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Federal Income Taxation: Transactions in Aid of Education

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FEDERAL INCOME TAXATION: TRANSACTIONS IN AID OF EDUCATION

Part I *

By

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Introduction

The purpose of this paper is primarily a survey of the impact of federal income taxation on some of the commonly reoccurring transactions in aid of education. Excluded are the problems involved in determining the exempt status of an organization under section 101 of the *Internal Revenue Code,* and the problems involved under section 162(a) permitting trusts and estates an unlimited charitable deduction.[1] However, as will be seen, the term "education" has the same meaning in sections 101(6) and 162(a) as prevails in sections 23(o) and 23(q) which will be discussed in the second installment. The paper also has a reformative aspect: a suggestion for a revaluation of policies in the interests of tax equity and long range general welfare.

The term "education" has a broad content. Of necessity, evaluation is dependent upon those transactions where there has been an expression of judicial, legislative or administrative policy. The problems involved would seem to fall under three major headings: (1) those involving the character of the receipt; (2) those involving the character of the payment as a charitable (educational) deduction; and (3) those involving the character of the payment as a business expense.

PART I.

THE RECEIPT: IS IT INCOME OR A GIFT?

Section 22(a) of the *Code* expressly embraces compensation for services and income from business and trade as two of the many income categories; section 22(b)(3) expressly excludes gifts. Also excluded by implication are capital receipts. Rarely, however, has this latter concept played an important part in this area. More often than not the competing concepts involved in the transactions characterized below are compensation for services and gift. This is true notwithstanding that generally the courts have interpreted section 22(a) as being but illustrative of income categories, and not as containing an exclusive listing.

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* [Editor's Note: Professor Chommie discusses the subject in three parts, of which this is the first. The second installment, dealing with the problems involved in determining the character of a payment as a charitable (educational) deduction, will appear in the next issue of the *DICKINSON* LAW REVIEW.]

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1 For a comprehensive coverage of exempt organizations: 6 Mertens, Law of Federal Income Taxation (Rev. Ed. 1949 Callaghan & Co.) §§ 34.01 to 34.53 incl., hereinafter referred to as Mertens; for discussion of the unlimited charitable deduction see: ibid., §§ 36.68 to 36.76 incl.

It is elementary that the legal standard of the gift in section 22(b)(3) is the common law standard of donative intent, and that the burden is on the taxpayer so to establish.[2] This makes each case largely an individual problem in logic. Thus, in the categories listed below the broad approach is simply: has the taxpayer established a donative intent on the part of the payor?

The Contest Prize

From an early date the Commissioner has taken the position that prizes and awards received in commercial ventures constitute taxable income to the recipient.[3] With rare exceptions he has been able to maintain his position in the courts. His only two losses have involved lotteries where the lottery winner performed neither services nor gave other consideration as a participant.[4] On the other hand he has won numerous sweepstakes[5] and essay contest cases.[6] Two of the latter deserve attention here.

In *Herbert Stein,*[7] the taxpayer, a government economist, won the first prize in an essay contest sponsored by the Pabst Brewing Company. Although the subject matter of the contest, post-war employment, was hardly related to the payor's business, the payor did exploit it in newspaper advertisements and treated its costs as business expense. From such advertising and expense treatment the Tax Court inferred a want of donative intent.

In *Fredrick V. Waugh,*[8] the commercial aspect of the contest was much fainter. The essay contest was sponsored by the American Farm Economic Association, a non-profit organization. The subject of the contest was farm price policies. The taxpayer was another government economist. In finding taxable income the Tax Court admitted that the payor neither sought nor derived pecuniary profit, but inferred a want of donative intent from the fact that the purpose of the contest seemed to be to create an interest in itself and in farm economics. It further pointed out that the payment in question was a gain to the taxpayer from his services.

Where the contest promotes a business interest of the payor the results have been fairly consistent in finding a want of donative intent. On the other hand, where the contest is conducted without a taint of commercialism, where the recipient has rendered a service from which the public as a whole benefits, and where the payment for such services comes from an organization devoted to the public welfare, a donative atmosphere is often created that makes a decision difficult.

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[2] See e.g. Mary G. Mulqueen, Ex., 25 B.T.A. 441, 446 (1932); Smith v. Manning, 189 F.2d 345 (C.A.3d 1951).

[3] See e.g. I.T. 1651, II-1 C.B. 54 (1923) (newspaper contest); I.T. 1667, II-1 C.B. 83 (1923) (lottery ticket given with each meal purchased); I.T.3987, 1950-1 C.B. 9 (radio contest).

[4] Pauline C. Washburn, 5 T.C. 1333 (1945) (taxpayer's telephone number selected by chance on a radio program); Bates v. Glenn, 114 F.Supp. 445 (D.C.W.D.Ky. 1953) (taxpayer's free ticket winning automobile). Neither of these decisions is free of criticism. See e.g. Mintz, "Pot O' Gold in the Tax Court," 24 Taxes 940 (1946), criticizing the Washburn case.

[5] Christian H. Droge, 35 B.T.A. 829 (1937); Harry J. Riebe, 41 B.T.A. 935 (1940), affirmed per cur., 124 F.2d 399 (C.C.A.6th 1941); Max Silver, 42 B.T.A. 461 (1940).

[6] Herbert Stein, 14 T.C. 494 (1950); Fredrick V. Waugh, 9 T.C.M. 309 (1950); United States v. Amirikian, 197 F.2d 442 (C.A.4th 1952).

[7] Ibid.

[8] Ibid.

In *McDermott v. Commissioner*,[9] the taxpayer, a law professor, won the 1939 Ross essay prize. The $3000 prize was paid by a trustee, the American Bar Association, pursuant to a provision in the will of Erskine M. Ross, a former federal judge. The subject matter of the contest was "To What Extent Should Decisions of Administrative Tribunals be Reviewable by the Courts?" The Court of Appeals for the District of Columbia listed eight circumstances which "taken together" required the conclusion that the award was a gift: (1) in "plain English the Association gave petitioner the prize;" (2) "the purpose of Judge Ross and the American Bar Association . . . was likewise to 'give' and to 'incite', not to employ or buy"; (3) "money may be a gift . . . although services are or have been rendered by the donee"; (4) "the entire advantage accrued to the petitioner and the community . . . distinguishes the Ross prize from puzzles, guessing contests . . . for commercial purposes"; (5) a characteristic of a gift is that it can not be counted on in advance and may never recur; (6) the dominant motive of such a contestant is "not a hope of immediate financial gain"; (7) a long continued administrative practice of not attempting to tax Nobel prizes, Guggenheim fellowships, Rhodes scholarships and the like "is entitled to great weight"; and (8) taxing such payments would discourage such scholarly work.

The Tenth Circuit refused to follow the *McDermott* case in *United States v. Robertson*.[10] In this case, the Detroit Orchestra, Inc. announced a contest for musical compositions written by native-born composers of North, Central and South America. The announced purpose of the contest was to promote understanding among the Pan-American nations. One of the conditions of the contest required the transfer of certain rights to the payor by a winning contestant. The taxpayer's submission, composed prior to the announcement of the contest, won the first award of $25,000. In reversing the district court, the court of appeals relied on the view, adopted by the Tax Court in the *Stein* case, that the payment was responsive to the taxpayer's services. It also stated that its decision was not based upon the narrow ground that the relinquishment of the rights in the composition was a consideration sufficient to determine the issue.

The conflict between the two circuits was resolved in favor of the Tenth Circuit view by the Supreme Court in *Robertson v. United States*.[11] Mr. Justice Douglas disposed of the issue in a short opinion:

> "In the legal sense payment of a prize to a winner of a contest is the discharge of a contractual obligation. The acceptance by the contestants of the offer tendered by the sponsor of the contest creates an enforceable contract . . . The discharge of legal obligations—the payment for services rendered or consideration paid pursuant to a contract—is in no sense a gift. 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 im-

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9 150 F.2d 585 (C.A.D.C. 1945). The Internal Revenue Service expressly refused to follow the decision, I.T. 3960, 1949-2 C.B. 13.
10 190 F.2d 680 (C.A.10th 1951).
11 343 U.S. 711, 72 S. Ct. 994 (1952).

pulses. Where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it."[12]

The *Robertson* decision perhaps renders the formal contest cases *sui generis*. However, their development, cumulating in the *Robertson* decision, provides the background for awards of a type more commonly associated with education.

The Scholarship Award

A scholarship may perhaps be defined as a stipend received by a deserving student to enable him to pursue some additional formal training. As such, the Service has ruled, "If a grant or fellowship is 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 consideration therefor, the amount of the grant is a gift which is excludable from gross income."[13] The Rhodes Scholarship, mentioned in the *McDermott* opinion, presumably falls within this rule.

Two types of scholarship awards, on which there is a dearth of authority, however, warrant some additional consideration. The first of these involves scholarships (and fellowships) awarded as a result of a formal competitive contest. In one sense all formal training is competitive. However, a distinction between the formal contest and the usual competition of the classroom is believed justified. With the formal contest, adoption of the contract analogy of the *Robertson* case would result in taxation. A variation on this fact pattern is the academic contest conducted to incite scholarship. In many cases the recipient would escape taxation because of the small amounts involved. The argument, however, in favor of taxability of the prize seems sound.

Where such contests are conducted by schools or other non-profit organizations, perhaps the courts would experience some difficulty in the application of the *Robertson* rule. On the other hand, where sponsored by commercial firms, such as the Fisher Body contests of some years back, exploited in advertising and treated as business expense, want of a donative intent should be easily established.

The second type of scholarship award presents a number of problems. This is the award that is sometimes made to an employee or a child of an employee. More often than not the courts have had little difficulty in finding that any benefit flowing from an employment relationship, regardless of how characterized, is compensation for services rather than a gift.[14] In an early ruling the Internal Revenue Service held that an employer's expenditures for books and tuition in connection with the outside schooling of its employees should be included in the gross income

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12 343 U.S. at 713-14, 72 S. Ct. at 996.

13 I.T.4056, 1951-2 C.B. 8. See also I.T.3702, 1944 C.B.74 (tuition and subsistence allowances to veterans under Public Law 346, 58 Stat. 284, excludable); I.T.3756, 1945 C.B.64 (tuition and maintenance to nurses and others in training under the Social Security Act held gifts); cf., Letter Ruling, Jan. 10, 1946, 1 P-H Tax Service, ¶ 7606 (stipends received by student nurses held wages).

14 1 Mertens § 8.08.

of the employees even though such schooling was required in order to retain their jobs.[15] Perhaps this early ruling is not to be considered as conclusive. There does seem to be a fine line drawn here between this outside schooling and on-the-job training for a particular employment function. Further, under different circumstances, such as in case of a grant based on merit out of an employees trust and treatment by the employer as a charitable contribution, a finding of a gift might well be anticipated.

In the case of a scholarship awarded an employee's child, if it be considered a benefit flowing to the employee—a constructive payment of compensation—the same considerations as discussed above would apply. On the other hand, if it be considered as income to the recipient, it might result in the loss of a dependency exemption to the employee. As a gift, of course, it would not seem to affect either the recipient or the employee.

The Research Fellowship

It can hardly be said that a "bright shining line" marks the division between a scholarship and a fellowship. The terms are often used synonymously, and the term "fellow" has a variety of meanings. One common type of an award is that of the research fellowship. This may perhaps be defined as an award made to enable a graduate to do research work, to maintain himself and permit expenditures for the necessary equipment, books, supplies and the like. In practice there is hardly a common type of grantor. Schools, independent foundations, commercial concerns, and individuals have all granted research fellowships. Further, as a matter of practice, terms and conditions are commonly attached to the grant. These terms and conditions and their execution, it would seem, would ordinarily be indicative of donative intent or the want thereof.

In *I.T.* 4056,[16] a comprehensive ruling on four different grants made by a private foundation upon application by the grantees, the Internal Revenue Service has taken a position based upon the direction of the payor's donative intent. Following the language set out above in connection with scholarships, the ruling states: "However, when the recipient of a grant or 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 Internal Revenue Code are not present." Referring to the four awards: "to the extent 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 whose services are expected in return for the grant." What this seems to say is that the donor intends a benefit (gift) to society and is paying compensation to the grantee of the award to bring about this benefit. It should be pointed out that this ruling was issued after the decision of the Tenth Circuit in the *Robertson* case, but before the affirming decision was handed down by the United States Supreme Court.

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[15] I.T.1304, I-1 C.B. 72 (1922).
[16] 1951-2 C.B. 8, cited n. 13, supra.

The court in the *McDermott* case pointed out a long continued administrative practice of not taxing awards such as the Guggenheim fellowship. As such, *I.T.* 4056, would seem to constitute a reversal of policy in this area.

The courts have not as yet been called upon to appraise the view of the Service expressed in *I.T.* 4056. However, it was apparently urged to be controlling in *Ephraim Banks.*[17] In this case, the taxpayer was awarded a research fellowship to enable him to participate in a project under a contract between the grantor college and the United States Navy. The appointing letter characterized the award as a "stipend", and stated that the taxpayer would be expected to devote thirty-five hours a week to the project, and that he would be entitled to a vacation. It also suggested that he file a withholding statement with the school bursar. While the taxpayer used his research experience as the basis for a doctor's dissertation, this was not considered as controlling in the finding of taxable income as compensation for services. The Tax Court stated that the indicative factors were: the use of the term "stipend" as constituting a literary term for "salary" or "compensation"; the vacation provision; the tax withholding suggestion; and the required thirty-five hours of work each week. It pointed out that the facts presented a stronger case for taxability than the recently enacted ruling of the Internal Revenue Service in *I.T.*4056.

Another factor which might well be considered sufficiently indicative of compensation for services in fellowship awards is the practice of reserving the fruits of the research to the grantor. This might consist in simply the right to publish the dissertation where the fellow is a candidate for a degree. In *Robert F. Doerge,*[18] the Tax Court, in following the *Banks* decision, noted without comment that any patents resulting from the research would have been controlled by the grantor university. And, as discussed above, a fellowship awarded as a prize in a formal contest, or flowing to the recipient as a result of an employment relationship, might also form a sufficient basis for taxation.

The Achievement Award

Seemingly, the Commissioner has attempted to reach but a few types of public service awards as taxable income. An early administrative view is G.C.M.5881.[19] This ruling dealt with an award by a public welfare organization. It was said: "It appears that the award was made to the taxpayer in recognition of his achievements in science and his services in promoting the public welfare. An award of this kind made by one to whom no services have been rendered is a gratuity as distinguished from compensation for services. Clearly the award was not a competitive prize . . . therefore . . . constituted a gift."

While it might be arguable that the "broad sweep" of section 22(a) is sufficient to characterize such an award as taxable income, the usual criteria of a gift

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17 17 T.C.1386 (1952); accord: Robert F. Doerge, ¶ 52,140 P-H Memo. T.C.
18 Ibid.
19 VIII-1 C.B. 68 (1929); cf. Israel Strauss, 6 T.C.M. 880 (1947).

seem to be present. It seems to be still the administrative view and is in accord with the dicta of Mr. Justice Douglas in the *Robertson* opinion. Presumably it would apply to such awards as the Nobel prize, noted to be excluded from income in the *McDermott* opinion, and the Philadelphia Award.[20]

On the borderline, however, might be such awards as the Pulitzer prize, or similar awards not resulting from a formal contest. An author who would submit a published or unpublished work in a formal literary contest would be, presumably, in the same position as taxpayer Robertson.[21] Between this situation and that where a committee selects a published work without formal submission is but a short step. It is a reasonable certainty that every author is more or less consciously aware of the fact that his work might be considered for such an award. It is thus arguable that any award made is responsive to his personal efforts and should be treated as taxable income. At this point it is also but a short step to treating the Nobel prize as taxable income. Perhaps this logic is faulty. If not, it is then only because of some overriding policy that such awards go untaxed.

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20 See Bok v. McCaughan, 42 F.2d 616 (C.C.A.3d 1930), for features of this award and ruling that its source was deductible as a charitable contribution.

21 Where a publisher, owning all the literary rights in a published work, submits the work in a contest where the award is won by the author, it is arguable that under the contract analogy of Mr. Justice Douglas that the author would be taxable as a third party donee beneficary. But—Whose income is it? Has the publisher made a gift to the author?