

TAXATION OF FELLOWSHIPS AND SCHOLARSHIPS

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Considering the large number of scholarships and fellowships which are granted each year to students in the United States, it is rather singular to find but one case¹ regarding their taxability. Probably the reason for this lack of authority lies in the fact that the great majority of such aids are relatively small in amount and, when the Commissioner rules that they are taxable as income under section 22 (a)² of the Internal Revenue Code, the recipients in most instances have neither the time, funds, nor interest to contest his ruling.

Since actual decisions in point are practically non-existent, it is necessary to turn to analogous cases in order to ascertain the courts' viewpoint on the question of whether scholarships and fellowships are taxable as income.

Decisions involving payment of prize money fall into two categories:

A. Those which are gifts and consequently not subject to Federal income tax under the provisions of section 22 (b) (3)³ of the Internal Revenue Code.

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¹ Ephriam Banks, 17 T. C. No. 167 (1952).

² 26 USCA § 22 (a). "Gross Income—general definition. 'Gross income' includes gains, profits, and income derived from salaries, wages or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, of the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

³ 26 USCA § 22 (b) (3). "Exclusions from gross income. The following items shall not be included in gross income and shall be exempt from taxation under this chapter: . . . (3) Gifts, bequests, devises, and inheritances. The value of property acquired by gift, bequest, devise, or inheritance. There shall not be excluded from gross income under this paragraph, the income from such property, or, in case the gift, bequest, devise, or inheritance is of income from property, the amount of such income. For the purposes of this paragraph, if, under the terms of the gift, bequest, devise, or inheritance, payment, crediting, or distribution thereof is to be made at intervals, to the extent that it is paid or credited or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property."

B. Those which are considered to be income to the recipient and taxable as such under section 22 (a) of the Code.

The Courts' Interpretation of "Gifts" under Section 22 (b) (3) of the Internal Revenue Code as Related to Prize Winnings

The leading case under this first category is *McDermott v. Commissioner*.⁴ Petitioner, a professor of law, was awarded the Ross Essay Prize for 1939 for submitting the winning treatise on a topic selected by a committee of the American Bar Association. By a two to one split, the Circuit Court of Appeals held that the prize was a gift and did not constitute income under the definition of section 22 (a) of the Code. The opinion emphasized the *donative intent* of the *non-profit* association awarding the prize. The court stressed the non-pecuniary motive of the taxpayer in that his reason for entering the contest was more a matter of prestige than of monetary gain. The prize was analogized to the Nobel Prizes, Rhodes Scholarships, and Guggenheim Fellowships which are awarded on a competitive basis to scientists, scholars, and students, and which have never been taxed because of the policy of encouraging scholarly work.

The decision reached in the *McDermott* case has been criticized both in subsequent opinions⁵ and by numerous writers;⁶ yet the case has never been overruled and presumably its reasoning remains controlling today. However, two cases involving similar factual situations have subsequently arisen in which the *McDermott* case was not followed.⁷ The distinctions of the *Stein* and *Waugh* cases

⁴ 3 T. C. 929 (1944). The decision of the Tax Court, which held the award taxable as income, was *reversed* in 150 F. 2d 585 (D. C. Cir. 1945). The Commissioner did not appeal this decision, but in 1949 the Bureau of Internal Revenue announced its non-acquiescence in the *McDermott* opinion and stated that in future years, winners of the Ross Essay Prize would be considered to have received taxable income. See I. T. 3960, 1949-2 Cum. Bul. 13.

⁵ Herbert Stein, 14 T. C. 494 (1950); Frederick V. Waugh, PH-TC Mem. Dec. ¶ 50,095 (1950); cf. Pauline C. Washburn, 5 T. C. 1,333 (1950).

⁶ *Money Won as a Prize in Musical Composition Contest Held Not Taxable*, 37 VA. L. REV. 333 (1951); Soll, *Essay Competitions and Income Tax Contests*, 6 TAX L. REV. 109 (1950).

⁷ Herbert Stein, note 5 *supra*. The Pabst Brewing Company awarded a prize to Stein in recognition of the best essay submitted in a contest sponsored by Pabst. The essay was subsequently printed by the company and widely distributed. The distributed copies contained several references to the Pabst Brewing Company and the cost of the prize awarded Stein was deducted by the company as a business expense. The court, in holding that the prize constituted taxable income to the taxpayer, distinguished the case from *McDermott v. Commissioner* on the grounds that Pabst received commercial advantages as a result

are so unsubstantial that they are virtually imperceptible. Certainly, if the distinction between the charitable and commercial character of the payor is shallow, then a differentiation between *Waugh* and *McDermott*, based upon ascribing different motives to two tax-exempt charitable corporations is absurd. In net effect, the Tax Court has refused to follow the *McDermott* rule which subjectively evaluates the payor's intent and discriminates in favor of "scholarly" work.

In summary, the essential conflict in these cases stems from the stress placed on the motives of the payor in categorizing the award as a gift as against the emphasis placed on the nature of the receipt as a reward for labor in determining its quality as income.

In 1952, *Robertson v. United States*⁸ was appealed to the Supreme Court and it was hoped that the decision of that court would clarify the principles established in the cases arising in the lower Federal courts and the Tax Court concerning taxation of prize winnings. The Supreme Court instead confined itself almost entirely to the facts of the case and did not announce a definite and comprehensive rule. It affirmed the Tenth Circuit Court of Appeals decision⁹ holding that the petitioner received taxable income, and not a gift, when his symphony won first prize in a contest sponsored by a philanthropic organization. The Supreme Court based

of the contest and this fact negated any donative intent on the part of the company in awarding the prize. Stein argued against a tax discrimination between himself and *McDermott* which ignored the similarity of their labor and which stressed the absence or presence of pecuniary motives on the part of the respective payors. The Tax Court acknowledged the discrimination and despite their supposed distinctions between the two situations, impliedly overruled the *McDermott* case.

Frederick V. Waugh, note 5 *supra*. This case arose from facts quite similar to those in the *McDermott* case. The case involved an essay contest sponsored by a tax-exempt farm association, the awards for such contest emanating from a fund established by an individual. The Tax Court attempted to distinguish the *McDermott* case by utilizing the test of the payor's donative intent. Finding in the association's minutes certain evidence of prestige enuring to the association as a result of the contest, the court declared that the *pure* donative intent prescribed in the *McDermott* case was absent and that the award was taxable to the recipient.

⁸ 343 U. S. 711 (1952). The taxpayer was a professional musician, who, between the years 1936 and 1939, composed a symphony. In 1945, he entered his composition in a contest sponsored by a philanthropy. The symphony won first prize; it remained the property of the composer but he was required to grant certain recording rights to the Detroit Orchestra. See also *Amirikian v. United States*, 197 F. 2d 442 (4th Cir. 1952).

⁹ 190 F. 2d 680 (10th Cir. 1951).

its decision on a ground not previously urged in the Appeals Courts' cases. Legally, the payment of the prize to a winner of the contest is the discharge of a contractual obligation; the contestant's acceptance of the offer tendered by the sponsor creates an enforceable contract. The discharge of legal obligations, such as the consideration paid pursuant to a contract can in no sense constitute a gift. Douglas, J., in writing for the majority of the court, stated:

"The case would be different if an award were made in recognition of past achievements or present abilities, or if payment was given not for services but out of affection, respect, admiration, charity or like impulses. Where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it."¹⁰

The Treasury, in its vain effort to balance the national budget, has in recent years attempted to tap every available source of revenue. To effectuate this policy, existing concepts of taxation have been extended and new ones created. The foregoing line of decisions, beginning with *McDermott v. Commissioner* and ending with the 1952 decision of *Robertson v. Commissioner*, is illustrative of this process. The *McDermott* decision was based primarily upon the donative intent of the sponsor and the scholarly aspect of the contest. The intervening cases whittled away that decision, drawing fine-line distinctions, until, in the *Robertson* case, the emphasis was placed not upon the donor's intent in granting the award, but upon the contestant's intent in participating in the contest.

The criteria at which the courts have apparently arrived in determining whether essay prizes are taxable as income or non-taxable as gifts is whether the contestant was required to render any services in winning the contest. Although they have made tenuous differentiations as to what actually constitutes "services," this remains the basic concept upon which the decisions have turned. Nor is the rule confined to essay contest cases; it applies with equal force to decisions involving scholarships and fellowships. Another way of stating the same rule as applied to these grants is that, in order for the money received from such funds to be considered a gift to the donee, the fellowship or scholarship must be *solely* for the benefit of the individual.

¹⁰ 343 U. S. 711 at 713.

**Criteria for Determining the Tax Status of Funds
Received from Scholarships and Fellowships**

Scholarships are funds granted to undergraduate students in a college or university, whereas fellowships are awards made to graduate students. For tax purposes, students in law, divinity, forestry, medical and dental schools are considered to be enrolled in undergraduate study since courses taken in these schools are considered to be basic requirements for the enrollee's life work. As a general rule, students holding scholarships are required to render no services to the donor in order to qualify, nor are written reports of the student's progress required. Scholarships are therefore considered to be gifts and non-taxable under section 22 (b) (3) of the Internal Revenue Code. Some scholarships are awarded on the basis of competitive examinations and this raises the question as to whether participation in such an examination constitutes either services rendered or consideration for a contract. Apparently the answer is in the negative and is based on one or more of the following lines of reasoning:

- (1) Scholarships are non-taxable because of the public policy argument involved: granting scholarships promotes the general welfare in that if more people are better educated, the citizens of the country as a whole will be benefited.
- (2) It is the general policy of the Bureau of Internal Revenue not to tax Rhodes Scholars, *etc.*,¹¹ who are given scholarships on the basis of competitive examinations, and this principle is likewise applicable to all scholarships.
- (3) The concept that scholarship competitions are not based upon contract theory; that instead of an offer being made by the donor and accepted by the contest winner, the scholarship is a gift to the best qualified student as determined from the results of the competition.

If the scholarship is granted upon the contingency that the recipient must perform certain services, such as grading papers or proctoring examinations, then it would appear that the requisite donative intent on the part of the grantor is lacking and that funds thus received constitute taxable income under section 22 (a) of the Code. Colleges and universities throughout the United States yearly grant athletic scholarships, the cumulative value of which

¹¹ *McDermott v. Commissioner*, note 4, *supra*.

amounts to millions of dollars. The majority are unconditional grants to promising athletes and do not theoretically constitute taxable income to the recipients in view of the fact that, under the terms of the scholarships, the donees are not compelled to engage in athletic activities. However, it would seem that funds received under such scholarships are granted upon the implied condition of services being rendered and, therefore, properly taxable as income. Anyone familiar with the athletics of any school where scholarships are granted for that purpose will readily admit that if the student does not perform to suit the coach, or if he is rendered physically incapable of participation, that scholarship will in all probability be withdrawn. Thus, it would seem that, due to the implied condition of rendition of services, such scholarships ought to be taxable as income.

Fellowships are awarded students engaged in fulfilling the requirements for graduate degrees. They are considered to have already received the foundation of their education and, while in graduate school, are utilizing that foundation in specialized and technical creative work. Authority on this point is negligible but according to *dicta* of the Treasury Department, if the fellowship has been awarded in recognition of the taxpayer's past achievements in his chosen field and his services in promoting the public welfare, the award is a gift and not taxable.¹² Similarly, if the award is made for the training and education of an individual, as a part of his program in acquiring a degree, the amount of the grant is a gift which is excludable from gross income.¹³

This requirement is simple to state but difficult to apply with any degree of certainty because of the Treasury's narrow interpretation. When the recipient of a fellowship applies his skill and training to advance research, creative work, or some other project or activity, the essential elements of a gift as contemplated by section 22 (b) (3) of the Code are not present, and to the extent

¹² GCM 5881, VIII CUM. BUL. 68.

¹³ I. T. 4056, 1951-2 CUM. BUL. 8. Thus X Co. awarded a fellowship in physics to a graduate student, the selection of whom was left to the discretion of the department chairman of the university. Funds were to be sent directly to Y University for distribution to the chosen student. The recipient, Z, was not obligated to fulfill any special requirements except that the X Co. Foundation expressed a desire to receive copies of publications, theses, and papers resulting from Z's research. The Commissioner held that the award was in the nature of a gift and not compensation for services.—From a letter of November 17, 1950, United States Treasury Department, Office of Internal Revenue, Internal Revenue Service, District of North Carolina.

that there is any donative intent present in the making of an award it appears that the beneficiary is society at large and not the recipient of the award.

Conceivably, this interpretation might be used to tax all fellowships since, theoretically at least, all research and creative work made possible by fellowships is beneficial to the public welfare. The Treasury, however, apparently regards all post-doctoral fellowships as taxable on the premise that the doctor's degree represents completion of the educational process with the exception of fellowships which do not designate the field in which work is to be done and require no services of the fellowship holder.¹⁴

¹⁴ The conclusion reached by a symposium of tax attorneys as reported in HIGHER EDUCATION AND NATIONAL AFFAIRS, issued by the American Council of Education, Bulletin No. 155, p. 7, May 25, 1950. Although this is the rule generally applied, it is not consistently followed as is shown by the following situation which, upon the available facts, appears to be a tax free fellowship but which was held taxable by the Commissioner.

The American Council of Learned Societies awards Faculty Study Fellowships to professors in various universities who have already received their Ph.D. degrees and have chosen the teaching profession as their life work. The donor does not receive any financial return from the fellow or the institution and the fellow does not incur any obligation for either present or future services to the donor. The object of the fellowship is to enable outstanding scholars to pursue a course of study apart from their specialized fields. Dr. X received a Faculty Study Fellowship; he was placed on part-time status insofar as his employment by Y University was concerned and received compensation for such part-time services. The effect of the award was predominantly and almost exclusively for the education and development of the individual and not for services rendered. The Commissioner ruled that the amounts received by Dr. X constituted compensation for services and was taxable under section 22 (a).—From a letter of November 17, 1950, United States Treasury Department, Office of Internal Revenue, Internal Revenue Service, District of North Carolina.

An interesting situation has recently arisen which is illustrative of the confusion existing in this field. Two doctors, both of whom have completed their formal education and are serving as professors in the Duke University School of Medicine, received Markel Fellowships. These awards are given to outstanding teachers in medical schools throughout the United States and their objective is to encourage the recipients to remain in the teaching profession instead of going into the more lucrative field of private practice. The donees are not required to render any reports concerning their activities; they are not required to engage in any type of research program; nor are they obliged to remain in the teaching profession. The university, in disbursing the fellowship funds to the professors, paid withholding tax to the government. Both recipients applied to Commissioner A for a refund of the tax; Dr. Y received his refund and Dr. Z was assessed a deficiency. Arguments could be made in support of either ruling, but it would appear that the action taken on Dr. Y's application is the more tenable on the ground that the award is made unconditionally and no services of any type are required to be rendered by the grantee; in fact, should the recipient so desire, he might take a year's vacation and yet, under the terms of the fellowship, be entitled to the full grant.

The concept of services rendered by the fellowship holder has received an extremely narrow construction. Thus, where awards are granted by a foundation on the basis of qualifications of the recipients to do the work required by their projects, which projects are approved by the foundation with the expectation of results consistent with the recipient's qualifications, to the extent that there is any donative intent present in the making of the awards, the beneficiary is society at large and not the recipient of the award whose services are expected in return for the grant. Accordingly, stipends received under such awards are not exempt from tax under section 22 (b) (3) of the Code, but are includible in gross income as compensation for personal services under section 22 (a).¹⁵

From this reasoning, it would seem to follow that if the recipient is required to submit reports of the progress of his research, if the scope of the student's graduate work is defined by the foundation granting the fellowship, if the donor requires that its grant be acknowledged in any papers published by the student connected with his research, if the grant is terminable upon condition (such as the recipient's withdrawing from the institution), the required donative intent on the part of the grantor is absent. The above requirements would be considered services rendered by the recipient, and the funds received under the fellowship would be classified as taxable income.

The leading case in this field is *Ephriam Banks*,¹⁶ decided in 1952. Petitioner was fulfilling requirements for a Ph.D. degree in a university holding a government contract under which it was to test certain strategic materials. Banks was appointed to the research staff conducting the experiments under the stipulation that he would devote thirty-five hours weekly to the research under the direction of his supervisors. The taxpayer received a stipend, from which withholding taxes were deducted; and he was permitted to use the results of his research in his doctoral dissertation. The Tax Court, in holding that payments to Banks were for services rendered and therefore taxable, stated that, "Intent is to be found from the payor's characterization of the payments."¹⁷ The court then found that from the following factors it was evident that the grantor intended the payments as compensation and not as gifts:

¹⁵ I. T. 4056, 1951-2 CUM. BUL. 8.

¹⁶ 17 T. C. No. 167 (1952); see also R. F. Doerge, PH-TC Mem. Dec. ¶ 52,140 (1952).

¹⁷ *Ephriam Banks*, 17 T. C. No. 167 (1952).

(a) designation of the payments to Banks as "stipend" or "salary"; (b) the provision for a vacation which is a characteristic of employment contracts; (c) the requirement that petitioner should work a specified number of hours per week on the project; (d) supervision of petitioner's research in a designated field; and (e) notice to the taxpayer at the date of the appointment that Federal income tax was being withheld from his monthly payment.

The Treasury has expressly exempted from Federal income tax payments for tuition, books, and supplies¹⁸ made under the G.I. Bill.¹⁹ But similar payments made by an accounting firm to a local accounting school, in which all of the firm's junior accountants were required to attend as a condition of their employment by the firm, were held to be income to the students and therefore taxable.²⁰

Conclusion

The recent trend of cases and Treasury rulings indicate that all scholarships, which do not require services to be rendered by the recipient, are considered to be gifts and consequently tax exempt. Similarly, fellowships awarded in recognition of the donee's past services in his chosen field or awarded solely for the training and education of the individual, no services being required in consideration thereof, are tax-exempt gifts. However, if the fellowship holder applies his skill and training to advance research, creative work, or some other project, the essential elements of a gift as contemplated by section 22 (b) (3) of the Internal Revenue Code are not present and the funds thus received by the taxpayer are considered to be income under section 22 (a) of the Code and taxable as such.

¹⁸ I. T. 3702, 1944 CUM. BUL. 74.

¹⁹ SERVICEMEN'S READJUSTMENT ACT of 1944, PUBLIC LAW 346, 78th Congress, Second Session.

²⁰ I. T. 1304, I CUM. BUL. 20.