AAU endorses the exclusion from gross income all funds used for qualified higher education expenses that are received in the form of scholarships, fellowships, and grants. This is consistent with the favorable tax treatment given to other forms of Federal educational assistance. Until 1986, scholarship, fellowship, and grant funds used for higher education related room and board expenses received tax-free treatment, but the 1986 tax bill narrowed this exclusion.

**Background**

Currently, under section 117 of the Internal Revenue Code (Code), only the portion of funds received in the form of a scholarship, fellowship, or grant that is used for the payment of tuition and required fees, books, supplies, and equipment is excluded from gross income and thereby is not subject to taxation if the recipient is a candidate for a degree at a primary, secondary, or post-secondary educational institution. Scholarship, fellowship, or grant funds used for living expenses, including room and board, are not excludable from income and are therefore subject to taxation.

This unfavorable tax treatment applies to all forms of grant assistance, including Federal Pell Grants and fellowships for graduate students provided by the National Institutes of Health and the National Science Foundation.

**Need for Fair and Consistent Treatment of Living Expenses**

Other forms of Federal educational assistance already provide favorable tax treatment for qualified higher education expenses, including limited living expenses, such as room and board. These amounts are capped at amounts set by the Department of Education. For example:

1. Amounts withdrawn from a Coverdell education savings account under section 530 of the Code receive favorable tax treatment if the distributions do not exceed the amount spent on "qualified higher education expenses."

2. Withdrawals from a qualified tuition program under section 529 of the Code receive favorable tax treatment if used for "qualified higher education expenses."

3. Section 108 of the Code provides that gross income does not include student loan indebtedness that is forgiven, provided that the forgiveness is contingent on the student working for a certain period of time in certain professions. Student loans proceeds eligible for this treatment may be used not only for tuition and required fees, but also to cover room and board expenses.

---

1 Under IRC Sections 529 and 530, the amount of room and board expenses treated as "qualified higher education expenses" may not exceed the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965 (20 U.S.C. 1087ll), as in effect on the date of enactment of the Economic Growth and Tax Relief Reconciliation Act (P.L. 107-16) (June 7, 2001).
Under each of these provisions of the Internal Revenue Code, favorable tax treatment is provided to amounts used for living expenses, such as room and board. As previously noted, this does not apply to scholarships and fellowships under section 117. This uneven treatment imposes an additional tax on certain students based on the form of education assistance received. In addition, this treatment creates unneeded complexity and administrative burdens on schools and students and undermines the policy and goals of student aid.

**Proposed Solution**

The simplest and most effective way to address this issue would be to redefine “qualified educational expenses” in 26 USC 117 to cover the entire “cost of attendance” defined in Title IV of the Higher Education Act (20 USC 1087LL), and could be accomplished by cross-referencing section 117 and 529 of the Code. This definition of educational expenses already applies to other educational provisions in the Code (most notably to distributions from section 529 plans), and this would further harmonize and simplify the tax code with respect to the treatment of monies used for educational expenses.

This proposed solution would: 1) benefit low-income students by taking many students off the tax rolls; 2) simplify the tax treatment of scholarships, fellowships and grants by conforming the definition of "qualified higher education expenses" to the same definition used for Coverdell education savings accounts and qualified state tuition programs; and 3) eliminate unnecessary administrative burdens imposed on schools, students and the IRS, including the need for certain information reporting, such as the filing of Forms 1099 and W-2 for small amounts.