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Taxation - Federal Income Tax - Exclusion of Scholarship and Fellowship Grants from Gross Income Held Not to Apply to Grants for Which a Substantial Quid Pro Quo was Extracted from the Recipient. *Bingler v. Johnson* (U.S. 1969)

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remains only potential. Respect for these rights will encourage the parolee's reciprocal trust and respect for the law, thereby facilitating the state's interest in the achievement of rehabilitation. Exactly where the delineation of procedures necessary to protect the parolee's rights should be made remains a question of due process, an ephemeral concept.⁷⁸ The current trend toward realization of fundamental rights through due process, however, is permeating even those proceedings cloaked in administrative cover; fortunately, the days of *Martinez* are numbered.

MICHAEL V. MILLS

TAXATION—FEDERAL INCOME TAX—EXCLUSION OF SCHOLARSHIP AND FELLOWSHIP GRANTS FROM GROSS INCOME HELD NOT TO APPLY TO GRANTS FOR WHICH A SUBSTANTIAL QUID PRO QUO WAS EXTRACTED FROM THE RECIPIENT. *Bingler v. Johnson* (U.S. 1969).

The Westinghouse Electric Corporation, under a jointly funded program with the Atomic Energy Commission (AEC), allowed certain employees educational leave of absence to pursue formal education. Johnson¹ availed himself of this program and studied, full time, for his doctoral degree. During the period he was on leave he was paid a stipend by Westinghouse, which, depending on certain factors, was 70 to 90 percent of the former salary. Westinghouse treated these payments as indirect labor costs and withheld federal income tax. Johnson retained all of his employee benefits and seniority. Before commencing the educational leave he was required to sign a contract agreeing to return to the employ of Westinghouse.² In addition, Johnson was required to make periodic progress reports to Westinghouse and to submit his thesis topic to Westinghouse and the AEC for approval.

Johnson brought suit claiming a refund of federal income taxes withheld while he was attending school, contending that

78. See e.g., *Gideon v. Wainwright*, 372 U.S. 335, 339 (1963).

1. The respondents consisted of Johnson and two co-workers who will hereinafter be referred to as Johnson.

2. Respondent Wolfe did not sign a contract, but he was advised that he was expected to return to Westinghouse. He honored the obligation. *Bingler v. Johnson*, 89 S.Ct. 1439, 1441 n.7 (1969).

these payments were scholarships³ and excludable from gross income. On appeal by the Commissioner to the United States Supreme Court, *held*, reversed and the decision of the district court reinstated; the payments were not excludable from gross income as they were payments for services rendered. *Bingler v. Johnson*, 89 S. Ct. 1439 (1969).

Under the Internal Revenue Code of 1939, grants were exempted from gross income if they met the tests of a gift.⁴ In 1951 the Treasury promulgated a specific rule for the taxation of grants which narrowed the definition of gifts as it pertained to grants, although it was still necessary to show that no consideration was given for the grant. The rule stated:

If a grant or fellowship award is made for the training and education of an individual either as part of his program in acquiring a degree or in otherwise furthering his educational development, *no services being rendered as consideration therefor*, the amount . . . is a gift which is excludable from gross income.⁵

The mixture of gift and compensation in many of the cases⁶ resulted in decisions which varied from case-to-case depending on which ingredient of the mixture surfaced as dominant. The inconsistency created by this gift v. compensation test was aptly demonstrated by the Tax Court just prior to the enactment of the 1954 Internal Revenue Code. In *Ti Li Loo*⁷ the grantee conducted research in drugs at a university under a National Science Foundation grant. The court held the grant includable in gross income because the grantee's services were a valuable consideration moving to the grantor.⁸ Later the same year, the Tax Court held the grant in *George Winchester Stone*⁹ was

3. Treas. Reg. §§ 1.117-3(a) and (c) (1956) respectively define a "scholarship" as an amount paid to a student in pursuing his studies; and "fellowship" as an amount paid to an individual to aid him in the pursuit of study or research. Hereinafter scholarships and fellowships will be referred to as grants.

4. INT. REV. CODE OF 1939, § 22(b)(3), 53 Stat. 47 (now INT. REV. CODE OF 1954, § 102).

5. I.T. 4056, 1951-2 CUM. BULL. 8, 10 (Emphasis added).

6. See Chommie, *Federal Income Taxation: Transactions in Aid of Education*, 58 DICK. L. REV. 93, 189, 291 (1954); Gordon, *Scholarship and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U.L. Q. 144; Note, *Fellowship Grants Under the Internal Revenue Code of 1954*, 8 BUFFALO L. REV. 286 (1958-59).

7. 22 T.C. 220 (1954).

8. *Id.* at 225.

9. 23 T.C. 254 (1954).

excludable from gross income although it appeared to involve as much consideration as in *Ti Li Loo*. Stone received a grant from a charitable foundation to do research in 18th Century English drama. He was obligated to "engage in no other occupation"¹⁰ during the period of the grant and the grantor became obligated to make installments of the grant only so long as the research continued.¹¹ The court reached its result by characterizing the grant as a conditional gift.¹²

Recognizing that the confused tax status of grants had become a problem, Congress formulated section 117 of the 1954 Internal Revenue Code. The legislative history of the section reflects congressional intent: (1) to eliminate "existing confusion as to whether such payments are to be treated as income or gifts,"¹³ and thereby (2) to avoid a case-by-case determination of that tax status.¹⁴ In effectuating this goal, section 117 excludes all grants and associated payments from gross income¹⁵ of candidates for degrees,¹⁶ but specifically provides that any amount received in payment for services which are required as a condition to receiving the grant shall not fall within the exclusion.¹⁷

10. *Id.* at 264.

11. *Id.* at 265.

12. *Id.* at 264.

13. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 16 (1954), 3 U.S. CODE CONG. & AD. NEWS 4041.

14. *Id.*; see S. Rep. No. 1622, 83d Cong., 2d Sess. 17 (1954), 3 U.S. CODE CONG. & AD. NEWS 4648.

15. INT. REV. CODE OF 1954, § 117(a) states:

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 fellowship grant, but only to the extent that the amount is so expended by the recipient.

16. Non-degree candidates are treated separately. INT. REV. CODE OF 1954, § 117(b)(2). This section was not at issue in *Johnson*.

17. INT. REV. CODE OF 1954, § 117(b)(1):

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.

In 1956 the Treasury Department promulgated regulation § 1.117. The regulation states that although "some incidental benefit" accrues to the grantor, the exclusion will be allowed when the "primary purpose" of the grant is to further the training or education of the grantee in his individual capacity.¹⁸ Included in gross income by the regulation are grants which are in the nature of compensation for past, present, or future services¹⁹ or grants which are for study or research primarily for the benefit of the grantor.²⁰

Under the Code and the regulation, the courts appear to have shifted their emphasis from the gift v. compensation test to discovery of the primary purpose of the grant where some benefit accrues to the grantor. In extracting this primary purpose, the courts have looked to the grantor.²¹ Grantees generally had similar purposes, *i.e.*, reaching an immediate educational goal; but

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 scholarships or fellowship grants) for a particular degree as a condition to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of this paragraph.

18. Treas. Reg. § 1.117-4(c)(2) (1956) disallows:

Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor. However, amounts paid to or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

19. Treas. Reg. § 1.117-4(c)(1) (1956). Included are:

Amounts paid as compensation for services or primarily for the benefit of the grantor.

(1) Except as provided in paragraph (a) of § 1.117-2, any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment or represents payment for services which are subject to the direction or supervision of the grantor.

20. *Id.*

21. *But see* Chandler P. Bhalla, 35 T.C. 13 (1960); Rev. Rul. 60-378, 1960-2 CUM.

grantors had vastly dissimilar purposes in awarding grants.²² Thus, different results—again—were reached even though grantees were in similar situations.²³ In the cases of *Wrobleski v. Binger*,²⁴ *Woddail v. Commissioner*²⁵ and *Ethel M. Bonn*,²⁶ each grantee was a graduate physician. The grantor was a hospital where the grantee was studying to obtain professional certification. Each of the grantees was required to perform certain services for the hospital as a condition of the grant. The grant was held excludable from gross income in *Wrobleski*, but not in *Woddail* and *Bonn*. The distinguishing factor was that in *Wrobleski* the hospital was a teaching hospital whereas in *Woddail* and *Bonn* the purpose of the hospital was to treat patients. Thus, although the grantees received the same training and performed similar duties, the purpose of the hospital determined the tax status of the grants.

The disparity of results, in fact situations more closely resembling *Johnson*, is again demonstrated in *Ussery v. United States*,²⁷ *Stewart v. United States*²⁸ and *Aileen Evans*.²⁹ In each of these cases the grant was from a state welfare department and the grantee was required to work for the grantor upon the completion of his education. The grant was held excludable from gross income only in *Evans*. The distinguishing factor was that the grantee in *Evans* had no prior employment relation with the grantor, but in *Ussery* and *Stewart* the grantee was in the employ of the grantor at the time of the grant.³⁰ This was the generally

22. See, e.g., Rev. Rul. 522, 1957-2 CUM. BULL. 50 (grant to theology students); Rev. Rul. 50, 1957-1 CUM. BULL. 74 (grant to outstanding public servant). See also cases collected in Gordon, *Scholarship and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U.L.Q. 144 n.2.

23. The difficulties in applying the primary purpose test were similar to those in the gift v. compensation test. As stated by the Tax Court:

The primary purpose test requires a determination of the *raison d'être* of the payment—was it to further the education and training of the recipient or was it, in reality, payment for services which directly benefited another person?

Often more than a single purpose is involved.

Elmer L. Reese, Jr., 45 T.C. 407 (1960), *aff'd mem.*, 373 F.2d 742 (4th Cir. 1961).

24. 161 F. Supp. 901 (W.D. Pa. 1958).

25. 321 F.2d 721 (10th Cir. 1963).

26. 34 T.C. 64 (1960).

27. 296 F.2d 582 (5th Cir. 1961).

28. 363 F.2d 355 (6th Cir. 1966).

29. 34 T.C. 720 (1960), *acquiesced in*, 1965-1 CUM. BULL. 66.

30. In a situation analogous to the *Ussery*, *Stewart* and *Evans* cases, the Tax Court held that although a portion of a grant was for compensation, the grant was nevertheless excludable provided that the primary purpose of the grant was not to compensate the

confused state of the law prior to *Bingler v. Johnson*. In a situation where some benefit accrued to the grantor, it was impossible to determine in advance whether a particular grant would be taxable.

Johnson based his case for exclusion on two contentions. Sections 117(b)(1) and (2)³¹ placed limitations on the type of payments that could be excluded from gross income. Therefore, he contended that by application of the canon of construction that the expression of one thing is the exclusion of another,³² the Treasury Regulation imposing further limitations was invalid. He also contended that the Treasury Regulation was invalid because it conflicted with the congressional intent to end the case-by-case basis of determining taxability of grants.³³ The Court of Appeals for the Third Circuit agreed with the two contentions in extensive dicta, but did not invalidate the regulation.³⁴ Instead, the court held that Johnson's situation was governed by the *Evans*³⁵ case.³⁶

The Supreme Court pointedly ignored the appellate court's express ground of decision and addressed itself to the validity and scope of the Treasury Regulation. The Court held that the Treasury Regulation did not add additional limitations to section 117, but merely supplied the definitions of scholarships and fellowships which were lacking in the Code but that were necessary for its enforcement.³⁷ The Court further stated: "We do not sit as a committee of revision to perfect the administration of the tax laws. . . . In this area of limitless factual variations it is

grantee for services rendered. The government argued that if any portion of the grant was compensation, the entire grant was taxable. *William Wells*, 40 T.C. 40 (1963), *acquiesced in* 1965-1 CUM. BULL. 67. The Court in *Johnson* was informed that the Treasury Regulation might be revised to conform to the *Wells* decision. 89 S.Ct. at 1449 n.32.

31. See notes 16 and 17, *supra*.

32. *Expressio unius est exclusio alterius*. For the general operation of *expressio unius* on the tax laws see, 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 3.17 at 30 (rev. ed. 1962).

33. *Johnson v. Bingler*, 396 F.2d 258, 262 (3d Cir. 1968), see text at note 13, *supra*.

34. The court stated: "To decide this issue, we do not have to consider the validity of [Treasury Regulation § 1.117] in light of the statutory language and legislative history of § 117." *Id.* at 263.

35. The Court in *Johnson* was informed by the Solicitor General that the *Evans* acquiescence would be modified. (Presumably to conform to the holding in *Johnson*.) 89 S.Ct. at 1448 n.30.

36. See *Johnson v. Bingler*, 396 F.2d 258, 262 (3d Cir. 1968), *noted in* 21 Ala. L. Rev. 375 (1969).

37. 89 S.Ct. at 1444.

the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments."³⁸

The Court then proceeded to do what they said they could not do—make adjustments. In restating the Treasury Regulation, the Court said: “[S]cholarships’ and ‘fellowships’ [are] relatively disinterested, ‘no strings’ educational grants, with no requirement of any substantial *quid pro quo* from the recipients.”³⁹ In substance, if not in form, this test for excludability of grants is a return to the pre-1954 gift v. compensation rule. The language of the Court is reminiscent of the dissent in the 1954 *Stone*⁴⁰ case which was decided under that rule. There the dissenters stated: “In short, the performance of the services or the doing of the work . . . was a prerequisite or the *quid pro quo* for the money received.”⁴¹

The result of the *Johnson* decision is that there will still have to be a case-by-case resolution of those grants which the Commissioner desires to contest. And the test will be the same whether it is called *quid pro quo*, primary purpose, or gift v. compensation. For all practical purposes the problem has come full circle and rests where it was prior to the 1954 Code.

One conclusion that may be drawn is that Congress is satisfied with the way grants are being taxed. It has been sixteen years since the Code was enacted and Congress has not moved to reform section 117. It is especially worthy of note that the Tax Reform Act of 1969⁴² does not change section 117. However, it is more probable that Congress has realized the difficulties of devising a new test⁴³ and has shifted its emphasis toward other methods of aiding education through tax relief.

Evidence of a new concern⁴⁴ for education is demonstrated by the fact that ninety-two bills have been introduced in the 91st Congress to aid education through tax relief. The bills provide

38. *Id.* at 1445, quoting from, *United States v. Correll*, 389 U.S. 299, 306-07 (1967).

39. *Id.*

40. 23 T.C. at 265.

41. *Id.*

42. H.R. 13270, 91st Cong., 2d Sess. (1969).

43. No new methods of determining taxability of grants have been suggested to date.

44. In 1968 there were over 7 million students in institutions of higher learning. Educational expenses, which these students must bear directly, have more than doubled since 1958. U.S. Dep't of Health, Education and Welfare, DIGEST OF EDUCATIONAL STATISTICS 68, 95 (1968).

three primary methods⁴⁵ of aid to higher education through the medium of tax relief: (1) Deductions for expenses of higher education,⁴⁶ (2) Full tax credit for expenses,⁴⁷ and (3) Partial tax credit.⁴⁸ While none of the bills attempt to clarify the taxation of grants, they indirectly resolve some of the problems caused by section 117.

If any of the plans are enacted, the effect on recipients of grants, such as in *Johnson*, would be twofold. First, the grantee would not be faced with the situation of either paying no taxes if the grant was held to be a nontaxable grant or paying taxes on the total amount if the grant was held to involve a substantial *quid pro quo*. No matter what restrictions were placed on the grant, the grantee would receive a tax benefit based on that amount actually expended on his education. Secondly, the grantee would know in advance the various alternatives open to him. He could weigh the relative ease of taking the tax benefit against the possible time and expense of litigating to exclude the entire grant.

The deduction and full tax credit plans are subject to serious drawbacks in that the relief is not uniform⁴⁹ or that it is too great

45. Four bills provide the following types of tax relief: H.R. 3705, 91st Cong., 1st Sess. (1969) (tax credit depending on number of family in college); H.R. 7576, 91st Cong., 1st Sess. (1969) (deduction if adjusted gross income is less than \$7,500); H.R. 9062, 91st Cong., 1st Sess. (1969) (deduction for room rent); H.R. 11727, 91st Cong., 1st Sess. (1969) (deduction of \$1,800 per annum).

46. S. 1098, 91st Cong., 1st Sess. (1969); H.R. 5 H.R. 298, H.R. 306, H.R. 348, H.R. 415, H.R. 541, H.R. 1301, H.R. 2109, H.R. 2110, H.R. 2164, H.R. 2392, H.R. 3245, H.R. 4137, H.R. 5261, H.R. 5512, H.R. 7582, H.R. 8167, H.R. 8274, H.R. 8276, H.R. 8371, H.R. 8410, H.R. 9005, H.R. 9758, H.R. 10144, H.R. 10286, H.R. 10328, H.R. 10389, H.R. 10626, H.R. 10691, H.R. 10828, H.R. 11115, H.R. 11139, H.R. 11185, H.R. 11263, H.R. 11464, H.R. 11723, H.R. 12336, H.R. 12514, H.R. 13192, 91st Cong., 1st Sess. (1969).

47. H.R. 136, H.R. 176, H.R. 198, H.R. 318, H.R. 538, H.R. 540, H.R. 674, H.R. 939, H.R. 994, H.R. 1041, H.R. 1099, H.R. 1116, H.R. 1363, H.R. 2355, H.R. 3700, H.R. 4169, H.R. 4176, H.R. 4235, H.R. 4826, H.R. 4859, H.R. 5249, H.R. 5813, H.R. 6002, H.R. 6289, H.R. 6511, H.R. 6819, H.R. 9054, H.R. 9069, H.R. 9568, H.R. 9691, H.R. 9887, H.R. 9917, H.R. 10522, H.R. 10540, H.R. 10601, H.R. 10671, H.R. 11126, H.R. 11844, H.R. 12269, H.R. 13213, 91st Cong., 1st Sess. (1969).

48. H.R. 851, H.R. 979, H.R. 2137, H.R. 4151, H.R. 9094, 91st Cong., 1st Sess. (1969) (30% credit); S. 1258, 91st Cong., 1st Sess. (1969), H.R. 5499, H.R. 8758, 91st Cong., 1st Sess. (1969) (20% credit).

49. The deduction plan would provide a benefit only if the taxpayer's total itemized deductions (deductions from gross income) exceed the 10% standard deduction. Those taxpayers who do not itemize deductions, but take the standard deduction would receive no benefit. Such plans have been introduced in the past. For a detailed criticism, see 76 Harv. L. Rev. 368, 383 (1962).

to be fiscally sound.⁵⁰ The 30 percent partial tax credit plan appears to be the most effective of those introduced because it would aid middle and low income taxpayers, but would not have a substantial impact on the taxation of income not expended on education.⁵¹

Clearly a tax law which not only satisfies a pressing need for aid to education, but also provides an important measure of certainty in the taxation of grants is desirable. Such a law is within the immediate grasp of Congress.

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50. Assuming an educational expense of \$1000.00, the full tax credit plan would operate as follows:

<i>Taxpayer</i>	<i>A</i>	<i>B</i>	<i>C</i>
Taxable income	\$5,000	\$10,000	\$25,000
Effective tax rate (approximate)	19%	22%	34%
Gross tax	950	2,200	8,500
Example tax credit	1,000	1,000	1,000
Net tax	0	1,200	7,500
Net effective tax rate			
as % of taxable income	0	12%	30%
Change in effective tax rate	—19%	—10%	—04%

Thus the government would lose about 25 percent of its total revenue from these three hypothetical taxpayers. With the number of students growing each year, the enactment of such a plan might pose grave fiscal problems.

51. A 30 percent tax credit would, in effect, be an exclusion of that amount of income expended on higher education if the taxpayer was taxed at an effective rate of 30 percent (currently a taxable income of about \$16-18,000). Persons taxed at a rate below 30 percent would find that the 30 percent tax credit would offset taxes on income expended for higher education and carry over to a portion of income not expended on education. The lower income taxpayer would not only receive a tax benefit on income expended on education, but would receive a small benefit on his total income. The 30 percent plan would operate as follows:

<i>Taxpayer</i>	<i>A</i>	<i>B</i>	<i>C</i>
Taxable income	\$5,000	\$10,000	\$25,000
Effective tax rate (approximate)	19%	22%	34%
Gross tax	950	2,200	8,500
Example tax credit (30% of \$1,000)	300	300	300
Net tax	650	1,900	8,200
Change in effective rate	—6%	—3%	—1%