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Income Tax -- Tests under Section 117 for Exclusion of Educational Grants

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Only the failure of state law enforcement bodies to observe federal constitutional principles and the lack of faith in state court implementation of those principles are responsible for the continuing trend toward federal intervention in civil rights cases such as *Wheeler*. State enforcement agencies should be better trained and better supervised to prevent systematic unconstitutional police harassment. State courts and prosecutors both should be careful that procedural devices, such as the *nolle prosequi* with leave, are not abused where there is a lack of evidence or a desire to avoid a constitutional question. The proper forum for matters of state criminal law enforcement and state criminal statutory interpretation is in the state courts rather than in the federal district courts. But the principles of *Dombrowski* can be held to their narrowest construction by the federal courts only if the states through their law enforcement and judicial institutions provide adequate safeguards against the deprivation of constitutional rights.

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Income Tax—Tests under Section 117 for Exclusion of Educational Grants

Section 117 of the Internal Revenue Code provides for the exclusion from gross income of amounts received as scholarships or fellowships.[1] Prior to its enactment there was no specific statutory provision covering educational stipends. Instead, the inquiry was "[w]hether such grants . . . fell within the broad provision excluding from income amounts re-

significant deterrent to effective police action. For a discussion of possible limitations on 42 U.S.C. § 1983 actions and the policy considerations behind such limitations, see Note, *Limiting the Section 1983 Action in the Wake of Monroe v. Pape*, 82 HARV. L. REV. 1486 (1969).

[1] The section reads in part:

§ 117. Scholarships and fellowship grants.

(a) General rule.—In the case of an individual, gross income does not include—

(1) any amount received—

(A) as a scholarship at an educational institution (as defined in section 151(e)(4)), or

(B) as a fellowship grant,

including the value of contributed services and accommodations; and

(2) any amount received to cover expenses for—

(A) travel,

(B) research,

(C) clerical help, or

(D) equipment,

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.

ceived as 'gifts.' "[2] The intent of Congress in passing section 117 was to exclude scholarships and fellowships as a separate category of income, thereby avoiding the artificial income-gift distinction.[3] In doing so, Congress evidently hoped to prevent inconsistent ad hoc court determinations of qualifying stipends.

The Treasury Department has provided guidelines for application of the statute in a regulation defining a scholarship 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 studies."[4] In addition to satisfying this definition, the income in question must not fall within either of two categories established in section 1.117-4(c) of the Treasury Regulations. First, the exclusion is denied for any amount paid to enable an individual ". . . to pursue studies or research, 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."[5] An employment relationship between the scholar and his sponsor usually is sufficient to place the income within this category. Second, the stipend is taxed if the recipient pursues ". . . studies or research primarily for the benefit of the grantor."[6] The "primary purpose" test has been developed to determine whether the grant is covered by this language. In *Bingler v. Johnson,*[7] the Supreme Court had its first occasion to apply section 117 and to rule on the validity of the tests furnished by section 1.117-4(c) of the Treasury Regulations. In *Johnson,* a corporation offered a program in which employees were granted time from work to complete the course of study for a doctorate in a field related to the employee's work with the company. To qualify for the program, an employee was required to sign a contract obligating himself to work for the company for two years after he received his doctorate. When the course work had been

[2] Bingler v. Johnson, 394 U.S. 741, 752 (1969) (footnote omitted). *See, e.g.,* George W. Stone, 23 T.C. 254 (1954).

[3] H.R. REP. No. 1337, 83d Cong., 2d Sess. 16 (1954).

[4] Treas. Reg. § 1.117-3(a) (1956). A fellowship is an amount ". . . paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research." *Id.* § 1.117-3(c).

[5] *Id.* § 1.117-4(c)(1).

[6] *Id.* § 1.117-4(c)(2).

[7] 394 U.S. 741 (1969) (Douglas, J., dissented on the grounds of the circuit court holding). The Court of Appeals for the Third Circuit had held that the amounts received under the program were excludable. Johnson v. Bingler, 396 F.2d 258 (3d Cir. 1968). In reaching its decision that court held Treasury Regulation section 1.117-4(c) invalid as being contrary to congressional intent and an improper reading of section 117. *Id.*

completed, the employee was granted an educational leave in order to write his doctoral dissertation, the subject of which required company approval. The employee received tuition expenses, a stipend based on his current salary and number of dependents, and retained such employee benefits as seniority.

The question presented to the Court was whether a stipend paid under such an educational leave program constituted a "scholarship" excludable from income under section 117. The Court held that the amounts received under the program could not be excluded because they failed to pass the employment relationship test. In upholding section 1.117-4(c) of the Treasury Regulations, the Court approved the technique that had been used by the lower courts and the Treasury Department—application of the "primary purpose" test and the employment relationship test to decide each case on its particular facts without establishing more definite standards.

Except where part-time work is required, scholarships or fellowships have generally fallen within section 117 without having to survive such tests. But the tests have been applied to stipends paid degree candidates when more than mere class attendance is expected of them. The Code provides for the taxation of money received for ". . . teaching, research, or any services in the nature of part-time employment . . ."[8] even if the work is mandatory for scholarship recipients. If the work is required of all candidates for that degree, however, the pay is excludable.[9]

This rather straightforward provision has been inconsistently interpreted by the Treasury and the courts. For instance, the exclusion was allowed nursing students who worked in a hospital and received room and board;[10] a doctoral candidate in psychology required to work part-time at a Veterans Administration hospital;[11] students of medical technology doing laboratory work;[12] students attending a college that demanded work of every student;[13] a student conducting research in physics where it was required of all candidates;[14] and to students receiving funds

[8] INT. REV. CODE of 1954, § 117(b)(1).

[9] *Id. See, e.g.*, Chandler P. Bahalla, 35 T.C. 13 (1960).

[10] Rev. Rul. 338, 1958-2 CUM. BULL. 54.

[11] William Wells, 40 T.C. 40 (1963). The Tax Court reasoned that the primary purpose of the program was to train students. *Id.* at 48. *Accord*, Rev. Rul. 59, 1965-1 CUM. BULL. 67, *suspending* Rev. Rul. 118, 1959-1 CUM. BULL. 41.

[12] Rev. Rul. 29, 1964-1 CUM. BULL. 79.

[13] Rev. Rul. 54, 1964-1 CUM. BULL. 81. The work here was termed an "integral part of [an] overall scholastic program."

[14] Rev. Rul. 250, 1963-2 CUM. BULL. 79, *acquiescing in* Chandler P. Bahalla, 35 T.C. 13 (1960).

under the War Orphans Educational Assistance Act of 1956.[15] On the other hand, the exclusion was denied to a state welfare worker who received a grant and leave of absence to work on her master's degree;[16] to seminary students required to be assistant pastors for a year with pay;[17] and to an education student required to be an "intern teacher" in order to receive her master's degree.[18]

Some categories have not been explored by the courts or by the Treasury Department. For example, services are expected of the college athlete who wishes to remain eligible for his scholarship, but whether required participation in varsity sports should be considered "part-time employment" is an open question. The answer might well depend upon whether the main purpose of the athletic scholarship program is to educate the student or have a winning season.

Scholarship or fellowship holders who do not seek a degree have given rise to most of the problems under section 117. Grants to such students are excludable only if the grantor is a tax-exempt organization, a domestic or foreign government, or one of certain international organizations;[19] the exclusion is limited to three-hundred dollars a month for a maximum of thirty-six months.[20] It is in this area that the primary purpose test and the employment relationship test have been most extensively used. The courts have been obliged to examine the connection between the scholar and his benefactor in applying these tests. If an employment relationship appears to exist, the income is generally taxed either as "compensation" or on the theory that it is primarily for the grantor's benefit and not for the recipient's education.[21]

There can be no doubt that in deciding cases where the taxpayer was not working toward a degree, the Treasury Department's rulings have seemed inconsistent. For example, an individual given funds for pure research by a qualifying grantor who did not exercise any control has been

[15] Rev. Rul. 68-415, 1968 INT. REV. BULL. No. 32, at 9, *acquiescing in* Mary Keegstra, 48 T.C. 897 (1967), *and revoking* Rev. Rul. 355, 1959-2 CUM. BULL. 53.

[16] Stewart v. United States, 363 F.2d 355 (6th Cir. 1966).

[17] Rev. Rul. 522, 1957-2 CUM. BULL. 50.

[18] Elmer L. Reese, 45 T.C. 407, *aff'd per curiam*, 373 F.2d 742 (4th Cir. 1967). *Accord*, Rev. Rul. 443, 1967-2 CUM. BULL. 75.

[19] INT. REV. CODE of 1954, §§ 117 (b)(2)(A)(i)-(iv).

[20] *Id.* § 117(b)(2)(B).

[21] Stewart v. United States, 363 F.2d 355 (6th Cir. 1966); Woodail v. Commissioner, 321 F.2d 721 (10th Cir. 1963); Ussery v. United States, 296 F.2d 582 (5th Cir. 1961); Stephen L. Zolnay, 49 T.C. 389 (1968); Elmer L. Reese, 45 T.C. 407 (1966), *aff'd per curiam*, 373 F.2d 742 (4th Cir. 1967); Alex L. Sweet, 40 T.C. 403 (1963); Ethel M. Bonn, 34 T.C. 64 (1960); Frank Thomas Bachmura, 32 T.C. 1117 (1959).

held to be an "independent contractor" and not allowed to exclude the income under section 117.[22] But an alien who conducted research for a year under a grant from his government and who performed no services either for his grantor or for the institute where he worked was not taxed on the grant.[23]

The importance of the employment relationship was demonstrated in Revenue Ruling 58-222.[24] A college teacher was given a leave of absence to work on a project over which the college had no control. His expenses were paid in part by the college and in part by a private foundation that donated enough to make the sum equal his former salary. The Treasury Department held that the grant from the college was taxable as "compensation" even though the college was under no obligation to give either the grant or the leave of absence. However, the ruling permitted exclusion from gross income of the amount provided by the foundation. As for medical interns and residents, application of the employment relationship test has generally led to the taxation of their income.[25]

The primary purpose test and the employment relationship test obviously are conducive to inconsistent holdings on similar facts and therefore frustrate congressional purpose. The Supreme Court in deciding *Johnson* should not have endorsed these tests by sanctioning the regulation[26] that gave birth to them. Instead, the Court should have provided some new solutions.

It has been suggested that the primary purpose test not be applied at all in situations where every candidate for a particular degree does

[22] Rev. Rul. 127, 1957-1 CUM. BULL. 275. *Contra,* Rev. Rul. 130, 1960-1 CUM. BULL. 46, holding on similar facts that amounts received were excludable.

[23] Rev. Rul. 292, 1966-1 CUM. BULL. 280.

[24] Rev. Rul. 222, 1958-1 CUM. BULL. 54.

[25] Woodail v. Commissioner, 321 F.2d 721 (10th Cir. 1963); Quast v. United States, 293 F. Supp. 56 (D. Minn. 1968); Ethel M. Bonn, 34 T.C. 64 (1960); Rev. Rul. 68-520, 1968 INT. REV. BULL. No. 41, at 8; Rev. Rul. 117, 1965-1 CUM. BULL. 67. Three recent cases indicate, however, that residents may, in some situations, exclude their salaries. Pappas v. United States, 67-1 U.S. Tax Cas. ¶ 84,029 (E.D. Ark. 1967) (jury to determine whether payments made to plaintiff "were made primarily for the purpose of furthering his education and training in his individual capacity."); Anderson v. United States, 61-1 U.S. Tax Cas. ¶ 79,305 (D. Minn. 1960) (jurors instructed that if they found that the grant was primarily for the taxpayer's education, that residents at other hospitals performed the same work, and that the payments were not for past, present, or future services, they could find for plaintiff); Wrobleski v. Bingler, 161 F. Supp. 901 (W.D. Pa. 1958) (plaintiff found primarily engaged in education for his own benefit). *But c.f.* Quast v. United States, 293 F. Supp. 56 (D. Minn. 1968).

[26] Treas. Reg. § 1.117-4(c).

the same work and receives pay for it.[27] One court has stated that it will look to the amount of a grant to a candidate for a degree as a factor in determining whether it is compensation or a protected scholarship[28] although the statute itself provides no dollar maximum. With respect to interns and residents, one writer argues that since "[b]oth the interns and residents and their employer expect the employment relationship to end upon completion of the training . . . ,"[29] they should be treated differently under section 117 than they generally are at present. He furnishes what is perhaps a more workable approach to the employment test:

> Since Congress was concerned with the employment relationship where a non-degree candidate is an employee, Section 117 should be read in a way that denies the exclusion only where payment is made by an employer for employment activities that are designed to *advance the business.*[30]

Perhaps the best answer would be for Congress to discard section 117 and substitute a new statute excluding from gross income the expenses of tuition, books, fees, and a fixed living allowance. The distinction between degree candidates and those not seeking a degree should be abolished under this approach. Alternatively, the Code could be amended to allow a deduction from ordinary income of the costs of higher education. The Treasury, on the other hand, might provide a solution by providing a more definite test in its regulations such as allowing an exclusion unless it is shown that an employee-employer relationship will exist *after* the student has completed his studies. Past experience demonstrates the need for a new approach. Whether either the Treasury Department or Congress will provide it remains to be seen.

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[27] Tabac, *Scholarship and Fellowship Grants: An Administrative Merry-Go-Round,* 46 TAXES 485 (1968).

[28] Stephen L. Zolnay, 49 T.C. 389, 398 (1968).

[29] Tabac, *supra* note 27, at 492.

[30] *Id.* 493 (emphasis added). The distinction is between the business and the educational activities of a particular grantor. If the employee is expected to use his new learning for the grantor's future benefit, then the amount he receives should be taxed. If the grant is supplied for purely philanthropic reasons, the grant should be excludable.