

IRS Rulings & Other Documents (2001-Earlier), 87FED ¶6452, Cumulative Bulletin Notice 87-31, 1987-1 CB 475, (Apr. 27, 1987)

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[Code Sec. 117]

Scholarship and fellowship grants: Tax Reform Act of 1986: Changes.--The Internal Revenue Service provides guidance on the changes made by the Tax Reform Act of 1986 for scholarship and fellowship grants. BACK REFERENCE: 87FED ¶1179.01.

Background

Section 123 of the Tax Reform Act of 1986 (Pub. L. 99-514) (the Act) amended section 117 of the Internal Revenue Code (the Code), relating to the exclusion of scholarship and fellowship grants from gross income.

Section 117(a) of the Code, as amended by the Act, provides that gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii). Section 117(b), as amended by the Act, provides that a "qualified scholarship" is any amount received by an individual as a scholarship or fellowship grant to the extent that the individual establishes that the amounts received are used for qualified tuition and related expenses. Section 117(b)(2), as amended by the Act, provides that "qualified tuition and related expenses" are tuition and fees required for enrollment or attendance at the educational organization and fees, books, supplies and equipment required for courses of instruction. Thus, scholarship and fellowship grants that are used for other expenses, such as room and board, are not excludable from gross income. Additionally, section 117(c), as amended by the Act, provides that gross income *includes* any portion of amounts received as a scholarship or fellowship grant representing payment for teaching, research or other services required as a condition for receiving the qualified scholarship.

In addition, section 63(c)(5) of the Code, as amended by the Act, permits a child eligible to be claimed as a dependent under section 151(c) on the return of his or her parents to use the standard deduction to offset the greater of \$500 or earned income. For purposes of section 63(c), any amount of a scholarship or fellowship grant received by a dependent child that is includible in gross income under section 117 constitutes earned income.

The amendments to section 117 of the Code are applicable to taxable years beginning after December 31, 1986, but only in the case of scholarships and fellowships granted after August 16, 1986. A scholarship or fellowship granted after August 16, 1986, and before January 1, 1987, is governed by section 117 prior to amendment by the Act to the extent that it is received before January 1, 1987, and is attributable to expenses incurred before January 1, 1987. In addition, except as provided below, all scholarships and fellowships granted before August 17, 1986, are excludable from gross income to the extent permitted under section 117 prior to its amendment.

When is a scholarship or fellowship granted

For purposes of the effective date rules relating to section 117 of the Code, as amended by the Act, a scholarship or fellowship is granted when the grantor of the scholarship or fellowship grant either notifies the recipient of the award or notifies an organization or institution acting on the behalf of a specified recipient of the award to be provided to such recipient. If the notification is sent by mail, notification occurs as of the date the notice is postmarked. If evidence of a postmark does not exist, the date of the award letter shall be treated as the notification date.

Scholarships or fellowships granted before August 17, 1986

For purposes of the effective date rules relating to section 117 of the Code, a scholarship or fellowship will be considered granted before August 17, 1986, to the extent that, in a notice of award made before that date, the grantor made a firm commitment to provide the recipient with a fixed cash amount or a readily determinable amount. If a scholarship or fellowship was granted for a period exceeding one academic period (e.g., semester), amounts received in subsequent academic periods will be treated as granted before August 17, 1986, only if (1) the amount awarded for the first academic period is described in the original notice of award as a fixed cash amount or readily determinable amount, (2) the original notice of award contains a

firm commitment by the grantor to provide the scholarship or fellowship amount for more than one academic period, and (3) the recipient is not required to reapply to the grantor in order to receive the scholarship or fellowship grant in future academic periods. A requirement that the recipient file a financial statement on an annual basis to show continuing financial need will not be treated as a requirement to reapply to the grantor.

If a scholarship or fellowship satisfying the requirements of the preceding paragraph does not describe the amount to be received in subsequent academic periods as either a fixed cash amount or readily determinable amount, it is presumed that the amount granted before August 17, 1986, to be received in each subsequent academic period is equal to the amount granted for the initial academic period. To the extent that any amount received in a subsequent academic period exceeds the amount received in the initial academic period, the excess amount is treated as a scholarship or fellowship granted after August 16, 1986.

Example 1. On May 1, 1986, A is notified of a scholarship made in the amount of \$4,000 annually for four years. The total amount of the scholarship is a fixed cash amount. Thus, the total amount of the scholarship for all four years is subject to section 117 of the Code, prior to its amendment by the Act.

Example 2. On May 1, 1986, B is notified of a scholarship that will pay for B's tuition, room, and board for four years. The total amount of the scholarship is readily determinable. Thus, the total amount of the scholarship for all four years is subject to section 117 of the Code, prior to its amendment.

Example 3. On May 1, 1986, C notified that she is the recipient of a scholarship to attend University X. The notice provides that University X will provide scholarship funds for four years, and specifies that C will receive \$5,000 during the first year. C is not required to reapply in order to receive scholarship funds during years 2 through 4. However, the notice does not specify the scholarship funds to be received in years 2 through 4. The \$5,000 received in year 1 is treated as granted before August 17, 1986, because this amount is a fixed cash amount described in the notice of award. In addition, because University X has made a specific commitment to provide scholarship funds during years 2 through 4 without requiring C to reapply for the scholarship, an amount equal to \$5,000 per year is treated as granted before August 17, 1986 during years 2 through 4. Thus, if C receives \$4,000 in year 2, the entire amount is treated as granted before August 17, 1986. If, in year 3, C receives \$6,000, only \$5,000 of the amount received is treated as granted before August 17, 1986. The additional \$1,000 received in year 3 is treated as granted after August 16, 1986.

Expenditures incurred before January 1, 1987

In the case of scholarships and fellowships granted after August 16, 1986, amounts received before January 1, 1987, that were attributable to expenditures incurred prior to January 1, 1987, are subject to the rules of section 117 of the Code prior to its amendment. For purposes of this rule, an expenditure is treated as incurred when it becomes properly due and payable by the scholarship or fellowship recipient. However, expenditures relating to an academic period beginning after December 31, 1986, that were prepaid (before billing) by the recipient before January 1, 1987, are not treated as incurred before January 1, 1987. Thus, if in December 1986, an educational organization billed a scholarship recipient for expenses relating to the semester beginning in January 1987, and the recipient used scholarship amounts received prior to January 1, 1987, to pay the expenses on January 5, 1987, the scholarship amounts used to pay such expenses are considered attributable to expenditures incurred prior to January 1, 1987. If, however, on December 31, 1986, a scholarship recipient used scholarship amounts to prepay expenses relating to the academic period beginning January 1987 before the recipient was billed for such expenses, the amounts used are not treated as attributable to expenditures incurred before December 31, 1986.

Reporting and withholding requirements

In General

The Internal Revenue Service intends to promulgate regulations that will provide that unless a scholarship or fellowship grant is subject to the provisions of section 117(c) of the Code, neither the grantor nor the educational organization attended by the recipient (in the case where the educational organization is not the grantor) is required under section 6041 to file a return of information with respect to such grant.

In addition, unless section 117(c) of the Code applies, the amount of a scholarship or fellowship grant is not considered wages. Thus, such amount is not subject to section 3402 (relating to withholding for income

taxes), section 3102 (relating to withholding under the Federal Insurance Contribution Act (FICA)), or section 3301 (relating to the Federal Unemployment Tax Act (FUTA)).

Scholarship or fellowship grants subject to section 117(c)

A scholarship or fellowship grant that is includible in gross income under section 117(c) of the Code is considered wages for purposes of section 3401(a). However, the application of FICA or FUTA depends on the nature of the employment and the status of the organization. In addition, the grantor is subject to the provisions of section 6051 (relating to reporting of wages of employees), and is required to file Form W-2 with respect to amounts provided as a scholarship or fellowship grant that are subject to the provisions of section 117(c). For example, if a college reduces a student's tuition solely in return for performing services as a graduate assistant that are required as a condition to receiving the scholarship, the college must file Form W-2 reflecting the amount of the reduction.

Where a portion of a scholarship is granted in return for services described in section 117(c) of the Code, the grantor must make a good faith allocation, based on all the facts and circumstances, to determine that portion of the amount that represents compensation for services provided by the recipient. Factors taken into account in making the allocation include, but are not limited to: (1) compensation paid by the grantor for similar services performed by students with similar qualifications to the scholarship recipient, but who do not receive scholarship or fellowship grants; (2) compensation paid by the grantor for similar services performed by full- or part-time employees of the grantor who are not students; and (3) compensation paid by educational organizations, other than the grantor of the scholarship or fellowship grant, for similar services performed either by students or other employees. Only those amounts allocated to compensation for services provided by the recipient are subject to the reporting and withholding requirements described in this paragraph.

Recipient Obligations

The recipient of the scholarship or fellowship grant is responsible for determining whether the scholarship, in whole or part, is includible in gross income under section 117. In other words, the recipient is responsible for determining whether such grant was used for qualified tuition and related expenses. However, to assist students in understanding their federal tax liabilities, it is recommended that the grantor formally advise the recipient in writing that amounts granted after August 16, 1986 for expenses incurred on or after January 1, 1987, 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.

Coordination of section 117 of the Code as amended by the Act, with sections 4941(d)(2)(G)(ii) and 4945(g)(1)

Sections 4941(d)(2)(G)(ii) and 4945(g)(1) of the Code both refer to scholarship or fellowship grants "subject to the provisions of section 117(a)". There is no indication in the legislative history of section 123 of the Act that Congress intended to limit foundation grants to amounts excludable under section 117, as amended by the Act.

Pending clarification by Congress, the Service will interpret sections 4941(d)(2)(G)(ii) and 4945(g)(i) of the Code as if section 117 had not been amended. Generally, this means that scholarship or fellowship grants will not be treated as self-dealing acts under section 4941 or as taxable expenditures under section 4945 merely because they cover expenses for room, board, travel, research, clerical help, or equipment.

Private foundations that have outstanding rulings that scholarship or fellowship grants are neither self-dealing acts under section 4941 of the Code nor taxable expenditures under section 4945 can continue to rely on these rulings until the Service issues notice to the contrary. Such rulings, however, cannot be relied upon to the extent that such rulings indicate that the grants in question are excludable from recipients' gross income under section 117.

The collection of information requirements in this notice have been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 and has been approved by OMB.