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## SCHOLARSHIPS, FELLOWSHIPS AND PRIZES

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In the good old days when rates were low and exemptions high it was the rare scholar whose efforts were so well compensated as to require the payment of a substantial income tax. But it is the rare scholar who does not now have his income tax problems. And since a scholar's income does not usually make him familiar with the top tax brackets, he may be startled at the huge bite taken by the income tax should that perhaps unexpected but quite welcome award or prize turn out to be taxable income.

The issue is the extremely troublesome one of drawing the line between compensation, on the one hand, and gifts in the income tax sense, on the other. The Internal Revenue Code<sup>1</sup> defines gross income as including "gains, profits and income derived from salaries, wages, or compensation for personal services . . . of whatever kind and in whatever form paid . . . and income derived from any source whatever." But the code excludes from gross income "the value of property acquired by gift."<sup>2</sup> The term "gift" is here used in a narrower sense than its common law meaning, so that wholly voluntary payments made without legal or moral obligation are not gifts for income tax if made as compensation for services rendered, however much they may qualify as gifts at the common law.<sup>3</sup> It is not true, therefore, that all gifts are exempted from income tax. To be excluded from income, the gift must not be compensation.

In an early ruling<sup>4</sup> the General Counsel of the Bureau of Internal Revenue held that an award made in recognition of an individual's achievements in science and his services in promoting the public welfare was not taxable income. The award was made by a Foundation created to receive and use an endowment fund for awarding prizes, granting scholarships and engaging in research as a means of promoting the general welfare, the advancement of liberal thought and the furtherance of international peace. In concluding that the award was a gift, the ruling stated:

"An award of this kind made by one to whom no services have been

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<sup>1</sup>Section 22(a). The code uses the term "gross income" to define the items which must be reported as income. The subtraction from gross income of the deductions allowed by the code produces "net" income which (after allowing for the credits) becomes the amount upon which the tax rates are applied. "Gross" income is therefore synonymous with taxable income.

<sup>2</sup>Section 22(b)(3).

<sup>3</sup>For example, *Fisher v. Commissioner*, 59 F.2d 192 (2d Cir., 1932).

<sup>4</sup>C.C.M. 5831, Cum. Bull. VIII-1, pp. 68-69 (1929).

rendered is a gratuity as distinguished from compensation for services. Clearly the award was not a competitive prize.”<sup>5</sup>

The ruling excludes from taxable income such awards as the Nobel prize as distinguished from a “competitive prize.” In a broad sense there is competition for Nobel and other awards made in recognition of outstanding contributions in intellectual endeavor, but the bureau is here distinguishing between such recognition awards and a prize given in a contest, as a prize for the best novel, musical composition, architectural design or the like submitted to a board of judges. The bureau views awards of this kind as compensation for services, and is advancing this contention with increasing success in the courts.

There appears to be no disposition as yet by the bureau to tax recognition awards, not involving any contest, but it is a question whether this attitude will prevail if the bureau should achieve full victory in the contest cases. In these days of high tax rates and even higher revenue needs and in the face of a congressional reluctance to close the gap by increased taxes, the bureau is forced to tap all available sources of taxable income. The award enriches the recipient to the same extent whether or not it is made in a contest. Although the Court of Appeals thought otherwise in the *McDermott*<sup>6</sup> case, the concept of taxable income does not require an element of annual recurrence, as witness the tax imposed on sweepstakes winners, successful contestants on radio programs,<sup>7</sup> and capital gains. Is there any

<sup>5</sup>The requirement that services must be rendered to the payor in order to tax the payment as compensation seems clearly unsound. If A is paid by B to perform services for C, A receives compensation. If there is a gift present, it is a gift by B to C. Also since compensation under the code includes additional payments (such as a bonus or pension) made without legal or other obligation for services already rendered and compensated, it should make no difference that the bonus or pension is paid by some one other than the recipient of the services. The only ground for holding such a payment to be a gift is that it was made without thought of compensating for services. This was the view of the four dissenting Justices in *Bogardus v. Commissioner*, 302 U.S. 34 (1937). That case held that bonuses paid to employees by the former stockholders of a company were exempt gifts. It has been stated that “the position taken by the minority in the *Bogardus* case . . . is more apt to represent the law at the present time in view of the present membership of the United States Supreme Court.” Mertens, *LAW OF FEDERAL INCOME TAXATION* (2d ed., 1942), vol. 1, § 8.08, footnote 80. The majority opinion, however, still carries weight. *Newton v. Commissioner*, 11 T.C. 512 (1948) (A). And the Regulations contain the language that “so-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable.” Reg. 111, § 29.22(a)-2. This language was also used in L.O. 1040, 3 C.B. 120 (1920), in which the Solicitor of Internal Revenue held (reversing an earlier ruling) that pensions awarded by the Carnegie Foundation to retiring teachers or, after their death, to their widows were not taxable as compensation. Is there any sound reason why these pensions should be treated more favorably under the income tax laws than other pensions?

<sup>6</sup>*McDermott v. Commissioner*, 150 F.2d 585 (U.S.C.A. D.C., 1945).

<sup>7</sup>*Droge v. Commissioner*, 35 B.T.A. 829 (1937); *Silver v. Commissioner*, 42 B.T.A. 461 (1940); I.T. 3987, 1950-1 Cum. Bull. 9. But see *Washburn v. Commissioner*, 5 T.C. 1333 (1945), in which a winner on the Pot O’Gold program was held to have received a gift. The decision is based on the fact that the winner did nothing at all to receive the award. It seems clear that this decision would not be followed where there was anything at all constituting participation by the winner in the radio program.

reason why a Nobel prize winner should receive more favorable tax treatment than the novelist who labors all his life and finally produces a successful novel? Once it is conceded that the common-law concept of gifts does not govern, it is certainly at least arguable that any payment made on the basis of work done by the recipient in the course of his professional career is taxable as compensation for services rendered.

The bureau has recently stated that 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 excludible from gross income."<sup>8</sup> Thus, the usual scholarship or fellowship to a college or university student is not taxed. This ruling may indicate the unsoundness of the distinction between recognition awards and competitive prizes. Every student who has had to win a scholarship in order to stay in college will testify that a scholarship is a competitive prize. Yet it is clear that such awards are not compensation for services. They are made merely to enable the student to complete his education. The donor to this extent is acting as the foster parent of the student. It should, therefore, make no difference whether the award is to a person seeking an A.B., LL.B, M.D., Ph.D. or any other (or no) degree. Furthermore, it should make no difference whether the award is made by a charitable organization or by a commercial enterprise. In all these instances the element of compensation for services is lacking.

The grant of a scholarship or fellowship may be conditioned on the rendering of services, such as part time teaching or tutoring or the grading of examinations. To that extent there is an element of compensation present. Although an award may be primarily a scholarship and only to a minor extent compensation for services, the bureau may take the position that the burden is on the recipient to demonstrate what portion of the award is scholarship. Perhaps the only safe procedure in such situations is for the donor to specify how much is scholarship and how much compensation.

In addition to scholarships and fellowships there are many prizes available to university students upon the basis of a specific contest, such as the submission of the best piece of creative writing or research. Is it likely that the bureau will seek to tax these prizes, using the contest cases as precedents? Here, again, the distinction between recognition awards and competitive prizes breaks down. Grants to students on the basis of specific contests are, equally with scholarships, made in furtherance of their educational development. Perhaps the simple approach is that the student has not reached the stage of income producing activity in his educational work but

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<sup>8</sup>I.T. 4056, Cum. Bull. 1951-17-13643.

is merely acquiring the training necessary to produce income. It is far-fetched to regard awards of any kind to a student on the basis of work done by him in his courses or in any of the other intellectual activities offered by the university as being compensation for that work.

When, however, the student has completed his university training and presumably is ready to put his acquired skill to work, the bureau takes the position that the fellowships he receives are taxable income. The bureau's recent ruling on fellowships<sup>9</sup> considered four "representative" awards made by a foundation. Two of the awards were to university professors who were undertaking specific scientific research. One was to enable a professional writer to finish a novel. The fourth was to finance research in Europe by the holder of A.B. and Ph.D. degrees into the relations between government and economic processes. The foundation received no rights in any of the work produced by the recipients, did not require them to submit progress reports, nor were the awards contingent upon the completion of the projects. The bureau ruled that all four stipends were taxable as compensation for personal services. The bureau reasoned that the fellowships were "not for the training or education of the recipients" but were granted in consideration of the application by the recipients of their respective skills and training "with the expectation of results consistent with the recipients' qualifications," and that "to the extent there is any donative intent present . . . the beneficiary is society at large and not the recipient of the award whose services are expected in return for the grant."

This distinction between a grant to enable an individual to complete his education and one to secure the employment of an individual's skill and training is one of substance. To be sure, an undergraduate studying on a scholarship is employing skills and training already acquired and, on the other hand, a professional scholar or writer is necessarily furthering his educational development by the employment of his skills and training. Nevertheless, in the former case it is clear that the grant is made for the purpose of furthering education, whereas in the latter case the primary purpose of the grant is to put the individual's skill to work to achieve concrete objectives. The distinction is valid even though in both situations the donor relies upon the honor of the individual to carry out the objectives of the grant. The loose arrangements between foundations and recipients of awards is presumably in recognition of the fact that the special skills sought to be employed flourish best in an atmosphere of freedom. There are doubtless many similar arrangements by industrial corporations for the employment of inventive or other creative talent. When the individual has finished his schooling and seeks to employ his acquired skills for economic

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<sup>9</sup>See footnote 8 *supra*.

gain it does not seem fair to other taxpayers to grant him an exemption upon some supposed ground that his skills contribute more directly to human betterment than do the daily activities of the masses of the population whose combined efforts produce the economic wealth of the nation. Nor is such a favored treatment justifiable on any notion that the recipient is merely furthering his own education. So does the lawyer or doctor further his education by the daily practice of his profession. If school days are over and the scholar has offered his skills for monetary gain there is no reason why he should not bear his fair share of the cost of civilized government along with everybody else.

The bureau may, therefore, meet with considerable success in its effort to tax fellowship awards by foundations.<sup>10</sup> There will be cases in which the line suggested by the bureau's ruling may be difficult to draw. Thus, a graduate student may be required to produce an original piece of work in order to qualify for a Ph.D. degree. Under such circumstances is a fellowship granted to that student compensation for the employment of skills or assistance in furtherance of an education? It would seem that this situation falls in the latter category. The grant is essentially to enable the individual to develop special skills and training in much the same way as a scholarship to a law or medical student is to aid him in qualifying for his chosen profession. Similarly, a fellowship to a graduate in law working for his doctor's degree would seem to fall on the side of furtherance of an education.

There are now five court decisions involving competitive prizes for essays and the like.<sup>11</sup> The commissioner was successful in the three cases coming before the Tax Court,<sup>12</sup> but one of these decisions was reversed on appeal.<sup>13</sup> The other two cases were suits for refund in district courts,<sup>14</sup> and in both the taxpayer was successful, but one of these cases has been reversed and is now pending in the United States Supreme Court.<sup>15</sup>

In the *McDermott* case<sup>16</sup> the United States Court of Appeals, District of Columbia, reversing the Tax Court, held that the Ross essay prize awarded annually by the American Bar Association was an excludible gift. The

<sup>10</sup>In *Straus v. Commissioner*, 6 T.C.M. 830 (1947), a doctor of established reputation in the field of neurology and psychiatry had been devoting so much of his time to the work of a hospital for the mentally ill that his practice had suffered materially. A group of his friends decided to give him \$10,000 but in order to obtain a deduction for a charitable contribution, they employed the procedure of paying the money to a charitable foundation, which thereupon made a grant of \$10,000 to the doctor, stating that "this grant . . . is intended to enable you to give your maximum attention for the next two years to the development of the Hillside Hospital." The court sustained the commissioner's determination that the \$10,000 was taxable as compensation.

<sup>11</sup>*McDermott v. Commissioner*, 150 F.2d 585 (U.S.C.A. D.C., 1945); *Stein v. Commissioner*, 14 T.C. 494 (1950); *Waugh v. Commissioner*, 9 T.C.M. 309 (1950); *Amirikian v. United States*, 100 F.Supp. 263 (D.C. Md., 1951); and *Robertson v. United States*, 93 F.Supp. 660 (D.C. Utah, 1950) reversed 190 F.2d 680 (10th Cir., 1951), certiorari granted December 11, 1951.

<sup>12</sup>The *McDermott*, *Stein* and *Waugh* cases, *supra* footnote 11.

<sup>13</sup>The *McDermott* case.

<sup>14</sup>The *Amirikian* and *Robertson* cases, *supra* footnote 11.

<sup>15</sup>The *Robertson* case, *supra* footnote 11.

<sup>16</sup>*Supra*, footnote 11.

Chief Justice dissented. The majority of the court reasoned that the American Bar Association was not buying the services of the winning contestant nor did the latter regard himself as exchanging his services for money. The court distinguished this competition from contests operated for commercial purposes and concluded that "requiring winners of scholarly awards to pay taxes on them would conflict with the wise and settled policy of encouraging scholarly work." In 1949 the bureau announced that it would not follow this decision.<sup>17</sup> The reasoning of the court appears broad enough to include in the category of gifts all types of grants by charitable foundations for research or other creative work.

In two cases decided by the Tax Court in 1950 the court distinguished the *McDermott* case on its facts. In *Stein v. Commissioner*<sup>18</sup> the Tax Court held that a prize paid by the Pabst Brewing Company for the best plan for post-war employment was taxable as compensation. The same result was reached in *Waugh v. Commissioner*<sup>19</sup> involving a prize for an essay on farm price policies in a contest held by the American Farm Economic Association, a tax-exempt organization. In both cases the Tax Court viewed the *McDermott* decision by the Court of Appeals as based upon a finding by that court of donative intent on the part of the American Bar Association, although the Tax Court made it clear that it did not agree with such a finding nor with the reasoning of the Court of Appeals. The Tax Court held that the Pabst Brewing Company did not intend a gift since it treated the expenditures in the contest as a business expense, as part of its advertising program, and that the American Farm Economic Association's motive was not purely donative since it did derive benefit from the contest by stimulating interest in itself and in American farm economics. The Tax Court, however, plainly expressed its view that the intent of the donor is not the controlling factor, stating "that in the *McDermott* case . . . too much importance was placed on the question whether the original furnisher of the money intended to make a gift and too little attention was paid to the question whether there was as to the recipient gain or compensation from labor or work at a business or profession."<sup>20</sup>

In *Amirikian v. United States*<sup>21</sup> the District Court held that an award for an engineering paper on arc welding in a contest conducted by a tax-exempt foundation created to stimulate scientific research was a gift. The court expressed the view that an award within the objectives of a philanthropic organization must be regarded as donative.

The reversal of the *Robertson*<sup>22</sup> case by the Circuit Court of Appeals is

<sup>17</sup>I.T. 3960, 1949-2 Cum. Bull. 13.

<sup>18</sup>See footnote 11 *supra*.

<sup>19</sup>See footnote 11 *supra*.

<sup>20</sup>14 T.C. 494, 501.

<sup>21</sup>See footnote 11 *supra*.

<sup>22</sup>See footnote 11 *supra*.

the most important victory achieved to date in the campaign to tax all competitive prizes. In that case a composer submitted a symphony written years before without thought of profit or sale as his entry in a contest<sup>23</sup> for the best symphonic composition written by native born composers of the Western Hemisphere. The prize money was supplied by an individual who was the president of a non-profit organization which apparently sponsored the Detroit Symphony Orchestra. The court held, reversing the District Court, that the award was taxable income.<sup>24</sup> Starting from the familiar premises that the broad definition of gross income in section 22(a) of the code shows a congressional purpose to exercise the full measure of the constitutional power and that the exemption for gifts should therefore be strictly construed, the court interpreted prior decisions as applying "the practical test" of determining whether the "income was received gratuitously and in exchange for nothing." Even though the composition was originally written without thought of profit, it was nevertheless the product of the composer's professional skill and training, and in submitting that product in a contest he was seeking financial gain for his labors "just as much as though he had sold it or had been paid for its use." The court, therefore, concluded that it cannot be said that the prize was "entirely gratuitous and received in exchange for nothing."

It is to be hoped that the United States Supreme Court in reviewing the *Robertson* case will take this opportunity to shed some much needed light on the gift versus compensation issue. The average taxpayer who is finding it difficult to meet his living expenses out of what is left in his pay check after deducting the withholding tax may not easily understand why a gift recipient who contributes no labor may nevertheless spend the whole amount of the gift. It is difficult to convince him that the exemption for gifts does not do violence to the principle of taxation in accordance with ability to pay. While the favored treatment for gifts exists, it is understandable, however, that those who do labor for their "gifts" should regard themselves as much entitled to the exemptions as the wholly gratuitous donee. But two wrongs do not make a right. There is no reason why an individual who receives monetary reward for his labors should be any the less taxed because the reward is in the form of a grant or prize rather than a fee or salary or wage.

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<sup>23</sup>The facts of this case illustrate that the distinction between a recognition award and a competitive prize may be very tenuous. Thus, is an award by a non-profit organization for the best play written in 1951, where no entries are submitted but selection is made among the plays published during that year to be distinguished from an award made on the basis of the submission of unpublished plays to a board of judges? Is not the gain from work at a profession the same in both cases?

<sup>24</sup>Under the terms of the contest the composers of winning compositions were required to relinquish certain rights to the non-profit organization. The Circuit Court of Appeals expressly refrained from basing its decision on the narrow ground that the relinquishment of such rights was a consideration sufficient to prevent the award from being a gift.