Income Tax--Tax Status of Employer Financed Scholarships

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is of paramount importance to low-income groups.\textsuperscript{26} The decision in \textit{Hill v. Hill} is, therefore, consistent with a growing trend toward the extension of full faith and credit to modifiable decrees,\textsuperscript{27} and to analogous situations in the law\textsuperscript{28} in accordance with sound public policy.\textsuperscript{29}

\textit{Francis Lucas Warder, Jr.}

\section*{Income Tax — Tax Status of Employer Financed Scholarships}

Messrs. Johnson, Pomerantz, and Wolfe, employees of Westinghouse, were granted leave of absence for the purpose of researching and writing their doctoral theses. Mr. Johnson, as typical of the three plaintiffs, was granted leave from October 1, 1960 through June 30, 1961, and during this period he pursued the educational undertaking on a full time basis. Westinghouse paid him $5,670.00 which represented 80% of his normal salary for the period. Income taxes were withheld and Westinghouse treated the expenditures as indirect labor expenses on their records. The subject of the thesis had to relate at least generally to the employer's business. Employee benefits were continued and the employees were obligated to return to Westinghouse for a specified period at the end of the study leave. Claims for a refund were filed on the basis that the amounts received were scholarships or fellowship grants and excludible from income under section 117 of the Internal Revenue Code of 1954.\textsuperscript{1} The Supreme Court, in reversing

\begin{itemize}
\item \textsuperscript{28} \textit{See} Scoles, \textit{supra} note 4, at 817.
\item \textsuperscript{1} Section 117.
\item \textsuperscript{(a)} General Rule. In the case of an individual, gross income does not include—
\item \textsuperscript{(1)} any amount received—
\item \textsuperscript{(A)} as a scholarship at an educational institution (as defined in section 151 (e) (4)), or
\item \textsuperscript{(B)} as a fellowship grant, including the value of contributed ser-
the Court of Appeals for the Third Circuit held that the payments made to the taxpayers were compensation and not excludible as a scholarships or fellowship grants. Payments made primarily for the benefit of the grantor are not to be considered an amount received as a scholarship or fellowship grant. Bingler v. Johnson, 394 U.S. 741 (1969).

Section 117 was enacted as a part of the Internal Revenue Code of 1954 and had no counterpart under the 1939 Code. Prior to the enactment of section 117, scholarships and fellowship grants were taxable unless it could be shown that they were gifts, made to enable the recipient to acquire a degree or further his educational development. Section 117 was enacted primarily to resolve the problem of whether the scholarships or fellowship grant was a gift or taxable income. The number of rulings and cases arising under the section indicates that the desires of Congress, in achieving greater certainty as to the taxability of scholarships and fellow-

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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 expended by the recipient.

Johnson v. Bingler, 396 F.2d 258 (3d Cir. 1968). The district court for the Western District of Pennsylvania, in a trial by jury, had held that the grants were taxable compensation. The Court of Appeals for the Third Circuit reversed, declaring that the regulations relied on in the district court were invalid.

Governmental Accounting Standards Board (1954).

See, e.g., George Winchester Stone, Jr., 23 T.C. 254, 261 (1954). "The issue is whether the amount received . . . is taxable income . . . or a gift. . . . We have found that the fellowship payment to the petitioner was a gift."

Your committee's bill sets forth rules for determining the extent to which scholarships and fellowship grants are to be included in gross income and eliminates the existing confusion as to whether such payments are to be treated as income or as gifts. The present statute and regulations do not cover these grants. The basic ruling of the Internal Revenue Service which states that the amount of a grant or a fellowship is includible in gross income unless it can be established to be a gift provides no clear-cut method of distinguishing between taxable and nontaxable grants. Hence, the tax status of these grants must be decided on a case by case method.

Lawrence E. Bronowitz, 27 CCH Tax Ct. Mem. 1088 (1968) (taxpayer required to work part-time but paid separately for this and not obligated to work for the grantor upon receiving degree; exclusion allowed); Pappas v. United States, 67-1 U.S. Tax Cas. 9386 (E. D. Ark. 1967) (primary purpose of the grant
ship grants, has not been realized. The old rule required the
determination of excludibility to be on a case by case basis. The
effect of the new rule seems to have been much the same.

A number of cases under section 117 have been decided by
determining the primary purpose of the grant. Exclusion has been
allowed where the primary purpose of the grant was for the further-
ance of the taxpayer’s education and training but denied where the
grant was primarily for the benefit of the grantor. Authority for
basing the excludibility of a grant on the primary purpose for
which it was made is contained in the regulations. This formula-
tion is commonly referred to as the “primary purpose test” and was
solely relied on for determining the excludibility of the grant in

was furthering the taxpayer’s education and training in an individual capacity;
exclusion allowed even though the grantor may receive incidental benefits); Chandler P. Bhalla, 35 T.C. 13, (1960) (primary purpose of the grant was fur-
terance of taxpayer’s training; exclusion allowed); Frank Thomas Bachmura, 32 T.C. 1117 (1959) (payment not for the advancement of the education and
knowledge of the recipient personally; exclusion not allowed).

grants excludible); Rev. Rul. 419, 1956-1 Cum. Bull. 46 (American Cancer Soc-
ety grants excludible); Rev. Rul. 419, 1956-2 Cum. Bull. 112 (benefits to grantee
excludible, notwithstanding that the grantor may derive some benefit from the
(corporate grant to employee excludible where employee was not obligated
to render future services to the donor); Rev. Rul. 58, 1961-1 Cum. Bull. 37
assistance grant excludible); Rev. Rul. 81, 1959-1 Cum. Bull. 37 (foreign study
grant excludible); Rev. Rul. 101, 1916-1 Cum. Bull. 89 (hospital trainee grant
not excludible). These are but a few of the several rulings. The question of ex-
cludibility is so often raised that the Internal Revenue Service has issued
detailed special instructions to taxpayers receiving amounts for study or research.


1 Pappas v. United States, 66-1 U.S. Tax Cas. ¶ 9886 (E.D. Ark. 1967);
2 Woddall v. Commissioner, 321 F.3d 721 (10th Cir. 1961); Ussery v. United
States, 296 F.2d 582 (5th Cir. 1961).
3 See Treas. Reg. § 1.117-4(c) (2) (1956).

Items not considered as scholarships or fellowship grants.

(C) . . . . Amounts paid as compensation for services or primarily
o r the benefit of the grantor.

(2) . . . . 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 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 educa-
tion and training of the recipient in his individual capacity and the a-
mount provided by the grantor for such purpose does not represent compen-
sation or payment for services. . . . (emphasis added).
Reiffen v. United States,\textsuperscript{10} and applied reluctantly in Reese v. Commissioner.\textsuperscript{11} However, the courts have experienced great difficulty in determining the primary purpose of the grant.\textsuperscript{12} This same test was provided in Treasury Regulation 1.162-5 to determine the deductibility of education expenses under section 162. Owing to the difficulty encountered by the courts in applying the "primary purpose test" to education expenses, the regulations were amended and the "primary purpose test, was eliminated.\textsuperscript{13} The problem was with regard to the interpretation to be given the key words "primary purpose"\textsuperscript{14} and this same problem is encountered by the courts under section 117.\textsuperscript{15}

The decision of the Third Circuit was a more liberal treatment of employer-paid scholarships than the Commissioner's regulations permitted. The Third Circuit was of the opinion that Treasury Regulation 1.117-4 (c)\textsuperscript{16} was contrary to the intent of the Congress that enacted the Code; therefore, the court held the regulation was invalid. However, the Court of Appeals for the Fifth Circuit had previously held that the regulation governed in

\textsuperscript{10} 376 F.2d 883 (Ct. Cl. 1967).
\textsuperscript{11} 373 F.2d 742 (4th Cir. 1967).
\textsuperscript{12} Stewart v. United States, 363 F.2d 955 (6th Cir. 1966).
\textsuperscript{13} T.D. 6918, 1967-1 CUM. BULL. 36. Is the primary purpose test now used to determine excludibility under section 117 anything more than the pre-1954 gift or compensation test in disguise?
\textsuperscript{14} See, e.g., Marlor v. Commissioner, 251 F.2d 615 (2d Cir. 1958). The court found that the taxpayer's long range objective was to become a permanent member of the university teaching staff, for which position the possession of a doctoral degree was required. The pursuit of the doctoral degree was found to have dual objectives: (1) to retain his present appointment (which was temporary), and (2) to qualify for the permanent teaching staff (which would be a new position). The court determined that the expenses incurred by Mr. Marlor in pursuit of his doctorate were deductible.
\textsuperscript{15} See, e.g., Stewart v. United States, 363 F.2d 855, 357 (6th Cir. 1966):
We believe, however, 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 grantors. Obviously, in all instances where the employment relationship — past or future — is involved, there is at least some mutuality of benefit. . . .
\textsuperscript{16} In pertinent part, Treas. Reg. § 1.117-4 (c) (1956) provides as follows:
The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117: . . .
\textsuperscript{C} 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 amounts 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.
determining the taxability of educational grants.\(^1\) Decisions in the Fourth Circuit,\(^2\) Sixth Circuit,\(^3\) Tenth Circuit,\(^4\) and the Court of Claims\(^5\) were generally in accord with the decision in the Fifth Circuit.

In reversing the Third Circuit’s decision in *Bingler*, the Supreme Court noted: (1) the employer-employee relationship, (2) a close relationship between the amounts paid to the employee while on educational leave and his prior salaries, (3) continuation of employee benefits, (4) the requirement that the thesis topic had to relate, at least generally, to the work of the employer, and (5) that the employee was obligated to return to Westinghouse for a substantial period following completion of his studies. Thus, the Court clearly indicated that it felt the grant had the normal characteristics of compensation and was not a scholarship or fellowship. Furthermore, the Court stated that the definition of scholarship and fel-

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(2) 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 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...
lowship grant supplied by the regulations22 are "prima facie proper, comporting as they do with the ordinary understanding of 'scholarships' and 'fellowships' as relative disinterested 'no strings' educational grants, with no requirement of any substantial quid pro quo from the recipients."23

In the future, an employer financed education program for advanced study by an employee, where the employee is required or expected to return to work following the completion of the education is going to be difficult to qualify for exclusion. However, it is certain that there will be extensive litigation to determine the excludibility of employer financed scholarships and fellowship grants in situations where the employer does not exercise as much control as was present in Bingler v. Johnson. Furthermore, the validity of the regulations under section 117, with all their shortcomings, has been determined.

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(a) Scholarship. A scholarship generally means 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. The term includes the value of contributed services and accommodations . . . and the amount of tuition, matriculation, and other fees which are furnished or remitted to a student to aid him in pursuing his studies. The term also includes any amount received in the nature of a family allowance as a part of a scholarship. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in pursuing his studies where the grantor is motivated by family or philanthropic considerations. If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship.

(c) . . . Fellowship grant. A fellowship grant generally means an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. The term includes the value of contributed services and accommodations . . . and the amount of tuition, matriculation, and other fees which are furnished or remitted to an individual to aid him in the pursuit of study or research. The term also includes any amount received in the nature of a family allowance as a part of the fellowship grant. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in the pursuit of study or research where the grantor is motivated by family or philanthropic considerations.