



TAX MATTERS

Types of ‘free money’ for school – and the taxman’s view

TIM CESTNICK

Special to The Globe and Mail

Published Thursday, Sep. 01, 2016 4:36PM EDT

Last updated Thursday, Sep. 01, 2016 6:09PM EDT

Our youngest son, Michael, will be entering eighth grade this year. I told him the [story of Michael Avery](#) who, in eighth grade, received a full scholarship to the University of Kentucky for basketball, which was to begin after his high-school graduation. I didn’t want to pressure our son, but I did ask him when I could expect a call from an Ivy League school offering him a scholarship. “Dad, I don’t play basketball very well,” he said. “But son, no one at your age can play the bagpipes like you can; we’ve spent a lot of money on those lessons.” I encouraged him that a scholarship could be on the horizon.

When it comes to paying for an education, there are five strategies you can use: [Begging, borrowing, stealing, sweating and saving](#). “Begging” is the idea of finding free money to help cover the cost of an education. This free money can include scholarships, fellowships, bursaries, prizes and grants. Let’s look at how the taxman treats these payments.

Types of free money

A scholarship is an amount given to a student based on merit, not need. A student might be entitled to a scholarship for high academic, artistic or athletic achievement, for example. Scholarships are “free money” because they don’t have to be repaid. This can be contrasted to a bursary that is usually offered to a student with a financial need. There can be academic requirements attached to bursaries as well, but they are most commonly offered to students who don’t have the financial resources to pay for school on their own. The greater the financial need, the higher the bursary can be.

Next are fellowships. A fellowship is also free money and typically refers to an amount paid for the purpose of advancing a person’s education – so it’s similar to a scholarship or bursary, but is generally given to a graduate student by a university, charity or similar organization for doctoral studies or post-doctoral work.

Then, there are prizes. These are typically awarded to someone from a group of potential recipients and given for something that is accomplished, attained or carried out successfully. A prize is awarded for success in an area in which the recipient regularly applies effort. Successful Olympic athletes often receive prizes from sponsors.

Finally, there are research grants. These grants are generally given to allow the individual to pay the expenses necessary to carry out research on a project. The grant might also include some element of remuneration to the recipient.

Taxation of free money

Just because an amount is given without expectation of repayment doesn’t mean that it’s tax-free. The tax treatment of a particular amount doesn’t depend on the label affixed to it, but on its true nature. You’ve got to figure out whether an amount should properly be characterized as a scholarship, bursary, fellowship, prize, research grant or some other amount such as employment income, business income or something else.

As a general rule, any payment that is provided in exchange for services rendered is likely taxable as employment or business income. Research grants are similar to these taxable amounts in that you'll have to report research grants as income, but can deduct from this the specific expenses incurred in the research undertaken. The result is that you'll face tax on the research grants net of the research expenses incurred.

The taxation of scholarships, bursaries, fellowships and prizes can be the most tax-efficient of the payments I've talked about. Our tax law does include these amounts in the income of the recipient, but the first \$500 is tax-free. Even better, the balance of the payments received may also be eligible for an exemption. Basically, the balance of the amount received will be exempt from tax if the student enrolls in certain educational programs (most common programs will qualify) or the amount is used in the production of a literary, dramatic, musical or artistic work. The amount of your exemption cannot be greater than the total of the scholarships, bursaries, fellowships and prizes that you have to include in your income (so, you can't create a loss on your tax return using this exemption rule).

As an aside, payments out of a registered education savings plan (RESP) are not considered to be scholarships, bursaries, fellowships or prizes, and so cannot be fully exempt from tax.

More about free money

Visit the taxman's website at cra.gc.ca and look up Income Tax Folio S1-F2-C3, Scholarships, Research Grants and Other Education Assistance for the taxman's view of these things.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author and founder of WaterStreet Family Offices.