

## Part C. Excluded Sources of Income--Others

### LIMIT SCHOLARSHIP AND FELLOWSHIP EXCLUSION

#### General Explanation

#### Chapter 3.15

##### Current Law

Current law provides an exclusion from income for the amount of certain scholarships or fellowship grants. In the case of candidates for a degree at an educational organization with a regular faculty, curriculum and enrolled body of students, any scholarship or fellowship grant is excludable unless it represents compensation for services. If teaching, research, or other services are required of all such degree candidates, a scholarship or fellowship grant is not regarded as compensation for such services.

Nondegree candidates may exclude scholarships or fellowship grants only if the grantor is a charitable organization, a foreign government or an international organization, or an agency of the United States or a State. The amount that may be excluded is limited to \$300 per month, with a lifetime maximum of 36 months. This limit does not apply, however, to amounts received to cover expenses for travel, research, clerical help, or equipment, which are incidental to the scholarship or the fellowship grant ("incidental expenses").

Compensation for past, present, or future services is generally not treated as a scholarship or as a fellowship grant. However, in addition to the special rule for degree candidates, there is an exception for certain amounts received under a Federal program. These amounts are treated as scholarships even though the recipient must agree to perform future services as a Federal employee as a condition of obtaining the scholarship.

##### Reasons for Change

Scholarships and fellowship grants confer a benefit on the recipient that should be taxed as income. The full exclusion of these benefits from income under current law is unfair to the ordinary taxpayer who must pay for education with earnings that are subject to tax.

In theory, it might be appropriate to include the full amount of any scholarship in income. In practice, this would create real hardships for many scholarship recipients. Scholarship awards are often made on the basis of need. If students were taxed on such amounts, they would often not have the resources to pay the tax. Moreover, unlike most cases in which in-kind benefits are subject to tax, the recipient of a scholarship is not receiving an in-kind benefit in lieu of a cash amount and does not otherwise have the

ability to convert the in-kind benefit to cash. The definition of income for tax purposes is appropriately limited by considerations of ability to pay. Accordingly, income from a scholarship for tax purposes should, in general, be limited to amounts that represent out-of-pocket savings for regular living expenses.

An exception for incidental expenses of nondegree candidates is also appropriate. Such expenses would typically be deductible as ordinary and necessary business expenses, and thus in most cases an exclusion simply provides an equivalent tax result.

### Proposal

Scholarships and fellowship grants generally would be includible in gross income. In the case of degree candidates, scholarships would be excludable to the extent that they were required to be, and in fact were, spent on tuition and equipment required for courses of instruction. In the case of nondegree candidates, reimbursements for incidental expenses (as defined in current law) would be excludable.

The special rules concerning performance of future services as a Federal employee and compensation for services required of all degree candidates would be repealed.

### Effective Date

The proposal generally would be effective with respect to scholarships and fellowships received on or after January 1, 1986. However, if a binding commitment to grant a scholarship in the case of a degree candidate was made before January 1, 1986, amounts received pursuant to such commitment would be excludable under the current-law rules through the end of 1990.

### Analysis

The proposal generally would tax scholarships and fellowship grants in the same manner as other income. For degree candidates, amounts granted to cover room and board or other living expenses would be taxable. Students receiving scholarships that were used for tuition and fees would not be liable for tax by reason of the award. Moreover, even students receiving scholarship amounts for expenses other than tuition and fees would not pay tax as a result of the award where the student's total income is less than the sum of the zero bracket amount and the personal exemption (\$4,800 if single, and \$7,800 for a married couple filing jointly).

## REPEAL EXCLUSION FOR PRIZES AND AWARDS

### General Explanation

#### Chapter 3.16

##### Current Law

In general, the amount of a prize or award is includible in income on the same basis as other receipts of cash or valuable property. Current law provides an exception to this general rule, however, for prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. To qualify for this exclusion, the recipient of the prize or award must be selected without any action on his or her part to enter the contest or proceeding, and must not be required to render substantial future services as a condition of receiving the prize or award.

##### Reasons for Change

Prizes or awards increase an individual's ability to pay tax the same as any other receipt that increases an individual's economic wealth. In effect, the failure to tax all prizes and awards creates a program of matching grants under which certain prizes or awards also bestow the government-funded benefit of tax relief. Basing this program in the tax code permits it to escape public and legislative scrutiny and causes benefits to be distributed not according to merit but to the amount of the tax the individual would otherwise owe.

##### Proposal

The amount of any prize or award received by a taxpayer would be fully includible in income, regardless of whether for religious, charitable, scientific, educational, artistic, literary, or civic achievement. The rule of current law would continue to apply, however, to the extent that the individual recipient of a prize or award designated that such prize or award go to a tax-exempt charitable organization.

##### Effective Date

The proposal would be effective for prizes and awards received on or after January 1, 1986.

##### Analysis

Repeal of the exclusion for certain prizes and awards will affect the tax liability of only a few taxpayers, but it will reduce the complexity of the tax laws and preclude attempts to characterize income as a tax-exempt award.