

LB&I International Practice Service Concept Unit

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Unit Name	Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien
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Table of Contents

(View this PowerPoint in “Presentation View” to click on the links below)

[General Overview](#)

[Relevant Key Factors](#)

[Detailed Explanation of the Concept](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Issues](#)

General Overview

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

In general, a Nonresident Alien (NRA) engaged in a U.S. trade or business (USTB) is taxable on effectively connected income (ECI) from that business. See IRC § 871(b)(1).

IRC § 871(c) provides that an NRA who is not engaged in a U.S. trade or business, but who is temporarily in the United States on an F, J, M or Q visa is treated as engaged in a U.S. trade or business. U.S. sourced scholarship and fellowship grant income derived by such individual is treated as ECI from the conduct of a U.S. trade or business. See IRC § 871(c) and IRC § 1441(b). Regardless of the name, the taxability of U.S. sourced scholarships or fellowship grants depends on the character and purpose of the payments.

Generally, U.S. source income in the form of a scholarship or fellowship grant may be treated in whole, or in part, in one of three ways:

- (1) Excludable under IRC § 117,
- (2) Exempt by an applicable income tax treaty, or
- (3) Taxable income subject to 14% withholding for an NRA with an F, J, M or Q visa under IRC § 1441(a), (b) or 30% withholding under IRC § 1441(a) and reported on a Form 1042-S.

This Concept Unit will focus on the U.S. taxation of scholarships and fellowship grants received by NRA students and trainees and includes a discussion on the income exclusion for “qualified scholarships” under IRC § 117 and income tax treaty exemptions.

Relevant Key Factors

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Key Factors

In determining whether a scholarship or fellowship grant payment to an NRA student or trainee is subject to U.S. income tax, the following factors should be considered:

- **Residency.** Determine whether an NRA individual is a resident of a treaty country and therefore eligible for treaty benefits that would exempt his or her scholarship or fellowship payments from U.S. income tax and U.S. withholding and reporting requirements.
- **Student/Trainee or Teacher/Researcher.** An NRA individual's status as either a student/trainee or a teacher/researcher will determine whether the individual may claim treaty benefits under the student/trainee article.
- **Source Rules for Scholarships and Fellowship Grants.** Scholarships and fellowship grants or award payments are sourced to the country of the grantor's residence (Rev. Rul. 89-67, 1989-1 C.B. 233) .

Exception: Grants for study or research activities performed outside of the United States are treated as foreign source. This rule does not apply to amounts paid as salary or compensation for services. See Treas. Reg. § 1.863-1(d)(2)(iii).

Detailed Explanation of the Concept

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Taxation Under the Internal Revenue Code

Analysis	Resources
<p>For an NRA, a scholarship or fellowship grant is taxable if it is determined to be U.S. source income and it does not qualify for an exclusion under IRC § 117 or an exemption under an applicable income tax treaty.</p> <p>A Scholarship is generally defined as an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his or her studies.</p> <p>A Fellowship Grant is generally defined as an amount paid or allowed to, or for the benefit of, an individual to aid him or her in the pursuit of study or research.</p> <p>To determine whether a payment is a scholarship or fellowship, the payment is broken into different component payments (tuition, fees, books, room/board, travel, etc.), with each component payment analyzed separately.</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.117-3(a)▪ Treas. Reg. 1.117-3(c)

Detailed Explanation of the Concept (cont'd)

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Taxation Under the Internal Revenue Code

Analysis	Resources
<p>A payment will be excluded under IRC § 117 if:</p> <ol style="list-style-type: none"> (1) The payment is a qualified scholarship, (2) The recipient is a candidate for a degree, and (3) The payment is for the purpose of conducting study or research at an educational organization. <p>(1) A qualified scholarship is a payment for either (i) tuition and fees required for enrollment or attendance at the educational institution, or (ii) books, supplies or equipment required for a course of instruction. Incidental expenses, such as room and board, travel, research, clerical help and equipment, do not qualify. Payments for teaching, research or other services by the student required for receiving scholarship do not qualify.</p> <p>(2) A candidate for degree is an individual who is enrolled in a degree-seeking program and includes a student who is not seeking a degree so long as the educational institution where the student is enrolled offers degrees and is properly accredited.</p> <p>(3) An educational organization is an organization described in IRC § 170(b)(1)(A)(ii) that has as its primary function the presentation of formal instruction, normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students.</p>	<ul style="list-style-type: none"> ▪ IRC 117(a) ▪ IRC 117(b) ▪ Treas. Reg. 1.117-3(e) ▪ Treas. Reg. 1.117-3(b)

Detailed Explanation of the Concept (cont'd)

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien


Taxation Under the Internal Revenue Code

Analysis	Resources
<p>If a payment meets all three tests, then the payment is excludable from the recipient's gross income and need not be reported on a Form 1042-S or Form 1040/1040NR.</p> <p>Non-Qualified scholarship and fellowship grant payments: Any portion of scholarship or fellowship grant payments that do not meet the exclusion criteria is taxable unless exempt under an applicable income tax treaty. The taxable portion of scholarships or fellowships is subject to a withholding tax of 30% or 14% under IRC § 1441.</p> <p>Example: "Non-qualified" scholarship & fellowship grant payments may include payments for room and board (housing and meals), medical, stipends, thesis support, travel, cash, as well as non-required fees, books, supplies and equipment.</p>	<ul style="list-style-type: none">▪ IRS Notice 87-31

Detailed Explanation of the Concept (cont'd)

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Tax Treaty Exemptions

Analysis	Resources
<p>A scholarship or fellowship grant that does not meet the requirements of IRC § 117 may be exempt from U.S. income tax if paid to an NRA who is a resident of a country that has an income tax treaty with the United States. Many U.S. income tax treaties provide a U.S. income tax exemption for scholarships and fellowships grants paid to NRA students and trainees.</p> <p>Eligibility for an exemption depends on many factors including but not limited to:</p> <ul style="list-style-type: none">▪ The individual's country of tax residence,▪ The primary purpose of the individual's visit,▪ Previous visits to the United States, time and dollar limits set forth in the treaty, and▪ Any retroactive or prospective loss provisions. <p> CAUTION: This explanation is intended to illustrate commonly encountered income tax treaty issues for scholarships and fellowship grants. The availability of an exemption will depend upon each treaty. Consult the specific income tax treaty and the Treasury Department's Technical Explanation (if available).</p>	<ul style="list-style-type: none">▪ Publication 901, U.S. Tax Treaties

Detailed Explanation of the Concept (cont'd)

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Tax Treaty Exemptions

Analysis	Resources
<p>To be eligible for the scholarship or fellowship grant exemption under a treaty, the following factors should be considered:</p> <ol style="list-style-type: none"><li data-bbox="89 675 1295 746">(1) The NRA's residence for purposes of the treaty. Generally, the NRA must be a tax resident of the treaty country immediately before entering the United States.<li data-bbox="89 789 1398 896">(2) The NRA's classification as student or teacher/researcher. The NRA's status as a student as opposed to a teacher/researcher will determine the applicable treaty article. The primary purpose of the individual's visit is the determining factor.	<ul style="list-style-type: none"><li data-bbox="1425 561 1933 589">▪ Publication 901, U.S. Tax Treaties

Detailed Explanation of the Concept (cont'd)

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Tax Treaty Exemptions

Analysis	Resources
<p>There are generally two types of articles in U.S. income tax treaties that exempt scholarship and fellowship grant payments:</p> <p>(1) The treaty article only exempts payments received by the NRA student from outside the United States. There is no U.S. tax benefit because the United States already treats such payments as nontaxable foreign source income since the source of the income is determined by the grantor's residence. For example, the U.S.-Japan Tax Treaty Article 19 only exempts payments from Japan. Any payments received from inside the United States would not be subject to Article 19 and the tax treatment is determined under the Code.</p> <p>(2) The treaty article exempts payments received by qualifying NRA students regardless of source, which may include grants for tuition and related expenses that are also exempt under IRC § 117 as well as grants for other expenses. In some cases, these treaty provisions only apply for a limited period of time, such as five years, while in other cases the exemption can extend for a reasonable period of time to allow the NRA student to finish his or her studies. Additionally, the treaty article provides a tax exemption for a specified amount of personal services income. For example, the U.S.-Republic of Korea Tax Treaty, Article 21 applies to payments from U.S. source.</p> <p>Generally, the treaty terms for "grant," "award," "allowance" or other similar payments includes scholarship and fellowship grants to the extent they do not represent payments for personal services.</p>	<ul style="list-style-type: none"> ▪ U.S. Model Treaty Art. 20 (Nov.15, 2006) ▪ U.S. – Japan Income Tax Convention. Art. 19 (Nov. 6, 2003) ▪ U.S. – Republic of Korea Income Tax Convention, Art. 21, (June 4, 1976)

Detailed Explanation of the Concept (cont'd)

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Tax Withholding and Reporting

Analysis	Resources
<p>A scholarship or fellowship grant received for any purpose other than tuition, fees, books, supplies and equipment is usually taxable unless an applicable income tax treaty provides an exemption. For an NRA, this taxable portion would be reported on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding with income code 16, "Scholarship or Fellowship Grants," on item 1 of the form.</p> <p>A scholarship or fellowship grant received with the condition that the individual receiving the money performs a service, such as teaching or research, is treated as wages (i.e., compensation for services). The taxable portion of wages is reported on a Form W-2, and the amount exempt by a tax treaty is reported on Form 1042-S, using income code 19, Compensation for Teaching, or income code 20, Compensation for Studying and Training, on item 1 of the form.</p> <p>If the scholarship or fellowship grant is exempt from withholding under applicable treaty provisions, the NRA would need to complete the following additional forms:</p> <ul style="list-style-type: none"> ▪ For non-compensatory scholarship and fellowship grant payments – Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals). ▪ For compensation income paid in addition to a non-compensatory scholarship or fellowship grants – Form 8233, Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual. 	<ul style="list-style-type: none"> ▪ 2014 Form 1042-S ▪ 2014 Form W-8BEN ▪ 2014 Form 8233

Detailed Explanation of the Concept (cont'd)

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien


Tax Withholding and Reporting

Analysis	Resources
<p>An NRA who receives a Form 1042-S, which reports both taxable and nontaxable components of his or her scholarship and/or fellowship grants, is required to file a Form 1040NR or 1040NR-EZ. The return is required for an NRA with F, J, M, or Q visa status even if the payment is exempt under a tax treaty or does not exceed the personal exemption amount.</p> <p>The NRA should include the total taxable and nontaxable components of his or her scholarships and/or fellowship grants as reported on a Form 1042-S on line 12 of Form 1040NR or on line 5 of Form 1040NR-EZ. He or she should then enter the non-taxable portion as reported on the Form 1042-S on line 31 of Form 1040NR or on line 8 of Form 1040NR-EZ. Thus, only the NRA's net taxable scholarship or fellowship grant income will be included in his or her Adjusted Gross Income (AGI) on line 36 of Form 1040NR or on line 10 of Form 1040NR-EZ.</p> <p>If the NRA is a resident of a country that has an income tax treaty with the United States that provides a tax exemption for scholarships or fellowship grants, he or she should report the amount that is exempt under the treaty on line 22 of Form 1040NR or on line 6 of Form 1040NR-EZ. This will ensure that his or her exempt scholarship or fellowship grant income will not be included in his or her AGI and will not be taxed.</p>	<ul style="list-style-type: none">▪ 2014 Form 1040NR and Form 1040NR-EZ instructions▪ Publication 901, U.S. Tax Treaties

Detailed Explanation of the Concept (cont'd)

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Tax Withholding and Reporting

Analysis	Resources
<p>Deductions allowable:</p> <p>An NRA may deduct business expenses under certain conditions. Rev. Rul. 70-614 held that an NRA, who is in the United States and receives a scholarship or fellowship grant, is by virtue of IRC § 871(c) treated as being engaged in a USTB. An NRA holder of an F, J, M or Q visa in the United States may deduct business expenses, including travel expenses, while away from his or her tax home in the United States.</p> <p>The NRA must claim the deductions on Schedule A of the Form 1040NR and file Form 2106 or Form 2106-EZ.</p> <p> CAUTION: Such an NRA may deduct only those business expenses attributable to the taxable portion of the scholarship or fellowship Grant.</p>	<ul style="list-style-type: none">▪ IRC 871(c)▪ Rev. Rul. 70-614▪ 2014 Instructions for Form 1040NR▪ 2014 Instructions for Form 2106

Training and Additional Resources

Taxation of Scholarships and Fellowship Grants Paid to a Nonresident Alien

Type of Resource	Descriptions and/or Instructions for Accessing	References
Centra sessions	<ul style="list-style-type: none"> ▪ Network Event: Tax Residency of Foreign Students and Scholars (January 28, 2014) ▪ Network Event: Tax Residency of Foreign Students and Scholars – A Deeper Dive (July 15, 2014) ▪ Network Event: NRA Taxation of Scholarships and Fellowships (August 25, 2014) 	<ul style="list-style-type: none"> ▪ Centra
Issue Toolkits	<ul style="list-style-type: none"> ▪ Treaty / Visa Tool (to be updated) 	<ul style="list-style-type: none"> ▪ U.S. Business Activities IPN homepage
Databases / Research Tools	<ul style="list-style-type: none"> ▪ <i>BNA Tax Management Portfolios 914-2nd: U.S. Income Taxation of Foreign Students, Teachers and Researchers</i> 	<ul style="list-style-type: none"> ▪ Westlaw

Glossary of Terms and Acronyms

Term/Acronym	Definition
AGI	Adjusted Gross Income
ECI	Effectively Connected Income
FDAP	Fixed or Determinable Annual or Periodical
NRA	Nonresident Alien
USTB	U.S. Trade or Business

Index of Related Issues

Issue	Associated UILs	References
Substantial Presence Test	▪ 9431.01-03	▪ Practice Unit, “Substantial Presence Test,” DCN: JTO/9431.01_03(2013)
Effectively Connected Income	▪ 9441.02-01	▪ Practice Unit, “Effectively Connected Income,” DCN: USB/CU/P_14.2_01(2014)
Overview of FDAP	▪ 9442.01-01	▪ Practice Unit, “Overview of FDAP,” DCN: JTO/9431.01_02(2013)IPS Unit – DCN: WIT/CU/P_15.1_01(2014)