
GENERAL COUNSEL NOTE

October 2008

As a general rule, a scholarship, fellowship, or grant is a cash sum paid to aid an individual in the pursuit of study or research. Such a broad definition, obviously, includes any amounts provided to an individual for tuition, room and board, and other fees. However, for tax law purposes, the focus is on whether amounts meet the definition of “qualified” scholarship expenses in order to exclude such payments from the recipient/student’s taxable income. The label or designation of the payment as a scholarship, fellowship, or grant is not relevant. Indeed, often such terms are used loosely or interchangeably, but the federal Tax Code makes clear that the name applied to the payment has no relevance in determining the resulting tax consequences to the payee.

A “qualified” scholarship, fellowship, grant, or award is excluded from the recipient’s taxable income only to the extent that the proceeds are used for “qualified” tuition and related expenses. It is the responsibility of the student to establish that the amounts received qualify for the exclusion and if the student is unable to substantiate the appropriate use of any funds for a “qualified” purpose, the student could be required to recognize the payment or award as taxable income. Therefore, the definition of tuition and related expenses is of paramount importance.

Tuition is simple; it is the price charged by Vanderbilt to attend and enroll in courses offered by the institution. In addition, related expenses which qualify for exclusion from taxable income include the fees, books, supplies, and equipment which are required of all students taking a particular course. Incidental expenses are not considered related expenses and if a scholarship, fellowship, or grant amount is used for such incidental expenses, those funds are taxable to the student. Incidental expenses (non-qualified expenses) include room and board, travel, research, clerical help, equipment, and other expenses that are not required for enrollment or for a particular academic course, such as computers, medical insurance, monthly spending allowances, and other non-mandatory fees, such as student activity or health services.

A further condition to exclude a scholarship or other payment as “qualified” is that the recipient must be a “candidate for a degree.” The meaning of this term is much broader than the traditional understanding of the phrase. For example, a student does not need to be studying or performing research at the educational institution that is going to confer the degree in order for the amount granted to be excluded from the student’s income. That is, if a student is pursuing a degree at Vanderbilt and receives a grant amount to do so but then takes classes during the summer at the local state university and pays for those classes with a portion of the scholarship or grant amount, the student will be considered “a candidate for a degree.”

Finally, to exclude scholarship, fellowship, and other payments from taxable income, the “qualified” expenses must be used for attendance at an educational organization as defined by the federal Tax Code. This definition, in general, covers an organization which has as its primary purpose the presentation of formal instruction with a regular faculty, curriculum, and enrolled student body. For this element of the test of a “qualified” scholarship, Vanderbilt clearly qualifies as such an institution.

Amounts paid to a student specifically for teaching, research, or other services that are a condition of receiving a scholarship cannot be excluded from the student's income as a "qualified" scholarship. This treatment applies even if all students are required to perform such services as a requirement for receipt of a particular degree. If a scholarship or any other payment award is made in exchange for past, present, or future services, then Vanderbilt must comply with all applicable withholding and reporting requirements and treat the payments as "wages" for federal tax purposes. The IRS has issued regulations which provide that if there is a requirement that the student pursue studies, research, or other activities primarily for the benefit of the institution, then this requirement involves the performance of services and will be regarded as a condition to the receipt of any scholarship, grant, or award. However, if the payment from the institution has the "primary purpose" of furthering the student's education and training, it may not be regarded as a condition to receiving the scholarship or award and, accordingly, need not be included in the student's income as taxable, nor is it reported as a taxable payment to the student.

This "primary purpose" test has resulted in much frustration and IRS examination as well as rulings in the area. This guidance makes clear that when Vanderbilt exercises, or has the right to exercise, direction or supervision over the student's activities or if the student is pursuing studies or research primarily for the benefit of Vanderbilt (Vanderbilt possesses the legal right to any intellectual property, invention, or patents) or if the payment is made for services for which Vanderbilt would otherwise have to hire an employee to perform (such as for a teaching assistant), that the primary purpose of the payment was for services and that amount should be reported as taxable wages to the student.

On the other hand, if a stipend award is made primarily for the benefit of the student's education and training and serves to help the student defray general living expenses, pay professional fees, travel related to the educational activity, or a general room or housing allowance, such a payment would not represent compensation for services. Accordingly, such a scholarship or award payment would not be reported to the student as wages or subject to any withholding for income or employment tax.

In many instances, a scholarship, fellowship, or grant award may include only a portion to be treated as compensation for services. It is the responsibility of Vanderbilt as the disbursing of any scholarship award to determine on a good faith, reasonable basis an allocation between services subject to tax reporting and withholding or a scholarship award that need not be reported on any IRS form or document. Note here that such an award or payment may not meet the definition of a "qualified" scholarship rendering the amount tax-free to the student; rather, the student may have the obligation to file an individual tax return and report and pay the tax on the amount that does not meet the narrow definition of "qualified" scholarship expenses for purposes of exclusion from taxable income.

In determining the allocation for services from a scholarship, fellowship, or other grant award, Vanderbilt must look to similar services and the amount paid by full- or part-time employees and allocate a comparable portion of the award to be deemed services subject to tax. After this allocation, any amount in excess need not be reported to the student as a scholarship, fellowship, stipend, or other payment.

As with virtually all tax rules, there are exceptions. In the area of scholarship awards and tax treatment, the IRS has expressly recognized that fellowships or grants from the National Institutes of

Health, particularly National Research Service Awards (NRSA), are deemed “not compensatory” for purposes of wage treatment. This means that awards to NRSA grant recipients will not be deemed wages or employment reportable on IRS Form W-2.

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