Recent Decisions: Internal Revenue--Income Tax--Scholarships Excludable from Gross Income


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Counsel asked for jury trials in light of Duncan and Bloom, and New York State Supreme Court Judge McCaffrey ordered the Manhattan District Attorney to show cause why jury trial should not be granted. A most significant advantage has accrued to the accused once he has asked for a jury trial since the burden of proof is now upon the state to show cause why the jury trial should not be granted.

Although the Court has not expressly defined "serious" crime and has left unresolved the question of whether the ancillary rights to a 12-man jury and a unanimous verdict are to apply to the states, the Bloom decision has achieved a desirable result in overturning the doctrine of summary trials in criminal contempt proceedings.

LAWRENCE B. LITWIN

INTERNAL REVENUE — INCOME TAX — SCHOLARSHIPS EXCLUDABLE FROM GROSS INCOME


The tax treatment to be afforded scholarship and fellowship grants paid by employers to their employees has perplexed the courts and the federal taxpayers. The general rule excluding such grants from the recipient’s gross income under section 117 of the Internal Revenue Code of 1954 has been subjected to three conditions. Code section 117(b)(1) provides that amounts received by a degree candidate for part-time employment may not be excluded unless all recipients must perform similar work. The Treasury regulations further provide that amounts received which represent either compensation for past, present, or future services, or which subsidize research primarily for the benefit of the grantor similarly may not be excluded from the grantee’s gross income. The recent case of Johnson v. Bingler, however, has indicated that the only qualification in excluding scholarship and fellowship grants under section 117 is the limitation imposed by section 117(b)(2) of the Code, and that section’s applicability is to be determined by the court as a matter of law.

33 N.Y. Times, Aug. 30, 1968, at 26, col. 4 (city ed.).
The taxpayer-plaintiffs in *Johnson* filed an action against the District Director of Internal Revenue for refund of income taxes withheld from a monthly living allowance paid to them by their employer, the Westinghouse Corporation. They alleged that the payments constituted fellowship grants within the purview of section 117 and were excludable from gross income. To support their claim, they contended that they had been full-time students, conforming to all university requirements prerequisite to obtaining their degrees, and that the grantor corporation had not directly influenced their academic endeavors. The Commissioner, however, argued that the grants constituted compensation for past, present, or future services, or were grants to support research primarily for the grantor. In deciding that the grants were not includable as gross income, the court indicated that the legislative purpose of section 117, to encourage financial aid, was determinative.

Attempting to have the grants characterized as income, the

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2 Int. Rev. Code of 1954, § 117(a) [hereinafter cited as Code] provides:
   In the case of an individual, gross income does not include —
   (1) Any amount received —
      (A) as a scholarship at an educational institution....
      (B) as a fellowship grant, including the value of contributed services and accommodations;
   (2) Any amount received to cover expenses for — ....
      (B) research, ...
   which are incident to such a scholarship or to a fellowship grant, but only to the extent that the amount is so expended by the recipient.
3 In the case of an individual who is a candidate for a degree... subsection (a) shall not apply to that portion of any amount received which represents payment for... research, or other services in the nature of part-time employment... [unless all candidates for a particular degree must perform such services or research, then it] shall not be regarded as part-time employment within the meaning of this paragraph. Code § 117(b).
4 These regulations are set forth in notes 8 & 12 infra.
6 These factual tests are reminiscent of the 1939 Code criteria. The Internal Revenue Code of 1939, ch. 1, 53 Stat. 10, contained no provision for the exclusion of fellowship grants from section 22(a), gross income; consequently, to exclude these amounts from income, taxpayers had to qualify them as gifts under section 22(b) (3). For further discussion, see Mansfield, *Income from Prizes and Awards and from Scholarships and Fellowship Grants*, N.Y.U. 19th Inst. on Fed. Tax. 129, 139 (1961).
7 The legislative policy to encourage financial aid, with preference to degree candidates, is implemented by excluding those grants which are primarily for the benefit and training of the student, but to tax those grants which are otherwise. See generally H.R. Rep. No. 1337, 83d Cong., 2d Sess. 16, app. 37 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 17 (1954).
8 Generally, where it appears that the grant is quid pro quo for services or research, the grant is likely to fall within the compensation test of Treasury regulation 1.117-
Commissioner sought to apply the future compensation and primary purpose tests of the Treasury regulations, arguing first that the amount received by each participant in the program was calculated as a percentage of his base salary when in active employment and therefore was in reality a disguised salary payment;\(^9\) second, that the classification by the grantor of the payments as "indirect overhead" showed that the corporation did not treat the grants as fellowships;\(^10\) third, that the future employment contracts executed by the recipients in exchange for their grants colored the amounts as compensatory;\(^11\) and finally, that the recipients qua Westinghouse employees derived benefits which inured primarily to the corporation.\(^12\)

\(^4\)(c)(1) (1956): "[A]ny amount . . . if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor" is not an excludable scholarship or fellowship grant within section 117.

\(^9\) 396 F.2d at 261. See authorities cited notes 16 & 18 infra. In response to the government's argument the court indicated that the scholarship exclusion is not lost simply because the amounts received are based on a percentage of the employee's former salary. More important is whether the amounts are reasonable, and to whom the benefit from the educational activities accrues. 396 F.2d at 261.

\(^10\) Id. The thrust of the government's contention was that the treatment by the corporation of the grants as deductible business expenses for the purposes of section 162(a) of the Code controls their character for the purpose of section 117. The determinative consideration, however, "is not the primary purpose of the grantor in subsidizing the student, but rather the primary purpose of and the primary benefit from the subsidized study." Commissioner v. Ide, 335 F.2d 852, 855 (3d Cir. 1964). In Johnson the court found that the academic work of the grantees was primarily for their benefit. 396 F.2d at 261-62.

\(^11\) 396 F.2d 262. Cf. Stewart v. United States, 363 F.2d 355 (6th Cir. 1966); Ussery v. United States, 296 F.2d 582 (5th Cir. 1961). The government argued that future employment contracts negotiated between the grantees and the employer were further proof that the amounts received by the taxpayers were payments received in contemplation of future services. The court disagreed, pointing out that when returning to employment the grantees would still have the freedom to negotiate a new salary, commensurate with their new skills, and that they would not have to take a downward adjustment which might be related to the grants they had received. 396 F.2d at 262. Cf. Aileene Evans, 34 T.C. 720 (1960), acquiesced in 1965-1 CUM. BULL. 4 (no compensation income where grantee had entered into a future employment contract with the grantor).

\(^12\) 396 F.2d at 262-63. Treasury regulation 1.117-4(c)(2) (1956) provides: "Any amount paid or allowed to . . . an individual to enable him to pursue studies or research primarily for the benefit of the grantor . . . [except] if the . . . research is to further the education and training of the recipient in his individual capacity" is not considered to be an excludable grant. Typically, the government has prevailed under this argument where a student-employee must perform services for the grantor in order to obtain his degree; see Woddail v. Commissioner, 321 F.2d 721 (10th Cir. 1963); Rev. Rul. 57-385, 1957-2 CUM. BULL. 109; or, where he must perform services necessary for the continuing operation of the grantor organization. See Ethel M. Bonn, 34 T.C. 64 (1960); Rev. Rul. 65-117, 1965-1 CUM. BULL. 67. In some cases, the fact that the grant program entices prospective employees to accept positions may be sufficient to color the grants as primarily for the benefit of the grantor. The strongest indication of such status arises if the grant is stated to be for the purpose of the grantor. Reiffen v. United States, 376 F.2d 883 (Ct. Cl. 1967) (grant held to be primarily for the benefit
The court, however, in rejecting the Commissioner's contentions suggested that the conditions for exclusion imposed by the regulations are not legitimate indicia of compensation and instead chose to rely upon the congressional intent manifested in section 117. It reasoned that section 117 excluded in unqualified terms those grants which fell within the fellowship category, and that the only limitation to obtaining the exclusion is that imposed by section 117(b)(1). The court then dismissed the Treasury regulations' tests as contrary to the legislative intent because they purported to advance a concept (gift versus compensation) considered and intentionally rejected by the Congress which enacted the Code.

In reaching its conclusion the Johnson court refused to acknowledge the decisions of a majority of courts which have upheld the validity of the regulation 1.117-4(c) tests, and which have held grants in cases with facts analogous to those of Johnson to be ineligible for the section 117 exclusion. For example, the court in Stewart v. United States determined that the legislative purpose of section 117 related basically to the compensation test and not to the encouragement of education. Similarly, in Ussery v. United States, the Court of Appeals for the Fifth Circuit upheld the priority of the grantor where the fellowship program was organized to help the grantor maintain its competitive recruitment position among scientific laboratories. The court, in rejecting the government's contentions, argued that even though Westinghouse might obtain an indirect or secondary benefit through its scholarship program, the advantage as alleged by the government is beyond the scope of the regulation. 396 F.2d at 263.

13 396 F.2d at 260.
14 Id.; H.R. REP. NO. 1337, supra note 7, at 16. While Congress did intend to eliminate the gift versus compensation test, it further expressed the desire to exclude only those amounts which were truly scholarships and not disguised salary or compensation. It was this factor that the Johnson court did not consider, but which was considered by the courts in Stewart v. United States, 363 F.2d 355 (6th Cir. 1966), and in Ussery v. United States, 296 F.2d 582 (5th Cir. 1961), in upholding the regulations' tests as within the congressional intent. See authorities cited notes 16 & 18 infra. The Supreme Court has upheld the validity of the tests in the regulations as contemporaneous constructions of the Code by those charged with its administration. Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948) (decided under the 1939 Code but reaffirmed in Ussery v. United States, 296 F.2d 582 (5th Cir. 1961)).

16 See authorities cited notes 16 & 18 infra. In Stewart the petitioner had been employed by the grantor before and after her leave of absence, had accrued fringe benefits during her leave, and had received a monthly allowance calculated as a percentage of her salary — all of which the court held to be "indicia of compensation." Id. at 357.
17 Id. See note 14 supra.
18 296 F.2d 582 (5th Cir. 1961). In that case the court held the grant to be taxable since the recipient was a permanent employee studying in a work-related area and receiving a monthly allowance equal to his salary. Ussery, as in the case of the Johnson plaintiffs, accrued the benefits of his employment and was obligated to return to that employment at the conclusion of his studies.
mary purpose test and, after a lengthy examination of the legislative history of section 117, ascertained that the thrust of the congressional intent was to exclude the payments which are of primary benefit to the student, but not those which are compensatory or of primary benefit to the grantor. Also supporting the Commissioner's position (and contrary to the Johnson court) are numerous Revenue Rulings dealing with both analogous and diverse factual situations;\textsuperscript{19} common to these rulings is the reliance on the compensation and primary benefit tests. In the face of such adverse authority, it is difficult to anticipate whether the approach taken by the Johnson court will be adopted by other courts.\textsuperscript{20}

Regardless of the correctness of the Johnson decision, the case definitely does not help obviate the current confusion regarding which criteria are to be used in settling questions under section 117. The Ussery and Stewart courts recognized a consistency between the legislative purpose and the tests of the Treasury regulations. The Court of Claims in Reiffen v. United States\textsuperscript{21} held that, because the employee's research helped the employer maintain its competitive edge, the payments were for the primary benefit of the grantor and includable as income. While the essence of the legislative intent was ostensibly to foster support for education, it was nonetheless intended that those grants which are quid pro quo for services or research be taxed as ordinary income. Thus, the decisions of the Courts of Appeals for the Third, Fifth, and Sixth Circuits, and those of the Court of Claims, all conflict as to which tests should be ap-

\textsuperscript{19} These rulings are catalogued and summarized in 1 MERTENS, FEDERAL INCOME TAXATION § 7.42 (Supp. 1968).

\textsuperscript{20} The Tax Court in William Wells, 40 T.C. 40 (1963), and in Chander P. Bhalla, 35 T.C. 13 (1960), supported the need to acknowledge the congressional intent. However, in those cases the court declined to decide the issues solely on that criterion; instead, it also relied upon regulation 1.117-4(c) tests.


\textsuperscript{21} 376 F.2d 883 (Ct. Cl. 1967).
plied in scholarship matters. The question is ripe for review by the Supreme Court.\textsuperscript{22}

In view of its decision in \textit{Commissioner v. South Texas Lumber Co.},\textsuperscript{23} upholding the Treasury regulations as contemporaneous constructions of the \textit{Code} by those charged with its daily administration, and in light of the past extensive reliance upon the regulation 1.117-4(c) tests,\textsuperscript{24} it is arguable that the Court will reverse \textit{Johnson} on the theory that the Treasury regulations are within the purpose of section 117 and are, therefore, the valid criteria to be used in scholarship matters.

As a result of the \textit{Johnson} decision, the federal taxpayer is given no clear guidelines with which to deal in scholarship matters, the employer is provided with no hint as to how its employee fellowship programs should be administered to obtain the best tax status, and the courts have no definitive standard to apply in these matters.\textsuperscript{25} The prospective taxpayer-plaintiff can take some solace in the fact that scholarship issues are now afforded special consideration by the courts and are not treated according to the strict gift test criteria of the Internal Revenue Code of 1939. However, if the full intent of the Congress which enacted section 117 is to be given effect, individual case determinations probably are the only valid method by which the tax status of complex scholarship and fellowship grant programs can be determined.

ROGER E. BLOOMFIELD

\textsuperscript{22} Petition for certiorari has been granted. Bingler v. Johnson, 396 F.2d 258 (3d Cir.), \textit{cert. granted}, 37 U.S.L.W. 3181 (U.S. Nov. 19, 1968) (No. 473).
\textsuperscript{23} 333 U.S. 496 (1948).
\textsuperscript{24} \textit{See} notes 8 & 12 \textit{supra}.
\textsuperscript{25} One writer has proposed the following seven criteria as being determinative of fellowship grants: (1) motive, \textit{e.g.}, desire to encourage worthwhile scholarship; (2) relationship, \textit{e.g.}, absence of control over activity; (3) economic function, \textit{e.g.}, increase in knowledge; (4) and (5) status of payor and recipient, \textit{e.g.}, absence of familial status; (6) need of recipient, \textit{e.g.}, directly related to grant and its size; and (7) social value judgment, \textit{e.g.}, importance of well-trained teachers and scientists to national survival. Gordon, \textit{supra} note 20, at 144.