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Taxation—Stipends Given in Conjunction with Employer Doctoral Programs are Taxable as Compensation for Employment

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ing the specifically excluded views as having no relation to religion. Had the court thereafter determined that Sisson's belief had some relation to religion, even though minor, Sisson's belief would be within the congressional definition of religion, Sisson could have been afforded exemption from the draft, and the exemption's constitutionality would have been upheld. By utilizing such a procedure, the court may have been able to avoid "imputing to Congress an intent to classify different religious beliefs, exempting some and excluding others, and [would have been] in accord with the well-established congressional policy of equal treatment for those whose opposition to service is grounded in their religious tenets."[87]

Because the Supreme Court may choose, on appeal, not to adopt the new points of law developed in *Sisson*, the method the court chose to exempt Sisson from the draft may have provided relief of a temporary nature only, and a remedy which is tenuous at best. It is apparent, therefore, that the court should have made an overt attempt to construe the provisions of section 6(j) of the Act so as to include Sisson within the section's coverage. While it is true that the court may have found that Sisson's convictions had no basis whatsoever in religion, in making that determination alone the court would have made an attempt to uphold the validity of the statute, and would have explored every route available in fashioning its remedy.

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TAXATION—STIPENDS GIVEN IN CONJUNCTION WITH EMPLOYER DOCTORAL PROGRAMS ARE TAXABLE AS COMPENSATION FOR EMPLOYMENT

Respondents, Johnson, et. al.,[1] received stipends (which were originally included in their gross income for the years 1961-1962) from their employer, Westinghouse, while they were completing dissertations for doctoral degrees. Such stipends constituted the second phase of a two-part program known as the Westinghouse Bettis Fellowship and Doctoral Program.[2] The payments from Westinghouse were based on a specified percentage of respondents'

87. United States v. Seeger, 380 U.S. 163, 176 (1965).

1. Respondents were Richard E. Johnson, Richard A. Wolfe, and Martin L. Pomerantz, all engineers at the Bettis Atomic Power Laboratory and employed by Westinghouse. Their wives were parties to the action merely because joint tax returns were filed for the years in question.

2. This program was a two-phase schedule of subsidized post-graduate study in engineering, physics, or mathematics. The first phase was a "work-study" concept with the employee being paid for a forty-hour week and receiving up to eight hours off for the purpose of attending classes. When an employee completed all preliminary requirements for his doctorate he could apply for an educational leave of absence, which constituted the second phase, to complete work on his doctoral dissertation. The employee was required to submit a proposed dissertation topic for approval by Westinghouse and the Atomic Energy Commission. Approval was based, *inter alia*, on a determination that the topic had at least some general relevance to the work done at Bettis.

prior salaries plus adders which depended upon individual family needs. While on leave, the employees maintained seniority, received company benefits and submitted periodic progress reports relating to their dissertations. Furthermore, respondents signed a written agreement promising to return to the employ of Westinghouse for a period of at least two years upon completion of their studies.[3] Upon returning, respondents were to "assume duties commensurate with their education and experience," at a salary "commensurate with the duties assigned."[4] Respondents filed income tax refund claims stating that the stipends they had received were excludable from gross income as "scholarships" or "fellowships" under section 117 of the Internal Revenue Code of 1954.[5] These claims were rejected by the Commissioner and suit was filed in the United States District Court for the Western District of Pennsylvania.[6] There the jury was instructed to consider Treasury Regulation section 1.117-4(c)[7] in reaching its verdict. This regulation provides that amounts representing compensation for past, present, or future employment services and amounts paid to an individual to enable him to pursue studies or research primarily for the benefit of the grantor are not excludable from gross income as scholarships or fellowships. The jury found that the amounts were taxable income. On appeal, the United States Court of Appeals for the Third Circuit reversed, holding that Regulation section 1.117-4(c) was invalid, and that, as a matter of law, the amounts in question were "scholarships" excludable under section 117.[8] Certiorari was granted by the Supreme Court of the United States.[9] *Held*, Regulation section 1.117-4(c) was a valid exercise of discretion given to the Treasury by Congress; the jury properly found the amounts received by the respondents were taxable compensation rather than excludable scholarships. *Bingler v. Johnson*, 394 U.S. 741 (1969).

Under the 1939 Internal Revenue Code[10] there was no provision dealing expressly with the question of scholarship or fellowship grants. Determinations were basically made on a case-by-case method with the subjective test of gift versus compensation being applied.[11] The question was whether the amounts received were of such character as to fall within the statutory definition of gross income as amounts representing compensation for services rendered, or were, on the other hand, to be considered as gifts to the recipients

3. The specific enforceability of this written agreement was strongly attacked by the Court of Appeals. Johnson v. Bingler, 396 F.2d 258, 262 (3d Cir. 1968) (dictum).
4. Bingler v. Johnson, 394 U.S. 741, 744 (1969).
5. INT. REV. CODE of 1954, § 117 [hereinafter cited as § 117].
6. Johnson v. Bingler, 47-1 U.S. Tax Cas. ¶ 9165 (D.C. W.D. Pa. 1966).
7. Treas. Reg. § 1.117-4(c) (1956) [hereinafter cited as Reg. § 1.117-4(c)].
8. Johnson v. Bingler, 396 F.2d 258 (3d Cir. 1968).
9. Bingler v. Johnson, *cert. granted*, 393 U.S. 949 (1968).
10. INT. REV. CODE of 1939.
11. I.T. 4056, 1951-2 CUM. BULL. 8 at 10. "If a grant or fellowship award is made for the training and education of an individual, either as a part of his program in acquiring a degree or in otherwise furthering his educational development, no services being rendered as consideration therefor, the amount of the grant or award is a gift which is excludable from gross income."

and therefore, by definition, excluded from gross income.[12] The consequence of this method of determination was one of confusion for the taxpayer, the Internal Revenue Service, and the courts. Congress sought to alleviate this confusion by including section 117 in the Internal Revenue Code of 1954.[13] It was Congress' intent that this section would provide "a clear-cut method of distinguishing between taxable and non-taxable grants" and consequently would eliminate decisions "on a case-by-case method."[14] Section 117(a) sets out the general rule that gross income does not include amounts received as scholarship or fellowship grants.[15] A limitation placed on the general rule is that degree candidates cannot exclude payments for services unless similar services are required of all degree candidates regardless of whether they receive scholarships or fellowships.[16] While Congress did limit the exclusion of "scholarship" and "fellowship" grants, it never defined these terms. However, as stated in *Frank Thomas Bachmura*,[17] Congress evidently felt these terms had a commonly understood meaning since it failed to give them definitions when enacting section 117. The Treasury attempted to remedy this lack of definitiveness in its regulations. The Treasury Regulations define scholarship as "an amount paid or allowed to, or for the benefit of, a student, whether

12. *See* George Winchester Stone, Jr., 23 T.C. 254 (1954); Ti Li Loo, 22 T.C. 220 (1954); Ephraim Banks and Libby K. Banks, 17 T.C. 1386 (1952).

13. For a comprehensive historical outline of § 117, *see* Mansfield, *Income From Prizes and Awards and From Scholarship and Fellowship Grants*, N.Y.U. 19TH INST. ON FED. TAX. 129 (1961).

14. H.R. Rep. No. 1382, 83d Cong., 2d Sess. 16 (1954); S. Rep. No. 1662, 83d Cong., 2d Sess. 17 (1954).

15. INT. REV. CODE of 1954, § 117(a). Section 117(a) reads as follows:

§ 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.

16. *Id.*, § 117(b)(1) reads as follows:

(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 (as defined in section 151(e)(4), subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the 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.

17. Frank Thomas Bachmura, 32 T.C. 1117, 1122 (1959).

undergraduate or graduate, to aid such individual in pursuing his studies."[18] A fellowship is defined as "an amount paid to, or for the benefit of, an individual to aid him in the pursuit of study or research."[19] Of critical importance is Reg. section 1.117-4(c) which states in part that amounts paid as compensation for services, whether past, present or future, are not scholarships or fellowships.[20] The interpretation of Reg. section 1.117-4(c) has been the issue in much of the litigation concerning section 117.[21]

Since 1954, the situation with respect to the taxability of scholarships and fellowships has remained as unsettled as it was prior to the enactment of section 117. The Commissioner and the courts have persistently focused on the intent of the grantor and, in determining this intent, have continued to apply the pre-1954 test of gift *versus* compensation.[22] However, Reg. section 1.117-4(c) (2) has given rise to an additional test which has become known as the "primary-purpose" test and has been used by a number of the courts.[23] Under this test, even though a grant may be compensatory in nature, it may still be a scholarship so long as its primary purpose is for the benefit of the grantee.[24] In other words, even though the stipend and its en-

18. Treas. Reg. § 1.117-3 (1956).

19. *Id.*

20. *Id.*, § 1.117-4(c) reads as follows:

> The following . . . shall not be considered to be amounts received as a scholarship or fellowship grant for the purposes of section 117:
>
> . . . .
>
> (c) Amounts paid as compensation for services or primarily for the benefit of the grantor.
>
> (1) Except as provided in § 1.117-2(a) [dealing with degree candidates and required services], 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 services or represents payment for services which are subject to the direction or supervision 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 . . . an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purposes 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 does not represent compensation or payment for the services described in sub-paragraph (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. [Emphasis added.]

21. *Comment*, 17 KAN. L. REV. 104, 108 (1968). *See also* Elmer L. Reese, Jr. and Dorothy L. Reese, 45 T.C. 407 (1966); Frank Thomas Bachmura, 32 T.C. 1117 (1959).

22. *See* Gordon, *Scholarship and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U. L.Q. 144.

23. *See* Wells v. Comm'n, 40 T.C. 40 (1963); Ussery v. United States, 296 F.2d 582, 587 (1961) [hereinafter cited as *Ussery*]; Chandler P. Bhalla, 35 T.C. 13, 17 (1960).

24. In Chandler P. Bhalla, 35 T.C. 13, 17 (1960), the Court quoted with approval from the brief filed on behalf of the Commissioner the following statement: "[W]hether a payment qualifies as a scholarship or fellowship grant excludable from gross income under section 117 of the 1954 Code 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." *Also see* Wrobleski v. Bingler, 161 F. Supp. 901 (W.D.

suing results may give some benefit to the grantor, it is a scholarship so long as the primary benefit flows to the recipient in his individual capacity. The rulings and decisions under both tests have generally been adverse to the taxpayer when his employer has been the payor of the alleged scholarship or fellowship grant.[25] Most of the rulings and decisions holding such "trainee-employees" taxable on the amount they receive have emphasized that these persons render services which must be performed for the employer to carry out its function.[26] Few of these cases give more than superficial attention to the intent of, and benefit to, the recipient as is suggested by the primary purpose test. As indicated by seemingly inconsistent decisions,[27] the enactment of section 117 and the ensuing Treasury Regulations has done little to clarify an historically unsettled area of law. Reg. section 1.117-4(c), being at the vortex of litigation regarding section 117, has been held to be both valid and invalid with respect to Congressional intent.[28] The Supreme Court of the United States, in a case of first impression,[29] attempted to clarify this situation.

Johnson came to the Supreme Court from the Court of Appeals[30] which stated that Congress, in enacting section 117, intended to encourage financial aid "to students at accredited schools and especially to candidates for degrees."[31] The Court of Appeals noted that the legislature desired "to do away

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Pa. 1958); Wells v. Comm'r., 40 T.C. 40 (1963); Frank Thomas Bachmura, 32 T.C. 1117 (1959); Rev. Rul. 57-560, 1957-2 CUM. BULL., 108; Rev. Rul. 57-127, 1957-1 CUM. BULL., 275; Rev. Rul. 56-419, 1956-2 CUM. BULL., 112.

25. Stewart v. United States, 363 F.2d 355 (6th Cir. 1966); Ethel M. Bonn, 34 T.C. 64 (1960); Frank Thomas Bachmura, 32 T.C. 1117 (1959). A notable exception occurred in Ailene Evans, 34 T.C. 720 (1960). In the *Evans* case the Department of Mental Health of the State of Tennessee paid a stipend to the taxpayer while she was enrolled in a psychiatric nursing program at a university and the taxpayer agreed to accept employment with the department after completing the course. The Tax Court, in holding that the stipend was excludable, noted that the taxpayer would receive the prevailing salary for any future services.

26. Ethel M. Bonn, 34 T.C. 64 (1960); Rev. Rul. 59-118 CUM. BULL. 1959-1, 41; Rev. Rul. 57-386, CUM. BULL. 1957-2, 109; Rev. Rul. 56-101, CUM. BULL. 1956-1, 89.

27. *See, e.g.*, Ailene Evans, 34 T.C. 720 (1960) and Bronowitz v. Comm'r, P-H 1968 T.C. Mem. Dec. ¶ 68,221 (1968) as opposed to Stewart v. United States, 363 F.2d 355 (6th Cir. 1966) and Ussery v. United States, 296 F.2d 582 (5th Cir. 1961).

28. Holding Reg. § 1.117-4(c) invalid were Johnson v. Bingler, 396 F.2d 258, 260-61 (1968) and Bronowitz v. Comm'r, P-H 1968 T.C. Mem. Dec. ¶ 68,211 (1968). *Contra* Bingler v. Johnson, 394 U.S. 741, 751 (1969). *See also* Stewart v. United States, 363 F.2d 355 (6th Cir. 1966) and Ussery v. United States, 296 F.2d 582 (5th Cir. 1961). In *Ussery*, the court specifically upheld Reg. § 1.117-4(c) and taxable monthly payments received by an employee of the Mississippi Department of Public Welfare who had been given leave to secure a Master's Degree in social work. The taxpayer there received employee benefits while on leave, and was obligated to return to the department following completion of his studies. Stewart involved a similar arrangement under which an employee of the Tennessee Department of Public Welfare received monthly stipends and other benefits during an educational leave of absence but was required to return thereafter to her previous position.

29. Instant case.

30. Johnson v. Bingler, 396 F.2d 258 (3d Cir. 1968). Mr. Justice Douglas dissented from the Supreme Court's majority opinion for reasons given by the Court of Appeals. Instant case at 758.

31. Johnson v. Bingler, 396 F.2d 258, 260 (3d Cir. 1968).

with the touchstone of compensation versus gift"[32] and further, to provide a clear cut manner for eliminating the necessity of determining the tax status of grants "on a case-by-case method."[33] Urging a strict construction of section 117, the court took notice that only in the case of grantees who are not candidates for degrees did the legislature specify that it desired "to tax those grants which are in effect merely payments of a salary during a period when the recipient is on leave from his regular job,"[34] and that this concern was specifically expressed in section 117(b)(2) by limiting the grantors that could qualify and the amount which could be excluded. The court reasoned further that, since Congress had imposed no restriction on the amount to be excluded by a degree candidate, the canon of statutory construction *expressio unius exclusio ulterius*[35] applied and, therefore, the "indicia of compensation such as suggested by the Regulations [were not] legitimate criteria for taxing the excludability of an alleged scholarship."[36] The Court of Appeals determined that the facts, as shown, did not give rise to the assumption that the payments were compensatory in nature, assuming, *arguendo*, that the Regulations in question were within the legislative intent of section 117. The Supreme Court, however, while describing its position as "fundamental doctrine," stated that as "contemporaneous constructions by those charged with the administration of the Code, the Regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and should not be overruled except for weighty reasons."[37] Using this rationale the Court held that the Commissioner's Regulations merely supplied "the definitions [of scholarship and fellowship] that Congress omitted,"[38] and were a legitimate exercise of prescribing "all needful rules and regulations for the enforcement of the Internal Revenue Code."[39] Further, the definitions supplied by the Regulation comport "with the ordinary understanding of 'scholarships' and 'fellowships' as relatively disinterested, 'no-strings' educational grants, with no requirements of any substantial *quid pro quo* from the recipients."[40] The Court declared that the legislative intent in enacting section 117 was not "to exclude from taxation all amounts, no matter how large or from what source, that are

32. *Id.* at 259-60.
33. *Id.* n.9.
34. *Id.*
35. Under this maxim, if a statute specifies one exception to a general rule or assumes to specify the effects of a certain provision, other exceptions or effects are excluded. The Supreme Court dismissed the Third Circuit's reasoning on this point by stating that such an interpretation could create great inequities and the Court declined "to assume that Congress intended to sanction" such a situation. Instant case at 752.
36. Johnson v. Bingler, 396 F.2d 258, 260 (3d Cir. 1968). *Contra*, Stewart v. United States, 363 F.2d 355, 357 (6th Cir. 1966).
37. Instant case at 750.
38. *Id.* at 749. While the Court of Appeals (in invalidating Reg. § 1.117-4) accepted *Evans* and rejected *Ussery* and *Stewart*, the Supreme Court (in validating Reg. § 1.117-4) endorsed the two latter cases by footnote (*Id.* n.30.) and stated that "we are informed by the Solicitor General . . . that the *Evans* acquiescence will be modified." *Id.*
39. *Id.* at 751.
40. *Id.*

given for the support of one who *happens to be a student*,"[41] but merely that scholarships and fellowships are sufficiently unique to merit tax treatment separate from that accorded gifts. The Supreme Court held that the facts clearly indicated that the payments were compensatory since the recipients were receiving a *quid* for their *quo*, *i.e.*, respondents were furnishing services, both present and future, by virtue of their ongoing relationship and future employment with Westinghouse.

The Supreme Court's ruling in *Johnson* has apparently re-established the test of gift *versus* compensation as the method for determining whether a stipend is a scholarship or taxable income. The Court has singled out two significant facts to be considered: one, the intent of the donor, and two, whether or not the stipend is in any way compensatory in nature *vis-à-vis* payment for past, present, or future services. The Court's delineation of scholarships as "relatively disinterested, 'no-strings' educational grants, with no requirements of any substantial *quid pro quo* from the recipients"[42] sounds strikingly similar to the language used in *Commissioner v. Duberstein*.[43] There the Court defined a gift as "detached and disinterested generosity"[44] and emphasized examination of the transferor's intent. This use of the gift *versus* compensation test is clearly contrary to legislative intent in enacting section 117[45] in that this test requires a case-by-case determination depending on the factual setting of each situation. Moreover, the Court's construction of section 117 and Reg. section 1.117-4 has directly thwarted the Congressional intent of encouraging scholarship aid. The Court in upholding the Regulations as valid has reached a decision that does not comport with the clear national purpose behind section 117, *i.e.*, to encourage scholarship aid and hence to encourage higher education of the populace.[46] The ramifications of this decision remain, of course, to be seen. It would seem, however, that the Commissioner may now treat as taxable income the vast majority of stipends that have been traditionally treated as scholarships. Using the language of the Court regarding "no-strings . . . with no requirements of any substantial *quid pro quo* from the recipients," the Commissioner might well label as taxable such stipends as National Collegiate Athletic Association scholarships and ordinary academic scholarships

41. *Id.* at 753 [emphasis added].
42. *Id.* at 751.
43. Commissioner v. Duberstein, 363 U.S. 278 (1960).
44. *Id.* at 285-86.
45. *See* text, p. 442, *supra*.
46. The Court's "reluctance to believe that § 117 was designed to exclude from taxation all amounts, no matter how large or from what source, that are given for the support of one who *happens* to be a student," is a case in point. Instant case at 753. The logic of this statement is certainly questionable. The stipends in question were not given to "one who happened to be a student," but rather, so that one *might* be a student, as is the normal "scholarship incentive" offered by companies to their employees. However, in upholding Reg. § 1.117-4(c) the Supreme Court seems to have held as valid not only that language in Reg. § 1.117-4(c)(1) which gives rise to the gift versus compensation test, but also Reg. § 1.117-4(c)(2) from which the primary purpose test has been derived.

based on one's prior and future academic performances.[47] In addition, the test used by the Supreme Court may have the effect of discouraging the widespread practice of governmental agencies and private corporations offering "scholarship incentives" to encourage their employees to continue in their acquisition of higher education degrees. It is highly improbable that any agency or corporate enterprise would provide stipends to employees to pursue a course of study alien to that entity's purpose for existence.[48] In the Court's opinion the intent of the donor and whether or not the stipends are compensatory in nature would seem to control. This is different from Reg. section 1.117-4(c)(2) which indicates that a stipend may be excludable even though compensatory in nature so long as it is primarily for the benefit of the recipient in his individual capacity.[49] Without legislative action giving more definite guidelines as to what a scholarship is, the possibility exists that courts may interpret *Johnson* in such a fashion as to maintain the primary purpose test. Such an interpretation may result in decisions more in line with the original legislative intent of section 117. The facts of *Johnson* are such that, using the primary purpose test, one may still arrive at the ultimate conclusion that the stipends received by respondents were taxable income. The jury in fact did consider Reg. section 1.117-4(c)(2) by instruction and may well have reached their decision based on that subsection without relying on Reg. section 1.117-4(c)(1). One might make the argument that "substantial" *quid pro quo* (with emphasis on substantial) is necessary for the language of Reg. section 1.117-4(c)(1)—gift *versus* compensation—to take precedence over Reg. section 1.117-4(c)(2)—primary purpose test—as the best method of determining whether a stipend is excludable from taxable income as a scholarship or fellowship. If it were decided that the *quid pro quo* was not "substantial" then the issue would be decided on whether or not the primary purpose of the stipend was for the benefit of the recipient in his individual capacity.

A. BRUCE NORTON

47. The National Collegiate Athletic Association scholarships are given by member universities and colleges to incoming "students" who are required to perform for the given institution in their particular area of expertise, *e.g.*, football, basketball, etc. If the students fail to perform their specialties for reasons that are other than "valid" the institutions will withdraw the "scholarship." This certainly would seem to qualify as a "substantial *quid pro quo*." While an academic scholarship does not, at first glance, look to be a *quid pro quo* situation, further study shows that an institution does receive a service from the "good" academic students who receive these scholarships (and often lose them if their academic work falls below better than average standards) in that the institution enhances its' academic standing and reputation by having such students in attendance. Active recruiting by institutions for the excellent academic student is a fairly commonplace occurrence.

48. Such a program would enhance the chances of the entity losing the employee to another entity in a field in which he obtained his higher education degree.

49. Reg. § 1.117-4(c)(2) has given rise to the primary purpose test. *See* notes 25-26 *supra* and accompanying text.