

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

Date: January 24, 2002

Dear [REDACTED]:

This is in response to letters from your office dated [REDACTED], and [REDACTED], relating to the taxability of payments made to various recipients by the [REDACTED] program. As described to us in the letters, and at a meeting on September 6, 2001, the [REDACTED] program provides educational and training awards to participants in the program and to certain dependent children of [REDACTED]. We are pleased to provide the following general information relating to the tax consequences of these educational and training benefits.

In the case of educational benefits for participants in the [REDACTED] program, this letter is intended to address only those amounts paid to recipients for educational expenses incurred after their enrollment in the [REDACTED] program. It is not intended to address amounts paid to recipients for educational expenses incurred prior to joining the program.

FACTS

The [REDACTED] program offers [REDACTED] scholarship awards for tuition and related educational expenses on a competitive basis to students who agree to serve as [REDACTED] for a specified period of time following the completion of their college studies. Students must pursue a degree in a course study appropriate to [REDACTED]. Participants agree to become [REDACTED] in geographical areas that have the greatest need for additional [REDACTED]. In addition, in the event a participant fails to comply with his or her service obligations, the participant must repay all scholarship amounts and other reimbursements, plus interest, received under the program.

The information submitted in your letters indicates that a person interested in the [REDACTED] (participant) may apply to any of about 30 participating states. A participant may apply to multiple states provided he or she is willing to serve in each of

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those states. A participant is not required to serve as a [REDACTED] in a state in which he or she lives or attends college. Applications to participate are made through "lead agencies" of the states. If a participant is highly rated by a state lead agency, the agency seeks to identify [REDACTED] departments or [REDACTED] offices interested in hiring the candidate after he or she completes both college and [REDACTED] training. A participant's agency can be changed during college or training to address special circumstances. Once a participant begins to serve [REDACTED] with a particular jurisdiction, he or she is expected to remain there for a four-year term of service. With good reason, however, he or she may be granted a request to be moved to another agency. Your letter indicates that such moves have occurred in several cases. Since participants choose the state in which he or she will be trained and will serve, transfers to another state are rare. In special cases, however, the Director [REDACTED] may approve inter-state transfers.

In addition to their academic studies, all participants in the [REDACTED] program must complete a 16-week basic training program. During this training period, participants receive a stipend.

Finally, the [REDACTED] program includes a scholarship program for the dependent children of [REDACTED]. The application process for these awards is non-competitive, and such recipients incur no service or repayment obligation.

LAW AND ANALYSIS

The federal income tax treatment of qualified scholarships and fellowship grants is addressed in § 117 of the Internal Revenue Code. Section 117(a) provides that gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in § 170(b)(1)(A)(ii) (describing, generally, a school).

To be considered a scholarship or fellowship grant, an amount need not be formally designated as such. Generally, a scholarship or fellowship grant is any amount paid or allowed to, or for the benefit of, an individual to aid such individual in the pursuit of study or research. A scholarship or fellowship grant may also be in the form of a reduction in the amount owed by the recipient to an educational organization for tuition, room and board, or any other fee.

Only "qualified scholarships" may be excluded from income. A qualified scholarship is defined as an amount expended for "qualified tuition and related expenses." Qualified tuition and related expenses are tuition and fees required for the enrollment or attendance of a student at an educational institution, and fees, books, supplies, and equipment required for courses of instruction at such an educational organization. Amounts received for room, board, travel, and incidental living expenses are not related

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expenses. Thus, scholarship receipts that exceed expenses for tuition, fees, books, supplies, and certain equipment are not excludible from a recipient's gross income under § 117.

Section 117(c) provides that the exclusion for qualified scholarships does not apply to that portion of any amount received that represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship or fellowship. Regulations governing the includibility of compensatory grants in income have been upheld by the Supreme Court of the United States, which has described excludible grants as "relatively disinterested, 'no-strings' educational grants, with no requirement of any substantial quid pro quo from the recipient." *Bingler v. Johnson*, 394 U.S. 741 (1969).

A scholarship or fellowship grant represents payment for services when the grantor requires the recipient to perform services in return for the granting of the scholarship or fellowship. A requirement that the recipient pursue studies, research, or other activities primarily for the benefit of the grantor is treated as a requirement to perform services. A scholarship or fellowship grant conditioned upon either past, present, or future services by the recipient, or upon services that are subject to the direction or supervision of the grantor, represents payment for services.

Rev. Rul. 73-256, 1973-1 C.B. 56, addresses whether a state medical education loan scholarship program provided excludible scholarships within the meaning of § 117. In the program, a state, in order to increase the number of doctors in its rural areas, awarded amounts to qualified students to aid them in attending medical school. In lieu of repaying the amounts to the state, a student must practice as a doctor in a rural area of the state, selected by the state, for a period of five years. The ruling holds that because the payment to the student is conditioned on the student practicing medicine in a state-selected rural area for five years, the payment requires a substantial quid pro quo by its recipient. The payments, thus, do not further an educational purpose and are designed to accomplish a basic objective of the grantor. Thus, the amounts provided by the state are not excludible under § 117 and must be included in the recipient's gross income. See also *Porten v. Commissioner*, T.C. Memo 1993-73, which holds that academic assistance provided by the state of Alaska in exchange for recipients working in Alaska following graduation is taxable to the recipients, and Rev. Rul. 76-122, 1976-1 C.B. 42, which concludes that students in an Iowa nursing program must include in gross income tuition payments they receive because the students are required to provide nursing services in Iowa in exchange for the tuition.

Although scholarships that represent payment for services are not excludible from income under § 117(c), not all grants that are subject to conditions or limitations represent payment for services. Determining whether a particular awards program makes compensatory payments within the contemplation of § 117(c) is an inherently

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factual matter, requiring a consideration of the nature and extent of the impositions, and of all other relevant facts and circumstances of the program.

Tuition payments and related expenses

As discussed above, scholarship grants to be awarded under a program such as the one described above should not be viewed as compensation for services within the meaning of § 117(c) where the service commitment imposed upon the recipients of the scholarships does not constitute the requirement of a substantial quid pro quo from the recipients. On the contrary, where the grants are relatively disinterested grants designed to accomplish public rather than private or proprietary purposes, they should be considered excludible scholarships under § 117(a).

All relevant facts and circumstances should be considered in determining whether a service commitment for grant recipients imposes the requirement of a substantial quid pro quo, or, alternatively, is intended to accomplish public rather than private or proprietary purposes. For example, in your program, scholarship recipients have significant input into which state he or she will serve. The state of service is a mutually agreed upon decision of the [REDACTED] and the scholarship recipient. Further, as discussed in the October 22, 2001, letter submitted by your office, while transfers to other departments are not encouraged once a choice of departments has been made, requests to move to another [REDACTED] department are granted. In fact, in special cases, transfers to departments in different states are permitted. Compare this commitment with the types considered in Rev. Rul. 73-256, Rev. Rul. 76-183, and *Porten v. Commissioner, supra*, where the grant recipient was required to perform services in a manner determined by the grantor, in a specific location determined by the grantor, and in an office of the grantor. To the contrary, a program that imposes as its only condition a requirement that the scholarship recipient must, following graduation, perform services consistent with his or her college degree in any one of approximately 30 states, should not be viewed as imposing a substantial quid pro quo. Consequently, the scholarships provided by your program should not constitute compensation for services within the meaning of § 117(c) of the Code.

Finally, scholarships not representing compensation for services within the meaning of § 117(c) of the Code do not constitute "wages" for purposes of § 3401(a). Additionally, such amounts are not subject to § 3402 relating to withholding for income taxes at source, § 3102 relating to withholding under the Federal Insurance Contribution Act (FICA), or § 3301 relating to the Federal Unemployment Tax Act (FUTA). Thus, there is no requirement to file Forms W-2, or any return of information under § 6041, with respect to such grants.

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The recipient of a scholarship or fellowship grant is responsible for determining whether a scholarship grant is, in whole or in part, includible in gross income for federal income tax purposes. As discussed above, qualified scholarships include only amounts expended for "qualified tuition and related expenses." Qualified tuition and related expenses are tuition and fees required for the enrollment or attendance of a student at an educational institution, and fees, books, supplies, and equipment required for courses of instruction at such an educational organization. Amounts received for room, board, travel, and incidental living expenses are not related expenses. Thus, scholarship receipts that exceed expenses for tuition, fees, books, supplies, and certain equipment are not excludible from a recipient's gross income under § 117.

Stipends

The analysis discussed above relating to § 117(c) and whether the amounts received by the recipients constitute payment for services also applies in the case of the stipend amounts paid to the [REDACTED] participants. In addition, as discussed above, where the stipends do not represent compensation for services, the payor of the stipend is not required to file a W-2 or pay employment taxes with respect to the stipend amount. For purposes of § 117(a), however, the stipend amounts are not excludible from the recipients' income because they do not represent amounts expended for qualified tuition or related expenses.

Payments for tuition of dependent children

Section [REDACTED] of the [REDACTED] provides that a dependent child of a [REDACTED] [REDACTED] plan and [REDACTED] shall be entitled to scholarship assistance for any accredited institution of higher education. There is no repayment obligation in exchange for the scholarship assistance.

Section 104(a)(1) provides that gross income does not include amounts received under workmen's compensation acts as compensation for personal injuries or sickness.

Section 1.104-1(b) of the Income Tax Regulations states that § 104(a)(1) excludes from gross income amounts received by an employee under a workmen's compensation act or under a statute in the nature of a workmen's compensation act that provides compensation to the employee for personal injury or sickness incurred in the course of employment. Section 104(a)(1) also applies to compensation which is paid under a workmen's compensation act to the survivor or survivors of a deceased employee. Section 104(a)(1) does not apply to a retirement pension or annuity to the extent it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness. Section 104(a)(1) also does not apply to amounts which are received as compensation for a non-occupational injury or sickness nor to

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amounts received as compensation for an occupational injury or sickness to the extent that they are in excess of the amount provided in the applicable workmen's compensation act or acts.

In Rev. Rul 77-235, 1977-2 CB 45, section 701(a) of the Public Safety Officers' Benefits Act of 1976 provided that when the Law Enforcement Assistance Administration determined that a public safety officer died as the direct and proximate result of a personal injury sustained in the line of duty, the Administration paid a benefit to certain surviving dependents. The ruling concluded that the benefit paid pursuant to section 701 is an amount received under a statute in the nature of a workmen's compensation act and excludible from gross income under § 104(a)(1) of the Code.

The educational assistance provided to dependent children of [REDACTED] are paid pursuant to a statute, are limited to [REDACTED] employees who [REDACTED] as the direct and proximate result of a personal injury incurred in the course of employment and are not determined by reference to the employee's age, length of service or prior contributions. Accordingly, [REDACTED] qualifies as a statute in the nature of a workmen's compensation act and benefits paid to or on behalf of dependent children of [REDACTED] as scholarship assistance are excludible from the dependent children's gross income under § 104(a)(1).

We note that this information is an "information letter", which calls attention to well-established interpretations or principles of tax law without applying them to a specific set of facts. An information letter is advisory only and has no binding effect on the Service. We thank you for your interest and concern in this matter and hope that the general information and comments we have provided are helpful. If we may be of further assistance, please do not hesitate to contact me at (202) 622-7147 [REDACTED].

Sincerely,

Stephen J. Toomey
Assistant to the Branch Chief
Associate Chief Counsel
Income Tax & Accounting