Scholarship providers often receive conflicting information about how they are required to report scholarship payments to the IRS and the students. The confusion comes, in part, because the provider’s obligation will depend on the nature of the payment (whether the scholarship is taxable or non-taxable, and if taxable the reason why), the status of the scholarship recipient (U.S. student or foreign student, and if foreign the student’s nation of residency) and the nature of the provider (university, other public charity or private foundation). The aim of this section is to help guide providers through these multi-leveled factors, and highlight the different reporting (and withholding obligations) that could apply to their organizations.

**Authors’ Note:** This section is intended to serve as a starting point for consideration of these issues. The authors strongly encourage providers to consult with their own legal and tax advisors as to their particular circumstances and the specific laws that may apply to them.

**Background**

Scholarship awards may be taxable or non-taxable to the recipient, depending on use of the funds and the conditions attached to the scholarship.

- Scholarship awards for tuition, fees, books, supplies and equipment required for enrollment, attendance or instruction at an educational institution\(^1\) (i.e., “qualified tuition and related expenses”) are generally non-taxable for federal income tax purposes.\(^2\)

- Scholarship awards for all other purposes, such as room, board, travel and miscellaneous expenses, are taxable.\(^3\)

- Compensatory scholarships—i.e., scholarship that are conditioned upon the performance of services (e.g., working for the provider during or after the scholarship period, working for a third party determined by the provider, or working in a specific location determined by the provider)—are taxable, regardless of the use of funds.\(^4\)

---

\(^1\) An “educational institution,” for this purpose, is an organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled study body in attendance at the place where its educational activities are regularly carried on. See Sections 117(a) and 170(b)(1)(a)(ii) of the Internal Revenue Code (“I.R.C.”).

\(^2\) I.R.C. § 117(a) and (b).

\(^3\) Id..

\(^4\) I.R.C. § 117(c). However, some scholarships are subject to conditions or limitations that will **not** be considered “services” for this purpose. For example, a law school scholarship program that required recipients to agree to work in a lower-income setting for a fixed number of years upon graduation did not represent payment for services, largely because the requirement the recipients had a lot of latitude in deciding where to work. Priv. Let.
The fact that a scholarship is taxable, however, does not necessarily mean that it must be reported by the scholarship provider. Whether the scholarship provider must report a taxable scholarship award as income to the IRS or the student, and withhold taxes from the scholarship payments, depends both on the taxable nature of the scholarship payment (compensatory or not) and whether the student is a U.S. or foreign student.

A “foreign student” for this purpose is any person who is not either a U.S. citizen or resident alien. Resident aliens include:

- Lawful permanent residents of the U.S. (i.e., a person who holds a green card); and
- Persons that have a substantial presence in the U.S. (i.e., at least 183 days during the current and preceding two years and at least 31 days during the current year). There is an exception to the substantial presence test for students who are temporarily present in the U.S. under a F, M, J or Q visa, which means these students will be considered foreign students.\(^5\)

An organization may generally rely on a student’s withholding certificate--i.e., an IRS Form W-8Ben or Form 8233 (for foreign students) or an IRS Form W-9 (for U.S. students)--to determine their status. So it’s advisable to seek a withholding certificate from scholarship recipients whenever possible.

Apart from reporting a scholarship payment as income to the student, scholarship providers may have other information reporting requirements, either to the IRS, the students and/or state governments. This will vary depending on the nature of the organization, as discussed further below.

**Reporting of Scholarships to U.S. Students**

Scholarship providers are not required to report taxable or non-taxable scholarship awards to U.S. students as income, either to the IRS or the student, or to withhold taxes from the scholarship payments, so long as the scholarship is not conditioned on the performance of services.\(^6\) The federal tax laws consider it the student’s sole responsibility to know what is taxable or not, and to report income accordingly on his or her personal tax returns.\(^7\)

Realizing, however, that most students will not know what is taxable or not, and may not even suspect that some portion of a scholarship award may be taxable, the IRS has encouraged scholarship providers to voluntarily alert recipients that at least some portion of an award may be taxable. Specifically, IRS Notice 87-31 states:

---

\(^5\) I.R.C. § 7701(b).

\(^6\) IRS Notice 87-13, 1997-1 CB 475.

\(^7\) *Id.*
To assist students in understanding their federal tax liabilities, it is recommended that the grantor formally advise the recipient in writing that amounts granted ... for expenses ... are taxable income, if the aggregate scholarship or fellowship amounts received by the recipient exceed tuition and fees (not including room and board) required for enrollment or attendance at the educational institution and fees, books, supplies and equipment required for courses of instruction."

Although there is no penalty for failing to provide such information to the recipients, it may nonetheless be useful and considerate to alert recipients to their potential tax responsibilities. Providers may wish to send a letter that directs students to IRS Publication 970 for additional information.

A scholarship conditioned on the student’s performance of services (see above description) or forbearance in pursuing other earned income opportunities, however, is handled much differently than a straight scholarship award. In this case, the scholarship provider must make a decision whether, under the relevant facts and tax law, the recipient is to be treated as an "employee" or as an "independent contractor," and comply accordingly with the applicable reporting and withholding requirements that go along with that relationship. 9

If the recipient is to be treated as an "employee," then the scholarship provider must withhold for federal and state income tax purposes, if applicable thresholds are met, and pay and withhold for applicable payroll taxes. 10 Such "wages" are also to be reported to both the recipient and the IRS on Form W-2.

If the recipient is to be treated as an "independent contractor," then such “earned income” must be reported to both the recipient and the IRS on Form 1099 if the payments exceed $600. 11 Although the scholarship provider would not be responsible for withholding or payroll taxes in this situation, the recipient may have to pay estimated taxes and self-employment taxes, as well as report the payment as part of the recipient’s gross income.

It is important for scholarship providers to be particularly mindful of the distinction between employee and independent contractor. The IRS scrutinizes this type of classification, and often conducts audits around the issue. Improper classification can mean that a scholarship provider is liable for some or all of back employment taxes and income taxes that should have been withheld and were not paid by the recipient, as well as interest and penalties. Therefore, providers should consult with legal or tax counsel prior to making the determination.

---

11 I.R.C. § 6041(a). Although the instructions for the Forms W-2 and 1099-MISC contemplate that payments conditioned on the performance of services will be considered employee wages, there are some circumstances under which the recipient would be considered an independent contractor, and filing of a 1099 would be appropriate. See, e.g., BERTRAND M. HARDING, JR., THE TAX LAW OF COLLEGES AND UNIVERSITIES 298 n.4 (3d ed. 2008).
Reporting of Scholarships to Foreign Students

Scholarship providers generally are not required to report and withhold taxes on non-taxable scholarships to foreign students. They are required report and withhold taxes on taxable scholarships (both compensatory and non-compensatory). Once a provider determines the recipient is a foreign student, it must therefore take the additional step of restricting or ascertaining how the scholarship funds will be used, to determine its reporting and withholding obligations.

The actual obligation to report and withhold is imposed on the “withholding agent” for the scholarship, which may be the scholarship provider itself or someone else down the chain. The withholding agent is, basically, the organization that has control over or custody of the grant funds to be paid to the foreign student or to a third person on behalf of the foreign student. This is generally the last person to handle the funds before they are remitted to the foreign student or a third person on behalf of a foreign student. Taxable scholarships to foreign individuals should be reported on IRS Form 1042 (to the IRS) and IRS Form 1042-S (to the student).

A scholarship provider that fails to withhold the required taxes is liable for those taxes, plus interest and penalties. There are additional penalties for failure to file the required information returns. A provider should, therefore, consult with legal or tax counsel to clarify who serves as the withholding agent for the scholarship, and not simply assume that the provider is not a withholding agent.

Taxable scholarships are subject to either a 14% or 30% back-up withholding rate, unless a treaty exemption applies. The 14% withholding rate applies if:

1. The recipient is a degree candidate (this requirement does not apply if the scholarship provider is a 501(c)(3) organization, a governmental entity or an international organization);
2. The recipient is temporarily present in the U.S. on a F, J, M or Q visa;
3. The scholarship is for study or research in the U.S.; and
4. The scholarship is incident to a non-taxable scholarship.

The 30% withholding rate applies in all other cases. Examples of situations in which the 30% rate might apply include:

- the student is not a candidate for a degree
- the scholarship is for study or research abroad
- the student is in the U.S. under a visa other than a F, J, M or Q visa.

---

12 See Treas. Reg. § 1.1441-2(b).
13 See I.R.C. § 1441(a).
14 I.R.C. § 1441(b).
15 Id.
**Caution:** Scholarship providers that make taxable awards to foreign students must reckon with the possibility that once they withhold, the balance of the award payment may be insufficient to cover the student’s expenses. For example, if the provider awards $10,000 for room and board, once the provider withholds 30% (or $3,000), the remaining $7,000 may be insufficient to cover the recipient’s room and board expenses. The provider may want to seek verification from the recipient that other funds are available to cover the difference. A provider that pays expenses on behalf of a student directly to the third party must be especially mindful of the withholding obligation. If the provider makes the payment to the third party in full, without withholding, the provider will either need to pay the recipient’s taxes and seek reimbursement, or gross up the scholarship to cover the taxes, to avoid penalties and interest.

It is important to note that the U.S. has numerous tax treaties in effect with other nations that alter the tax treatment of and/or withholding obligations for taxable scholarships to foreign students. Many universities post tables on their websites summarizing the treaty exemptions available. It should be noted, however, that the scholarship is still subject to reporting. Also, under certain circumstances, the scholarship provider and the student can take advantage of reduced withholding procedures if the student can claim a business expense deduction for his or her educational expenses covered by the scholarship.  

Scholarship payments may also be subject to state withholding and reporting obligations. The provider should first determine whether the student is a resident for state income tax purposes, and if so, whether state withholding and reporting is required.

**Form 990 Reporting of Scholarships by Tax-Exempt Entities**

Tax-exempt scholarship providers (whether they are 501(c)(3) private foundations or public charities, or other types of tax-exempt entities, such as 501(c)(6) organizations) must report their scholarship activity to the IRS on their annual information returns, which are publicly available documents.

- **Private foundations** report this information on IRS Form 990-PF, and must disclose if any of their awards failed to comply with the IRS rules relating to scholarships. Additionally, they must disclose or provide:
  - Their application procedures, including to whom applications should be addressed
  - Their application form and required information and materials
  - Submission deadlines
  - Restrictions and limitations on awards.

---

18 See Form 990-PF, Part XV, Line 2.
Form 990-PF, Part XV asks for a listing of grant recipient names, addresses and the amount of grants paid. Scholarship providers typically do not provide student names here, and instead attach a listing of the educational institutions attended by recipients.

- **Public charities and other 501(c) tax-exempt entities** report this information on IRS Form 990. If the provider makes more than $5,000 in grants to individuals, it must complete Schedule I, Parts I and III. This requires disclosure of:
  - Their procedures and records maintained for substantiating the grant amount, and the eligibility requirements and selection criteria used to award the grants
  - Their procedures for monitoring the use of grant funds in the U.S.
  - The type, amount and number of scholarships awarded (not individual names of recipients). 19

**Additional Reporting for Universities and Colleges**

Scholarship providers that are universities or colleges are required to submit Form 1098-T to the IRS for U.S. resident students for which they have received payments of “qualified tuition and related expenses” (as defined above), and to send the form to the students as well. 20 This form is provided to assist in determining student eligibility for Hope and Lifetime Learning education tax credits. The form must list separately any grants or scholarship funds administered or processed by the institution for the payment of the student’s cost of attendance, and also must list any reductions to scholarship or grant amounts that were reported for any prior year after 2002. However, organizations are not required to issue the form to students whose qualified tuition and related expenses are entirely waived or paid entirely with scholarships or grants.

**Conclusion**

Scholarship providers may be subject to reporting and withholding requirements for scholarship payments. A provider’s requirement could be as simple as filling in some information on its annual Form 990 or 990-PF. However, a provider may be required to submit several different forms for reporting and withholding purposes, due to the status of the scholarship recipient, the nature of scholarship payment and the type of organization. A multi-level analysis will be required by each organization in order to sort out what is necessary.

---

19 See Form 990, Part IV Line 22, and Schedule I, Parts I and III.