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ADMINISTRATIVE MEMORANDUM No. 133

DATE: March 15, 2004

TO: Deans
Department Heads
Business Administrators

FROM: Howard E. Jackson
Vice President for Research
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Dale L. McGirr
Vice President for Finance
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Thomas Guerin
Associate Vice President for Administrative & Business Services

RE: Classification & Processing of Scholarship/Fellowship Aid to Students

As a follow-up to our most recent IRS audit, we have investigated compliance questions that have arisen regarding classification and reporting of scholarships, fellowships, and payments to students that are often referred to as "stipends". It was determined that UC was not in compliance with IRS and U.S. Department of Education financial aid regulations (see background and rationale detailed below). As a result, the use of PAF's (Personnel Action Forms) and payroll checks to pay scholarships and fellowships will end on June 30, 2004. Departments should immediately take the necessary steps to begin processing these payments through the student information system (UniverSIS) via the E-160 process.

BACKGROUND & RATIONALE

The three areas of concern relate to:

1. Taxation & Reporting: is the payment taxable income to the recipient? If so, reporting issues.
2. Accounting: to which types of accounts should the payment be charged?
3. Processing: which method of processing is appropriate, E-160 (UniverSIS) or PAF (HRMS)?

The central question to each point is the same – Is the student required to perform services for the university as a condition of receiving the award? Once this question is answered the accounting, processing, and taxation/reporting issues become clearer. Further guidance can be found in the "Principles of Good Practice", methods for offering state-supported financial assistance to graduate students, (01.1.23.07) adopted and approved by the University Board of Trustees on January 23, 2001.

TAXATION & REPORTING

If a student is expected to perform services for the university, as a condition of receiving a payment, the payment is taxable to the student as compensation. Terms used to describe a payment, such as stipend, fellowship, scholarship, etc., do not alter the nature of the payment as compensation for services rendered. The university is required to withhold taxes from payments classified as compensation and report the compensation paid and taxes withheld on Form W-2 each year.

When no services are provided, and payments are based solely on academic merit or financial need, then payments are considered scholarship/fellowship income under Internal Revenue Code (IRC) Section 117. Qualified scholarship payments are not taxable to the recipient provided they are used for tuition, course related fees, books, supplies, and equipment. Nonqualified scholarships must generally be self-reported by the student taxpayer. Scholarship distributions/payments are not reportable by the university except for nonqualified amounts issued to nonresident alien individuals.

ACCOUNTING

Determining whether a payment constitutes scholarship/fellowship income or wages (compensation for services rendered) cannot be based on the source of funds available. Scholarship accounts should be charged when payments are determined to be scholarships, and salary accounts used when payments constitute compensation for services rendered. As stewards of University funds – sponsored, gift, endowment, etc. – great care should be taken to ensure that the purpose of the fund/account is honored. Questions concerning the proper use of sponsored accounts should be referred to the Office of Sponsored Programs or Sponsored Program Accounting.

PROCESSING

The payroll process has historically been used to pay certain scholarships or fellowships to students whenever monthly distribution is deemed appropriate. The use of our payroll system for this purpose raises serious tax and financial aid compliance issues. By processing scholarships and fellowships in UniverSIS we can take advantage of established processes that will ensure our compliance. Currently UC is not in compliance with two key areas which could have devastating consequences if they are not addressed in a timely manner:

First, scholarships and fellowships are, by definition, financial aid. Federal Title IV regulations require the university to monitor and approve financial aid awards so that they are within guidelines established by the Department of Education. Processing fellowships in the payroll system circumvents the financial aid system (Financier) which in turn could award total aid in excess of the allowed "cost of education" limit.

Secondly, at the end of each calendar year the university is required to provide IRS Form 1098-T to all payers of qualified educational expenses. This statement summarizes payments made on behalf of a student throughout the calendar year. The program that generates these reports uses UniverSIS data. Once again, using the payroll process circumvents the process used to compile the data thereby underreporting aid students received.

Since UniverSIS already has an established interface with Financier, by processing scholarships and fellowships entirely in UniverSIS via the E-160 process we will be in compliance.

If a payment is made in return for any service (teaching, research, administrative, or clerical) rendered by the student, the payment constitutes compensation and **must** be processed through payroll via the Personnel Action Form (PAF). If the payment is based solely on academic merit or financial need, and no services are rendered in return, then it satisfies the definition of a scholarship or fellowship under Section 117 IRC, and should in all cases be paid through UniverSIS via the E-160 process.

Effective July 1, 2004 only compensation for services rendered will be paid through payroll. All applicable taxes and deductions will be withheld and reported. Recipients will receive a Form W-2 summarizing their annual wages and deductions. Additionally, all scholarships/fellowships payments must be processed via the E-160 process in UniverSIS. Departments failing to follow this policy will be assessed any additional taxes, interest and/or penalties that result from an audit finding.

A few things regarding UniverSIS and the E-160 process departments should be aware of:

- Payments to students follow the academic quarter in accordance with Student Accounts expense check procedure which currently limits the disbursed amount to \$700 through the third week of classes. The remaining balance is paid during the 4th week.
- Students must be enrolled for a minimum of 1 credit hour to receive any scholarship/fellowship for a term. A scholarship/fellowship may have *other enrollment requirements*; however, UniverSIS will not distribute aid if the student is not enrolled.
- Scholarships should be set-up in UniverSIS as restricted aid (low priority number). Common items that scholarships are restricted to include instructional fee, general fee, health insurance, ITIE Fee, etc.
- Fellowships should be set-up in UniverSIS as un-restricted aid (high priority number). This means that once all fees are paid any credit balance will be paid to the student in the form of an expense check.