

# Is Scholarship Money Really Free?

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Scholarships can help reduce the cost of school for students at every education level – elementary, high school, college, grad school – even for students who attend accredited vocational schools. The money is not required to be repaid, but how does it affect your taxes? Scholarships (and fellowships) are generally tax-free. 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 met.

***Tuition and related expenses.*** A scholarship is tax-free only if 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. The student (or parent) is responsible for establishing how much of the award was used for qualified tuition and related expenses. You should maintain records (copies of bills, receipts, cancelled checks, etc.) to show how you used the scholarship money.

***Scholarship award 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. For example, 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. 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) The dependency exemption that you claim for your child shouldn't be threatened by the scholarship. To claim an individual as your dependent, you must meet a support test. Although education is a support item, a special rule states 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.

(2) Any taxable scholarship amounts should increase your child's standard deduction. If 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 claimed as a dependent by his parent and takes the standard deduction, he or she may qualify for a higher standard deduction.

The standard deduction allowed to dependents for 2014 is the greater of (a) \$1,000 or (b) \$350 plus the dependent's earned income. But the standard deduction can't be more than the regular standard deduction (\$6,200 for single taxpayers in 2014). So even though part of a scholarship is taxable, it may be "covered" by the standard deduction. For 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 \$3,350 standard deduction, which reduces his taxable income to zero.

(3) The tax-free scholarship may limit other higher education tax benefits to which you or your child may be entitled. Neither you nor your child may claim a credit, deduction, or exclusion for expenses paid with tax-free scholarship funds.

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:

- American Opportunity Tax Credit and Lifetime Learning Credit
- Deduction for interest on student loans
- Coverdell ESA distribution exclusion
- Qualified tuition (529) plan distribution exclusion
- Savings bond interest exclusion

If you have questions about your child's scholarships or tax planning and saving for college, call your Henry & Horne, LLP tax adviser.

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