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TAX STATUS OF EDUCATIONAL GRANTS

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INTRODUCTION

Ladies and gentlemen, it is definitely an honor and a challenge to appear before such a distinguished group to discuss the Tax Status of Educational Grants (Scholarship and Fellowship Grants) and the current administration of Section 117 of the Internal Revenue Code. So much so, in fact, that as an administrator for Internal Revenue, I feel some compulsion to say that I am venturing into the thicket of a difficult technical area.

My subject is of current interest, particularly to those in the academic field since a well educated citizenry has aptly been described as one of our most important national interests.

I would like to discuss this topic in the light of recent court cases and revenue rulings under Section 1.117-4(c) of the regulations relating to amounts which represent compensation for past, present or future services and also amounts which subsidize studies or research primarily for the benefit of the grantor.

To set the scene for this discussion I feel that a brief resume of some of the salient features of this section of the code and regulations would be appropriate.

To begin with, Section 117(a) of the 1954 Code excludes from the gross income of an individual any amount received as a scholarship at an educational institution or as a fellowship grant including the value of contributed services and accommodations, subject to the limitations prescribed by Section 117(b).

Prior to its adoption in 1954, the matter of inclusion or exclusion of some types of scholarships and fellowships involved exactly the same interpretative difficulty as was then encountered in fixing the tax treatment of certain so-called prize awards. In other words, because of the mixed or hybrid completion of many so-called scholarships and fellowship grants, to say, as was done before 1954 that such were "gifts" under Section 102 did not provide a "clear-cut method of determining whether a grant is taxable."

One of the questions which we might consider involves the extent to which Congress was able by adopting Section 117 to fulfill its intention to resolve that interpretative difficulty so as to provide more precise guide lines. It might be well, however, at this point to review briefly the terms "Scholarship" and "Fellowship Grant." In general, a scholar-

ship is an amount paid or allowed a student to aid him in pursuing his studies which are pursued in regularly organized classes. This amount may include contributed services, board, lodging, tuition and family allowance. A fellowship grant is an amount furnished to an individual to do independent research or independent study. This amount may also include contributed services, board, lodging, tuition, and family allowance. Also, in the case of a fellowship the regular course work is incidental to the independent work.

A few moments ago I stated that Section 117(a) of the Code excluded from gross income amounts received as a scholarship at an educational institution or as a fellowship grant subject to the limitations prescribed by Section 117(b). Actually, there are two different sets of limitations; one set 117(b)(1) applies to recipients of scholarships or fellowship grants who are candidates for a degree at an educational institution and the other set 117(b)(2) applies to all other recipients.

Section 117(b)(1) provides that in the case of an individual who is a candidate for a degree at an educational institution (as defined in Section 151(e)(4), Subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or fellowship grant. If teaching, research, or other services are required of all candidates (whether or not recipients of scholarship or fellowship grants) for a particular degree as a condition to receiving such degree, then such teaching, research or other services shall not be regarded as part-time employment within the meaning of this paragraph.

The limitation reflected in this Subsection was developed to avoid any possibility of educational institutions characterizing as scholarships or fellowship grants amounts which were really in part consideration for services required to be performed by the recipient for the benefit of the institution. For example, University X might grant a scholarship to an advanced accounting major, but as a condition of the award prescribe as a part-time requirement that he must conduct two accounting labs each week for freshmen. Or, a graduate student working on a Ph.D. in English might be granted an award as a "teaching fellow," a requirement being that he conduct three classes a week for freshmen English students. In such cases, determination of the allocation is to be made in accordance with Sec. 1.117-2(a)(1) of the regulation which provides as follows: ". . . payments for such part-time employment shall be included in the gross income of the recipient in an amount determined by reference to the rate of compensation ordinarily paid for similar services performed by an individual who is not the recipient of a scholarship or fellowship grant."

But consider the case of one who is working on a master's degree in education as a prelude to a teaching career. Suppose that this recipient, as a condition of the grant, is required on a part-time basis to conduct three classes a week in the practice-teaching elementary school associated with the university. Assume, also, that all other candidates for a degree, as a condition to receiving the degree, must also perform similar practice teaching functions. In such circumstances, the university in effect has two "holds" on the recipient of the grant, but while he faces two conditions, one relating to the degree he seeks and one to the award, performance of the same function satisfies both. The last immunizing sentence of Sec. 117(b)(1) which provides that where such services are required of all candidates for a particular degree as a condition to receiving such degree, that such services shall not be regarded as part-time employment.

In the case of a taxpayer who is not a candidate for a degree, the exclusion provided by Section 117(a)(1) is conditioned by the status of the grantor (briefly, any Governmental or State Agency, an Exempt Organization, Foreign Governments and International Organizations, etc.), and is limited by Section 117(b)(2)(B) to an amount equal to \$300 times the number of months for which amounts under the grant are received during a taxable year, and no exclusion is allowable under Section 117(a)(1) to a nondegree candidate after the recipient has, as an individual who is not a candidate for a degree, been entitled to an exclusion under that Section for a period of 36 months. In other words, the 36-month exclusion is a life-time exclusion regardless of the number of grants received during the period.

Amounts received over and above the \$300 exclusion and amounts received after the 36-month exclusion period has expired are subject to tax. However, though subject to tax, they are neither wages nor income from a trade or business and, thus, are not subject to withholding, social security, or self-employment taxes. (Rev. Rul. 60-378, C.B. 1960-2, 38).

In addition to grants, amounts received to cover expenses specifically for travel, research, clerical help, or equipment incident to a scholarship or fellowship grant are also excludable to the extent that such expenses are incident to the grant. However, if only a portion of the grant is excludable, because of part-time employment limitations placed on candidates for degrees or because of the expiration of the 36-month period applicable to nondegree candidates, then only the amount received to cover expenses incident to the exempt portion is excludable. That portion of any amount received to cover expenses which is not actually expended for such expenses shall, if not returned to the grantor within the grant period, be included in the gross income of the recipient.

In an employer-employee relationship difficult problems often arise in deciding whether the payments are for employment services or whether a scholarship or fellowship grant is primarily for the benefit of the grantor.

The regulations (Section 1.117-4(c)) provide in effect that amounts received as compensation for past, present or future services and amounts received to enable the recipient to pursue studies or research primarily for the benefit of the grantor are not scholarship or fellowship grants. Amounts paid to an individual to enable him to pursue studies or research are not considered to be tax-exempt scholarship or fellowship grants if they represent compensation or payment for services even though the education or training of the individual might be advanced. Such amounts are includible in the gross income of the recipient for the years in which received under Section 61(a).

In recent years the courts have resolved a number of cases involving situations where an employer-employee relationship has been present and in so doing have held treasury regulations Section 1.117-4(c) to be valid on the ground that it is a reasonable interpretation consistent with the statutory purpose of Section 117 of the Code. In this connection, see the cases of *Paul J. Ussery*, 296 F. 2d 582; *Betty Jane Stewart*, 363 F. 2d 355; *Barney Reiffen*, 376 F. 2d 883; and *David Marks*, T.C. Memo. 1967-222.

Take for example the results reached in an earlier decision by the court in the case of *Aileene Evans*, 34 T.C. 720. This case involved a registered nurse who applied for and received a stipend from the Tennessee Department of Mental Health to enable her to attend a university program in psychiatric nursing. She agreed to perform services for the department for a limited period of time upon completion of her training. The court, in holding the stipend to be excludable, declared that any benefits the Mental Health Department or the State of Tennessee might receive in the future by virtue of petitioner's training were merely incidental. The State would naturally desire that her training be used for the benefit of its citizenry. The court concluded that the primary purpose of payment made was to enable petitioner to obtain psychiatric training in her individual capacity.

However, in a second case—that of *Betty Jane Stewart v. U.S.*, decided in the U. S. Court of Appeals for the 6th Circuit, the taxpayer received an educational grant from the Tennessee Department of Public Welfare while an employee of that department to take a year's work on a master's degree in social work at the University of Tennessee. The grant provided her with \$175 a month maintenance, plus tuition and travel expense. Plaintiff contended that the \$175 monthly payment was exempt from income tax as either a "Scholarship" or "Fellowship"

under Section 117 and relied primarily upon *Evans v. Commissioner*, (Supra.).

In the *Evans* case there was a stipend of \$160 per month while the petitioner attended the University of Tennessee in a psychiatric nursing course. The taxpayer had signed a contract with the Tennessee Department of Mental Health, undertaking to work in the field for which she was being trained for a period equivalent to the length of the training or to repay the stipend. She actually did perform the work which the contract called for.

In the *Stewart* case, the taxpayer was, in addition, an employee of the Tennessee Department of Welfare before the grant was made and returned to the same department afterwards. Also, during her educational leave, taxpayer maintained her civil service status as a member of the department. She received credit toward retirement under the department retirement program. Retirement benefits, social security, and insurance payments were withheld from her State check. The department received progress reports concerning her which were added to her permanent file.

The court held that under regulations 1.117-4(c)(1) the grant is taxable in the light of indicia of "compensation for past, present or future service." The court also stated that consideration of the facts as indicia of compensation for services is a more meaningful test than that of whether the stipend was primarily for the benefit of the grantor and observed that "obviously, in all instances where an employment relationship, past or future, is involved, there is at least some mutuality of benefits."

Following the *Stewart* case the Service published Rev. Rul. 65-146 which announced that the Service would dispose of pending cases under Sec. 117 of the Code relating to exclusions from gross income for scholarship and fellowship grants which are substantially identical on their facts to the case of *Aileene Evans v. Commissioner*, in accordance with the decisions of the Tax Court of the U. S. in that case. The ruling pointed out that the *Evans* case is distinguishable from *Ussery v. U. S.*, and *Stewart v. U. S.* in that taxpayers in these latter two cases were employees of the grantors prior to continuing their education and, thus, the stipends represented continuing salary payments.

The *Ussery* and *Reiffen* cases which we have referred to previously follow in this line of decisions favoring the Government where an employer-employee relationship is involved. *Ussery* was decided by the U. S. Court of Appeals for the Fifth Circuit and the *Reiffen* case in the U. S. Court of Claims. In *Ussery* we find facts which are comparable to those in the *Stewart* case: that is, taxpayer is an employee of the State Welfare Department and took a one-year educational leave to

pursue studies leading to a Master's degree in social work. While on leave he retained his regular salary and other employee benefits. He was required to return to work for the Welfare Department for at least one year upon completion of his studies, or to return his employer's investment in his education. The Department of Welfare stated that the purpose of educational program was to improve the training and efficiency of its personnel. The court found that Ussery's case fell squarely within the regulations denying relief under the Section 117 exclusion for payment to a taxpayer to enable him to pursue studies or research primarily for the benefit of the grantor, and that such regulations are U. S. Court of Appeals for the Fifth Circuit and the Reiffen case in the proper interpretation of the statute.

The Court's decisions in both the Reiffen and Marks cases are in accord with the prior decisions which we have discussed here, and in Reiffen the Court again held the regulations: that is, Section 1.117-4(c) (2) to be valid on the grounds that it is a reasonable interpretation consistent with the statutory purpose of Section 117 of the Code.

During recent periods the Service has issued a number of Revenue Rulings relating to items not considered as scholarship or fellowship grants under the criteria of Section 1.117-4(c) of the regulations. These rulings relate primarily to various teacher-intern or employer-employee relationships and while time does not permit a detailed analysis of each, they include the following:

Rev. Rul. 67-212, C.B. 1967—Amounts received by teachers, supervisors and administrators from a local board of education for participating in workshops to assist the local educational agency in educating children of low income families.

Rev. Rul. 67-443, C.B. 1967—Teaching interns hired by a local board of education to provide teaching services, and who secure a monthly salary equal to the amount paid a beginning teacher.

Rev. Rul. 68-146, I.R.B. 1968-16, 7—Stipends and dependency allowances received by college faculty members who are awarded national teaching fellowships.

Rev. Rul. 68-312, I.R.B. 1968-25, 7—Amounts received by participants of the national teacher corps during their pre-service training and in-service period which prepare them to perform service in the grantor's programs are taxable to recipient.

However, additional amounts paid by the Office of Education to colleges and universities on behalf of teacher-interns pursuing their studies leading to advanced degrees are made for the primary purpose of furthering their education and training in their individual capacity and do not represent compensation for services. Therefore, these amounts are excludable from gross income.

Rev. Rul. 68-520, I.R.B. 1968-41, 8—Amounts paid to interns

and resident physicians by a hospital operated in conjunction with a state medical school are compensation for services and not excludable from gross income.

Let us now turn our attention to a final and most recent case in this line of employer-employee grants, *Richard E. Johnson, et ux., et al. v. John H. Bingle, 68-1 USTC 9414*. This case was decided for the taxpayer by the U. S. Court of Appeals for the Third Circuit on June 5, 1968, and the Government's petition for certiorari has recently been granted by the Supreme Court of the U. S. Therefore, the holding of the Third Circuit is not controlling pending a decision by the Supreme Court.

The Circuit Court held that the stipends received by three (3) Westinghouse Corporation employees studying for Ph.D. degrees while on educational leave from their employment to be tax-free scholarships. Additionally, to reach this result the court rejected regulation Section 1.117-4(c)(1) and (2) which would subject to tax any stipend for study or research that represent either compensation for services or subsidize studies for research primarily for the benefit of the grantor. The essential facts in the Johnson case are that the taxpayers were employees of Westinghouse at the Bettis Atomic Power Laboratory, a facility owned by the Atomic Energy Commission and operated by Westinghouse under a "cost plus" type contract. Pursuant to the Westinghouse Bettis fellowship and doctoral programs which made educational grants subject to approval of the Atomic Energy Commission, taxpayers were granted leaves of absence to obtain Ph.D. degrees in mechanical or metallurgical engineering at the Carnegie Institute of Technology or the University of Pittsburgh. The stated purpose of the program was to aid in meeting the needs of Westinghouse for key professional personnel. Each taxpayer was required to enter into an employment agreement obligating himself to continue in the employ of Westinghouse after the end of his educational leave for a specified period. During taxpayers' leaves of absence Westinghouse paid each taxpayer monthly stipends based on a percentage of their salaries, plus a family allowance. Westinghouse treated the leave payments as cost chargeable to an indirect labor account and withheld taxes from each stipend.

In reversing the judgment of the District Court in this case, the Third Circuit held that any reasonable stipend which comes within the common understanding of what constitutes a scholarship is paid to finance the schooling of a degree candidate and does not fall within the limitation of Section 117(b)(1) is excluded from gross income.

In reaching its conclusion the Court repudiated that portion of regulations Section 1.117-4(c)(1) which disallows an exclusion for amounts which represent "compensation for past, present or future services".

Additionally, while deeming it unnecessary to consider the validity of the "primary purpose" rule, set forth in regulations Section 1.117-4(c) (2), the Court nevertheless restricted its application by holding the "indirect advantage" derived by Westinghouse from the research pursued by the taxpayers to be "beyond the scope of the regulations."

By rejecting outright the provisions of regulations Section 1.117-4 (c)(1) and by holding the primary purpose test inapplicable in Section 117 cases, wherein no direct benefit to the employer-grantor from the recipient's research is shown, it is the government's position that the Third Circuit has created a direct conflict in whole or in part with the following decisions, all of which have either upheld the validity of regulations Section 1.117-4 (c) or have sustained lower court conclusions to that effect: *Reiffen v. United States*, 376 F. 2d 883 (Ct. Cl. 1967); *Reese v. Commissioner*, 373 F. 2d 742 (4th Cir. 1967); *Stewart v. United States*, 363 F. 2d 355 (6th Cir. 1966) *Woddail v. Commissioner*, 321 F. 2d 721 (10th Cir. 1963); *Ussery v. United States*, 296 F. 2d 582 (5th Cir. 1961).

In conclusion we might consider again our initial question whether Congress was able by adopting Section 117 to fulfill its intention to resolve the interpretive difficulty under prior law in fixing the tax treatment of scholarships and fellowship grants. If we consider this question in the light of the volume of both court decisions and administrative rulings, it is apparent that substantial questions still exist as to the proper tax treatment of an educational grant to an individual recipient.

However, the position of the service is clear. The regulations and the weight of decided cases hold that in order for the benefits of Section 117 to apply, the primary purpose of a grant or payment must be to further the education and training of the recipient rather than to compensate the recipient for services rendered or to be rendered which directly benefit the employer-grantor.