

# CRS Report for Congress

Received through the CRS Web

## Federal Taxation of Student Aid: An Overview

Linda Levine  
Specialist in Labor Economics  
Domestic Social Policy Division

Bob Lyke  
Specialist in Social Legislation  
Domestic Social Policy Division

### Summary

This report summarizes the current rules regarding federal taxation of financial aid for students enrolled in colleges, universities, and other postsecondary educational institutions. Most financial aid provides income to students, so the question arises whether they must pay federal income taxes on it. Some aid also involves employment, so students may have to pay Federal Insurance Contribution Act (FICA) taxes as well.

Scholarships and fellowships (including grants) generally are not taxable if they are used for tuition and required course expenses. Tuition reductions also are not taxed. However, both types of aid are subject to income and sometimes FICA taxes to the extent that they represent payment for services. Neither veterans' education benefits nor loans are taxable; however, loan amounts that are forgiven or otherwise discharged generally are subject to income taxes. Work-study awards are subject to income and sometimes FICA taxes. Employer tuition reimbursements are taxable unless they qualify as a deductible business expense or are provided through an employer education assistance program under Section 127 of the Internal Revenue Code.

### Introduction

This report outlines the general rules for whether six types of postsecondary student aid are subject to federal income and FICA taxes: scholarships and fellowships (including grants), tuition reductions, veterans' benefits, loans, work-study awards, and employer tuition reimbursements. For additional information, readers might consult three annual Internal Revenue Service (IRS) publications, *Tax Benefits for Work-Related Education* (publication 508), *Scholarships and Fellowships* (publication 520), and *Tax Benefits for Higher Education* (publication 970).

Taxation of student aid is discussed from the standpoint of students who receive it. Implications for other taxpayers (parents, employers, private foundations, and schools)

are not addressed. This focus excludes federal unemployment taxes, which are paid only by employers, as well as the dependency exemption for students 19 through 23 years of age, which is available only to parents. Also not discussed is the financial assistance students get from trust funds or their parents, which can involve important tax issues, or the tax-advantaged ways that families can save for college.<sup>1</sup>

**Federal Income Tax.** Much of the aid considered in this report provides students with income in the basic sense of that term: it increases students' financial net worth. Since the federal income tax covers "all income from whatever source derived" unless there is a specific exception,<sup>2</sup> student aid is subject to it like other forms of income, barring such exceptions.

Generally, it is the economic characteristics of student aid that determine its income tax status, not the name or outward form. The terms "scholarship" and "fellowship" in particular are frequently used loosely. Rather than being aid offered solely to help people pursue their studies or research, they sometimes involve obligations to provide service (and so are really compensation for employment) or to pay back funds (and so are really loans). Similarly, some tuition reductions represent partly employment compensation for teaching and partly an additional remission that is like a scholarship.

The source of student aid generally is irrelevant for income tax purposes. Whether financial aid originates with federal, state, or local governments, or whether it comes from private non-profit or for-profit organizations, typically does not affect whether it is taxable. In contrast, the source of student employment income can be relevant for FICA taxes, as is discussed below.

Student aid that is taxable is not necessarily taxed, at least not to the extent it is included in gross income on income tax returns. Taxpayers can offset some portion of taxable income with their personal exemption and their standard deduction or itemized deductions.

**Federal Insurance Contribution Act Taxes.** Student aid that involves employment (employer tuition reimbursements, work-study awards, and scholarships or tuition reduction that require the performance of services) may be subject to FICA taxes. FICA taxes are used toward the payment of Old Age, Survivors, and Disability Insurance and Medicare Hospital Insurance.

If students are employed by the school they attend, the general rule is that their wages are not subject to FICA taxes, regardless of whether they are subject to federal income taxes.<sup>3</sup> However, there are exceptions to this rule at public colleges and universities in several states that elect coverage for student employees under Section 218(c)(5) of the

---

<sup>1</sup> Tax-advantaged savings for higher education include qualified tuition (Section 529) plans, Coverdell savings accounts (formerly called Education IRAs), and "education" savings bonds. For tax and other information on qualified tuition plans see: CRS Report RL31214, *Saving for College Through Qualified Tuition (Section 529) Programs*, by Linda Levine.

<sup>2</sup> Section 61(a) of the Internal Revenue Code (IRC).

<sup>3</sup> Section 3121(b)(10) IRC.

Social Security Act. It should also be noted that the general rule applies only to students who are considered to be “enrolled and regularly attending classes;” it may not apply to students who take only one course or work for their school during the summer. If students are employed by other employers, the general rule is that their wages are subject to FICA taxes.

## **Scholarships and Fellowships**

Scholarships and fellowships include awards based upon financial need (such as Pell grants) as well as those based upon scholastic achievement or promise (such as National Merit Scholarships). They can be excluded from taxpayers’ gross income for income tax purposes provided that (1) the taxpayer is a degree candidate and (2) the amounts are used for “qualified tuition and related expenses.”<sup>4</sup> These expenses include tuition and fees required for enrollment or attendance as well as fees, books, supplies, and equipment required for courses. They do not include room, board, or incidental expenses.

Scholarships and fellowships are considered used for tuition and required course expenses if they are either (1) designated for such purposes or (2) unrestricted or not designated for other purposes. Students need not trace how unrestricted funds are actually used: there is a presumption they are used for qualified expenses, up to the net amount of such expenses (that is, taking into account tuition reductions and other scholarships).

If scholarships or fellowships have a requirement for the performance of services (teaching, research, or anything else) the portion that represents payment for such services must be included in gross income. It makes no difference whether the service is to be performed before, during, or after the scholarship or fellowship period. It also makes no difference whether the service requirement applies to all students or is necessary for attaining a degree. The portion representing payment for services may be subject to FICA taxes as well.

## **Tuition Reductions**

Tuition reductions for employees of educational institutions can be excluded from gross income if they are (1) restricted to education below the graduate level (with one exception discussed below), (2) do not discriminate in favor of highly compensated employees, and (3) do not apply to amounts representing payment for services.<sup>5</sup> The last restriction is identical to the one just discussed for scholarships: amounts that represent payment for teaching, research, or other required activities must be included in gross income and may be subject to FICA taxes. Only reductions in excess of such deemed payments are excludable (these excess amounts are like scholarships).

Tuition reductions are excludable even if they are made for the employee’s spouse and dependent children; they can also occur at schools other than where the employee works, provided they are remitted by the school attended, not paid by the employee’s school. For example, college A could reduce the tuition of students who are children of

---

<sup>4</sup> Section 117(a) IRC.

<sup>5</sup> Section 117(d) IRC.

teachers employed by college B, and neither the students nor parents would have to include the remissions in their gross income.

Tuition reductions for graduate education can be excluded only with respect to teaching or research (not other activities) carried out by the students themselves (not other family members) at the school they are attending. Consistent with the general rule, only amounts in excess of payments for such services are excludable; reductions representing payment are included in gross income and may be subject to FICA taxes.

## **Veterans' Education Benefits**

Veterans currently receive education benefits under the Post-Vietnam Era Veterans' Educational Assistance Program and the Montgomery GI Bill. In addition, educational assistance is available to the spouse and children of veterans who die or are totally and permanently disabled due to a service-connected incident. While some of these benefits represent returns of contributions the veterans made (or pay reductions they agreed to) during service, the balance constitutes additional economic income. For federal income tax purposes, however, the entire amount is excludable from gross income.<sup>6</sup>

## **Loans and Interest Payments**

Loans as such are not income; they do not increase borrowers' financial net worth. (While loans increase borrowers' assets, typically their cash, such increases are offset by a liability to pay the loans back, leaving net worth the same.) As a consequence, loans as such are not subject to income taxes.

Many education loans, however, have interest subsidies that represent income to student borrowers. For example, for subsidized Stafford loans insured under the Federal Family Education Loan (FFEL) program, the federal government pays interest to lenders (or subsequent purchasers of the loans) when students are in school, during a 6-month grace period afterwards, and in periods of deferment. In addition, throughout the life of any FFEL loan the government may pay lenders a "special allowance" to make the return on the loans more equivalent to the market rate. The federal government makes these payments directly to the lenders, but they nonetheless represent income to the borrowers, who are relieved of what would otherwise be their financial obligation. The IRS has ruled that these interest payments are excludable from borrowers' gross income for income tax purposes since they can be considered scholarships.<sup>7</sup> There have been similar rulings for some other education loans.

When education loans are forgiven or otherwise discharged, the amounts discharged represent income to the borrowers. (Loan discharge constitutes income since liabilities are reduced without corresponding reductions in assets; thus, net worth is increased.) Discharged indebtedness must be included in taxpayers' gross income for income tax purposes unless there is a specific exception; the only ones currently allowed for education loans involve (1) cases of bankruptcy or insolvency; (2) loans made by the United States

---

<sup>6</sup> Section 134 IRC.

<sup>7</sup> Rev. Rul. 75-537.

or state and local governments (including public hospital corporations) and forgiven because borrowers subsequently work in certain professions for certain broad classes of employers (such as teaching in schools in lower-income areas); (3) loans made by educational institutions pursuant to agreements to carry out the loans described in (2); and (4) loans made by educational institutions pursuant to programs designed to encourage students to serve in occupations or areas with unmet needs under the direction of a governmental or tax-exempt entity.<sup>8</sup>

For tax year 2001, an above-the-line deduction (i.e., not restricted to taxpayers who itemize) of up to \$2,500 a year is allowed for interest payments on education loans during the first 60 months in which interest payments are required; amounts taken into consideration are phased out for taxpayers with modified adjusted gross incomes between \$40,000 and \$55,000 (\$60,000 to \$75,000 in the case of married couples filing jointly).<sup>9</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) eliminated the 60-month limitation and increased the income phase-out ranges to \$50,000-\$65,000 (\$100,000-\$130,000 for joint filers) for interest paid in 2002 and thereafter. Otherwise, interest payments on education loans are not deductible in accordance with the general rule for consumer loans established by the Tax Reform Act of 1986. An exception to the latter rule allows taxpayers who itemize to deduct interest payments on home equity loans (which can be used for any purpose) up to a debt limit of \$100,000 (\$50,000 for married individuals filing separately) or their net equity in the residence, whichever is lower.<sup>10</sup> While few college students are homeowners, many have parents who are and who could use these loans to pay college expenses.

## **Work-Study Awards**

Work-study awards are a form of financial aid in which students are given jobs in order to help pay for their college education. Many awards are financed by the federal College Work-Study program, but there are also separate state and institutional programs. Students typically work for their schools, though some work for other employers. Sometimes work is integrated with the curriculum, while other times it is not. Regardless of the program, work-study awards are included in gross income for federal income tax purposes. This is the case even if earnings are used to pay tuition and required course expenses. In addition, work-study awards may be subject to FICA taxes.

## **Employer Tuition Reimbursements**

Many employers have tuition reimbursement programs for their employees.<sup>11</sup> The general rule is that employer tuition reimbursements are excluded from taxpayers' gross income if (1) the assistance is provided through an accountable plan (i.e., employees are required to substantiate reimbursements to their employer and return any excess payments) and (2) the education meets the two-part IRS tests for a deductible business expense.

---

<sup>8</sup> Section 61(a)(12) IRC; Sections 108(a) and 108(f), respectively, IRC.

<sup>9</sup> Section 221 IRC.

<sup>10</sup> Section 163(h)(3)(C) IRC.

<sup>11</sup> The programs discussed here are for employees themselves. If employers pay the tuition costs of an employee's spouse or dependents, the amounts are included in the employee's taxable compensation.

(Under these tests, a deduction is allowed only if the education is job-related — it must either be required by one's employer or by law, or it must maintain or improve skills in one's present work — *and* it does not enable one to meet minimum requirements for current work or prepare for a new career.)<sup>12</sup> If either of these requirements is not met, tuition reimbursements must be included in employees' gross income and are subject to FICA taxes. However, taxpayers who itemize deductions might be able to deduct some of the reimbursements if they meet the two-part tests for a deductible business expense. The deduction would be limited to the amount that the reimbursement plus other miscellaneous deductions exceeds 2% of adjusted gross income; thus not all (or even any) of it might be deductible.

An exception to the general rule is allowed for tuition reimbursements made through an employer education assistance program meeting the requirements of Section 127 IRC. Under this provision, up to \$5,250 in reimbursements may be excluded annually from employees' gross income even if the education does not meet the two-part IRS tests for a deductible business expense. Thus, courses do not have to be job-related (though with some exceptions they cannot be for sports, games, or hobbies) and they can prepare students for a new career. FICA taxes also do not apply. The exclusion does not apply to graduate-level courses that began after June 30, 1996 and on or before December 31, 2001; however, the EGTRRA restored the exclusion for graduate courses that begin after December 31, 2001.<sup>13</sup>

Employees who receive tuition reimbursements that are not deductible or excludable might be able to claim either the Hope Scholarship or Lifetime Learning tax credits, which were established by the Taxpayer Relief Act of 1997.<sup>14</sup>

---

<sup>12</sup> IRS regulations 1.162-5.

<sup>13</sup> Sections 127 and 3131(a)(18) IRC. The program must have a separate written plan and employee notification. It cannot discriminate in favor of highly compensated employees.

<sup>14</sup> For information on the two credits, see CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by Adam Stoll and James B. Stedman.