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TAXABILITY OF SCHOLARSHIPS AND FELLOWSHIPS

I. INTRODUCTION

The Internal Revenue Code of 1939 contained no statutory provisions pertaining to the taxability of scholarships and fellowships, and decisions under that Code turned on whether the grants were excluded as gifts or included in gross income as compensation. If the recipient could not establish that the payment was a gift, the grant was included in gross income.¹ Thus, the tax status of these grants had to be decided on a case by case basis. In 1954, Congress enacted section 117² of the Internal Revenue Code which was designed to end the uncertainty of the tax status of these grants by establishing rules for determining their tax treatment.³

Section 117(a) provides that gross income does not include any amount received as a scholarship or fellowship. In this broad exclusion, Congress

1. I.T. 4056, 1951-2 CUM. BULL. 8.

2. INT. REV. CODE OF 1954, § 117.

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,

b) Limitations.—

(1) Individuals who are candidates for degrees—

In the case of an individual who is a candidate for a degree at an educational institution . . . , sub-section (a) shall not apply to that portion if any amount received which represents payment for teaching, research, or any 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.

(2) Individuals who are not candidates for degrees—

In the case of an individual who is not a candidate for a degree at an educational institution, . . . , subsection (a) shall apply only within the limitations provided in subparagraph (B).

(B) Extent of Exclusion.—The amount of the scholarship or fellowship grant excluded under subsection (a) (1) in any taxable year shall be limited to an amount equal to \$300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in Section 151 (e) (4)).

3. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 15 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 17 (1954).

recognized the traditional difference between a scholarship and a fellowship. The principal feature of a scholarship is pursuit of a regular course of study, with any research being incidental; a fellowship, on the other hand, often accents research and specialized educational training, and a regular study program is incidental. Because of this difference, section 117 (a) grants an exclusion for amounts received as a scholarship only if the study takes place "at an educational institution," while no such requirement is provided in the case of a fellowship grant.

To these broad exclusions, Congress added certain limitations. In the case of a degree candidate, there is neither a dollar limit on the exclusion nor are there any qualifications that the donor must meet. However, payments representing compensation for part time employment, required as a condition of the grant, are not to be excluded, unless all candidates for the degree are required to perform these services, whether on scholarship or not.⁴ One not a candidate for a degree may only exclude payments from certain sources⁵ and the exclusion is limited to \$300 per month for a total period not to exceed 36 months.⁶

When Congress enacted section 117, it was apparently intended to be the sole test for exclusion.⁷ Thus, if an amount can properly be classified as a scholarship or fellowship, its exclusion is controlled solely by section 117, even though it might also be classified as a prize or as a gift under other provisions of the Code.⁸ Therefore, if a grant to one not a candidate for a degree exceeds the dollar limits of the section, the excess is includable in gross income.⁹

Since section 117 was enacted in part to end the confusion created by the gift-compensation test under the 1939 Code, one might expect the section to resolve the basic definitional issue: which payments qualify as scholarship and fellowships? Yet, nowhere in section 117 or in its legislative history are the terms scholarship and fellowship defined. Either Congress was satisfied that these terms had generally accepted meanings which were not open to question¹⁰ or that there was no simple definition which would resolve the hard cases and that these might better be left to resolution by the Service and the courts on a case by case basis. On the one hand, the broad exclusion of the section might indicate that all payments to a student are to be excluded. Within the same section, however, exclusion is denied to compensatory payments. This provision, if logically extended would require any payment to a student that had a compensatory element

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

5. Section 117 (b) (2) (A) allows the exclusion for non-degree candidates only if the grantor is an organization exempt from tax under Section 501 (a), a foreign government, an international organization, or the United States or any of its agencies.

6. INT. REV. CODE OF 1954, § 117 (b) (2) (B).

7. See reports quoted note 3 *supra*; Clarence Piess 40 T.C. 78, 81 (1963); Frank Thomas Bachmura, 32 T.C. 1117, 1121 (1959).

8. INT. REV. CODE OF 1954, §§ 74, 102; See REV. RUL. 59-80, 1959-1 CUM. BULL. 39.

9. See REV. RUL. 66-241, 1966-2 CUM. BULL. 40; REV. RUL. 59-80, 1959-1 CUM. BULL. 39.

10. Frank Thomas Bachmura, 35 T.C. 1117 (1959).

to be included in gross income. Thus, the statutory language, instead of resolving the gift-compensation problem created by the 1939 Code, perpetuates the problem as a scholarship or fellowship-compensation problem under section 117. The purpose of this comment is to determine how the Service and the courts have faced the problem.

II. THE OFFICIAL SOLUTION—THE REGULATIONS

A. *Definitions and Requirements*

The regulations have done little to remedy the construction problem. For the most part they deal with the problems that arise *after* it has been determined that an amount qualifies as a scholarship or fellowship, *e.g.*, the calculation of the amount to be excluded.¹¹ Thus, in dealing with the threshold question of what payments qualify, the regulations are unfortunately no better than the Code. It is apparent that:

a proper reading of the statute requires that before the exclusion comes into play there must be a determination that the payment sought to be excluded has the normal characteristics associated with the term 'scholarship'.¹²

However, the regulations do not describe these "normal characteristics," but rather characterize the terms broadly, and then list certain items which do not qualify. A scholarship is "an amount paid . . . to . . . a student to aid such individual in pursuing his studies"; a fellowship is "an amount paid . . . for the benefit of an individual to aid him in his studies." These broad statements are of little value in solving the problem of whether a particular payment is a scholarship or is compensation.

Most disputes concerning the wording of the regulations have arisen because of the Treasury's attempt to list the categories of payments which it would *not* consider to be scholarship or fellowship grants. These categories are: (1) payments under which the recipient is subject to the supervision or direction of the grantor;¹³ (2) payments which represent compensation for past, present, or future services;¹⁴ or (3) payments which enable the recipient to pursue studies or research primarily for the benefit of the grantor, unless the primary purpose of the grant is to further the education of the recipient in his individual capacity.¹⁵ With these categories the Treasury has written additional qualifications into the Code which indicate that its current position on these grants is strikingly similar to its pre-1954 position, *i.e.*, the prime consideration is a determination of whether the payment in *any way* represents compensation. The official position on the borderline case is a test phrased in terms of purpose: is the primary purpose to further the education of the recipient in his individual capacity? The purpose test itself creates difficulties which are discussed below.¹⁶

11. Treas. Reg. § 1.117-1, § 1.117-2 (1956).

12. Elmer L. Reese, 45 T.C. 407, 413 (1966), *aff'd per curiam*, 373 F.2d 742 (4th Cir. 1967).

13. Treas. Reg. § 1.117-4(c) (1) (1956).

14. *Id.*

15. Treas. Reg. § 1.117-4(c) (2) (1956).

16. *See infra* at IV.

In contrast to the official Treasury position, several authorities¹⁷ have felt that Congress, in section 117, recognized that scholarships are "sufficiently unique in terms of their social function, and in the framework in which they are employed, to merit separate treatment from that accorded gifts and compensation."¹⁸ Their belief is that the regulations which perpetuate the pre-1954 gift-compensation test are "an attempt to write into [section 117] a concept which was considered and intentionally rejected by the Congress which enacted the Code."¹⁹

Apparently, the one thing that is clear about the words "scholarship" or "fellowship" is that the use of these terms by the grantor is meaningless. For example, a business advertised the prize in its contest as a "scholarship to the college of your choice." Although the company encouraged the winner to use the award for education, there were no restrictions on the use of the prize money. The Service ruled that these payments could not be considered a scholarship for purposes of section 117 because of the lack of restriction on their use.²⁰ In the same manner, merely because the grantor does not treat the payments as scholarships in his own bookkeeping system will not mean that they will fail to qualify for exclusion under the section. In *Chander P. Bhalla*,²¹ a decision in which the Treasury acquiesced,²² the court placed no significance on how the grantor treated the payment because it felt that the granting institution, not knowing how the grant should be treated for tax purposes, might have been overly cautious.

B. *The Problem in Context: Johnson v. Bingler*²³

The validity of the regulations was upheld by the Supreme Court recently in the case of *Johnson v. Bingler*. Taxpayer, an employee of the Westinghouse Corporation at a facility owned by the Atomic Energy Commission, pursuant to a Westinghouse fellowship and doctoral program, received an educational leave from his employment and a grant amounting to 80 per cent of his former salary, to research, write, and defend a Ph.D. thesis in engineering. The dissertation topic was subject to the approval of the Atomic Energy Commission. The stated purpose of the Westinghouse program was to aid in meeting the needs of Westinghouse for key professional personnel. Each recipient of a grant and leave was required to agree to continue working for Westinghouse upon completion of his educational leave for a period of at least two years. While on leave he

17. See the decision of Judge Weiner in *Johnson v. Bingler*, 396 F.2d 258 (3d Cir. 1968), *rev'd*, 394 U.S. 741 (1969); Chommie, *Services Rendered, Not Donative Intent, Governs Exemption of Study Grants*, 4 J. TAXATION 375 (1956); Gordon, *Scholarships and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U.L.Q. 144.

18. Gordon, *Scholarships and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U.L.Q. 144, 151.

19. *Johnson v. Bingler*, 396 F.2d. 258, 260 (3d Cir. 1968), *rev'd*, 394 U.S. 741 (1969).

20. REV. RUL. 65-58, 1965-1 CUM. BULL. 37.

21. *Chander P. Bhalla*, 35 T.C. 13 (1960).

22. REV. RUL. 63-250, 1963-2 CUM. BULL. 79.

23. 394 U.S. 741 (1969).

retained his seniority status and received all employee benefits. Westinghouse deducted the payments on its return and withheld tax from payments to taxpayer, who in turn filed a refund claim on the ground that the payments were excludable as a scholarship under section 117. This claim was rejected both by the Commissioner, who viewed the payments as compensation, and later by a jury in a refund suit in federal district court which found the payments were taxable income.²⁴ Reversing the judgment in favor of the United States, the Third Circuit Court of Appeals held that the regulations and the instructions to the jury based on them were invalid and that as a matter of law the grant was excludable as a scholarship. The Court of Appeals stated: "any reasonable stipend which comes within the common understanding of what constitutes a scholarship . . . is excluded from gross income."²⁵ By this decision the court created a direct conflict with other circuits which had either upheld the validity of the regulation or had sustained lower court conclusions to that effect.²⁶ The Supreme Court granted certiorari to resolve this conflict and to determine the proper scope of section 117 and the regulation.

In its first examination of section 117, the Supreme Court did little more than state the general proposition that "regulations 'must be sustained unless unreasonable and plainly inconsistent with revenue statutes' and 'should not be overruled except for weighty reasons'."²⁷ The Court, declaring that the regulations under section 117 were not unreasonable, thus ruled in the Government's favor. It believed that Congress had tried to insure that payments which were a continuing salary would not escape taxation merely because they also fit into the broad definition of a scholarship and that the Treasury had permissibly implemented this underlying Congressional concern. The Court inferred from the legislative history that Congress did not intend all grants to students to be excludable. The Court cited Section 117(b)(2), which severely limits excludability of payments to non-degree candidates, as an example of the precautions that Congress took in an area that it felt was open to abuse.

The Third Circuit in *Johnson*, through use of the canon of construction, *expressio unius est exclusio alterius*, had reasoned that, by applying the limitation on the exclusion only to payments to non-degree candidates and a limited class of degree candidates, Congress had intended the restriction in the Code to be the only restriction. The Supreme Court, however, did not believe that the added restrictions of Regulation § 1.117-4, excluding amounts received as compensation from the term scholarship, were "plainly inconsistent" with the intent of Congress. The high court thus rejected the *expressio* argument.

24. 19 Am. Fed. Tax R.2d 426 (W.D. Pa. 1966).

25. 396 F.2d 258, 260 (3d Cir. 1968).

26. *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); *Reiffen v. United States*, 376 F.2d 883 (Ct. Cl. 1967).

27. 394 U.S. at 750, quoting *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948).

III. EXCLUDED CATEGORIES (1) AND (2) OF TREAS. REG. § 1.117-4 (c): COMPENSATION PER SE

By its ruling in *Johnson*, the court has approved regulations which give rise to inconsistent rulings and decisions.²⁸ Unless the Treasury Department rewrites these regulations,²⁹ taxpayers must live with a case by case approach; and in view of the Supreme Court's decision, it is not likely that the regulations will be made more precise.

The regulations state that a payment is not to be considered a scholarship if it represents compensation for past, present, or future services.³⁰ The courts, however, have not literally followed this regulation, and have consistently held that a scholarship or fellowship "may be compensatory in character [but] that with the enactment of Section 117 of the 1954 Code, it no longer follows that such amounts are to be included in gross income merely because they were in the nature of compensation for services rendered."³¹ At the same time, however, some courts have recognized that certain factors "are such indicia of 'compensation for past, present, or future services'"³² as to be excluded from the definition of scholarship and fellowship. These indicia usually include: (1) taxpayer's activities subject to the supervision of the grantor or (2) the existence of an employer-employee relationship. The problem, therefore, is to determine how the Service and the courts differentiate between a payment that is considered compensation and a payment for employment services which is excludable under the section.

A. Supervision by the Grantor

The regulations clearly state that generally a payment is not to be considered a scholarship for services subject to the direction or supervision of the grantor.³³ The Commissioner, relying on this mandate, will often rule for or against exclusion on this factor alone.³⁴ The courts, however, have not been so dogmatic. In *William Wells*,³⁵ a taxpayer, as part of a Ph.D. program in clinical psychology, enrolled in a training program with the Veteran's Administration. She was compensated by the Veteran's Admin-

28. See cases cited in Meyers, *Tax Status of Scholarships and Fellowships*, 22 TAX LAWYER 391 (1969). See also Edward A. Jamieson, 51 T.C. 635 (1969). In *Stephen L. Zolnay*, 49 T.C. 389, 395 (1968), Judge Tannewald stated, "[s]uffice to say that the decided cases run the gamut of the full spectrum with all its shadings, making precisional line-drawing [under section 117] impossible."

29. In REV. RUL. 65-146, 1965-1 CUM. BULL. 66, the Commissioner announced that the Regulations to § 117 were in the process of revision. No such revision, or proposed revision, has yet been published.

30. Treas. Reg. § 1.117-4 (c) (1) (1956).

31. Frank Thomas Bachmura, 32 T.C. 1117, 1125 (1959).

32. *Stewart v. United States*, 363 F.2d 355, 357 (6th Cir. 1966).

33. Treas. Reg. § 1.117-4 (c) (1) (1956).

34. See *Woodail v. Commissioner*, 321 F.2d 721 (10th Cir. 1963), and *Anderson v. United States*, 61-1 USTCas. 9162. In *Anderson*, the jury was instructed that if the payments to taxpayer were for services which were subject to the supervision of the grantor, this would indicate that the payment was not a scholarship.

35. 40 T.C. 40 (1963).

istration, at an hourly rate for the time she worked. The Commissioner argued that, since the training program was supervised by the hospital and university, the amounts received should be automatically denied scholarship treatment. The court rejected this argument and stated that such a rule would bring about a result clearly contrary to the provisions of the statute—elimination of university research fellowships performed under university supervision. Although supervision by the grantor is certainly evidence that the payment is compensation, in light of *Wells*, the presence or absence of supervision does not appear to control its tax treatment.

B. *The Employment Obligation Test*

The existence of an employer-employee relationship usually raises a strong presumption that payment is compensation, hence not excludable. The Government usually contends that any time there is a commitment to work for the grantor in the future, the grant represents compensation. This contention has not always been followed by the courts. In *Aileen Evans*,³⁶ petitioner agreed to work for a period of time equal to that needed to complete her training. The court held that the only services which nullify the exclusion are those rendered at the time the payment is made. This analysis removes a contract for future services from consideration in determining if an exclusion is to be granted. Although the decision in *Evans* was a departure from previous published rulings,³⁷ the Service stated that it would follow this ruling in disposing of similar cases.³⁸ However, the taxpayer in *Evans* was not in the grantor's employment before the grant was made, hence the Service and the courts have distinguished *Evans* on this point.³⁹ Thus, before *Johnson v. Bingler*, the exclusion of a payment under section 117, when a future obligation existed, depended on the status of the recipient at the time of the grant.

The Supreme Court, in *Johnson*, held that the true meaning of the regulation dealing with compensation is that "bargained for payments, given only as a *quo* in return for the *quid* of services rendered—whether past, present, or future—should not be excludable from income as 'scholarship' funds."⁴⁰ It would appear, therefore, that the ruling in *Evans* is no longer good law, and that now, any employment relationship may nullify the exclusion under section 117.

C. *The Percentage of Compensation Test*

Courts have generally treated the fact that a former employer makes a grant which equals or is based on the employee's former salary as indic-

36. 34 T.C. 720 (1960), *acquiesced in* REV. RUL. 65-146, 1965-1 CUM. BULL. 66.

37. See *e.g.*, REV. RUL. 55-347, 1955-1 CUM. BULL. 21; REV. RUL. 57-370, 1957-2 CUM. BULL. 105; REV. RUL. 58-322, 1958-1 CUM. BULL. 59.

38. REV. RUL. 75-146, 1965-1 CUM. BULL. 66.

39. In REV. RUL. 65-146, 1965-1 CUM. BULL. 66, the Service stated that *Evans* was distinguishable from cases in which the employee had been in the grantor's employment before the commencement of the education. The Service cited *Ussery v. United States*, 296 F.2d 582 (5th Cir. 1961) and *Stewart v. United States*, 363 F.2d 355 (6th Cir. 1966), as examples of this previous employment.

40. 394 U.S. at 757.

ative of compensation which precludes scholarship or fellowship treatment. Such was the view of the court in *Ussery v. United States*,⁴¹ a case involving a program in which certain employees were granted a leave of absence to pursue their studies. During the absence, the employees were given monthly payments equal to their previous salary. The Fifth Circuit Court of Appeals stated that such payments indicated that the program was "in effect employee training sponsored by the employer and undertaken by the employee as part of his employment." Some courts, however, have recognized that while a scholarship or fellowship is based partly on need, payments are often designed to permit a scholar to maintain his accustomed standard of living. Thus, a relationship of the size of the grant to a prior salary need not destroy the scholarship status of a grant.⁴² This seems to be entirely consistent with the purpose of section 117, which was designed to aid students, especially at the graduate level, who might be placed in a position of hardship if they left work to attend school. However, this enlightened view was not endorsed by the Supreme Court in *Johnson v. Bingler*. The Court reasoned that such a result would be anomalous in view of the fact that, under the section, the "comparatively modest sums" received by part-time teaching assistants are clearly subject to taxation, and that Congress did not intend to sanction such an inequitable result.⁴³ It therefore appears that a grant based on a large percentage of former salary will in the future be a factor that weighs heavily against exclusion from income, particularly where the amount is large in relation to typical scholarship grants.

IV. EXCLUDED CATEGORY (3) OF TREAS. REG. § 1.117-4 (c): THE PRIMARY PURPOSE TEST

Even though an employer-employee relationship may exist, the Service, in its regulations and rulings, and most courts usually apply a test based on the primary purpose of the grant rather than one based on indicia of compensation. This final restriction is treated as controlling over the other restrictions in the regulations. Even if the work is to be performed under the supervision of the grantor and even if a particular payment has all the indicia of compensation, the payment may still be excludable if the primary purpose of the grant is to benefit the recipient in his individual capacity.⁴⁴

As one court stated:

whether a payment qualifies as a scholarship or fellowship grant excludable from Section 117 . . . depends upon whether the primary purpose of the payment is to further the education and training of the recipient or whether the primary purpose is to serve the interest of the grantor.⁴⁵

41. 296 F.2d 582 (5th Cir. 1961). See also Stephen L. Zolney, 49 T.C. 389 (1968), and John E. McDonald, 52 T.C. 393 (1969).

42. See e.g., the court of appeals decision in *Johnson v. Bingler*, 396 F.2d 258 (3d Cir. 1968).

43. 394 U.S. at 751.

44. Chander P. Bhalla, 35 T.C. 13, 17 (1960).

45. *Id.*

Determining the primary purpose of the grant becomes difficult when it appears, as in most cases, that there is a mutual benefit from it. The question of primary purpose "must be resolved on a factual basis and depends upon the facts and circumstances in each particular case."⁴⁶ Due to the necessity of a case by case analysis, no useful guidelines have been developed.

A. *Whose Purpose Is to Be Emphasized?*

The first problem raised by the primary purpose test is a determination of whose purpose is to be adopted as the standard of measurement—the grantor's or the grantee's? In *Elmer L. Reese*,⁴⁷ taxpayer, as a candidate for a teaching degree, was required to teach in a public school. For teaching, taxpayer received the normal pay of a similarly qualified teacher. The court in that case held that the determinative purpose was that of the grantor. However, in *Commissioner v. Ide*,⁴⁸ taxpayer's son received financial assistance while at college in connection with his enrollment in the Navy R.O.T.C. program. This program obligated him to render services to the Navy in the future. The court, in discussing the problem of whose purpose is controlling, stated:

under this regulation, the determinative consideration 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.⁴⁹

There are sound reasons to support the view in *Ide*. Frequently a grantor's purpose in making a payment is not completely benevolent. The grantor expects to receive something in return, e.g., a future employee or access to the results of research performed by the student. In these cases the grantor is interested in something more than "furthering the education and training of the recipient in his individual capacity." Thus if the view in *Reese* is followed, these cases are to be resolved on a case by case basis because even if the payment is made to the student with "no strings attached," the fact that the grantor will receive some benefit in return will raise a factual question of primary purpose. If, however, the purpose of the recipient is controlling, as in *Ide*, the sole question is whether the grantee is to be classified as an independent student or as an employee doing work at a university. Such a test would be easier to administer and arguably would be more consistent with the intent of Congress to eliminate from scholarship treatment only continuing payments of salary. But this approach may in practice prove too much, for the student will always say that it is primarily for his educational benefit, and then marshal facts to support his view.

The trend of rulings, both by the Treasury and the courts, is toward the view that the purpose of the grantor is controlling, and if the purpose of the grant is not primarily to aid the student, the grant is taxable.⁵⁰

46. *Id.*

47. 45 T.C. 407 (1966), *aff'd*, 373 F.2d 742 (4th Cir. 1967).

48. 335 F.2d 852 (3d Cir. 1964).

49. *Id.* at 855.

50. See e.g., REV. RUL. 57-484, 1957-2 CUM. BULL. 113.

This writer believes such a view could lead to an unsatisfactory result in a given case. Often the source of the grant is a charitable foundation or governmental agency desiring research. To speak of benefit to the grantor in such a case is somewhat meaningless because the purpose of these grants is not to benefit the institution, but rather to render a service to the general public. Even though a grant of this nature is one of the most common examples of fellowship grants prior to the passage of this section,⁵¹ the present law requires that if the student's betterment is not the primary purpose of the grant, it is taxable. A related problem arises because many governmental or foundation grants are made to an institution or a professor, and not directly to the individual student. The institution or professor will then grant a particular student a stipend to aid in research. If the Treasury, in determining the excludability of the stipend, looks to the primary purpose of the grantor in making the grant, which grantor should it look to—the original grantor or the “middle man”? It is because of these problems that the application of the regulation to these types of cases has caused the most litigation concerning the section.

B. *Research, Degree Candidates, Post Degree Recipients*

For some time after the adoption of the regulations to section 117 in 1956, the Service maintained that no fellowship existed when an individual received payments to do research from a university or governmental agency.⁵² The belief was that the purpose of the services rendered was the benefit of the grantor; thus, the payment did not qualify for exclusion under the primary purpose test.

The courts have not always followed this interpretation, particularly when the payment was made to a candidate for a degree. In *Lawrence Spruch*,⁵³ taxpayer, while working on a Ph.D., received a fellowship grant from the university to conduct research within her field of study. The Commissioner contended that the primary purpose of the research was to benefit the interests of the university rather than to enable the taxpayer to pursue her studies. The Tax Court, in holding for the taxpayer, rejected the government's arguments. Evidently the Court was more concerned with benefit to the taxpayer than with benefit to the grantor. After the ruling in *Spruch*, and a similar holding in *Chander P. Bhalla*,⁵⁴ the Service announced that it would follow these rulings in disposing of similar degree candidate cases.⁵⁵

Based on the facts in *Spruch* and *Bhalla*, this Revenue Ruling indicates that a stipend should be presumed to be primarily for the purpose of furthering the education of the recipient if equivalent research is required of all students and if the student will receive credit for the research performed under the grant. The primary purpose test of the Regulations was designed by the Treasury to assure that only payments which Con-

51. See I.T. 4056, 1951-2 CUM. BULL. 8.

52. See e.g., REV. RUL. 62-122, 1962-2 CUM. BULL. 12; REV. RUL. 58-322, 1958-1 CUM. BULL. 59.

53. 20 T.C.M. 324 (1961).

54. 35 T.C. 13 (1960).

55. REV. RUL. 63-250 1963-2 CUM. BULL. 79.

gress intended as scholarships will be given that treatment. The facts in *Spruch* and *Bhalla* seem clearly to fit within the "letter, spirit, and the intent of the last sentence of Section 117(b)(1),"⁵⁶ which grants the exclusion to degree candidates required to work as a condition of the grant, if all candidates for the degree have to work. In effect, the Service has held it will follow the mandate of the Code.

The Treasury has been more willing to engage in a strict interpretation of the primary purpose test when the taxpayer is not a candidate for a degree. It has consistently attempted to deny exclusion where services are rendered, contending that such services are primarily for the benefit of the grantor, and hence, taxable. Some courts, however, have not been as strict and are willing to grant the exclusion to a non-degree candidate if he can establish that the services rendered provide the grantor with little or no benefit.

The most frequently litigated cases for those not candidates for a degree involve individuals engaged in health care, not yet fully qualified in their field, but who are capable of rendering services of some value, e.g., interns, residents or nurses. In most of these cases⁵⁷ the Service has found that the taxpayers were primarily performing a service for compensation, even though they were also acquiring training and experience in their specialties. These rulings were based on the fact that the taxpayers were rendering services necessary to the grantor to carry out its function.

However, where the taxpayer has been able to establish that the payments were made primarily to further his education, the courts have allowed the exclusion. The cases indicate that the taxpayer must show that (1) the principal purpose of the granting institution is not the care and treatment of patients, but the development of the individual, and (2) that, although the taxpayer's services were of some value, his absence would not require the hiring of a replacement.

In *Wroblecki v. Bingler*,⁵⁸ taxpayer, a graduate physician, participated in a program leading to certification by the American Board of Psychiatry and Neurology. The program required performance of clinical services at designated hospitals. Taxpayer's hospital was not primarily a service organization. The patients were selected, from persons already confined in other hospitals, in an effort to provide the cross section of cases necessary for teaching, research, and training. The program at the hospital also included extensive classroom and seminar activity. The court in *Wroblecki* distinguished this institution from the ordinary hospital "where interns and residents are accepted for training in the performance of the type of services it is customarily the business of hospitals to furnish." The court also found that the hospital already had an ample staff and that the taxpayer was of no primary or material benefit to the institute within the meaning of the primary purpose test. The court therefore granted the exclusion.

56. Chander P. Bhalla, 35 T.C. 13, 17 (1960).

57. See REV. RUL. 56-101, 1956-1 CUM. BULL. 89; REV. RUL. 57-386, 1957-2 CUM. BULL. 105; REV. RUL. 65-117, 1965-1 CUM. BULL. 67; REV. RUL. 68-250, 1968-2 CUM. BULL. 58.

58. 161 F. Supp. 901 (W.D. Pa. 1958).

In *Ethel Bonn*,⁵⁹ the court found that the hospital in question was a general service hospital, organized and operated for the care and treatment of patients. The relative value of a case to the training of residents did not affect the hospital's admissions policy. The court also found that, should taxpayer be eliminated as a member of the staff, a new physician would have to be hired. Based on these facts, the court held that the taxpayer's situation was "diametrically opposed" to that in *Wroblewski*, and denied the exclusion.

Between these two clearly delineated situations, however, is a vast gray area in which the usual fact situation will typically arise. Since the issue in the primary purpose test is one of fact, neither the cases nor the rulings provide particularly useful guidelines. The possible inconsistent results in this area are best illustrated by two recent cases. In *Pappas v. United States*,⁶⁰ a resident studying gynecology and obstetrics at the University of Arkansas medical center was allowed an exclusion under section 117. In *Lingl v. Charles*,⁶¹ a resident studying psychiatry at a state hospital in Ohio was denied the exclusion. Both cases involved jury verdicts. It seems, therefore, that the tax status of payments to interns and residents is far from clear.

V. CONCLUSION

Section 117 was enacted in 1954 to resolve the problems created by prior case law in determining excludability under the gift-compensation test. From 1954-1968 the Treasury, and a majority of the lower courts, have continued to base their decisions on pre-1954 criteria, while taxpayers have argued that section 117 was intended to eliminate the gift-compensation test from the taxation of educational grants. When certiorari was granted in *Johnson v. Bingler*, it was hoped that the Court would clear up the difficulties in distinguishing between excludable scholarship grants and includable compensatory payments. But in upholding the regulations, the Supreme Court in *Johnson* merely perpetuated the problem which was present before adoption of section 117. Possibly Congress can remedy this situation with curative legislation; however, if experience with section 117 is any guide, this may only make matters worse.

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59. 34 T.C. 64 (1960).

60. 19 A.F.T.R.2d 1276 (D.C. Ark. 1967).

61. 21 A.F.T.R.2d 410 (D.C. Ohio 1967).