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Is My Child's College Scholarship Taxable??

It depends! If a scholarship is used to pay for tuition, fees, books, supplies, or equipment required for admission, then it's not taxable. But if it's used to cover incidental expenses like room and board, travel, or optional equipment, or if it's awarded as payment for teaching or research, then it's taxable.

Generally, if a scholarship is taxable and needs to be reported on your tax return, you will include the amount on the same line as "Wages, salaries, tips, etc." Fortunately, most scholarships let the recipient decide how to apply the money. However, there's one thing to consider here: if you use a scholarship to cover tuition, fees, books, or required equipment--making the scholarship tax free--you can't use those same expenses to qualify for the American Opportunity tax credit.

That's because the credit applies only to tuition and fees paid with after-tax funds--tuition and fees paid with tax-free funds like scholarships or 529 plan funds won't count.

The American Opportunity Tax Credit—available for each of the first four years of a student's college education--is worth up to \$2,500 per year and is calculated as 100% of the first \$2,000 in tuition and fees plus 25% of the next \$2,000 in tuition and fees. Your modified adjusted gross income must be below a certain level to get the full credit: \$160,000 for married couples filing jointly and \$80,000 for single filers.

If your child gets a scholarship and you qualify for the credit, you'll want to run some numbers to decide whether it's best to:

- Apply the scholarship to tuition and fees, making it tax free, but also disqualifying those same tuition and fees from counting toward the credit.

OR

- Apply the scholarship to incidental college expenses like room and board, making it taxable, but allowing the full amount of tuition and fees to count toward the credit.

In making this determination, keep in mind that a tax credit is generally more valuable than a tax deduction because a tax credit reduces any taxes owed dollar for dollar. For more information on the tax treatment of scholarships and the American Opportunity tax credit, refer to IRS Publication 970, Tax Benefits for Education.