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LEADERS IN NONPROFIT LAW

# Getting Schooled on Scholarships: Taxation and Reporting Issues

Becky Seidel

National Scholarship Providers Association

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## Agenda

1. Is the Scholarship Taxable?
2. Is There a Reporting Requirement?
3. Is There a Withholding Requirement?
4. Who Must Report and Withhold?



# Is the Scholarship Taxable?



# Is the Scholarship Taxable?

## Three Main Types of Scholarship Payments

1. **Qualified Scholarships** under I.R.C. 117 are nontaxable (if used for qualified tuition and expenses)
2. **Compensatory Scholarships** are taxable
3. **Nonqualified Expense Scholarships** are taxable



## Is the Scholarship Taxable?

### 1. Qualified Scholarship requirements:

- Funds must be for “qualified tuition and expenses”
- Recipient must be a candidate for a degree
- Recipient must attend an “educational organization”



## Is the Scholarship Taxable?

- “Qualified Tuition and Related Expenses” include:
  - Tuition and fees required for enrollment or attendance at an educational organization
  - Fees, books, supplies and equipment required for courses of instruction at educational organization

“Qualified Tuition and Related Expenses” does not include:

- Room/board
- Travel
- Expenses recommended but not required (e.g., laptop)



## Is the Scholarship Taxable?

- Candidate for a degree includes:
  - Both undergrad and grad students
  - Can include students not actually seeking a degree if educational organization:
    - Offers educational program acceptable for full credit toward BA or higher
    - Is authorized to provide such a program
    - Is accredited by nationally recognized accreditation agency
  - Study at educational organization other than the one that will confer degree, if it counts toward degree at conferring organization



## Is the Scholarship Taxable?

- “Educational organization” requirements:
  - Normally maintains a regular faculty and curriculum
  - Normally has a regularly enrolled body of pupils in attendance at place where educational activities regularly carried on





## Is the Scholarship Taxable?

### 2. Compensatory Scholarships are taxable

- Scholarships conditioned on performance of services (past, present or future)
- Requirements to conduct studies, research or activities primarily for the benefit of the grantor will be considered performance of services



## Is the Scholarship Taxable?

- Graduate student teaching and research
  - **Example 1:** Graduate student at Kentucky required to teach intro level chemistry class to undergraduates as condition of receiving scholarship award
    - *Compensatory?*
  - **Example 2:** Graduate student at Louisville is required to conduct chemistry research as condition of receiving scholarship award
    - *Compensatory?*



## Is the Scholarship Taxable?

- Factors to consider for research requirement
  - Extent of faculty supervision of work schedule
  - Student's ability to direct course of research work
  - Right of student to retain any copyrights or patents resulting from the research
  - Any reporting requirements, BUT reporting requirement, on its own, will not render scholarship compensatory



## Is the Scholarship Taxable?

- Requirement to perform services for third party
  - **Example 1:** Student is awarded scholarship to Ohio State by private foundation, and a condition of the scholarship is that the student must teach in Ohio after graduation.
    - *Compensatory?*
  - **Example 2:** Student is awarded law school scholarship to Kansas that requires student to practice law after graduation on a full-time, public interest basis.
    - *Compensatory?*



## Is the Scholarship Taxable?

- Athletic scholarships generally not compensatory (Rev. Rul. 77-263)
  - Scholarship may not be cancelled if student can't participate
  - Student may not be required to participate in another activity in lieu of sport
- There has long been a difference of opinion as to whether this is justified
  - Old NCAA rules allowing only one-year scholarships added to debate
  - Recent rule change allows multiyear scholarships



## Is the Scholarship Taxable?

- If only portion of scholarship is payment for services, allocation must be made, taking into account:
  - Amount of compensation paid by grantor to non-scholarship students with similar qualifications for similar services
  - Amount of compensation paid by grantor to non-student employees for similar services
  - Amount of compensation paid by other educational organizations for similar services by students or non-student employees



## Is the Scholarship Taxable?

3. **Nonqualified Expense Scholarships** (noncompensatory amounts that are paid or used for nonqualified expenses) are taxable
  - Room/board
  - Travel
  - Family allowance
  - Recommended but not required expenses (e.g., laptop, study aid)



## Is the Scholarship Taxable?

### Three Main Types of Scholarship Payments

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# Important Notes:

1. Assume “foreign” means **nonresident alien status**
  - Not a U.S. citizen
  - Not a resident alien under green card test
  - Not a resident alien under the substantial presence test, which requires both
    - Physical presence in the U.S. for at least 31 days during the calendar year being tested; and
    - Physical presence in the U.S. for at least 183 days, using all days present in the U.S. for the calendar year being tested; one-third of the days present in the U.S. for the preceding year; and one-sixth of the days present in the U.S. for the second preceding year

# Important Notes:

2. Treaty could exempt funds from general reporting and withholding regime
  - IRS Publication 901, available on [www.irs.gov](http://www.irs.gov) website
  - Either Form W-8BEN (for compensation) or Form 8223 (non-compensation including scholarships) must be received first

# Important Notes:

3. Only U.S. source income is subject to taxation, reporting and withholding requirements for nonresident aliens
  - Payments from U.S. organization to be used within U.S.
  - NOT certain payments from foreign organizations or from U.S. organizations to be used outside of U.S.



# Is There a Reporting Requirement?



## Is There a Reporting Requirement?

- U.S. recipients
  - No reporting required for **Qualified Scholarships** or for **Nonqualified Expense Scholarships**
  - Reporting required for **Compensatory Scholarships**
- Foreign recipients
  - No reporting required for **Qualified Nontaxable Scholarships**
  - Reporting required for **Compensatory Scholarships** and **Nonqualified Expense Scholarships**



## Is There a Reporting Requirement?

- U.S. recipients
  - **Qualified Scholarships**: no reporting required
  - **Nonqualified Expense Scholarships**: no reporting required, though IRS recommends notice to recipients alerting them to potential taxation (Notice 87-31)  
(also can refer them to IRS Publication 970)
  - **Compensatory Scholarships**: reporting required to both recipient and IRS



## Is There a Reporting Requirement?

- U.S. recipients (**Compensatory Scholarships**)
  - Independent contractor v. employee analysis determines form of reporting (W-2 v. 1099-MISC)
  - Test focuses on control over individual





## Is There a Reporting Requirement?

- Foreign recipients
  - **Qualified Scholarships**: no reporting required
  - **Nonqualified Expense Scholarships**: reporting required, using Forms 1042 and 1042-S
  - **Compensatory Scholarships**: reporting required, using either W-2 (employees) or 1042 and 1042-S (independent contractors)



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# Is There a Withholding Requirement?



## Is There a Withholding Requirement?

- U.S. Recipients
  - No withholding required for **Qualified Scholarships**, **Nonqualified Expense Scholarships** or **Compensatory Scholarships** to independent contractors
  - Withholding required for **Compensatory Scholarships** to employees
- Foreign Recipients
  - No withholding required for **Qualified Scholarships**
  - Withholding required for all **Nonqualified Expense Scholarships** and **Compensatory Scholarships**



## Is There a Withholding Requirement?

- **Compensatory Scholarships** to U.S. recipients
  - Independent contractor v. employee analysis determines if withholding necessary
  - Test focuses on control over individual
  - FICA exemption may apply to student employees  
(see IRS Publication 15, Circular E, Employer's Tax Guide, and Rev. Proc. 2005-11 for safe harbor)



## Is There a Withholding Requirement?

- Foreign recipients
  - **Qualified Scholarships**: no withholding required
  - **Nonqualified Expense Scholarships**: withholding required (at rate of 14 percent or 30 percent)
  - **Compensatory Scholarships**: withholding required (at rate of 30 percent or graduated employee rates)



## Is There a Withholding Requirement?

- 30 percent withholding rate is standard, but exceptions:
  - 14 percent rate for certain visa holders  
*(This is very important for scholarship providers)*
  - Graduated rate structure for foreign employees  
*(with some modifications from standard U.S. employee system)*



## Is There a Withholding Requirement?

- 14 percent withholding rate applies if:
  - Recipient temporarily present in U.S. on F, J, M or Q visa and
  - Recipient is a degree candidate and the payment is for scholarships expenses like room and board that aren't qualified expenses or
  - Recipient is not a degree candidate; the payment is for study, training or research at U.S. educational organization; and grantor is 501(c)(3), foreign government, international/multinational cultural organization, or a U.S. or state governmental entity

*Note:* Graduated rate structure can be used instead (optional)





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# Who Must Report and Withhold?



## Who Must Report and Withhold?

- U.S. Recipients
  - For **Compensatory Scholarships** to employees, employers will report and withhold
  - For **Compensatory Scholarships** to independent contractors, payor will report only
- Foreign Recipients
  - For **Nonqualified Expense Scholarships** and **Compensatory Scholarships** to independent contractors, withholding agent will report and withhold
  - For **Compensatory Scholarships** to employees, employer will report and withhold



## Who Must Report and Withhold?

- Withholding agent
  - Generally defined as entity that actually makes the payment, whether directly to the individual or to a third party on the recipient's behalf
  - Tax must be paid, even if it isn't possible to withhold from payment (e.g., payment to airline for travel expenses)
    - Take tax out of other funds paid directly to recipient\*
    - Pay tax on recipient's behalf, with or without reimbursement\*
    - Ask recipient to pay it directly
  - Responsible for tax, interest and penalties if withholding doesn't occur
    - \* *You may need to gross up payment amount to cover payment of tax and still have sufficient funds for recipient*



## Who Must Report and Withhold?

- Grossing up example
  - University awards \$20,000 scholarship to student (all taxable), and as part of scholarship makes \$2,000 payment for travel directly to airline. Student needs \$18,000 for living expenses and room and board
    - \$2,800 in tax (or 14 percent of \$20,000) must be withheld and paid over to IRS
    - \$20,000 - \$2,000 paid to airline - \$2,800 in tax leaves only \$15,200 net payment to student
  - But if university pays the tax, doesn't take it out of other funds and doesn't seek reimbursement, it will need to gross up to cover payment
    - $\$20,000 / (1 - .14) = \$23,256$  grossed up award amount
    - $\$23,256 - \$2,000$  paid to airline - \$3,256 in tax leaves \$18,000 net



## Resources for More Information

- NSPA Toolkit
- IRS website and materials
  - IRS Publication 970 (scholarships and other education benefits)
  - IRS Publication 901 (tax treaty information)
  - IRS Publication 15, Circular E (information on employee issues)
  - IRS Publication 1779 (independent contractor vs. employee)



# Conclusion



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## **Becky Seidel, Esq.**

303.781.6899

[becky.seidel@leafferlaw.com](mailto:becky.seidel@leafferlaw.com)

1899 Wynkoop Street | Suite 275 | Denver, CO 80202

**[LeafferLaw.com](http://LeafferLaw.com)**