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Fellowship Grants Under the Internal Revenue Code of 1954

The predictability of the tax status of grants for educational purposes was an area of great uncertainty under the Internal Revenue Code of 1939. That Act contained no specific provision for such grants, and so amounts received under fellowship and scholarship nomenclature were considered as part of the recipient's gross income, except as they qualified as gifts.¹ To so qualify, the intent of the donor must have been to make a gift² for the training and education of the individual only.³ If the recipient was obliged or expected to use his knowledge or skill in developing some particular project which benefited the grantor in some manner, the funds received were held to be consideration for the services of the recipient to the grantor.⁴

The Treasury position on the matter was summarized in a communication in 1951.⁵ If a grant or fellowship was 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 a consideration therefor, the amount of the grant was a gift, excludable from gross income. The Treasury statement continued, however, that if the recipient applied his skill and training to advance research, creative work, or some other project or activity, the essential elements of a gift were not present and the amount received was to be included in gross income. As a consequence of this Treasury position, if a student performed any services in connection with his educational development, while receiving funds from an institution, the amount thereof was likely to be deemed part of gross income by the Commissioner and the burden of showing it to be a gift would be on the student.⁶ To make this showing was an almost insurmountable task, for the slightest indication was enough for the courts to find an employment relation between the student and his grantor and sustain the Commissioner's position.⁷ Such a relation was considered established if: letters of appointment did not show a donative intent, the grantor controlled the recipient's research or required periodic reports thereon, the object of the research was specified by the grantor, the grantor withheld tax on the payments to the recipient, or the end of the research was of practical or commercial application.⁸

1. INT. REV. CODE OF 1939, §22(b)(3). This section was substantially the same as the present section 102 of the 1954 Code, which specifically excludes from gross income property received as a gift.

2. George W. Stone, Jr., 23 T.C. 254 (1954).

3. R. F. Doerge, 11 T.C.Memo. 475 (1952); Ti Li Loo, 22 T.C. 220 (1954).

4. Ephriam Banks, 17 T.C. 1386 (1952).

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

6. Huberman, *Scholarships, Fellowships and Prizes*, 3 HASTINGS L.J. 116 (1952).

7. *Scholarships, Fellowships and Prizes: Gift of Income*, 38 MINN. L. REV. 152 (1954).

8. *Ibid.*

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Thus it was that Congress was pressed to specify, for the first time, what it intended to include of educational grants in the gross income of the recipient. In the general revision of the internal revenue laws in 1954, that specification was made, through Section 117 of the Internal Revenue Code of 1954.⁹ The section generally provides that all amounts received as scholarships and fellowship grants, including services and accommodations received in kind, are excluded from the gross income of the recipient.¹⁰ A limit on the amount of the exclusion is set by distinguishing between degree and non-degree candidates, and the source of the grant.¹¹ Those seeking a degree from an educational institution, as defined by Section 151(e)(4) of the Code,¹² are entitled to exclude the entire amount of their grant and, with respect to such persons, Congress has specified that amounts received as payment for teaching, research, or other services are within the meaning of fellowships and scholarships if they are required of *all* candidates for the degree, whether or not they are recipients of grants.¹³ In order for a non-degree seeking recipient to exclude his grant from gross income, the grantor must be a tax-exempt organization as described in Section 501(c)(3),¹⁴ and he can exclude only an amount equal to \$300 per month for the taxable year involved, not exceeding a maximum of thirty-six months.¹⁵ No specification of the construction to be placed upon payments when services are required as part of the course or curriculum is made in respect to non-degree candidates.

Although Congress had declared that fellowships and scholarships were to be excluded from gross income according to the limitations prescribed in the Code, it had not distinguished between educational grants and compensation for purposes of the exclusion, except as to services required for degrees. The aura of uncertainty continued as to that distinction, especially in regard to non-degree seeking recipients of grants. Such was the setting when the Tax Court was presented with just that question in May, 1958, in the case of

9. The words of the Senate and House Committees, describing the Fellowship and Scholarship grants are substantially codified in the section itself. 3 U.S. CODE CONG. & AD. NEWS 4823, 5286 (1954). See Landman, *The Taxability of Fringe Benefits*, 33 TAXES 173 (1955); see also 7 SYRACUSE L. REV. 130 (1956).

10. INT. REV. CODE OF 1954, §117(a).

11. *Id.* §117(b).

12. A qualifying institution under this section is one which normally maintains a regular faculty and established curriculum, and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on. Generally, it includes colleges and universities. Treas. Reg. §1.117-3(c) (1956).

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

14. *Id.* §117(b)(2)(A). Section 501(c)(3) generally exempts corporations formed exclusively for educational purposes from income taxation. To gain this exemption, however, the institution must file appropriate papers with its district director (Treas. Reg. §1.501(a)(2)), not be a "feeder" organization for a profit-making concern (1954 CODE, §502), refrain from certain "prohibited" activities (1954 CODE, §503), and not unreasonably accumulate or improperly use its income (1954 CODE, §504).

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

Wrobleski v. Bingler.¹⁶ The taxpayer, a graduate physician, was one of a number of participants in a graduate course leading to a certificate in psychiatry from the American Board of Psychiatry and Neurology. He initiated the action, seeking a refund of taxes withheld from his stipend. As a requirement of this course, the participants performed certain clinical services and the taxpayer was one of a limited number of the participants who performed that obligation at the University of Pittsburgh Clinic. The Clinic was specially designed to provide this training, accepting only selected cases.

After finding that Wrobleski was not a candidate for degree¹⁷ and that the University of Pittsburgh was a tax-exempt organization,¹⁸ the Court faced the question of whether the stipend of \$3,400 was a fellowship or a salary. Ruling in favor of the taxpayer, over the Commissioner's argument that the stipend was payment for treating and counseling patients at the clinic, the Court made its determination by looking to the primary purpose of the grant. It held that all monies received by the taxpayer, called a "fellow", constituted a fellowship grant under Section 117, for the services performed were not for the grantor but for the primary purpose of furthering the education of the grantee. Wrobleski's stipend, then, was an allowable exclusion from gross income subject to the limitations on non-degree candidates.

Prior to the decision in the *Wrobleski* case, the Treasury had been employing the *primary purpose test* in making informal determinations of the nature of educational grants. The Treasury Regulations defined a fellowship grant as any amount paid or allowed for the benefit of an individual to aid him in the pursuit of study or research, including the value of contributed services, tuition, matriculation, and other fees.¹⁹ Certain payments and allowances are excluded under the regulations, however, when they may be viewed as payment for past, present, or future services, or for study or research primarily for the benefit of the grantor.²⁰ On the other hand, where the primary purpose of the grant is to further the education and training of the recipient in his individual capacity and no employment relation is established with respect to the particular grant, the funds will qualify under Section 117, notwithstanding that the grantor receives some incidental benefit, or that periodic reports are required.²¹

Using these guides of the regulations, the Treasury, considering "Traineeships" awarded nursing students under the Public Health Service Program,

16. 58-2 U.S.T.C. —, 161 Fed. Supp. 901 (1958).

17. Treas. Reg. §1.117-3(e) (1956) provides that a candidate for degree is an individual, undergraduate or graduate, who is pursuing studies or conducting research to meet the requirements for an academic or professional degree conferred by colleges or universities. [Italics supplied.]

18. Within the meaning of §501(c) (3), note 12 *supra*.

19. Treas. Reg. §1.117-3(c) (1956).

20. *Id.*, §1.117-4(c) (1), (2) (1956).

21. *Id.*, §1.117-4(c) (2) (1956).

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held that awards from the university participating in the program were excludable from gross income in amounts dependent upon whether the trainee was a degree candidate or not, although a period of work in a local hospital, whence it received benefit, was required.²² The contrast was made when the same principles were applied to the stipend of interns and resident physicians from a hospital for work done therein and required prior to being admitted to practice. That stipend was held by the Treasury to be a salary, for the primary benefit of the services was for the hospital with only incidental benefits to the intern.²³ Similarly, amounts received by students of a theological seminary from a parish congregation to which they were assigned as a requirement for ordination, were ruled includible in their gross income.²⁴

Although the line between the *Wrobleski* case and that of the interns seems fine at best, the situations appear to have been distinguished on the ground, less clearly enunciated by the court than the primary purpose rationale, that no salaried personnel would have been required to replace *Wrobleski* in the event he ceased his service, while the same cannot be said of hospital interns or residents. The decision in the *Wrobleski* case does not come as a surprise to students of the 1954 Code. If the case is of any moment, it is because it is the first clear statement by the Tax Court of what observers, including the Treasury, believed to have been the design of Congress in enacting the special provision of the Code in regard to scholarships and fellowship awards. Where a student and his grantor qualify as prescribed by the Code, the fact that the student performs some services of benefit to the grantor in connection with his grant is no longer the crucial determinant of the nature of his stipend, but merely has weight as evidence on the question of the primary purpose of the grant. The result reached in the *Wrobleski* case would almost certainly not have been reached under the 1939 Code. Since the student did perform clinical services under the grantor's supervision and taxes were withheld from his stipend, the courts, under the earlier act, would have had little choice but to find the existence of an employment relation, negating the donative intent there required.²⁵ At least to this extent, prospective scholars and grantors may now proceed with greater certainty in grants aiding higher education.

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22. REV. RUL. 57-370, 1957-2 CUM. BULL. 105.

23. REV. RUL. 57-386, 1957-2 CUM. BULL. 107.

24. REV. RUL. 57-522, 1957-2 CUM. BULL. 50.

25. *Supra*, notes 1, 2, and 3.