. Please contact us if you wish to discuss these or other tax matters further.

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