

SCHOLARSHIP AND FELLOWSHIP GRANTS AS INCOME: A SEARCH FOR TREASURY POLICY

DONALD H. GORDON†

More than five years have elapsed since the enactment of section 117 as a part of the Internal Revenue Code of 1954.¹ In that period there have been several revenue rulings² and one judicial decision³ dealing with problems arising under section 117. A reading of these suggests that the difficulties which characterized the income tax treatment of grants and awards in aid of student and scholar prior to the enactment of the section still remain. It is the thesis of what follows that this need not be so, that a broader reading of section 117 is justified and appropriate, and that a clarification of Treasury policy can eliminate further uncertainty in this sector of the income tax law.

I. PRIOR LAW AND THE PRESENT STATUTORY TREATMENT

In the years prior to 1954 the cases and rulings framed the issue of whether a scholarship or fellowship grant⁴ need be included in

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1. 68A Stat. (1954).

2. Rev. Rul. 554, 1955-2 Cum. Bull. 36 (amount of exclusion); Rev. Rul. 101, 1956-1 Cum. Bull. 89 (Education Exchange Act grant); Rev. Rul. 419, 1956-2 Cum. Bull. 112 (foundation grant to Ph.D. candidate); Rev. Rul. 50, 1957-1 Cum. Bull. 74 (Rockefeller Public Service award); Rev. Rul. 127, 1957-1 Cum. Bull. 275 (government grant for research made through a university); Rev. Rul. 131, 1957-1 Cum. Bull. 75 (grant to foreign exchange student); Rev. Rul. 370, 1957-2 Cum. Bull. 105 (U. S. Public Health Service grant); Rev. Rul. 385, 1957-2 Cum. Bull. 109 (grant for administrative residency in a hospital); Rev. Rul. 386, 1957-2 Cum. Bull. 107 (internship grant in a hospital); Rev. Rul. 484, 1957-2 Cum. Bull. 113 (institutional training in employer's school); Rev. Rul. 522, 1957-2 Cum. Bull. 50 (grant to theology students); Rev. Rul. 560, 1957-2 Cum. Bull. 108 (Mayo Foundation Fellowships); Rev. Rul. 76, 1958-1 Cum. Bull. 56 (American Heart Association Research Fellowship); Rev. Rul. 179, 1958-1 Cum. Bull. 57 (National Institute of Health grant); Rev. Rul. 222, 1958-1 Cum. Bull. 54 (sabbatical leave grant); Rev. Rul. 322, 1958-1 Cum. Bull. 59 (Air University Research award); Rev. Rul. 338, 1958-2 Cum. Bull. 54 (award to student nurse); Rev. Rul. 403, 1958-2 Cum. Bull. 49 (U. S. Navy educational assistance grant); Rev. Rul. 498, 1958-2 Cum. Bull. 47 (National Science Foundation grant for summer institute for high school and college science teachers); Rev. Rul. 59-81, 1959 Int. Rev. Bull. No. 11, at 10 (travel grant to teacher); Rev. Rul. 59-118, 1959 Int. Rev. Bull. No. 15, at 8 (Veterans' Administration grant to Ph.D. candidate); Rev. Rul. 59-191, 1959 Int. Rev. Bull. No. 22, at 10 (scholarship award by corporation).

3. *Wrobleski v. Bingler*, 161 F. Supp. 901 (W.D. Pa. 1958).

4. Scholarships and fellowships will be referred to as grants unless specifically distinguished.

the recipient's gross income in these terms: Is the grant, upon the facts of each case, more properly classifiable as a "gift" or as "compensation"? A resolution in favor of "gift" meant the recipient might exclude the payment from gross income, whereas a decision that "compensation" was the appropriate characterization led to inclusion. The difficulty with this kind of classification as applied to scholarships and fellowships lies in the fact that in many cases elements of both gift and compensation are present.⁷

Thus, if one examines I.T. 4056,⁸ which deals with four separate grants for scientific and literary work, the admixture referred to becomes apparent. The grantor in each received no benefit, indeed it did not even require that the recipients report progress.⁷ This is hardly typical of an employment relationship. On the other hand, each recipient was a professional in his field and was engaged, during the period of the grant, in the practice of his profession. The amounts were paid, if not on the condition that the skills of the recipient would be applied, at least in the expectation that this would be so.⁸ And although they were paid without assurance that the goals of the recipient would be achieved, it was a legitimate belief that these goals would at least be approached. To this extent the grants resemble compensation.⁹ Moreover, as to the benefits obtained by the recipients, these too resemble compensation. The recipient labors and is paid. The conclusion of the I.T. is that the grants in question are not excludible as gifts but rather are includible in gross income as compensation.

With this view one can compare the holding of the court in *McDermott v. Commissioner*.¹⁰ Although this case deals with prizes,¹¹ it in essence involves the same admixture of gift and compensation. Here taxpayer received the Ross Essay Prize of the American Bar

5. George Winchester Stone, Jr., 23 T.C. 254 (1954); Ti Li Loo, 22 T.C. 220 (1954); Ephraim Banks, 17 T.C. 1386 (1952); Israel Strauss, 16 P-H Tax Ct. Mem. 729 (1947); I.T. 3756, 1945 Cum. Bull. 64.

6. 1951-2 Cum. Bull. 8.

7. Treas. Reg. 1.117-4(c) (1958) makes it clear that the requirement of progress reports to the grantor does not of itself "destroy the essential character of such amount as scholarship or fellowship grant."

8. On the possibility that the grantor might recover the amount paid if the recipient failed to engage in the proposed activities, see Restatement, Restitution § 56(1) (1937). If the grantor was successful in obtaining recovery and was not a tax exempt institution, would the recovery be includible in gross income? See *Perry v. United States*, 160 F. Supp. 270 (Ct. Cl. 1958).

9. Compensation is defined as that which compensates; payment; amends. Funk & Wagnalls, *New Standard Dictionary of the English Language* (1960).

10. 150 F.2d 585 (D.C. Cir. 1945).

11. Int. Rev. Code of 1954, § 74.

Association.¹² The court held the receipt excludible from gross income. It noted that although the taxpayer performed services (the writing of the essay), these services were not rendered to the grantor. It further observed that the purpose of the payment was not "to buy" but to "incite,"¹³ a distinction which would be equally applicable to the situation in I.T. 4056. Here too the assumption is implicit that "gift" or "compensation" were the sole alternatives. The difficulty is occasioned by the admixture of both elements in the case.¹⁴

Against this background Congress enacted section 117. The approach it takes separates the treatment of the recipient of such a grant who is seeking an academic degree from the treatment of the recipient who is not. In the case of the former, the problem is dealt with almost exclusively as one involving the presence or absence of teaching activity or other services performed by the recipient. Thus section 117(b) (1) states:

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.

12. The Ross Essay Prize was established by the late Judge Erskine M. Ross who, in his will, left \$100,000 to the ABA for the purpose of awarding a prize from the income of the fund "for the best discussion of a subject to be by it suggested for discussion at its preceding annual meeting." *McDermott v. Commissioner*, supra note 10, at 585. See Soll, *Essay Competitions and Income Tax Contests*, 6 *Tax L. Rev.* 109 (1950).

13. This distinction lies at the bottom of the entire controversy. Its emphasis is, however, on the purpose of the payor. If one shifts his inquiry to the payee, the payor's motivation becomes less meaningful.

14. Chommie, *Federal Income Taxation: Transactions in Aid of Education*, 58 *Dick. L. Rev.* 93, 189, 291 (1954); Kelly, *Taxation of Fellowships and Scholarships*, 3 *Duke B.J.* 69 (1952); Loring, *Some Tax Problems of Students and Scholars*, 45 *Calif. L. Rev.* 153 (1957); Note, *Fellowship Grants Under the Internal Revenue Code of 1954*, 8 *Buffalo L. Rev.* 286 (1959); Note, *Nature of Awards to Faculty Members from Funds Donated to University for Such Purposes: Gifts or Compensation for Services?*, 43 *Cornell L.Q.* 510 (1958); Note, *Scholarships, Fellowships and Prizes: Gift or Income?*, 38 *Minn. L. Rev.* 152 (1953); Note, *Fellowships and Scholarships, Prizes and Awards—Ante 1954, Post 1954*, 7 *Syracuse L. Rev.* 130 (1955).

And in the House Report¹⁵ there is this statement:

When the scholarships and fellowships are granted subject to the performance of teaching or research services, the exclusion is not to apply to that portion which represents payments which are in effect a wage or salary.

On the other hand, in the case of the recipient who is not a candidate for academic degree no such reference to the presence or absence of services is made.¹⁶ It is of interest to note with respect to the last cited provision that it differs from the original version as proposed by the House.¹⁷ In the House Bill such grants were to be excluded only if the yearly receipt thereunder together with any payments received from the taxpayer's previous employer totalled less than 75% of the taxpayer's salary in the prior year. The House Report¹⁸ indicates that this percentage-of-prior-compensation test was intended to show "whether the grant is in effect a salary payment."

It is apparent that the House version was not based so much on the view that the activity of the recipient was thought to constitute consideration for the grant as that the activity of the recipient in enjoying the grant is substantially the same as that by which he earns his living ordinarily, i.e., study and research. This is substantiated by the House Report¹⁹ which says that the exclusion should not apply to "individuals who are not candidates for degrees [as to] amounts received as grants which in effect represent a continuing salary during a period while the recipient is on leave from his regular job."

One can see by comparing this with the final version²⁰ that sub-

15. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 7 (1954).

16. Int. Rev. Code of 1954, § 117(b)(2).

17. H.R. Rep. No. 8300, 83d Cong., 2d Sess. 17 (1954).

18. *Supra* note 15.

19. *Ibid.*

20. Int. Rev. Code of 1954, § 117(b)(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 (as defined in section 151(c)(4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within the limitations provided in subparagraph (B).

(A) Conditions for Exclusion.—The grantor of the scholarship or fellowship grant is an organization described in section 501(c)(3) which is exempt from tax under section 501(a), the United States, or an instrumentality or agency thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(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

stantial modification took place in the Senate. It was the Senate's view that a percentage-of-former-compensation test was unworkable because it might render includible in gross income grants which were not in the nature of compensation.²¹ Thus, the Senate substituted a time and dollar limitation and a requirement that the grantor be a religious, scientific, charitable or educational organization or a federal or state agency. It is clear from the Senate Report that the effect of this modification was not the mere substitution of one kind of quantitative limitation for another.²² Because the House version²³ was not an attempt to limit an exclusion, but rather was designed to distinguish between those grants to the non-degree-seeking recipient which should be excluded from those which should not, the Senate approach should be read with the same effect.

It should be noted that these portions of section 117 are sections of limitation on the more sweeping language of section 117(a)(1).²⁴ And it is this subsection which one might have expected to resolve the basic issue: What kinds of payments are to be excluded? However, as can be seen, we are told that only "scholarships" and "fellowships" grants are to be excluded. We are not told what these may be. And it was clear from prior law, at least prior to 1954, that not all

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)).

21. S. Rep. No. 1622, 83d Cong., 2d Sess. 18 (1954).

22. The Senate Report, *supra* note 21, contains this language: "Cases were brought to your committee's attention in which the formula of the House bill would tax grants which were clearly not a continuing salary payment. . . . Your committee therefore has substituted for the 75 percent rule an exclusion of \$300 per month of grants paid to individuals who are not candidates for degrees."

23. *Supra* note 15.

24. (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.

payments so labeled would qualify.²⁵ Thus, it is only in the subsections of limitation that intrinsic definitional evidence is found.

What significance can be given the distinction drawn by the Congress between recipients who seek academic degrees and those who do not? It has been suggested that such a distinction is justified on the basis that the person who is already qualified to practice his trade or profession is, in taking further training or in engaging in research, to be compared with the doctor or lawyer who acquires increased competence through his daily practice.²⁶ For this reason such a person should not receive tax preference. The individual who is engaged in acquiring the necessary training to begin his life's work, on the other hand, should be so entitled. But section 117 gives special advantage to both classes, the variation in treatment turning only on a limitation of the advantage in the case of the professional.

Thus the distinction between the two seems to be based on empirical considerations. As to the degree-seeking recipient the ordinary requirements of curriculum and the presumed desire of such persons to qualify as soon as possible would of themselves tend to limit receipt of tax advantage to a reasonable time. Whereas, in the case of the professional, embarked on a lifetime of such work, such a built-in brake is absent. As to him a time and dollar limitation is, therefore, necessary. And, in addition, there must be some reference to the character of the grantor to eliminate commercial arrangements.²⁷

When we move from the section to the Regulation²⁸ additional aid is given with regard to the definitional problem. Although the Regulation begins with a definition of scholarship and fellowship grant which is in accord with general usage,²⁹ it soon departs therefrom in its state-

25. *Supra* note 5.

26. Huberman, *Scholarships, Fellowships and Prizes*, 3 *Hastings L.J.* 116 (1952).

27. § 117(b) (2), *supra* note 20.

28. *Treas. Reg.* § 1.117 (1958).

29. *Treas. Reg.* § 1.117-3 (1958) provides:

Definitions. (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 consideration. 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

ment of what scholarships and fellowships are not. Thus the Regulation states that among payments not excluded from gross income are:

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

(1) Except as provided in § 1.117-2(a), 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.³⁰

Thus it appears that the section as read by the Treasury still involves the underlying question: Is the payment compensation? And indeed the problems which have arisen since 1954 support this observation. For example, an employee of the National Institute of Health received a grant from the Institute for foreign travel and study. Although he was not required to return to his employment at the end of the period of the grant he intended to do so. The Treasury ruled that the grant qualified under 117.³¹ On the other hand, an amount paid a professor by his employer to aid him in pursuing his research interests during a sabbatical year's leave was held not to qualify for exclusion under the section. The latter grant was thought, on the contrary, to constitute continuing compensation although the employer was not obliged to make this payment.³²

In another case,³³ the stipend paid medical interns was held to constitute compensation, although internship is a necessary part of the prospective medical practitioner's training. By contrast, in *Wroblewski v. Bingle*,³⁴ a stipend paid to a doctor engaged in graduate psychiatric training who as part of that training also treated patients was held to qualify for exclusion.

educational institution attended by such a 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 (see paragraph (d) of this section) 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 a 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 consideration.

30. Treas. Reg. § 1.117-4 (c) (1) (1958).

31. Rev. Rul. 179, 1958-1 Cum. Bull. 57.

32. Rev. Rul. 222, 1958-1 Cum. Bull. 54.

33. Rev. Rul. 386, 1957-2 Cum. Bull. 107.

34. 161 F. Supp. 901 (W.D. Pa. 1958).

If one compares these examples with the cases under pre-1954 law³⁵ one sees that there has been little change of focus. Indeed, it may be said that the value of section 117 lies not in providing a solution to the problem but rather in its recognition that scholarships and fellowships are sufficiently unique in terms of their social function and in the framework in which they are employed to merit treatment separate from that accorded gifts and compensation. But by the same token, the weakness of the application of the section by the Treasury thus far lies in the fact that the meaning of this uniqueness has not been sufficiently recognized and articulated.

II. THE ROLE OF SCHOLARSHIPS AND FELLOWSHIPS AND ITS RELEVANCE TO TREASURY POLICY

Certain observations must be made in order to locate ourselves in the area of gross income generally. The inclusiveness of the word "income" has been extended to its Constitutional limits.³⁶ Thus it is no longer necessary, if it was so once, to characterize the receipt of a scholarship or fellowship as compensation in order to include it in gross income. When such diverse items as the receipts of an extortionist,³⁷ findings,³⁸ punitive damages³⁹ and insiders' profits⁴⁰ are includible in the term "income" there is little reason, absent Congressional fiat, to exclude scholarships and fellowships. On the other hand, the more pervasive the concept of "income" becomes, the greater the strain on words of exclusion, such as "gift." Thus, it would appear that the establishment of a separate section of exclusion for scholarships and fellowships has as one of its functions the removal of part of the strain placed on the other sections of exclusion. But this function can be realized only if the determination of what is meant by scholarship and fellowship does not depend on a reference to such terms as "gift" on one hand, or "compensation" on the other.

In order to avoid such a reference, however, one must distinguish the characteristics of scholarship and fellowship grants from the characteristics of gift so that a separation of the treatment of such grants becomes meaningful. The same differentiation becomes important as between scholarships and fellowships and compensation. Without suggesting that the following is exhaustive, or is more than opinion, a number of points of reference are hereinafter set out in order to make

35. *Supra* note 5.

36. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

37. *Rutkin v. United States*, 343 U.S. 130 (1953).

38. Rev. Rul. 61, 1953-1 Cum. Bull. 17; Treas. Reg. § 1.61-14 (a) (1959).

39. *Supra* note 36.

40. *General Am. Investors Co. v. Commissioner*, 348 U.S. 434 (1955).

Association.¹² The court held the receipt excludible from gross income. It noted that although the taxpayer performed services (the writing of the essay), these services were not rendered to the grantor. It further observed that the purpose of the payment was not "to buy" but to "incite,"¹³ a distinction which would be equally applicable to the situation in I.T. 4056. Here too the assumption is implicit that "gift" or "compensation" were the sole alternatives. The difficulty is occasioned by the admixture of both elements in the case.¹⁴

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Definitions. (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 consideration. 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

ment of what scholarships and fellowships are not. Thus the Regulation states that among payments not excluded from gross income are:

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

(1) Except as provided in § 1.117-2(a), 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.³⁰

Thus it appears that the section as read by the Treasury still involves the underlying question: Is the payment compensation? And indeed the problems which have arisen since 1954 support this observation. For example, an employee of the National Institute of Health received a grant from the Institute for foreign travel and study. Although he was not required to return to his employment at the end of the period of the grant he intended to do so. The Treasury ruled that the grant qualified under 117.³¹ On the other hand, an amount paid a professor by his employer to aid him in pursuing his research interests during a sabbatical year's leave was held not to qualify for exclusion under the section. The latter grant was thought, on the contrary, to constitute continuing compensation although the employer was not obliged to make this payment.³²

In another case,³³ the stipend paid medical interns was held to constitute compensation, although internship is a necessary part of the prospective medical practitioner's training. By contrast, in *Wrobleski v. Bingler*,³⁴ a stipend paid to a doctor engaged in graduate psychiatric training who as part of that training also treated patients was held to qualify for exclusion.

educational institution attended by such a 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 (see paragraph (d) of this section) 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 a 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 consideration.

30. Treas. Reg. § 1.117-4 (c) (1) (1958).

31. Rev. Rul. 179, 1958-1 Cum. Bull. 57.

32. Rev. Rul. 222, 1958-1 Cum. Bull. 54.

33. Rev. Rul. 386, 1957-2 Cum. Bull. 107.

34. 161 F. Supp. 901 (W.D. Pa. 1958).

If one compares these examples with the cases under pre-1954 law³⁵ one sees that there has been little change of focus. Indeed, it may be said that the value of section 117 lies not in providing a solution to the problem but rather in its recognition that scholarships and fellowships are sufficiently unique in terms of their social function and in the framework in which they are employed to merit treatment separate from that accorded gifts and compensation. But by the same token, the weakness of the application of the section by the Treasury thus far lies in the fact that the meaning of this uniqueness has not been sufficiently recognized and articulated.

II. THE ROLE OF SCHOLARSHIPS AND FELLOWSHIPS AND ITS RELEVANCE TO TREASURY POLICY

Certain observations must be made in order to locate ourselves in the area of gross income generally. The inclusiveness of the word "income" has been extended to its Constitutional limits.³⁶ Thus it is no longer necessary, if it was so once, to characterize the receipt of a scholarship or fellowship as compensation in order to include it in gross income. When such diverse items as the receipts of an extortionist,³⁷ findings,³⁸ punitive damages³⁹ and insiders' profits⁴⁰ are includible in the term "income" there is little reason, absent Congressional fiat, to exclude scholarships and fellowships. On the other hand, the more pervasive the concept of "income" becomes, the greater the strain on words of exclusion, such as "gift." Thus, it would appear that the establishment of a separate section of exclusion for scholarships and fellowships has as one of its functions the removal of part of the strain placed on the other sections of exclusion. But this function can be realized only if the determination of what is meant by scholarship and fellowship does not depend on a reference to such terms as "gift" on one hand, or "compensation" on the other.

In order to avoid such a reference, however, one must distinguish the characteristics of scholarship and fellowship grants from the characteristics of gift so that a separation of the treatment of such grants becomes meaningful. The same differentiation becomes important as between scholarships and fellowships and compensation. Without suggesting that the following is exhaustive, or is more than opinion, a number of points of reference are hereinafter set out in order to make

35. *Supra* note 5.

36. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

37. *Rutkin v. United States*, 343 U.S. 130 (1953).

38. *Rev. Rul. 61, 1953-1 Cum. Bull. 17; Treas. Reg. § 1.61-14 (a) (1959)*.

39. *Supra* note 36.

40. *General Am. Investors Co. v. Commissioner*, 348 U.S. 434 (1955).

the comparisons above referred to. It is intended that this analysis will point out the means for developing a more successful interpretive role for the Treasury in this area.

The following points may be helpful:

1. *What are the similarities and dissimilarities with respect to motivation which are characteristic of employers, grantors and donors?*⁴¹

By and large one would expect that employers are motivated primarily by economic self-interest. Grantors, on the other hand, must be considered as intending by their payment to benefit society at large. When one considers donors (except as regards gifts to charitable organizations) the range of motivations is probably less susceptible to reasonable generalization; however, one hazards that gifts are generally motivated by affection, appreciation or concern for those related by ties of kinship or friendship. Thus on this point of comparison it seems clear that compensation, grant and gift are essentially unlike.

2. *What is the nature of the relationship between employer and employee, grantor and student or scholar, donor and donee and are these relationships similar in character?*

The employment relationship is typically that of strangers who bargain at arms length either individually or through a collective structure and in which the payor is in a position to direct the activity of the payee. Although grantor and scholar also are strangers, the latter is not directed in his activity by the former. On the other hand, the relationship of donor and donee is that of friend or relative. Moreover no activity is contemplated in return for or is stimulated by the payment. Here, therefore, also there is ground for considering compensation, grant and gift essentially unlike.

3. *What economic functions are most directly served by compensation, grant and gift, and are these functions similar?*

The economic function of an employment relationship is presumably the direct production of wealth whether in the form of goods or services or both. As to grants: insofar as increase in knowledge or competency is the expected result of study or research the primary effect of payments in this category is not the

41. For the purpose of what follows, the three relationships under discussion and the payments which arise because of them are described as follows:

- a. Employer—Employee—Compensation
- b. Grantor—Grantee—Grants
- c. Donor—Donee—Gifts

Relationship "a" is the familiar one wherein Employer hires Employee and pays him for his labor. Relationship "b" is that with which section 117 deals: grantor directly or indirectly provides funds to finance the education of student-grantee or the research of scholar-grantee. Relationship "c" is descriptive of the broad area of gratuitous payment in cash or property made to payees because of the affection or concern of the payor. As will be seen in the text, I have excluded charitable contributions from "c" for the purpose of discussion.

production of economic wealth, although ultimately such study and research may at some later time provide the stimulus or wherewithal for the production of economic wealth. And in some cases even the end product of such payments may be aesthetic pleasure rather than economic wealth. A gift, on the other hand, is primarily a distribution of wealth rather than a production of the same. Here too, therefore, essential dissimilarities are noted.

4. *Do employers, grantors and donors exhibit similar characteristics in regard to economic status, family status, and individual or corporate identity?*

Whereas the economic status of employers runs from one end to the other of the economic spectrum, particularly if one regards the stockholders of large corporate enterprises as the ultimate employers, one would expect that grantors and donors tend to fall at the upper end of the spectrum. It is impossible to contrast the family status of non-corporate employers and grantors, whereas donors will tend to be parents or spouses. Again employers and grantors cannot be distinguished as to corporate or individual identity, whereas donors are individuals. Thus here the distinction between employer and grantor is blurred while donors stand apart from the other two.

5. *Are the characteristics of employees, grantees, and donees similar in respect to economic status, family status and individual or corporate identity?*

The economic and family status of employee and grantee cannot be differentiated; whereas, again, donees are probably most often children or spouses. All three are similar with respect to individual rather than corporate identity. No substantial distinctions can be drawn.

6. *Are the relationships between the payment and the need of the recipient similar or dissimilar as to compensation, grant and gift?*

Insofar as the direction to hire and the rate of pay are mostly determined on the basis of general economic conditions, one could assume the need of the employee is significant only as it makes itself felt in the shaping of the market. On the other hand, the need of the potential recipient is directly related to the decision to make grants and gifts and to the size of them in a significant number of situations, although in the case of gifts this may be less true than it is of grants to students and scholars.

7. *Are there discernible bases for distinguishing among these three kinds of receipts with reference to an articulated scale of commonly accepted social values?*

To the extent that we have a commonly held judgment as to the worth of the employment relationship to our society it would seem to involve such notions as these: (a) We depend upon human labor for most of what we enjoy and accomplish. (b) Labor is therefore both a necessary and commendable activity. (c) Because of the accelerated pace of industrial concentration and the apparent desire for security, working for someone else as opposed to self-employment seems increasingly to be both necessary and desirable.

Although it is true that most people would as well concede that the making of grants to students and scholars is an activity of great value to our society, it seems clear that both the reasons for such an opinion and the intensity with which it is held are different from the social judgment concerning employment. Here feelings such as these are involved: (a) Our survival as a nation depends to a great extent on the supply of scientists, teachers and similarly occupied persons and upon the quality of their training. (b) To a degree the activities of such persons have an intrinsic worth greater than that of activities directed toward the production of wealth. (c) The preoccupation with physical comfort and enjoyment which seems to be typical of our major efforts and which negates to a degree our judgment as to the worth of scholarship and research concerns us.

A consideration of the role of gifts is more difficult. It is not so much that we value the act of making a gift (other than the making of charitable gifts) as that gift giving exemplifies a major value judgment: The desirability of the unrestricted use and enjoyment of one's own property. In any event, it seems that such a judgment is different in kind from that held with regard to the payment of compensation and is supplementary to that held as to the making of grants. By and large then, the characteristics of each type of receipt in most of the categories depicted is essentially dissimilar except as one includes charitable contributions in the category of "gifts."⁴² Therefore, at the very least, one can

42. The chart following depicts graphically the extent of dissimilarity expounded in the text. Similarities are indicated by the use of common letters. Double letters indicate approximate similarity.

| | COMPENSATION | SCHOLARSHIP & FELLOWSHIP | GIFT |
|-------------------------------------------------------------------------|--------------|--------------------------|------|
| 1. Motive of Payor | A | B | C |
| 2. Relationship between payor and recipient | D | E | F |
| 3. Primary economics function of relationship between payor & recipient | G | H | I |
| 4. Payors: | | | |
| a. economic status | J | K | K |
| b. family status | — | — | L |
| c. ind. or corp. | — | M | M |
| 5. Recipients | | | |
| a. economic status | — | N | NN |
| b. family status | — | — | — |
| c. ind. or corp. | O | O | P |
| 6. Relationship of payment to need of recipient | — | Q | QQ |
| 7. Commonly accepted social value judgment | R | S | T |

On the use of such charts in legal articles, see Horwitz and Netterville, *Unprivileged Refusal To Reap Where One Has Not Sown*, 12 J. Legal Ed. 201 (1959).

conclude that there is little that compels a reference to the word "gift" in an income tax definition of grant and even less that compels a reference to the term "compensation."

This is not to say that there is no problem with payments which are mislabeled, whether intentionally or otherwise. But in making a determination whether a particular payment is in fact what it purports to be one should look to see if there are present those elements of motive (e.g., desire to encourage worth-while scientific scholarship), relationship (e.g., absence of consanguinity), need of the recipient (e.g., in the case of most students, a substantial factor), etc. which are most often typical of grants, rather than to ask whether there are elements present which are also often present in situations of "gift" or "compensation."

One should note finally that of major significance in this problem of differentiation is the institutionalized framework which typifies the administration of scholarships and grants. It is by the universities and charitable foundations that most grants are administered. This is a significant distinction from the framework which surrounds the payment of compensation and the making of gifts. Although this approach to the problem of differentiation may at its essence involve only a difference in emphasis rather than a difference in kind from what has been criticized as the present attitude of the Treasury, it would go far to resolve the ambiguity which now seems to distort the Treasury's view. The position which this paper supports would not distinguish between the intern⁴³ and the National Health Institute award recipient,⁴⁴ nor would it distinguish the professor on sabbatical leave from the other two.⁴⁵ In all three cases the essential and fundamental characteristics of grants are found to be present.

III. THE RELEVANCE OF THE EXPENSE DEDUCTION OF STUDENT AND SCHOLAR TO SECTION 117

One difficulty with the separation of grants from compensation in the income tax law is raised by the possible significance of the deductibility of certain expenses to the scholar and student.⁴⁶

Suppose a teacher of English history travels abroad during a school vacation period to examine and collect materials related to a research project in his field. In order to support a claimed deduction for his expenses on the trip, the taxpayer must contend not only that the expenses were reasonable in amount but also that they were incurred in the "conduct of his *business* and *directly attributable* to it."⁴⁷ The important word is "business." Is research a teacher's business? An affirmative answer may be thought to involve the consequence that for purposes of section 177 also research is business. If so, the divorce-

43. *Supra* note 33.

44. *Supra* note 31.

45. *Supra* note 32.

46. Int. Rev. Code of 1954, § 162.

47. Treas. Reg. § 1.162-2(a) (1958).

ment for grants from compensation-like income in the case of the professional scholar would seem to become more difficult than has been indicated heretofore.

The Regulation dealing with the "Expenses of Education" also becomes important.⁴⁸ It states:

Expenditures made by a taxpayer for his education are deductible if they are for education (including research activities) undertaken primarily for the purpose of:

- (1) Maintaining or improving skills required by the taxpayer in his employment or other trade or business, or
- (2) Meeting the express requirements of a taxpayer's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his salary, status or employment.

In many academic institutions research activity is indeed expected of the teacher,⁴⁹ although the exact significance of accomplishment or failure in this regard is not generally made explicit. But if our English teacher contends that his travel expenses are "directly attributable" to his profession is he not, at least by implication, stating that to engage in research is to engage in effort closely associated with the retention of his position as a teacher? And if so is this not most material to the argument made under section 117? If research is the teacher's business, the argument would run, the grant made to him for conducting that activity is almost indistinguishable from compensation. But is this so compelling as it might seem?

In general for the purpose of finding a grant to be compensation one would expect to find (a) that the grantor received some benefit or (b) that the recipient was, in some sense, in an employment relationship to the grantor. On the other hand, to support a deduction for a business expense one need find only the existence of a trade and the necessary relationship of the expense to it, one need not also show an employment relationship nor a benefit to some other person. Thus, our English teacher may well qualify his expenses for a business deduction without conceding that a Ford Foundation grant he might receive the following year for further study is compensation. For, although he is engaged in a business while engaged in research, he is not an employee in using Ford Foundation funds to aid him in the furtherance of that business.

48. Treas. Reg. § 1.162-5(a) (1958).

49. If it is true that the primary obligation imposed upon the teacher by his employment is the teaching of students, one may wonder why so much emphasis is placed upon research and publication as criteria of eligibility for promotion. One explanation is that the classroom performance of a teacher provides little or no opportunity for the formation of judgments concerning his competence by those responsible for passing such judgments; and on the other hand publications do afford that opportunity.

Suppose, however, in the last example the grant was received from the university by which the professor is regularly employed rather than from the Ford Foundation. Would the existence of the employment relation between grantor and recipient alter the conclusion under section 117? Now both business and employer-employee relationship are present. On the other hand, in our example, the research activity takes place during a period when the teacher would not ordinarily be engaged in teaching activity. One Field Office⁵⁰ of the Internal Revenue Service has ruled that in a case such as this the juxtaposition of business and employment takes the case out of section 117.

Two observations may be made with respect to this rather special situation. First, for what reason should the grant be includible as compensation merely because it was received from the employing institution rather than the Ford Foundation? If all the other criteria concerning the characteristics of grants as differentiated from compensation are otherwise satisfied, why should the existence of a similarity in one category, that of the relationship of grantor and grantee, be conclusive? Second, section 117 itself establishes a standard which refers to the identity of the grantor. This standard does not, however, turn on the relationship of grantor to grantee but rather upon the nature of the grantor as a non-profit organization. A fair implication seems to be that Congress did not mean to exclude such a payment from the section of exclusion merely because the grant was made by an employer. Revenue Ruling 58-179⁵¹ supports this conclusion. It should be noted, however, that Revenue Ruling 58-222⁵² is apparently to the contrary.

IV. CONCLUSION

Section 117, enacted to resolve problems of prior case law in respect to the income tax treatment of scholarship and fellowship grants, affords a reasonable basis for the solution of these problems. The Treasury in its interpretation of the section has not thus far utilized its opportunity because it has failed to change its outlook on the nature of these problems. It has continued to make its chief reference the polar terms "compensation" and "gift" rather than the essentially unique function and characteristics of scholarships and fellowships themselves. A change in this outlook is impelled by the existence of section 117 and by the nature of these grants. Such a change should take the form of a recognition of the function of these kinds of payments and the way in which they are administered. An approach to the old problems in such a new light offers the most reasonable opportunity for their resolution.

50. Detroit, Michigan.

51. 1958-1 Cum. Bull. 57.

52. 1958-1 Cum. Bull. 54.

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