

COLLEGE 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) a condition of the award is that the money must be used for "qualified tuition and related expenses" (tuition and enrollment fees, books, supplies, and

equipment required for courses, but not room and board or incidental expenses), and (3) the recipient establishes that the money was actually used for the intended purposes.

Awards are treated as meeting the second standard in the preceding paragraph if (1) the funds are expressly designated for qualified tuition and related expenses or (2) the funds are unrestricted and not expressly designated for other purposes (such as room and board or incidental expenses). To meet the third requirement, the student need not 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 performance of services by the student (teaching, research, or anything else), 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. Amounts paid as compensation for services may also be subject to social security and Medicare taxes, as explained later in the discussion of work-study arrangements. 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 above, 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 below), (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 and may be subject to social security and Medicare taxes as well.)

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.

Generally, wages paid under a work-study program are also subject to social security and Medicare taxes. For 1999, these taxes apply at a rate of 7.65% on wages up to \$72,600 (the employer also pays an equal amount).

When students are employed directly by the school they attend, social security and Medicare taxes normally do not apply. However, wages paid to student employees of state institutions are subject to these taxes if the state has an agreement with the federal government for social security and Medicare coverage under Section 218(c)(5) of the Social Security Act. Finally, social security and Medicare taxes apply to wages paid by the college when the student-employee is not considered "enrolled and regularly attending classes."

When a student works for an employer other than the college he or she attends, wages are subject to federal income tax withholding and social security and Medicare taxes as well.

Student Loans

Naturally, student loan proceeds are not taxable income because the borrowed amounts must be paid back. However, many college education loans are subsidized to allow borrowers to pay reduced interest rates. For example, Stafford Loans are issued under the Federal Family Education Loan (FFEL) program. The federal government pays interest to the lender (or a subsequent purchaser of the loan) while the student is in school, during a 6-month grace period following graduation, and for certain periods of interest deferral. In addition, the government may pay lenders "special allowances" to provide market-rate returns on these loans. 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.

Current law allows an above-the-line deduction (i.e., available whether or not the borrower itemizes) 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. However, the write-off is limited to \$1,500 for 1999, \$2,000 for next year, and \$2,500 for 2001 and thereafter. Also, interest can be deducted under this rule only during the first 60 months for which interest payments are required under the loan terms. Finally, 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 \$60,000 and \$75,000 for joint filers and between \$40,000 and \$55,000 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 partially phased out for

high-income taxpayers and 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. Single taxpayers can offset income from all sources with their personal exemption (\$2,750 for 1999) and standard deduction (\$4,300 for 1999 single filers). Together these two breaks can shelter up to \$7,050 of 1999 income. For example, if a student receives a \$2,000 taxable scholarship this year, no federal income tax is generally due unless the student has over \$5,050 of taxable income from other sources (wages, interest, capital gains, etc.).

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) \$700 or (2) earned income plus \$250 up to the \$4,300 maximum for a single taxpayer. Fortunately, taxable scholarships, fellowships, and grants and taxable compensation from employment (for example, via a work-study program) count as earned income and therefore can 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 15%. (For 1999, the 15% bracket for single taxpayers applies to taxable income up to \$25,750.)

Conclusion

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