1996

Loan Repayment Assistance Programs for Public-Interest Lawyers: Why Does Everyone Think They are Taxable?

Richard C.E. Beck
richard.beck@nyls.edu

Recommended Citation
40 N. Y. L. Sch. L. Rev. 251 (1995-1996)

LOAN REPAYMENT ASSISTANCE PROGRAMS FOR PUBLIC-INTEREST LAWYERS: WHY DOES EVERYONE THINK THEY ARE TAXABLE?

RICHARD C.E. BECK*

Table of Contents

---

* Professor, New York Law School. I wish to thank the following persons for their valuable comments on earlier drafts: Charlotte Crane, Deborah Paulus, David Schoenbrod, Richard Westin, Thomas White, and George Zeitlin. This work was supported in part by a summer grant from New York Law School.

I. INTRODUCTION AND SUMMARY

In recent years many law schools have instituted loan repayment assistance programs (LRAPs) intended to encourage law graduates to work in public interest areas such as legal aid.[1] The typical LRAP provides for cancellation of some part of the student's educational loans for each year of such public interest work, or for work in any law-related area if the graduate earns less than a ceiling amount. Schools provide the LRAP benefits either by direct cancellation of the original loans, or if the loans are in the hands of a third party, by periodic cash payments to the participant to be used to pay down the original loans. The cash payments may be structured either as outright grants or as new cancelable loans. The purpose of LRAPs is to assist lawyers who would like to pursue public interest careers but would otherwise be forced into more remunerative private practice in order to support the crushing burden of servicing student loans.

This article addresses the question whether LRAP benefits are taxable as income. The question is unresolved, and to some extent even unasked, but it is becoming increasingly important as the number and size of legal LRAPs continue to expand.[2]

Although there is no published authority regarding the tax effects of LRAPs for legal education,[3] most if not all of the law schools which offer LRAPs have assumed that the financial assistance is taxable income to the participant. No law school or LRAP participant seems to have challenged this interpretation. Many national law schools report the financial assistance as income by sending 1099 Information Forms to participants

---

1. *Loan Repayment Assistance Creating Opportunities for Public Interest Careers*, NAPIL CLOSE-UP (Nat'l Ass'n for Pub. Interest Law, Washington, D.C.), Fall 1994, at 3 (reporting that 49 law schools now have such programs). In addition, six states have LRAP programs funded by state bar foundations, state interest on lawyers' trust accounts programs, or direct state legislative funding. *Id.*

2. New York University (NYU) School of Law began a $10,000,000 program in the fall of 1995 which can pay the entire cost of a law student's education, worth as much as $40,000 per year, if the graduate remains in public interest law for 10 years. The program is large enough to accommodate half of the entering class of 420 students for the years 1995, 1996, and 1997. *See* William Celis 3d, *Tuition for Public Service Law*, N.Y. TIMES, Nov. 9, 1994, at A25.

3. Except for a 1991 law review article. *See* J. Timothy Phillips & Timothy G. Hatfield, *Uncle Sam Gets the Goldmine—Students Get the Shaft: Federal Tax Treatment of Student Loan Forgiveness*, 15 SETON HALL LEGIS. J. 249 (1991). The article concluded that law school LRAPs are probably taxable; however, the analysis is brief and does not refer to the historical sources relied upon in this article.

and to the IRS.[4] Information reporting is clearly not required if LRAPs are a form of scholarship, however, even if they are a *taxable* form of scholarship.[5] This article concludes that LRAP benefits should be regarded as tax-free scholarships at least to the extent they are allocable to law school tuition loans.

The widespread belief that LRAP benefits are taxable is apparently due to two related sources. First, LRAPs do not meet the literal requirement of I.R.C. § 108(f)(1) which allows exclusion of student loan cancellations that are conditioned upon the student's employment in certain professions or designated areas but only if the source of the LRAP loan funds is a governmental entity. The source of law school LRAP funds is largely private. If one assumes that I.R.C. § 108(f) is the exclusive route to protection for student loan forgiveness, LRAP benefits would be taxable.

The second source is Revenue Ruling 73-256,[6] which held that forgiveness of state-provided medical school loans is taxable if conditioned upon the graduate's practicing medicine for a term of years in an underserved area of the state. The IRS held that the LRAP failed the test of Treasury Regulation § 1.117-4(c) which provides that a scholarship is taxable if the student must perform substantial future services, or if the primary beneficiary of the scholarship is the grantor. The Supreme

4. For example, NYU Law School's 1994-95 information brochure describing the Melvyn and Barbara Weiss Loan Repayment Assistance Program flatly states that "LRAP proceeds are taxable as 'other income'" and that the University will mail participants a Form 1099. NYU's assistance takes the form of cash payments to the participant who is required to use the funds to pay down loans. Harvard and Yale Law Schools also pay cash and also send Forms 1099. Columbia School of Law makes participants new interim cancelable loans to pay down existing debt, and when the interim loans are canceled, Columbia also sends Forms 1099. By contrast, certain other law schools which use the interim loan system do not send Forms 1099 when the interim loans are forgiven. These schools did not wish to be mentioned here.

5. I.R.S. Notice 87-31, 1987-1 C.B. 475 states very clearly that unless a scholarship is treated as wages under I.R.C. § 117(c) and wage withholding is required, no Form 1099 need be filed. *Id.* at 477. *See also* Announcement 93-2, 1993 I.R.B. 39, § 342.9 (same). Thus even where part of a scholarship is clearly taxable, such as amounts for living expenses rather than tuition, the school is expressly exempted from information reporting. It is clear that LRAP participants are not employees of their law school. If LRAPs do not qualify as tax-free scholarships, they are at least arguably "scholarships," and it is the responsibility of the recipient, not the grantor, to determine whether a scholarship is taxable. *Id.* at 478; *see also* INTERNAL REVENUE SERVICE, DEP'T OF THE TREASURY, PUB. NO. 520, SCHOLARSHIPS AND FELLOWSHIPS 3 (1994).

6. 1973-1 C.B. 56, discussed and criticized *infra* notes 65-67, 156-161 and accompanying text.

Court's decision in *Bingler v. Johnson*[7] is usually cited as upholding these regulations and interpreting them as imposing a *quid pro quo* test.

It was evidently for these reasons that when Senators Bumpers and Danforth introduced a bill in 1993 which was intended to make law-school LRAPs tax-free,[8] they too asserted that legal LRAPs are taxable under current law.[9] No action was taken on the bill,[10] which would have amended I.R.C. § 108(f) essentially by deleting the current requirement that the source of loan funds must be a government entity.[11]

Senator Bumpers stated that no tax policy supports treating privately-funded LRAPs differently from publicly-funded ones, and pointed out that the sole reason for the limitation in current I.R.C. § 108(f) appears to be the absence of any privately-funded LRAPs during the mid-1970's when the provision was enacted.[12] The bill would merely bring I.R.C. § 108(f) up to date, and would not represent any departure from existing tax policy.[13] The bill died in 1993 without any action having been taken and has not been reintroduced. The forecast for a legislative resolution seems dim.

---

7. 394 U.S. 741 (1969) (holding that engineers employed by Westinghouse Corporation who received 70-90% of regular salary while on nine month leave to complete doctoral dissertation received taxable income—not excludible fellowships—where stipends were withheld upon as salaries, taxpayers continued to receive employee benefits during leave, and had agreed to return to Westinghouse's employment for at least two years after leave).

8. S. 914, 103d Cong., 2d Sess. § 1 (1993).

9. 139 CONG. REC. S5647 (daily ed. May 6, 1993) (statement of Sen. Bumpers).

10. Although according to Senator Bumpers, the bill is strongly supported by the American Bar Association, the National Senior Citizens Law Center, the National Association for Public Interest Law, the National Legal Aid and Defenders Association, the National Association for Law Placement, the Project Advisory Group, and the Association of American Law Schools. *Id.* at S5648.

11. Although S. 914, *supra* note 8, is primarily aimed at law school loan forgiveness, it would apply to a number of other professions as well. Senator Bumpers stated that LRAPs are now available at the Kennedy School of Government, and the Harvard and Stanford Business Schools. 139 CONG. REC. S5648 (daily ed. May 6, 1993) (statement of Sen. Bumpers).

12. 139 CONG. REC. S5647 (daily ed. May 6, 1993) (statement of Sen. Bumpers). The statement seems accurate. Harvard was the first law school to introduce an LRAP in 1974, and for the following 12 years Harvard was virtually alone. The idea began to catch on at other schools after 1985. *See Student Loans: Be Good*, ECONOMIST, Nov. 11, 1989, at 36.

13. 139 CONG. REC. S5648 (daily ed. May 6, 1993) (statement of Sen. Bumpers). The Joint Committee on Taxation found that any revenue loss from the bill would be negligible.

The belief that LRAPs are taxable was bolstered by the Tax Court's 1993 decision in *Porten v. Commissioner*[14] which held that forgiveness of college tuition loans granted by the State of Alaska is taxable where conditioned upon the graduate's continuing residency in the state, citing as support Revenue Ruling 73-256. The court also held that I.R.C. § 108(f) is preemptive of the LRAP area and that the Alaska plan did not fit the literal terms of I.R.C. § 108(f) because it was not limited to "certain professions."

I disagree with the *Porten* court's conclusions which are based upon excessive deference to Revenue Ruling 73-256 and upon a failure to explore the IRS' earlier and sounder position on the same issue.[15] It appears to be forgotten now that for thirteen years, until its abrupt and unexplained change of position in Revenue Ruling 73-256, the IRS had held that the medical LRAP and other similar LRAPs for higher education were tax-free scholarships because the public-service requirement was not for the benefit of the grantor, but rather for the public at large so that the service requirement was not compensatory in nature. The IRS explained its change of position in Revenue Ruling 73-256 as compelled by *Bingler v. Johnson*, but in fact nothing in the *Johnson* decision required reconsideration of the earlier LRAP rulings.

Also forgotten is the fact that Congress explicitly disapproved both the reasoning and result of Revenue Ruling 73-256. In fact, Congress enacted the predecessor of I.R.C. § 108(f) expressly in order to overrule Revenue Ruling 73-256 and to reinstate the tax-free status of these and similar LRAPs as scholarships.[16] This history casts considerable doubt both upon the authority of Revenue Ruling 73-256, and upon the theory that Congress intended I.R.C. § 108(f) to be preemptive of the area of student loan relief.

Recently the IRS seems to have drifted back to its former position that public-service requirements are noncompensatory. In Private Letter Ruling (PLR) 9526020,[17] the IRS ruled that an outright grant of law school tuition is a tax-free scholarship even if the recipient is contractually obligated to work in public interest law for ten years and must pay a penalty for breach of the condition. There is no difference of substance between such a grant and a tuition loan which is cancelable under the same conditions. And except for timing, about which the IRS has never

---

14. 65 T.C.M. (CCH) 1994 (1993). This is the sole reported court decision regarding LRAPs of any kind. The decision is criticized *infra* notes 115-134 and 139-149.

15. *See infra* notes 38-48 and accompanying text.

16. *See infra* notes 68-72 and 131-134 and accompanying text.

17. Priv. Ltr. Rul. 9526020 (Apr. 3, 1995). This is the only ruling which addresses a law school LRAP.

made an issue, there is little or no difference between either of these and postgraduate LRAP cash payments which are intended to pay for tuition loans. Indeed, if a proper request were made, the IRS might even issue a favorable ruling.

This article will examine afresh the question whether law school LRAPs may be tax-free scholarships or rebates of tuition for reasons which have escaped those who have assumed the IRS' position on the question. Part II of this article provides background on the nature and purpose of LRAPs and on the history of their tax treatment. Part III analyzes this tax treatment and argues that LRAPs are not taxable under current law, at least to the extent the benefits are allocable to relief from law school tuition loans, on the ground that in the final analysis, LRAP benefits are simply rebates of tuition.

II. BACKGROUND

A. *Nature and Purpose of LRAPs*

All law school LRAPs have as their common purpose the advancement of public interest law by means of financial aid to graduates to offset the high cost of law school and low remuneration of public interest work.[18] Both factors have exacerbated a persistent shortage of public interest lawyers.[19] The National Association for Public Interest Law (NAPIL) reports that in 1991-92, more than 50% of law school graduates left school owing between $40,000 and $79,999. Starting salaries in the public interest sector declined from a median of $32,000 in

18. Not all observers agree that law school LRAPs are desirable, however. *See generally* Luize E. Zubrow, *Is Loan Forgiveness Divine? Another View*, 59 GEO. WASH. L. REV. 451 (1991). Professor Zubrow argues that LRAPs may encourage increased student indebtedness and unfairly reward borrowers at the expense of savers. She contends that if LRAPs are desirable at all, they should be confined to subsidizing legal aid to the poor and should not be available for public-issue advocacy work or for government employees. She further maintains that LRAPs are an inefficient means of providing aid to the poor, and that direct grants to legal aid societies or the establishment of fellowships would be more efficient. However, Professor Zubrow appears to assume, in her economic analysis, that LRAPs are taxable to the participants. Finally, Professor Zubrow questions whether encouragement of public interest law of any kind is a proper function of law schools except where it directly contributes to the education of students, such as aid provided through live student clinics.

19. *See* William P. Hoyle, *High Cost of Doing Good*, A.B.A. J., Jan. 1995, at 96 (discussing the need for more LRAP programs to alleviate the shortage of public interest lawyers and urging the institution of a comprehensive federally funded plan. Such an LRAP program would presumably be tax-free under current I.R.C. § 108(f) because it is federally funded.).

1989 to $27,000 in 1993.[20] Most graduates cannot afford to set aside more than 10% of their annual income for student loan repayment.[21] According to this formula, law students who have educational debts of $40,000 need an annual income of over $60,000 in order to repay the loans during the usual 10-year repayment period.[22]

All LRAPs are need-based both at the time of making the initial loan or grant during law school, and again at the time the aid is actually granted, generally by means of imposing income and net-worth ceilings as a qualification for relief.[23] There is great variety among LRAPs regarding other conditions for participation. Many plans condition eligibility upon employment by non-profit tax-exempt entities such as legal aid corporations; other plans include positions with federal, state or local governments as well, but exclude judicial clerkships; still others include judicial clerkships and even private-firm employment provided that a substantial percentage of the participant's work is spent on public interest or pro-bono cases (*e.g.*, Northeastern and Tulane); and some have expanded participation to include "all law-related employment."[24] At NYU, Harvard, and Yale, eligibility is solely need-based and is measured by compensation ceilings.[25]

The method of dispensing the financial aid also varies widely. When the law school is itself the lender and holds the graduate's note, relief takes the form of periodically reducing part of the principal and interest owed.[26] When the note is held by a third party lender, as is more usual, the law school may either: (1) pay the participant periodic cash amounts with which to pay down the original loan; or (2) make periodic cancelable interim loans to the participant for the same purpose; or (3) make payments directly to the original lender on the participant's behalf. Many law school LRAPs include repayment of undergraduate loans as well.[27]

---

20. *See Loan Repayment Assistance Creating Opportunities for Public Interest Careers*, *supra* note 1, at 3 (citing a study by the National Association for Law Placement).

21. *Id.*

22. *Id.*

23. *See generally* NATIONAL ASS'N FOR PUB. INTEREST LAW, THE NAPIL LOAN REPAYMENT ASSISTANCE PROGRAM REPORT (rev. ed. 1994) [hereinafter NAPIL REPORT].

24. *See Loan Repayment Assistance Creating Opportunities for Public Interest Careers*, *supra* note 1, at 3.

25. *Id.*

26. *Id.*

27. *Id.* at 4-5.

Some LRAP programs even pay extra amounts intended to defray the participant's real or imagined income tax burden on the basic LRAP benefits.[28]

Due to the great variety of existing and possible LRAPs, including those used to finance undergraduate education as well as medical and other professional training, this article does not purport to address the tax treatment of each and every one, but rather it is limited to the reported authorities and to general principles.

B. *History of Tax Exclusion for Scholarships*

Before 1954, although no specific Internal Revenue Code provision governed scholarships, they were excludible under the general provision exempting gifts. Like other gifts, scholarships were not excludible if they were in effect a disguised method of providing compensation for services. The IRS ruled in 1951 that an educational grant was an excludible gift if it provided "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 compensation therefor."[29]

When Congress enacted I.R.C. § 117 in 1954 as a specific exclusion for scholarships, it did not intend to limit the exclusion under prior law, but rather to expand its scope[30] and to provide a bright-line rule to avoid

---

28. NYU, Harvard, and Yale all provide such assistance for income taxes, despite uncertainty whether any tax is actually owed. Harvard pays a fixed additional 25%, and both NYU and Yale pay an additional 39% to compensate for the fact that the tax reimbursements are themselves taxable under Old Colony Trust v. Commissioner, 279 U.S. 716 (1929) (holding that employer's payment of employee's income taxes was additional compensation taxable to the employee).

The National Health Service Corps Loan Repayment Program which finances medical education similarly makes additional payments to the recipient of 39% (or more if appropriate) as an estimated reimbursement for the tax liability to the recipient. 42 U.S.C. § 2541-1(g)(c)(3)(a) (1994). The IRS has ruled this program to be taxable, although the correctness of the ruling may be doubted. *See infra* notes 107-112 and accompanying text.

29. I.T. 4056, 1951-2 C.B. 8, declared obsolete by Rev. Rul. 69-43, 1969-1 C.B. 310.

30. One of the purposes of I.R.C. § 117 was to preserve the scholarship exclusion from the possible consequences of the Supreme Court's 1952 decision regarding prizes and awards in Robertson v. Commissioner, 343 U.S. 711 (1952) (holding that cash award provided by philanthropist for best symphonic work submitted in contest was not an excludible gift but payment for services pursuant to offer and acceptance of contract, despite lack of any economic benefit to philanthropist). Until 1954, prizes and awards had also been excludible under the general provision for gifts. In 1954, Congress

the voluminous and troublesome case-by-case litigation under prior law over whether a given educational grant was made with donative intent.[31] Under the 1954 version of I.R.C. § 117, it became immaterial that a degree candidate performed teaching or research services if such services were required for all degree candidates.[32] Nondegree candidates were limited to an exclusion of $300 per month for an aggregate total of 36 months.

The aim of providing a bright-line rule was not achieved, however, partly because Congress failed to define the terms "scholarship" and

---

enacted the *Robertson* holding into new I.R.C. § 74 so that the exclusion of awards would apply to past achievements but not to accomplishments performed in order to compete for an award. Congress protected I.R.C. § 117 from the reach of *Robertson*, however, by specifically providing that if a grant was both a prize and a scholarship it is treated under I.R.C. § 117 so that scholarships which are awarded competitively on the basis of scholastic merit would continue to enjoy the exclusion. *See* 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS ¶ 11.2.1 (2d ed. 1989).

31. The House Committee Report states that:

> The basic ruling of the Internal Revenue Service which states that the amount of a grant or fellowship is includible in gross income unless it can be established to be a gift provides no clear-cut method of distinguishing between taxable and nontaxable grants. Hence, the tax status of these grants presently must be decided on a case-by-case method.

H.R. REP. NO. 1337, 83d Cong., 2d Sess. 16 (1954).

32. The rule was designed to liberalize pre-1954 law which Congress felt too often resulted in taxing scholarships of students who performed teaching and research. The House Report explained:

> 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. The amount included will be determined by reference to the going rates of pay for similar services. This allocation of the amount of the grant between taxable and nontaxable portions represents more liberal treatment than is allowed under present practice. Present law taxes the grant in its entirety unless services required of the recipient are nominal.
>
> This limitation on the exclusion will not result in the taxation of the portion of the grant which involves research or teaching services performed primarily for the training and education of the recipient.

Id. at 17. The Senate version of the bill, which was the version actually enacted, added "other services" to the "teaching or research" covered by the House version, but liberalized the House version still further by providing that "if teaching, research, or other services are required of all candidates for a particular degree (whether or not recipients of scholarship or fellowship grants) such services are not to be regarded as part-time employment." S. REP. NO. 1622, 83d Cong., 2d Sess. 17-18 (1954). It seems clear that all the services referred to in both versions concerned only those performed directly for the grantor institution.

"fellowship," and also because the Treasury promulgated regulations under new I.R.C. § 117 which reintroduced the old donative-intent test in a new guise.[33] The result was continued if not increased case-by-case litigation and growing uncertainty. Most of the difficulties involved medically-related disciplines where on-the-job training for degrees or specialty licensing and stipends for post-graduate research advanced the recipients' education while at the same time benefitting hospitals or other institutional grantors.[34] Many commentators observed that the 1954 legislation as interpreted by the Treasury Regulations was hardly distinguishable from the law which prevailed under the 1939 Code.[35]

The scholarship exclusion under I.R.C. § 117 was substantially eroded in 1986. Congress repealed the exemption for teaching, research or other services which are required for all degree candidates whether or not on scholarship, thus making scholarships taxable to the extent of the value of all such services provided. In addition, Congress repealed the exclusion for fellowships for non-degree candidates altogether,[36] thus ending the flood of litigation over postgraduate stipends for medical residents and fellows. Most importantly, Congress limited the exclusion

---

33. These regulations provided that the scholarship exclusion did not apply to any grant which "(1) . . . 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[, or] (2) . . . [is for] studies or research primarily for the benefit of the grantor." Treas. Reg. § 1.117-4(c) (1956).

34. For details of the immense body of inconsistent decisions and rulings, see, *e.g.*, Donald H. Gordon, *Scholarship and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U. L.Q. 144, 144-51 (1960); William W. Stuart, *Tax Status of Scholarship and Fellowship Grants: Frustration of Legislative Purpose and Approaches to Obtain the Exclusion Granted By Congress*, 25 EMORY L.J. 357, 360 (1976); Mary Ann Tucker, *Federal Income Taxation of Scholarships and Fellowships: A Practical Analysis*, 8 IND. L. REV. 749, 756 (1975). The basic problem with the "primary purpose" or "benefit" test is that all grants result in some benefit to both grantor and grantee and the regulations fail to specify in any detail how the relative benefits are to be weighted. As a result, the courts reached conflicting decisions. *See* Stuart, *supra*, at 367.

35. *See* Stuart, *supra* note 34, at 376, 379-85 and sources cited therein (discussing that at least since Bingler v. Johnson, 394 U.S. 741 (1969), the compensation versus gift (or *quid pro quo*) issue has been the primary test of scholarship status and the analysis is essentially the same as the unsatisfactory approach under the 1939 Code which Congress attempted to eliminate in 1954); *see also* Gordon, *supra* note 34, at 151 (observing that due to the Treasury's position, the 1954 reform resulted in little change from prior law, and rightly complaining that the Treasury's focus on the narrow gift versus compensation issue failed to recognize the essentially unique nature of educational grants).

36. Tax Reform Act of 1986, Pub. L. No. 99-514, § 123, 100 Stat. 2085, 2112 (codified at I.R.C. § 117(a) (1994)).

for degree candidates to amounts for qualified tuition and related expenses and made all grants for living expenses taxable.[37] Thus it must be remembered in the following discussion that pre-1987 tax law remains applicable only to the extent of tuition and related expenses of degree candidates.

C. *Pre*-Bingler v. Johnson *Tax Exclusion for LRAPs*

The first IRS pronouncement on the subject of LRAPs was PLR 5604265200A[38] which held taxable a state-funded LRAP under which medical school loans were forgiven over a five-year period if the student practiced medicine in a rural area of Mississippi. The ruling, which concerned itself principally with the timing of the income, did not explain why the LRAP was taxable, and apparently assumed that the LRAP was either compensation or income from cancellation of indebtedness. The ruling also held that the Mississippi plan could not qualify as a scholarship because it was in the form of a loan. The ruling noted that "[i]nasmuch as amounts received under the program are loans, and inasmuch as they must be repaid (either in cash or by service), they cannot be considered scholarship payments exempt from tax under section 117 of the Code."[39]

Two years after PLR 5604265200A, the taxpayer requested the IRS to reconsider, and it did so in PLR 5807039700A[40] which came to the opposite conclusion and revoked the earlier ruling. The second PLR was based upon General Counsel Memorandum (GCM) 30,700[41] which determined that the Mississippi plan was a scholarship and excludible under I.R.C. § 117. GCM 30,700 reasoned that the state was neither the employer of the grantee nor had the right to direct or supervise the grantee's practice of medicine. The requirement of practicing in a rural area was simply a condition of the gift which was intended to ensure that the primary purpose of the plan would be carried out, and was in no way intended as compensation. In other words, the LRAP was held to be a scholarship with a noncompensatory condition subsequent.

GCM 30,700 also prophetically suggested that "[t]he Assistant Commissioner may wish to consider whether as a matter of policy it would not be desirable to reach an answer favorable to the taxpayers in

---

37. I.R.C. § 117(b) (1994).

38. Apr. 26, 1956, *available in* LEXIS, Fedtax Library, RELS File.

39. *Id.*

40. July 3, 1958, *available in* LEXIS, Fedtax Library, RELS File.

41. May 27, 1958, *available in* LEXIS, Fedtax Library, RELS File.

this case because of the virtual certainty of relief legislation and the probable loss of the issue in the event of litigation."[42]

The next ruling on LRAPs was PLR 6004275330A,[43] which concerned loans under the National Defense Education Act of 1958[44] (NDEA) which were forgiven if the recipient performed teaching or research afterwards. The ruling followed the reasoning of GCM 30,700. As a result of national concern, if not panic, over the state of American education in the wake of the Russian scientific achievement with Sputnik, the NDEA established a variety of LRAPs designed to encourage talented individuals to study and work in educational fields designated by the government. The federal government provided NDEA educational loans for students who planned to become elementary or high-school teachers, and for especially talented students to engage in advanced study in the sciences and foreign languages. The typical loan agreement called for cancellation of 10% of the loan for each year of teaching or research up to a maximum of 50% of the loan principal.

In PLR 6004275330A, the IRS ruled that this loan forgiveness was a tax-free scholarship. The specific program concerned NDEA loan contracts designed to enable graduate students in engineering to pursue a doctoral degree and which were partially forgiven if the graduate engaged in full-time teaching. After reciting Treasury Regulation § 1.117-4(c)(1),[45] the IRS held that the loan forgiveness feature was outside these restrictions. The reasoning of PLR 6004275330A is instructive:

> There has been no employment relationship between the Department of Health, Education, and Welfare, which administers Title II of the Act, and the recipient of a loan under that Act; therefore, payments made pursuant thereto cannot be said to represent compensation for past, present, or future services. The manner in which recipients of loans under this program perform their teaching duties, after graduation, is in no way subject to the direction or supervision either by the grantor or the recipient's institution of learning. Only a reasonable condition is imposed upon the recipients of the Title II loans, which is to insure that the interests of the nation are adequately safeguarded, in requiring teaching services after completion of their education in partial cancellation of loans granted to them.

42. *Id.* There was no litigation, but the prediction of relief legislation proved correct when Congress enacted I.R.C. § 108(f). *See infra* notes 68-72 and accompanying text.

43. Apr. 27, 1960, *available in* LEXIS, Fedtax Library, RELS File.

44. Pub. L. No. 85-864, §§ 201-209, 72 Stat. 1580, 1584-86.

45. *Supra* note 33.

> . . . The conditions imposed under that program, as to the forgiveness-of-loans, have been considered to be merely contingent and not materially affecting the real nature of the grants which are provided by Congress primarily for the education and training of the student-recipients thereof.[46]

The following year, GCM 31,871[47] came to the same conclusion as PLR 6004275330A regarding an NDEA loan which was partially forgiven if the student taught in an elementary or secondary school anywhere in the United States.[48] Thus the IRS regarded such conditional scholarships as a kind of matching grant in which the grantor(s) advance funds (or forgive prior advances) to students on condition that they subsequently employ the education to provide a matching grant of services primarily for the benefit of some broad segment of the public.

For the next thirteen years there were no further developments and the law seemed clear and settled that public-interest LRAPs are tax-free scholarships. Then, in 1972, the IRS suddenly and unaccountably reversed its position.[49] It did so in purported reliance upon the Supreme Court's 1969 decision in *Bingler v. Johnson*.[50] Although *Johnson* did not concern an LRAP, it is the leading decision in the area of scholarships and will be described next before resuming the story of LRAPs in the following section.

---

46. Priv. Ltr. Rul. 6004275330A (Apr. 27, 1960), *available in* LEXIS, Fedtax Library, RELS File.

47. Jan. 19, 1961, *available in* LEXIS, Fedtax Library, RELS File.

48. The IRS reached similar conclusions regarding NDEA direct stipends as opposed to LRAPs. For example, in Revenue Ruling 62-205, NDEA stipends for both degree and nondegree candidates attending training institutes for student guidance and counseling, and for modern foreign language instruction, were held tax-free scholarships on the ground that the recipients owed no service either to the educational institution or to the government. *See* Rev. Rul. 62-205, 1962-2 C.B. 43, 44-45.

On the other hand, where the recipients were paid NDEA project funds administered by a college in return for specific services under the direction of the college to develop and evaluate new techniques for the instruction of ninth-grade algebra, and the college itself treated the amounts as "salaries," the amounts were held taxable. *See* Rev. Rul. 61-174, 1961-2 C.B. 28, 29.

49. *See* Gen. Couns. Mem. 34,498 (May 17, 1971), *available in* LEXIS, Fedtax Library, RELS File.

50. 394 U.S. 741 (1969).

D. Bingler v. Johnson

By 1969, growing confusion over the taxation of employer-provided paid educational leave led to a split in the Courts of Appeal which was resolved by the Supreme Court in *Bingler v. Johnson.* The taxpayer was an engineer who took a nine-month paid leave to complete his doctorate in engineering while he remained on the Westinghouse payroll as an employee and was obligated to return to full-time employment at Westinghouse for at least two years at the end of his leave. The taxpayer unsuccessfully challenged Treasury Regulation § 1.117-4(c)[51] on the ground that Congress had placed no limit on the dollar amount of scholarships for degree candidates, and had enacted I.R.C. § 117 in order to avoid the kind of case-by-case determinations of donative intent necessary under the challenged regulation.[52] The *Johnson* Court held that "[t]he thrust of the provision dealing with compensation [Treas. Reg. § 1.117-4(c)] is that bargained-for payments, given only as a '*quo*' in return for the *quid* of services rendered—whether past, present, or future—should not be excludable from income as 'scholarship' funds. That provision clearly covers this case."[53] Immediately preceding the last sentence of the above passage, footnote 32 of *Johnson* states:

---

51. *Supra* note 33.

52. It is not entirely clear that the decision in *Johnson* was correct under the law as it then stood. I.R.C. § 117 as enacted by Congress in 1954 placed no restriction on the amounts paid to degree candidates, whereas non-degree students were limited to stipends of $300 per month for 36 months. Congress expressed concern in the legislative history over stipends for nondegree students which were merely continuations of salary on leave, but none regarding degree candidates. Because Congress apparently intended to eliminate the compensation test for degree students in favor of a bright-line rule of exclusion, there was a strong argument that an employment relationship should be considered irrelevant if the scholarship is intended to further a degree student's studies, and that the Treasury Regulations were unreasonable to the extent they provided otherwise. The taxpayer in *Johnson* had family obligations and could not afford to take a one year leave without pay in order to pursue his research for a doctorate, and so the living stipend could very plausibly be regarded as a scholarship. The Third Circuit's pro-taxpayer opinion was far from unreasonable. *See* Johnson v. Bingler, 396 F.2d 258 (3d Cir. 1968); *see also* John Holt Myers, *The Tax Status of Scholarships*, 22 TAX LAW. 391 (1969). On the other hand, testimony at trial established that the taxpayer's initial employment was partly motivated by the possibility of later pursuing an advanced degree at Westinghouse's expense, which points to a compensatory fringe-benefit analysis. *See* Transcript of Proceedings, Bingler v. Johnson *in* U.S. SUP. CT., RECORDS & BRIEFS 25-26 (1968).

53. *Johnson*, 394 U.S. at 757-58 (footnote omitted).

We accept the suggestion in the Government's brief that the second paragraph of Treas. Reg. § 1.117-4(c)—which excepts from the definition of "scholarship" any payments that are paid to an individual "to enable him to pursue studies or research primarily for the benefit of the grantor"—is merely an adjunct to the initial "compensation" provision:

> By this paragraph, the Treasury has supplemented the first in order to impose tax on bargained-for arrangements that do not create an employer-employee relation, as, for example, in the case of an independent contractor. But the general idea is the same: 'scholarship' or 'fellowship' does not include arrangements where the recipient receives money and in return provides a *quid pro quo*.[54]

In another much-quoted variation of its *quid pro quo* test, the Court used the phrase "no strings" to describe an excludible scholarship: "Here, the definitions supplied by the Regulation clearly are prima facie proper, comporting as they do with the ordinary understanding of 'scholarships' and 'fellowships' as relatively disinterested, 'no-strings' educational grants, with no requirement of any substantial *quid pro quo* from the recipients."[55]

It should be noted that the *Johnson* decision concerned only the taxpayer's living stipend and ignored Westinghouse's reimbursements to the taxpayer for tuition and fees.[56]

---

54. *Id.* at 758 n.32 (quoting Petitioner's Brief at 22).

55. *Id.* at 751. The Court's use of the word "disinterested" echoed the Court's test of "detached and disinterested generosity" for distinguishing gifts from compensation in its 1960 decision Commissioner v. Duberstein, 363 U.S. 278 (1960) (holding that the non-contractual gratuitous transfer of a Cadillac from one businessman to another as a token of appreciation for prior valuable services was not excludible as a gift under I.R.C. § 102). This suggests that the '*quid*' must be in the economic interest of the grantor.

56. The IRS made no attempt to tax Westinghouse's reimbursement to the taxpayer of the cost of tuition, books and fees, and these amounts were not even mentioned in the decision. The government contended that "conceptually" the tuition and other reimbursements should also be treated as income, but pointed out that an offsetting deduction might be available to the taxpayer for business educational expenses under Treas. Reg. § 1.162-5. *See* Petitioner's Brief at 10 n.7.

E. *IRS Change of Position After* Bingler v. Johnson

Two years after *Bingler v. Johnson*, the IRS invoked the decision in GCM 34,498[57] to rescind its longstanding position regarding public-service LRAPs. The IRS' change of position occurs at the very end of the GCM, where it almost seems an afterthought, because the bulk of the GCM concerned a very different question. The principal purpose of GCM 34,498 was to analyze a proposed revenue ruling, later published as Revenue Ruling 71-380,[58] which concerned cash amounts received by project personnel who conducted advanced training sessions for grade-school teachers under a program directed by a state educational agency, but which was largely funded by the federal Department of Health, Education and Welfare (HEW). The GCM concluded that the payments were taxable despite the lack of any direct employment relationship between the project personnel and HEW. The principal authority cited was *Johnson.*

GCM 34,498 seized upon footnote 32 of *Johnson*[59] for the proposition that both the institution providing funds and the institution awarding or administering the grants are "grantors" within the meaning of the regulations. GCM 34,498 also cited the post-*Johnson* Tax Court decisions *Turem v. Commissioner*[60] and *Haley v. Commissioner.*[61] The taxpayers in both cases were required to perform specific services for a specific employer who was one of the grantors, as in the proposed Revenue Ruling 71-380 under consideration. After disposing of this ruling with twelve pages of analysis, GCM 34,498 went on to revoke the NDEA and Mississippi plan GCMs[62] in a single page with only the most cursory discussion, as if these public interest LRAPs involved the identical issue.

---

57. May 17, 1971, *available in* LEXIS, Fedtax Library, RELS File.

58. 1971-2 C.B. 101.

59. *Johnson*, 394 U.S. at 758 n.32, quoted in text at *supra* note 54.

60. 54 T.C. 1494, 1506-08 (1970) (holding that stipend paid by state welfare agency to enable employee of county welfare agency to take leave for advanced degree was taxable because recipient remained county employee while on leave and agreed to return to county employment; interrelationship of state and county sufficiently close to consider both to be "grantors").

61. 54 T.C. 642, 647 (1970) (holding that grant from Oregon State Welfare Commission to county welfare employee for educational leave to earn advanced degree in social work was taxable because taxpayer was obligated to accept county welfare position afterwards as condition for grant).

62. *Supra* notes 41 & 47. GCM 34,498 also revoked GCM 33,375 which had recommended proposed pro-taxpayer revenue rulings based upon GCMs 30,700 and 31,871. Thus none of the pro-taxpayer Mississippi plan and NDEA GCMs ever became a public ruling.

They clearly did not involve the same issue because the recipient of a public-service LRAP owes no service to any grantor.[63] The GCM did not mention the longstanding conditional-gift and public-benefit analyses it was reversing, and its entire analysis consisted of the following statement:

> In both GCM 30,700 and GCM 31,871, substantial services were required of the grantees as a condition of the grant. Although no employment relationship existed between grantor and grantee, these services were designed to accomplish the basic objectives of the grantors in both cases. Therefore, we now conclude that the grants in both cases are not scholarships or fellowships within the meaning of section 117 because they were made primarily for the benefit of the grantor.[64]

The IRS made its reversal of position public in Revenue Ruling 73-256,[65] which considered precisely the same facts as the Mississippi plan medical LRAP at issue in GCM 30,700 and PLR 5807039700A,[66] and came to precisely the opposite conclusion. Revenue Ruling 73-256 gave as its authority the "no strings" language in *Johnson*, and while admitting that there was no employment relationship with the state, nevertheless concluded that the scholarship was "primarily for the benefit of the grantor" within the meaning of Treasury Regulations § 1.117-4(c). The entire argument was contained in a single sentence:

> Thus, although no employment relationship exists between the grantor and the grantees, the services required do not further an educational purpose and are designed to accomplish a basic objective of the grantor.[67]

---

63. *See infra* note 154 and accompanying text.

64. Gen. Couns. Mem. 34,498, *supra* note 57.

65. 1973-1 C.B. 56.

66. July 3, 1958, *available in* LEXIS, Fedtax Library, RELS File. *See supra* notes 41-43 and accompanying text.

67. This statement seems erroneous because many students who could not otherwise afford to attend might be attracted to medical school by the LRAP, and thus the educational purpose is identical to that of any other need-based scholarship: removal of financial obstacles to education. Also, it is unquestionable that the ultimate aim of LRAPs is to attract qualified persons to public service work permanently rather than merely to obtain an agreed minimum term of service. Thus the educational purpose of the scholarship is *to train a public interest physician.*

The IRS itself may have been a little unsure of the soundness of its ruling, because it later made Revenue Ruling 73-256 applicable prospectively only for loans made after June 11, 1973. *See* Rev. Rul. 74-540, 1974-2 C.B. 38.

F. *Enactment of I.R.C. Section 108(f)*

Congress soon repudiated Revenue Ruling 73-256, as had been predicted in GCM 30,700.[68] In 1976, Congress enacted a provision exempting from tax any loan forgiveness pursuant to an LRAP requiring the student to work for a certain period of time in certain professions for any of a broad class of employers. The provision applied only if the loan was made by federal, state or local government directly or pursuant to an agreement with an educational institution.[69] The provision was temporary, but was extended in 1978[70] and made permanent in 1984 as I.R.C. § 108(f).[71]

Congress' reason for repudiating Revenue Ruling 73-256 was not to carve out an exception to the Treasury Regulations. Rather, the legislative history indicates in at least one place that Congress thought the IRS' interpretation of the Regulations was simply wrong. The Joint Committee report to the 1978 Act gives as its reason for rejecting the ruling:

> Many states and cities have experienced difficulty in attracting doctors, nurses, and teachers to serve certain areas, including

68. May 27, 1958, *available in* LEXIS, Fedtax Library, RELS File. *See* discussion *supra* note 42 and accompanying text.

69. The provision related to I.R.C. § 61, rather than §§ 108 or 117. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2117, 90 Stat. 1520, 1911 (codified as amended in scattered sections of 26 U.S.C.).

70. The provision was extended until January 1, 1983 by § 162 of the Revenue Act of 1978, Pub. L. No. 95-600, § 162, 92 Stat. 2763, 2810 (codified as amended in scattered sections of 26 U.S.C.).

71. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1076, 98 Stat. 494, 1053 (codified at I.R.C. § 108(f) (1994)). This seems misplaced because that implies the relief is an exception to I.R.C. § 61(a)(12) which treats discharge of indebtedness as gross income. The provision should more logically have been put under I.R.C. § 117, because the issue involves whether the loan forgiveness qualifies as a scholarship. It cannot be income from discharge of indebtedness because the indebtedness is paid in full through compliance with the conditions of the loan agreement.

The 1984 Act also made a few minor changes to the 1976 provision. These included tightening the restriction against compensation by requiring the qualifying employers to be from a broad class, thus precluding conditionment of loan forgiveness on performance of services for a single employer or a small group of employers. Also, the class of qualifying lenders was expanded to include public benefit hospital corporations which are treated as governmental entities under applicable state law, since these organizations perform a function which is essentially similar to governmentally-operated hospitals. *See* STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 1200 (Joint Comm. Print 1984).

> both rural communities and low-income urban areas. A provision in student loan programs for loan cancellation in certain circumstances is intended to encourage the recipients, upon graduation, to perform needed services in such areas. *In these circumstances, the loan cancellation is not primarily for the benefit of the grantor (as the Service ruled in 1973), but for the benefit of the entire community.* The exclusion from income of the amount of indebtedness discharged in exchange for these services promotes the purpose of the programs.[72]

The IRS ignored the Joint Committee's criticism, however, and in cases which did not conform precisely to the letter of I.R.C. § 108(f), it continued to adhere to its position in Revenue Ruling 73-256. For example, in Revenue Ruling 77-319,[73] the IRS cited the *quid pro quo* language of *Johnson* and its own Revenue Ruling 73-256 to hold that National Research Service (NRS) awards for medical research were taxable because they were conditioned upon the recipient's engaging afterwards in an equivalent number of years of teaching or research, or in medical practice in designated underserved areas. The NRS awards were not covered by the 1976 legislative relief (which was not mentioned in the ruling) because they are made in the form of outright grants which must be repaid if the conditions are not met, rather than as cancelable loans.[74]

In addition to the forbidden services, the IRS objected to another NRS condition: the government had reserved the right to make royalty-free use of any copyrighted materials produced during the award period. The IRS construed this as an additional *quid pro quo*, although it seems trivial[75] and had little or nothing to do with the principal purpose of the awards,

---

72. STAFF OF JOINT COMM. ON TAX'N, 95TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 120-21 (Joint Comm. Print 1979) (emphasis added). Very similar language appears in the 1976 explanation. The only substantial difference is that instead of the first clause of the above-quoted italicized sentence, the following clause appears instead: "Proponents of these programs believe that . . . ." STAFF OF JOINT COMM. ON TAX'N, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 630 (Joint Comm. Print 1976).

73. 1977-2 C.B. 48.

74. In principle, the *quid pro quo* test is the same for a cancelable note as for a conditional grant if both are tested as scholarships. Note that the range of possibilities for fulfillment of the NRS postgraduate obligation is far wider than under the Mississippi plan.

75. *See* Stuart, *supra* note 34, at 380, 384-85. Stuart correctly pointed out that the *Johnson quid pro quo* test resulted in "simplistic and mechanical" decisions turning on minor matters such as publication rights to reach "illogical and unjust" results. These decisions contradict the government's own Treasury Regulation § 1.117(4)(c)(2) which states that an "incidental benefit" to the grantor will not preclude scholarship status.

which was to assure the continued excellence of biomedical and behavioral research in the United States.[76]

In 1978, Congress stepped in and legislatively overruled Revenue Ruling 77-319 retroactively for awards made during years 1974 through 1979.[77] In 1983, the IRS relented and reversed Revenue Ruling 77-319 in Revenue Ruling 83-93[78] on the ground that changes made by the Omnibus Reconciliation Act of 1981[79] rendered the ruling obsolete. These changes consisted of dropping the service requirement as an alternative, so that the only post-grant requirement for an NRS award became health research or teaching, which was held to be in accordance

76. The IRS has displayed extreme aggressiveness in another aspect of medical scholarship programs. In Hawronsky v. Commissioner, 105 T.C. No. 8 (1995), the Tax Court denied the taxpayer physician a deduction for a statutorily compelled payment to the government of triple damages for breach of his contract to complete his service of years in the National Health Service Corps, on the theory that the damages constitute a non-deductible "penalty" under I.R.C. § 162(f). The decision seems erroneous because the treble damages are clearly labeled damages for breach of contract under 42 U.S.C. 254*o*(b) (1994), and Treasury Regulation § 1.162-21(b)(2) plainly states that "compensatory damages . . . paid to a government do not constitute a fine or penalty." Moreover, I.R.C. § 162(f) disallows only penalties "for the violation of any law," and the taxpayer violates no law by breaching the contract. Ironically, several federal courts had already rejected physicians' attempts to avoid payment of the treble damages on the ground that they are a penalty and hence unenforceable, holding that the treble damages clause represents "liquidated damages" rather than a "penalty."

Before NHSC scholarships became taxable in 1986 as a result of the repeal of former I.R.C. § 117(c), the IRS had ruled that the treble damages were non-deductible under a different and equally erroneous theory in PLR 8506050 (Nov. 13, 1984) and again in GCM 39,336 (Oct. 12, 1984). The IRS admitted that the payment of damages was a loss incurred in the taxpayer's trade or business, but denied the deduction by invoking I.R.C. § 265(a) on the dubious ground that the damages were "directly allocable" to the earlier receipt of the tax-free scholarship funds.

I.R.C. § 265(a) was enacted principally to prevent tax profits from arbitraging the payment of deductible interest in order to earn tax-free municipal bond interest. In any case I.R.C. § 265(a) applies only to expenses, not to losses, and the damages resemble a loss from abandonment of a business far more than a current expense. A deduction for loss of the principal of a municipal bond is unquestionably allowable despite the fact that it is "directly allocable" to exempt income in precisely the same sense. Neither PLR 8506050 nor GCM 39,336 cited any authority or reasoning for its conclusion other than the words of the statute itself.

77. Revenue Act of 1978, Pub. L. No. 95-600, § 161(b), 92 Stat. 2763, 2810 (codified as amended in scattered sections of 26 U.S.C.).

78. 1983-1 C.B. 364.

79. Pub. L. No. 97-35, 95 Stat. 357.

with the usual patterns of academic employment and therefore not a forbidden *quid pro quo.*[80]

G. *Amended I.R.C. Section 117 and Proposed Regulations*

Current I.R.C. § 117(c) as amended in 1986 denies the scholarship exclusion for any amount "which represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship."[81] As explained above,[82] the pre-1987 version applied only to "services in the nature of part-time employment" and even then it excepted any services which were required of all degree candidates.[83] Congress seems to have intended the prior provision to apply solely to services performed by students for the educational institution or its affiliates, although at least one reported decision might imply a broader interpretation. In *Ferris v. Commissioner,*[84] the Tax Court held that hourly wages paid by Columbia University to an undergraduate for part-time employment at a Better Business Bureau as part of a work-study program were taxable compensation for services under then I.R.C. § 117(b)(1). The decision seems correct although it does not address the fact that Columbia

---

80. Rev. Rul. 83-93 did not specify what these changes were. A 1981 IRS internal memorandum explains:

> the only requirement is that a recipient subject to the payback satisfy a commitment to engage in health research or teaching or any combination thereof *which is in accordance with the usual patterns of academic employment* for the specified period. No longer is service in the National Health Corps, service in a health maintenance organization in a medically underserved area, or any other service a possible alternative.

I.R.S. Memorandum (emphasis added) (excerpted from incomplete I.R.S. Memorandum kept on file with author).

The government's reserved right to any royalties was unchanged by the legislation, however, and remains in 45 C.F.R. § 74.36 (1995). The I.R.S. Memorandum explained that "[a]s a practical matter, however, there is no record that any copyright material has ever been reported by a grantee. Moreover, the officials of the Public Health Service are not aware of any instance where the Public Health Service has exercised the right to royalty free use of copyrighted material." I.R.S. Memorandum, *supra.*

81. I.R.C. § 117(c) (1994).

82. *See supra* note 32 and accompanying text.

83. I.R.C. § 117(b)(1) (1954). For legislative history, *see supra* note 32.

84. 58 T.C.M. (CCH) 774 (1989).

apparently had no affiliation with the Bureau and derived no benefit from the student's services.[85]

Current I.R.C. § 117(c) has potentially a far wider reach, and can be interpreted as applying to post-graduation services such as those in *Bingler v. Johnson.*[86] On the other hand, nothing in the legislative history of §

---

85. The taxpayer represented himself and did not raise the argument. If it had been raised, however, the result would probably have been the same. Although the facts were not developed in the decision, it appears that the work-study program was largely funded by the federal government pursuant to 42 U.S.C. §§ 2751-2754 (1988). Section 2751 states:

> The purpose is to stimulate and promote the part-time employment of students . . . who are in need of earnings from employment to pursue courses of study at eligible institutions, and to encourage students receiving Federal student financial assistance to participate in community service activities that will benefit the Nation and engender in the students a sense of social responsibility and commitment to the community.

Id. § 2751. The school administers work-study grants under an agreement with the government to place students in public interest part-time employment. Columbia's program is still in existence substantially as it was in 1985, the tax year in question in *Ferris*, and the Better Business Bureau is still one of the many approved participating employers. Columbia pays the student by the hour according to time sheets provided by the Bureau, withholds upon the wages and sends a Form W-2. The government reimburses Columbia for 70% of the expense, and the Bureau reimburses Columbia the other 30%. Telephone Interview with Maribel Longi, Assistant Director, Columbia Work-Study Program (Mar. 17, 1995).

The 30% paid by the Bureau is necessarily wages. The government's 70% is probably also wages, because Congress intended the program to provide "earnings from part-time employment" rather than a scholarship, and also because the student is paid by the hour. Note that this situation is easily distinguishable from LRAPs where the participant is fully compensated by the employer. Also, LRAP benefits are not determined by hours worked, but rather by the amount of student indebtedness and financial need.

86. 394 U.S. 741 (1969). Evidence for this interpretation may be found in the House Report. *See* H.R. REP. NO. 841, 99th Cong., 2d Sess., v. II, at 16 (1986). The 1986 Act also repealed former I.R.C. § 117(c) which excluded from taxable income grants under federal programs which were conditioned upon future employment for the federal government. The House Report explained that such future services will no longer be entitled to more favorable tax treatment than services for another employer, and the "general rule" will apply. *Id.* The "general rule" referred to appears to be that of current I.R.C. § 117(c) quoted in the text above. This is also the view of Bittker & Lokken, who state:

> The elimination of the reference to part-time work allows this language to be the fulcrum of the scholarship versus compensation dichotomy. For years after 1986, the *Bingler v. Johnson* test should be reformulated as three questions: (1) Did the student render services? (2) If so, were the services a condition for receiving the award? (3) If so, was the award payment for the services? If all three questions are answered affirmatively, the award is taxable compensation.

117(c) indicates that Congress intended any substantive change in the *Bingler v. Johnson* test, and as applied to post-graduation services, I.R.C. § 117(c) can be regarded as merely codifying the *quid pro quo* test as it then existed under Treasury Regulation § 1.117-4(c) and *Johnson*.[87] The "payment for services" language of I.R.C. § 117(c) is highly ambiguous on the critical question regarding LRAPs: services *for whose benefit*? Proposed Regulation § 1.117-6(d)(2), which interprets the new statutory "payment for services" language, is as ambiguous as the statute. It provides no guidance for the LRAP situation in which the required services are performed for third parties, and provide no benefit to the grantor.[88] The Proposed Regulation is more elaborate than Treasury Regulation § 1.117-4(c), but it is in substance the same,[89] except that the "primarily for the benefit of the grantor" test was explicitly abandoned as an independent criterion and rolled into the "services" or *quid pro quo* test.[90] The Proposed Regulation provides six examples to illustrate the payment-for-services test, but all six involve recipients who perform services directly for the grantor.[91] Thus, neither the amended statute nor the Proposed Regulation sheds any light upon the LRAP problem, and the applicable principles of law remain as they were before 1986.

> The compensation stigma is avoided, in contrast, if any of the three is answered no.

BITTKER & LOKKEN, *supra* note 30, ¶ 11.2.2.

87. This appears to be the view of Bittker & Lokken as well, because their explanation quoted *supra* note 86 simply restates the *Johnson* test. In addition, all three of the 1994 I.R.S. Information Letters discussed *infra* notes 102-103, 107 and accompanying text expressly state that the *quid pro quo* test remains unchanged.

88. Prop. Treas. Reg. § 1.117-6(d)(2), 53 Fed. Reg. 111 (1988).

89. Prop. Treas. Reg. § 1.117-6(d)(2) states:

> *Payment for services.* For purposes of this section, 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 teaching, research, or other services by the recipient represents payment for services under this section.

Id.

90. This change merely recognizes the development in the case law after *Bingler v. Johnson*. *See* discussion *infra* part III.B.

91. Prop. Treas. Reg. § 1.117-6(d)(5), 53 Fed. Reg. 111 (1988).

H. Porten v. Commissioner

The sole reported court decision concerning an LRAP is *Porten v. Commissioner*.[92] The decision does not concern legal education, but it would certainly be cited as authority in any future litigation over a legal LRAP. The LRAP program in *Porten* was instituted by the State of Alaska in 1972 in order to stem a "brain drain" from the state.[93] The state advanced loans to Alaska residents for college tuition and fees which were partially forgiven for each year the graduate remained an Alaska resident and was engaged in any form of employment without limitation.[94] For seventeen years the IRS made no attempt to tax beneficiaries of the Alaska LRAP, and everyone assumed it was tax-free.[95] In 1989, however, the IRS notified the Alaska Commission on Postsecondary Education that it had determined the plan was taxable and would make assessments retroactive one year to 1988.[96] The IRS' decision prompted an immediate reaction in Alaska. In a 1990 joint resolution, the Alaska state legislature declared that its intent was to provide tax-free scholarship grants,[97] and the Alaska delegation to Congress proposed legislation to overturn the IRS decision retroactively.[98] The *Porten* court took note of all this, but decided against the taxpayer nonetheless. After holding that the Alaska legislature's characterization of the LRAP as a "scholarship" was not controlling for federal tax purposes, the court went on to hold (1) that the LRAP did not fall within the exclusion of I.R.C. § 108(f) because the loan forgiveness was not conditioned upon employment in any particular profession; (2) that the postgraduate requirement of Alaska residency was

---

92. 65 T.C.M. (CCH) 1994 (1993).

93. *Id.* at 1996. Although limited to Alaska residents, the LRAP was not restricted to education within Alaska where opportunities were limited. The LRAP was designed to fund the education of Alaskans at out-of-state institutions (provided they return to Alaska after graduation) as well as to subsidize in-state education. *See* Letter from Rep. Don Young (AL) to Nicholas F. Brady, Secretary of the Treasury (Oct. 12, 1989) (on file with the *New York Law School Law Review*).

94. The grantee need not actually live or work in Alaska to maintain sufficient contact to remain a legal resident. *See Porten*, 65 T.C.M. (CCH) at 1996.

95. *See* Letter from Rep. Don Young to Nicholas F. Brady, *supra* note 93.

96. *See* Letter from John Havelock, Chairman, Alaska Commission on Postsecondary Education to LRAP recipients (May 30, 1990) (on file with the *New York Law School Law Review*).

97. *Porten*, 65 T.C.M. (CCH) at 1995 (citing Alaska Leg. Res. No. 95 (1990)).

98. S. 1803, 101st Cong., 1st Sess. (1989) (introduced by Sen. Ted Stevens); H.R. 3518, 101st Cong., 1st Sess. (1989) (introduced by Rep. Don Young). Both proposed bills died aborning.

a significant *quid pro quo* within the meaning of *Bingler v. Johnson*; and (3) that the loan forgiveness was not a gift on the ground that the residency requirement indicated a lack of "detached and disinterested generosity."[99] The *Porten* decision is criticized *infra* part III.

I. *Private Letter Ruling 9526020*

In PLR 9526020,[100] widely believed to have been requested by NYU, the IRS ruled that an outright grant of law school tuition is a tax-free scholarship even if the recipient is contractually obligated to work in public interest law for ten years following graduation and is further obligated to pay a penalty for breach of the condition. The IRS reasoned as follows:

> The service commitment imposed upon participants . . . does not constitute the requirement of a substantial quid pro quo from the recipients; on the contrary, the grants are relatively disinterested grants of the University, designed to accomplish public rather than private or proprietary purposes. Recipients are free to take nearly any position of their choosing, anywhere, subject only to the compensation limitations prescribed. The service commitment is essentially a de minimis limitation designed to assure that X's graduates practice in all income sectors of the legal profession, including public, lower-paying, and otherwise underserved areas or capacities, a public purpose for which the M scholarship program has been established by X. Any benefit inuring to the University-grantor appears remote, insubstantial and inconsequential for purposes of section 117(c).[101]

The holding of PLR 9526020 is not surprising in light of other recent IRS Information Letters from the same office concerning conditional grants for medical education which indicate that the IRS has significantly relaxed its position on the public-service issue. The IRS advised that two programs implemented by the Department of Health and Human Resources (HHR) are tax-free scholarships: the Exceptional Financial Need (EFN) scholarship,[102] and the Financial Assistance for Disadvantaged Health

---

99. *Porten*, 65 T.C.M. (CCH) at 1994-96 (citing Commissioner v. Duberstein, 363 U.S. 278, 285 (1960)).

100. Apr. 3, 1995.

101. *Id.*

102. 42 U.S.C. § 293 (1994).

Professions Students (FADHPS) scholarship,[103] on the ground that the post-graduation service requirement of a five-year term of primary care practice is "in accordance with usual patterns of employment."[104] Also, the IRS recently confirmed that NRS awards continue to be tax-free scholarships under Revenue Ruling 83-93,[105] because the post-award requirement of research or teaching for a term of years is similarly within the usual patterns of employment.[106] Like the law school grant in PLR 9526020, all three programs involve outright grants with repayment penalties rather than loans. However, all three arguably have narrower ranges of choice for fulfillment of the service requirement than does the law school grant. The EFN and FADHPS grants restrict the graduate to practice in the field of primary medical care for which the specialized training is provided, though without geographical limitation, and the NRS grant requires teaching or research, which seems more restricted than would be a requirement of medically-related work of any kind but with an income ceiling.

The outer limits of the IRS' ruling position appeared in a third letter relating to the National Health Service Corps (NHSC) scholarship program,[107] which is again a grant with a contractual service

103. 42 U.S.C. § 293(a) (1994). Under both programs, HHR provides grants to schools of medicine, dentistry and other health professions for disbursement to needy students to cover tuition, fees, books and other educational expenses. In the case of students of medicine and osteopathy, the student must (1) complete the education for which assistance is provided, (2) enter and complete a residency training program in a primary health care specialty within four years of such completion, and (3) practice in the specialty for five years following completion of the residency training. 42 U.S.C. § 295n(a) (1994). Failure to meet these conditions requires repayment of the award plus interest. *Id.* § 295n(b).

104. The IRS explained its decision as follows: "The obligated service commitment imposed upon participants in these two programs . . . does not constitute the requirement of a substantial *quid pro quo* from the recipients, in that recipients must engage only in activities which are in accordance with usual patterns of academic or professional employment." Information Letter from Branch 6, Assistant Chief Counsel, Income Tax & Accounting, Internal Revenue Service 3 (Sept. 26, 1994) (on file with the *New York Law School Law Review*).

105. 1983-1 C.B. 364. *See supra* notes 78-80 and accompanying text.

106. *See* Memorandum from Branch 6, Assistant Chief Counsel, Income Tax & Accounting, Internal Revenue Service 3 (Oct. 11, 1994) (on file with the *New York Law School Law Review*).

107. Information Letter from Branch 6, Assistant Chief Counsel, Income Tax & Accounting, Internal Revenue Service (Oct. 11, 1994) (on file with the *New York Law School Law Review*). Participants in the NHSC program receive grants for both tuition and living expenses in medical school, and are required to practice primary medical care following their training in one of a number of designated medically underserved areas.

requirement. The NHSC service requirement is to practice in a designated underserved area of the graduate's choice. The IRS regards this requirement as a substantial *quid pro quo* which negates scholarship status, despite the fact that participants generally do not work for the federal government, but rather for locally-operated community or migrant health centers[108] or even in private practice.[109] The IRS' position is apparently based on the fact that the NHSC has, in principle at least, the right to direct a given graduate to a given location of service,[110] although it rarely exercises this right.[111] It is unclear whether the offending factor is this right of control alone, or the fact that exercise of such control may result in employment by the federal government.[112]

There are apparently no recent rulings concerning cancelable loans as opposed to grants with conditions. PLR 9526020 states that the law school grants are not loans even if the penalty feature might have the effect of repayment, but it does not go on to explain the significance of this finding, or whether the result would be different if the ruling request had involved cancelable loans (or cash assistance for loan repayment) with

---

A substantial penalty (triple the amount of the award plus interest) is imposed for failure to complete the service requirement. *See id.* at 2.

108. *See* U.S. DEP'T OF HEALTH AND HUMAN SERVS., NATIONAL HEALTH SERVICE CORPS SCHOLARSHIP PROGRAM FOR FISCAL YEAR 1995/ACADEMIC YEAR 1995-96, at 10 (Dec. 1994) (stating that most participants serve as employees of such centers and are paid directly by the local health clinic). Participants may be federal employees if they choose placements with the Indian Health Service or the Bureau of Prisons. *Id.* at 11.

109. *Id.*

110. *See* I.R.S. Information Letter, *supra* note 107.

111. *See generally id.* (stating that the placement opportunity list for the NHSC will contain three times the number of vacancies as recipients available for service, or 500 vacancies, whichever is less. However, the NHSC will determine the number of available vacancies in a year if there are 500 or more recipients available for service. Thus, the NHSC rarely directs a participant to a particular location and then only because the participant has failed to select any one of the many hundreds of approved positions. On the other hand, if the participant is directed to a location, it may be as a federal employee.).

112. It is not clear that the IRS' position is justified in either case, except as applied to an individual who actually does work for the federal government.

the same service conditions.[113] Somewhat oddly, no one has ever requested such a ruling.

If such a ruling were requested, the result should in principle be the same as in PLR 9526020: a tax-free scholarship, because the public service requirement does not run afoul of the *quid pro quo* test, and that test was the only reason the IRS gave for its reversal of position in 1972 when it decided that the NDEA and Mississippi plan LRAPs were taxable.[114]

On the other hand, the enactment of I.R.C. § 108(f) in the interim may appear to have split off delayed financial aid in the form of LRAPs as a separate category to which the general scholarship tests under I.R.C. § 117 are no longer applicable. The *Porten* decision appears to be some authority for this view.

III. ANALYSIS: ARE LRAPS EXCLUDIBLE?

This Part will examine critically the authorities under which LRAPs might be excludible. Parts A through E consider whether LRAPs may qualify as scholarships and conclude that they do, and Parts F and G examine whether an LRAP may be a price adjustment or a gift. Part H considers a potential counterargument based upon horizontal equity, and Part I explores the effects that clarifying the law might have upon compliance.

A. *Does I.R.C. Section 108(f) Preempt the LRAP Area?*

If Congress intended I.R.C. § 108(f) to preempt the area, as the *Porten* court stated, LRAPs for legal education would be taxable under current law. Thus it is necessary to consider in some depth the intended scope of I.R.C. § 108(f) and whether the *Porten* decision is correct.[115]

---

113. NYU has three different public-service financial aid programs all running simultaneously: a grant-with-contractual-service-commitment such as that described in PLR 9526020; a grant-with-moral-commitment which is *a fortiori* a tax-free scholarship; and the Melvyn and Barbara Weiss LRAP which pays installments of cash. Recipients of both types of grants, which are limited to 2/3 of tuition, are also eligible for the LRAP assistance. The stated purpose of running all three programs is to make an "experiment" to determine over the next 10 years which type is most effective in encouraging public service law. *See Public Service at NYU*, NYU: THE LAW SCHOOL MAGAZINE, Spring 1995, at 60.

114. *See* discussion *supra* part II.E.

115. The taxpayer had only $268 at stake in the litigation and was not represented by counsel. The decision was not appealed. Porten v. Commissioner, 65 T.C.M. (CCH) 1994 (1993).

The Alaska LRAP in *Porten* clearly does not fall within the protection afforded by the literal language of I.R.C. § 108(f). The *Porten* court might have denied the taxpayer's claim for protection under I.R.C. § 108(f) upon that fact alone, but it did not. By its terms, I.R.C. § 108(f) applies only to loan discharges conditioned upon working "for a certain period of time in certain professions for any of a broad class of employers."[116] The court stated that this language carries the "clear implication" that "forgiveness of student loans, other than those identified in the statute, gives rise to income from discharge of indebtedness."[117] The court cited no authority supporting this conclusion, however, and provided no reasoning to defend it. I.R.C. § 108(f) itself does not state that it is the exclusive route to tax relief,[118] nor is there any such indication in the legislative history. If anything the reverse implication is more persuasive for at least two reasons: (1) the language of I.R.C. § 108(f) implies that the provision is not exclusive, and (2) the legislative history indicates that Congress simply intended to correct the IRS' erroneous interpretation of existing law in Revenue Ruling 73-256 and did not intend to create new law, preemptive or otherwise.[119]

Current I.R.C. § 108(f)(1), enacted in 1984, reads as follows:

> (f) Student loans.
>
> (1) In general. In the case of an individual, gross income does not include any amount *which (but for this subsection) would be includible in gross income* by reason of the discharge (in whole

---

Porten was decided by a Special Trial Judge rather than a Judge of the Tax Court and was reported as a "memorandum" decision. Memorandum decisions of the Tax Court are not officially published, and ordinarily involve the application of settled legal principles to the facts rather than novel questions of law. *See* 4 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 115.2.1. (1992). As explained here and *infra* notes 139-149 and accompanying text, however, at least two important legal questions of first impression were involved in *Porten*: (1) whether I.R.C. § 108(f) is preemptive; and (2) if not, whether post-graduate conditions providing no direct economic benefit to any grantor negate scholarship status. The court failed to recognize that these were novel issues and simply embraced the IRS' positions as if they were dictated by settled law and beyond discussion.

116. I.R.C. § 108(f)(1) (1994).

117. *Porten*, 65 T.C.M. (CCH) at 1996.

118. Congress might easily have provided that I.R.C. § 108(f) was preemptive had it desired this result. Cf. the neighboring provision I.R.C. § 108(e)(1) which states, "[e]xcept as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness." I.R.C. § 108(e)(1) (1994).

119. *See supra* notes 68-72 and accompanying text.

> or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.[120]

It is this italicized clause which seems to imply that Congress thought some LRAPs may be excludible even without the express protection of I.R.C. § 108(f). The clause was absent from both the 1976 and 1978 temporary versions of the provision.[121] Read literally, the clause appears to be surplusage. If a loan discharge would have been excludible in any case, the provision does not apply, but it need not apply because the discharge is already excluded. Thus the italicized language seems purposeless.[122]

However, as the *Porten* court itself pointed out, it is an "'elementary rule of construction that effect must be given, if possible, to every word,

---

120. I.R.C. § 108(f)(1) (1994) (emphasis added).

121. It is interesting to note that the *Porten* LRAP would have qualified under the earlier versions which specified disjunctively *either* a geographic condition *or* a class-of-employer restriction, but not both. The reason for the change is not apparent. The 1976 version reads as follows:

> In the case of an individual, no amount shall be included in gross income for purposes of section 61 of the Internal Revenue Code of 1954 by reason of the discharge of all or part of the indebtedness of the individual under a student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain geographical areas or for certain classes of employers.

Tax Reform Act of 1976, Pub. L. No. 94-455, § 2117, 90 Stat. 1520, 1911. In 1978, Congress changed the effective date of I.R.C. § 2117 to discharges of indebtedness made before January 1, 1983. Revenue Act of 1978, Pub. L. No. 95-600, § 162, 92 Stat. 2763, 2810 (codified as amended in scattered sections of 26 U.S.C.).

122. One might argue to the contrary that if the loan discharge were excludible outside I.R.C. § 108(f) by reason of the insolvency exception under I.R.C. § 108(a)(1)(B), attribute reduction would be required under I.R.C. § 108(b), and that the effect of the italicized language is thus to subordinate loan forgiveness under I.R.C. § 108(f) to the insolvency exception.

This interpretation, however, seems far-fetched. Congress showed no concern for this issue in the legislative history of I.R.C. § 108(f), and with good reason, because student loans are nondischargeable under § 523(a)(8) of the Bankruptcy Code, except in cases of undue hardship. *See* THOMAS D. CRANDALL ET AL., THE LAW OF DEBTORS AND CREDITORS ¶ 15.07(3)(h) (rev. ed. 1991 & Supp. 1994). Also, it seems very unlikely that a recipient of student loan forgiveness would ever have such tax attributes as net operating losses or basis in non-exempt assets, especially in cases of discharge for undue hardship.

clause and sentence of a statute.' A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant."[123]

It is always possible that the italicized clause is merely the product of poor drafting. On the other hand, the language can be read as an attempt to indicate that some student loan forgiveness may be excludible even if it is outside the express conditions of I.R.C. § 108(f). Because the provision explicitly applies only to forgiveness which is *not* otherwise excludible, this implies the drafter contemplated that some student loan forgiveness *is* (or at least *may be*) otherwise excludible. In short, the language can be interpreted as an intentional statement that I.R.C. § 108(f) is not preemptive of the area of LRAPs.

Some support for this interpretation can be found by analogy with the neighboring provision I.R.C. § 108(e)(5) which contains nearly identical language:

> (5) Purchase-money debt reduction for solvent debtor treated as price reduction. —If—
>
> (A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,
>
> (B) such reduction does not occur—
> (i) in a title 11 case, or
> (ii) when the purchaser is insolvent, and
>
> (C) *but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,*
>
> then such reduction shall be treated as a purchase price adjustment.[124]

---

123. *Porten*, 65 T.C.M. (CCH) at 1997 (citing 2A SUTHERLAND, STATUTORY CONSTRUCTION, § 46.06 (1986) (citations omitted)). The *Porten* court did not discuss the italicized language of § 108(f)(1) at all, but instead was referring to the phrase "in certain professions" and arguing that it should not be read out of the statute. *Id.* Perhaps not, but the absence of any restrictions at all as to the nature of employment should logically help rather than hurt the taxpayer's case, because the greater his freedom, the less resemblance there is to compensation for services. *See also supra* note 121 for qualification under statutory precursor to I.R.C. § 108(f).

124. I.R.C. § 108(e)(5) (1994) (emphasis added).

The meaning of this italicized clause is no more obvious than that of I.R.C. § 108(f)(1). However, it is clear that I.R.C. § 108(e)(5) is not preemptive, but rather a kind of safe harbor. Current I.R.C. § 108(e)(5), enacted in 1980,[125] provides that a reduction of a purchaser's debt to a seller of property is treated as a purchase price adjustment if the debt is still held by the seller and the reduction would otherwise be treated as income from cancellation of indebtedness (COD). Case law had recognized such an exception to the rule of COD income since 1940.[126] However, disputes as to its scope led Congress to codify the exception.[127] The provision is clearly not preemptive of the field of price adjustments,[128] and the IRS recently confirmed this by explicitly ruling that the price adjustment rule survives outside the I.R.C. § 108(e)(5) safe harbor.[129]

If the inartful "but-for-this-provision-would-be-income" language of I.R.C. § 108(e)(5) means simply that the subsection is not intended to preclude tax-free treatment for transactions outside its terms, as appears to be the case, the nearly identical language in neighboring I.R.C. § 108(f)

---

125. Enacted as part of the Bankruptcy Tax Act, Pub. L. No. 96-589, 94 Stat. 3389, 3393 (1980) (codified as amended in scattered sections of 11 U.S.C. and 26 U.S.C.).

126. *See, e.g.*, Hirsch v. CIR, 115 F.2d 656 (7th Cir. 1940) (holding that where taxpayer purchased property for cash and assumption of existing mortgage, and eight years later mortgagee reduced debt in recognition of property's decline in value, debt reduction was nontaxable price adjustment, not COD income). The courts placed limitations on the doctrine of price reduction, however, for example, it did not apply if the debt-financed property still had sufficient value to satisfy the entire debt. *See, e.g.*, Coddon & Bros Inc. v. CIR, 37 B.T.A. 393 (1938); CIR v. Coastwise Transport Co., 71 F.2d 104 (1st Cir. 1934). Debt reduction has also been taxed if it did not result from direct negotiations with the vendor-mortgagee, or if such negotiations concerned the debt rather than the property. *See* Fifth Avenue-Fourteenth St. Corp. v. CIR, 147 F.2d 453 (2d Cir. 1944).

127. *See* S. REP. NO. 1035, 96th Cong., 2d Sess. 16-17 (1980), *reprinted in* 1980-2 C.B. at 628.

128. By its terms I.R.C. § 108(e)(5) applies only if debt reduction would otherwise have been treated as COD income under prior case law. It was certainly not intended to overrule *Hirsch*, and similar cases. I.R.C. § 108(e)(5) does not apply to *Hirsch* as a technical matter, because such cases do *not* trigger COD income under longstanding case law. *See* cases cited *supra* note 126.

129. *See* Rev. Rul. 92-99, 1992-2 C.B. 35 (debt reduction by holder of note who is not the seller may qualify if the reduction clearly relates to the property rather than the debt); *see also* Richard M. Lipton, *New Rulings on Purchase Price Reductions Do Not Provide Much Relief*, 78 J. TAX'N 68 (1993).

enacted only four years later can plausibly be interpreted in the same way.[130] This interpretation at least gives meaning to statutory language that would otherwise be mere surplusage.

This interpretation is also consistent with the history of I.R.C. § 108(f). As noted above,[131] Congress enacted the predecessor relief in 1976 and 1978 to reverse Revenue Ruling 73-256 on the ground that the IRS had incorrectly interpreted its own regulations by failing to recognize that the primary beneficiary of the Mississippi plan (and of NDEA loans for teachers) was not the grantor, but rather the general public. Thus it seems fair to say that Congress did not intend to change the law by enacting I.R.C. § 108(f), but rather to clarify it by purging the IRS' erroneous interpretation in Revenue Ruling 73-256.[132] If this interpretation is correct, it follows that to the extent the law governing scholarships reasonably permits, LRAPs other than those within the I.R.C. § 108(f) safe harbor should also be excludible.

Because of their close resemblance to safe-harbor LRAPs, law school LRAPs appear to be likely candidates for just such "nonqualifying" but nonetheless excludible status as scholarships. The public-benefit rationale of I.R.C. § 108(f) and of the IRS' pre-*Bingler v. Johnson* pro-taxpayer position[133] seems to apply just as well to legal LRAPs as to the NDEA and Mississippi plans. Public need for legal services seems hardly less urgent than for medicine, nursing, and teaching, and is generally agreed to be in extremely short supply for the needy.[134]

---

130. Plausibly, but not certainly. An argument based upon symmetrical language alone is always dangerous. *See* Richard A. Westin, *Dubious Interpretative Rules for Construing Federal Taxing Statutes*, 17 WAKE FOREST L. REV. 1, 9-10 (1981) ("The tax laws are such a hodgepodge of exceptions, qualifications, special interests and sometimes logically inconsistent treatment that they cannot be treated as symmetrical exigeses. [sic]") (quoting Burck v. Commissioner, 533 F.2d 768, 772 n.7 (2d Cir. 1975)).

131. *See supra* notes 68-72 and accompanying text.

132. According to the Staff of Joint Committee on Taxation, the "certain professions" intended are medicine, nursing, and teaching. STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE DEFICIT REDUCTION ACT OF 1984, at 1199 (Joint Comm. Print 1984). As enacted, however, I.R.C. § 108(f) does not specify the "certain professions." This deliberate vagueness seems another indication that Congress disapproved of the IRS' interpretation of the public-service LRAP problem in general, and did not wish to limit its rejection to the specific result of Revenue Ruling 73-256 as applied to a single profession or even a specified list of favored professions.

133. *See* discussion *supra* part II.C.

134. *See* Zubrow, *supra* note 18, at 513-14; *see also* William J. Dean, *The Legal Services Corp.*, N.Y. L.J., Sept. 2, 1994, at 3 (stating that nationally, it has been estimated by the Legal Services Corporation that only about one-fifth of the needs of the poor are being met); William J. Dean, *Surveys of Activity in New York*, N.Y. L.J., July

Parts III.B through E analyze the general question whether I.R.C. § 117 permits exclusion of legal LRAPs as scholarships independently of I.R.C. § 108(f).

B. *The Primary Benefit Test*

Treasury Regulation § 1.117-4(c) denies scholarship status to any grant which is "primarily for the benefit of the grantor." The regulations provide no examples for guidance as to its meaning, however. The IRS and the courts have often invoked the primary-benefit language in order to deny scholarship status, including Revenue Ruling 73-256 which ruled against the Mississippi plan.[135] The primary-benefit test has always been applied in conjunction with the compensation or "*quid pro quo*" test, however, and seems not to be an independent criterion. This was explicitly recognized in *Bingler v. Johnson*, where the Court (following the IRS' own interpretation) termed the benefit test merely an adjunct to the compensation issue.[136] Subsequent decisions confirmed this view and regarded the *Johnson* decision as having melded the "principal purpose," "control," and "compensation" tests into a single test.[137]

This was a fortunate development, because scholarships by their nature benefit many different parties, and if taken seriously, the primary benefit test would be extremely difficult to apply. It seems safe to say that all scholarship grantors intend that the subsidized education be put to some useful purpose. If a student applied for financial aid with a statement of intent to be utterly unemployed in any capacity and that the education was purely for personal satisfaction or simply to meet a better class of people, it is probable that the student would not even be accepted for admission, let alone be awarded financial aid. By its nature a scholarship always benefits at least four different parties: (1) the student whose financial burden is reduced; (2) the school which can admit desirable students who could not otherwise afford to attend; (3) the public at large which profits generally from a better educated citizenry, and specifically from increased

---

1, 1994, at 3 (stating that a 1990 study by the New York State Bar Association estimated that no more than 14% of the overall civil legal needs of the poor were being met).

The situation is hardly better on the criminal side. Public Defender offices are everywhere understaffed and underfunded. Because of excessive caseloads, the Louisiana Supreme Court recently created a rebuttable presumption of ineffective assistance of counsel in Section E of Orleans Parish Criminal District Court. *See* State v. Peart, 621 So.2d 780 (La. 1993).

135. *See supra* text accompanying notes 65-67.

136. 394 U.S. 746, 758 n.32 (1969); quoted *supra* in text accompanying note 54.

137. *See, e.g.*, Kellogg v. United States, 79-2 U.S.T.C. (CCH) ¶ 9586 (D. Minn. 1979).

availability of highly skilled services; and (4) governments at all levels (federal, state, and local) which benefit from the prosperity which is generally associated with increased levels of education through enhancement of tax revenues, reduction of expenditures for welfare, unemployment, and crime control, and increased availability of qualified persons for government employment. To these beneficiaries may be added: (5) the grantor (in case the funds do not derive from the school itself) whose general or specific philanthropic aims are furthered. The question of who is the "primary" beneficiary is thus not a simple one,[138] and it is fortunate that it is no longer necessary to pose the question independently of the compensation or *quid pro quo* test.

C. *The* Quid Pro Quo *Test*

1. Residency as *Quid Pro Quo*: *Porten*

The *Porten* court held that in addition to failing to meet the literal terms of the § 108(f) safe harbor, the Alaska plan failed the *quid pro quo* test for scholarships as well. The court stated: "Petitioner earned her loan forgiveness by fulfilling a condition subsequent to the granting of the loan: completing her degree program and working in Alaska for a certain period of time. The offer of loan forgiveness thus represented consideration for remaining in Alaska."[139]

Completing the degree program obviously cannot be a forbidden *quid pro quo* because it is a condition of all scholarships that the grant be used for the student's education.[140] To regard the post-graduation residency requirement as valuable consideration raises a difficult question which the court overlooked entirely. Why should it be treated any differently than the pre-matriculation residency requirement of state universities which provide a tuition discount to residents but not to out-of-state students? No one has ever suggested that such discounts should be taxable as compensation for meeting the residency requirement. The residency requirement is intended simply to assure that the benefits of the subsidized education enhance the general welfare of the state. The typical one-year residency requirement is itself of no obvious value to the state, and it has been correctly held that its purpose is merely to serve as evidence that the student is a bona fide resident who intends to remain in the state

---

138. *See* Myers, *supra* note 52, at 399-401.

139. Porten v. Commissioner, 65 T.C.M. (CCH) 1994, 1996 (1993).

140. It is equally obvious that no forbidden services are involved in scholarships which are conditioned upon maintaining a certain grade point average or engaging in a particular field of concentration.

afterwards.[141] Intent to remain is more accurately measured after graduation, and that seems the sole purpose of the Alaska LRAP requirement. Thus the *Porten* residency requirement should be regarded as a condition to ensure the general welfare of the people of Alaska rather than as payment for services of any sort to the government which granted the funds.[142]

A final irony lies in the fact that Congress had determined earlier that the Alaska Permanent Fund dividend, which is paid to all Alaskans with residency as the sole qualification,[143] is eligible dividend income for purposes of the "kiddie tax" election under I.R.C. § 1(g)(7).[144] Because the kiddie tax applies only to unearned income, it appears to follow that residency is not a service performed for the state. Compensation for services is earned income and not subject to the kiddie tax in the first

---

141. *See* Vlandis v. Kline, 412 U.S. 441 (1973) (holding that state may not impose irrebuttable rules defining residency which arbitrarily prevent applicants for in-state tuition reduction from proving bona fide intent to remain domiciled in state).

142. Except perhaps indirectly, because to the extent that the state population prospers and increases, so will the tax revenues and the power of the government. Note that states are in constant and intense competition with one another to attract businesses from elsewhere and to retain those already in the state, using a variety of means such as tax holidays, preferential rates of borrowing, use of public lands, exemptions from regulatory restrictions, and the like, all of which are of economic benefit to the recipient. No one has ever suggested that such benefits should be taxable to the recipient as compensation for the "service" or *quid pro quo* of coming to or remaining in the state. To the extent the question has ever been considered at all, such benefits are treated as tax-free gifts. For example, a state or municipal grant of land to a corporation as an inducement for development is treated as a tax-free contribution to capital. *See* Treas. Reg. § 1.118-1 (1960).

143. *See* ALASKA STAT. § 43.23.005(a) (1995).

144. I.R.C. § 1(g)(7) (1994). The election applies to children's unearned income "only from interest and dividends (including Alaska Permanent Fund dividends)." *Id.* § 1(g)(7)(A)(i), enacted by § 6005 of Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3686. Indeed, enactment of the I.R.C. § 1(g)(7) election to include children's unearned income on parents' returns was prompted by complaints from the Alaska delegation regarding the burden of filing kiddie tax returns for the Permanent Fund dividend.

Permanent Fund dividends were held taxable as gross income in Beattie v. United States, 635 F. Supp. 481 (D. Alaska 1986) (holding a Permanent Fund dividend not to be a gift, but similar to a corporate dividend because it is distributed pursuant to statute whose stated purpose was to fulfill state's duty and obligation to its citizens without mention of charity or generosity), *aff'd sub nom.* Griesen v. United States, 831 F.2d 916 (9th Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988).

place.[145] Of course it is always possible that Congress might have intended to regard state benefits provided solely for residency as earned income for some purposes but not others. However, no very good reason to do so leaps to mind.

It might be argued that the employment requirement, rather than mere residency, represents the forbidden *quid pro quo*. The *Porten* court did not explore this possibility. The loan agreement in *Porten* did not require the participant to be employed in Alaska, as the court erroneously stated. It required only that the participant must either work in Alaska or be subject to Alaska state income tax, thus permitting employment out of state if residency is maintained. In addition, each post-graduation year spent attending a college or university within Alaska counted as a year of "employment."[146] Under these circumstances, the court was probably correct to consider residency rather than employment to be the primary condition for the loan forgiveness. A requirement simply to be employed in any capacity whatever, including self-employment or as a student, is so broad that it can hardly be regarded as a *quid pro quo* to the grantor.[147] It is merely a condition to assure that the subsidized education be subsequently put to some—any—useful purpose. As argued above, this is an implied condition of all scholarships.[148]

Finally, it is noteworthy that the IRS' litigating position in *Porten* seems curiously inconsistent with the IRS' own ruling position which finds no *quid pro quo* in public-service legal and medical education grants which require broad service conditions subsequent that are "in accordance with usual patterns of employment."[149] It is surely no more unusual to expect Alaska residents to remain in Alaska than to expect primary-care physicians to practice primary-care medicine.

---

145. It can no longer be argued that the Alaska LRAP is "primarily for the benefit of the grantor" despite the lack of any forbidden services, because as explained above the primary-benefit test is a dead letter. *See* discussion *supra* part III.B.

146. *See* ALASKA STAT. § 43.23.005(a) (1995).

147. *See supra* note 123. The most natural interpretation of "payment for services" is of course payment by the beneficiary of the services to the provider in a direct exchange or *quid pro quo*. The language cannot be interpreted as referring to any and all services of whatever kind. For example, it cannot apply to services performed for grantee's own benefit, because that would read the scholarship exclusion out of the statute altogether. Congress obviously did not intend to disqualify scholarships paid for students to study and do research or writing because that is the very essence of a qualifying scholarship.

148. *See* text accompanying notes 137-138.

149. *See supra* notes 101-106 and accompanying text.

2. Public Service as *Quid Pro Quo*

It is quite clear that scholarship status would not be disturbed if grantors earmarked certain scholarships solely for students who profess an intention to enter the teaching profession,[150] public interest law, or family-practice medicine for the poor. Grantors might go further and limit eligibility to those who have already provided evidence of public-spiritedness through a prior history of charitable volunteer work. Such a restriction would certainly not imperil the exempt status of a scholarship.

A still more effective way of ensuring that students will honor their expressed intention to enter public service in the learned professions is to wait until they have actually done so before awarding the scholarship. However, because students need the scholarship in order to obtain the professional education in the first place, it is impossible to apply the actual-service test until the funds have already been advanced. Thus the scholarship must be structured either in the form of loan forgiveness, or as an outright grant which must be repaid if the service commitment is not met, which is very nearly the same thing.[151] This is the essential reason for structuring a scholarship as an LRAP.

If the IRS were to disallow a legal LRAP because of the requirement of public interest service, it would rely upon *Bingler v. Johnson* and Revenue Ruling 73-256, as it did in *Porten* and in its own NHSC Information Letter.[152] As noted above,[153] *Johnson* was a case involving an ongoing employer-employee relationship and is all but

---

150. *See, e.g.*, Olick v. Commissioner, 73 T.C. 479 (1979) (holding that stipend to Native Alaskan for engagement in the Alaska Rural Teacher Training Corps was excludible as scholarship where student teaching did not replace paid teachers and there was no contractual commitment to later employment; "mere hope" of recruitment into school system insufficient to defeat donative intent). *But see* Rev. Rul. 77-44, 1977-1 C.B. 355 (holding that grants to college students who profess willingness to serve in public school system of particular state for two years after graduation are not tax-free scholarships despite foundation's treatment of commitment as moral only). Revenue Ruling 77-44 relied upon MacDonald v. Commissioner, 52 T.C. 386 (1969) (holding that study grant by IBM to IBM employee was taxable despite absence of contractual commitment to return to IBM employment; reasonable expectation sufficient). Reliance on *MacDonald* seems inapposite because there the private employer was the grantor and past services could reasonably be regarded as the direct *quid pro quo*.

151. *See* discussion *supra* part II.C.

152. *See supra* notes 107-112 and accompanying text.

153. *See* text accompanying *supra* note 63.

irrelevant to a service requirement which is not for the benefit of any grantor.[154]

Revenue Ruling 73-256 remains the only published ruling in which a general service requirement which did not benefit any grantor was held to vitiate the scholarship exclusion. The validity of this ruling is very doubtful for at least three reasons. First, the ruling was specifically disapproved by Congress as a misinterpretation of Treasury Regulation § 1.117-4(c) when Congress enacted the predecessor of I.R.C. § 108(f).[155]

Second, Revenue Ruling 73-256 was itself a complete reversal of the IRS' longstanding position that the Mississippi and NDEA plans were excludible scholarships.[156] Though purportedly based upon *Bingler v. Johnson*,[157] in fact, nothing at all in the *Johnson* decision supported the IRS' *volte-face*.[158] The ruling's reliance upon the Supreme Court's "no-strings" and "*quid pro quo*" language was either a misunderstanding or a pretext for some other reason which I have been unable to discover.

Third, the IRS' former pro-taxpayer position in private letter rulings and general counsel memoranda for thirteen years from 1958 until 1971 was longstanding, well-reasoned,[159] and closer in time to the 1954 enactment of I.R.C. § 117 and the 1956 promulgation of the applicable regulations. Under general principles of interpreting administrative regulations, all three factors lend weight to preferring the IRS' former

---

154. It is clear that the *Johnson* Court meant no more than that a scholarship cannot be excluded if it is in fact a bargained-for exchange of money or money's worth for services *to a grantor*. Even if the Court intended to include such "strings attached" as public interest work for third parties—and it clearly did not so intend—such a statement would be pure dictum because it is irrelevant to the *Johnson* fact situation.

155. *See* discussion *supra* part II.F.

156. *See* discussion *supra* part II.C.

157. *See* discussion *supra* part II.E.

158. In neither the NDEA nor the Mississippi plan LRAP was there any employment, independent contractor, or other service relationship between the taxpayer and either the ultimate grantor of the funds or the institution which selected the loan recipient. Neither grantor had the right to supervise or direct the student's post-graduate services, nor did either grantor receive any direct financial benefit from the taxpayer's services, unlike the direct barter in *Johnson*. The only benefit received by the LRAP grantors was the indirect and charitable one of helping to steer better medical and educational services to the public. The recipient was at all times free to satisfy the loan conditions through an extremely wide variety of possible employment (or self-employment) of the recipient's own choice.

159. *See* discussion *supra* part II.C.

position over its inexplicable change of mind in Revenue Ruling 73-256.[160]

Even if Revenue Ruling 73-256 were to be regarded as good law, it can be distinguished from the service requirements under legal LRAPs. There is at least some financial nexus between the state government as grantor and the state's interest in providing medical care to its poor because the state might feel obliged to satisfy these needs in some other way at greater cost. But there is no such nexus in legal LRAPs. There is no conceivable financial benefit to, say, NYU if one of its graduates serves as a public defender in California.[161]

The case for exclusion is even stronger where the sole condition of loan forgiveness is financial need. Acceptance of a low salary from a third-party employer is certainly not a service for the benefit of the grantor.[162] Such an LRAP differs from a traditional need-based scholarship only insofar as need is measured ex post rather than ex ante. To some extent, however, loan forgiveness based upon post-graduate need alone can serve as a proxy for public service, and in fact at least three legal LRAPs, those of NYU, Harvard and Yale,[163] are structured in precisely this way.

The fact that law school LRAPs are not publicly funded as required under I.R.C. § 108(f) should not affect the conclusion that they do not involve services within the meaning of I.R.C. § 117(c). If the public-funding requirement has any purpose at all other than simply to identify the Mississippi and NDEA plans and their congeners, it could only be to

---

160. See Colin Diver, *Statutory Interpretation in the Administrative State*, 133 U. PA. L. REV. 549, 562 n.95 (1985), who (in a slightly different context) sets forth ten factors that the Supreme Court has considered in deciding the validity of administrative interpretations, of which the first four seem directly relevant:

> A partial list of the factors cited by the Court would include: (1) whether the agency construction was rendered contemporaneously with the statute's passage, *see, e.g.*, Norwegian Nitrogen Prods. Co. v. United States, 288 U.S. 294, 315 (1933); (2) whether the agency's construction is of longstanding application, *see, e.g.*, NLRB v. Bell Aerospace Co., 416 U.S. 267, 275 (1974); (3) whether the agency has maintained its position consistently (even if infrequently), *see, e.g.*, Haig v. Agee, 453 U.S. 280, 293 (1981); (4) whether the public has relied on the agency's interpretation, *see, e.g.*, Udall v. Tallman, 380 U.S. 1, 18 (1965) . . . .

Id.

161. The reverse is probably true. Lawyers who are successful in private practice are surely more likely to make contributions to their alma mater, or at least more substantial ones.

162. Phillips & Hatfield agree that LRAPs with low income as the sole criterion should probably be tax-free. *See supra* note 3 and accompanying text.

163. *See supra* text accompanying note 25.

insure that the benefit of the required services is directed to government-approved employment. If so, this would raise no obstacle because nearly all legal aid and public defenders' offices are in fact already funded in whole or in part by government contributions.[164]

The following Part considers the *quid pro quo* test under the law of gifts and charitable contributions and argues that the *quid pro quo* test for scholarships should be the same, *viz.*, whether the "*quo*" constitutes a return of valuable goods or services to the donor.

3. Gifts and Charitable Contributions

Although as a technical matter scholarships have been governed by I.R.C. § 117 rather than I.R.C. § 102 since 1954,[165] many courts have been willing to consider the "detached and disinterested generosity" test for gifts under *Duberstein* as relevant to scholarships, including the *Porten* court. As noted above,[166] the *Johnson* Court's *quid pro quo* language requiring the grantor to be "disinterested" echoes *Duberstein*, and Treasury Regulation § 1.117-4(c) is itself in effect a reimportation of pre-1939 gift law into the 1954 scholarship provision.[167] Most recently, in *Spiegelman v. Commissioner*,[168] the Tax Court rested its decision that a postgraduate award was a "fellowship" upon *Duberstein* and upon a lengthy discussion of pre-1954 law under which scholarships were tested as gifts.[169]

For tax purposes, the disinterested intent of the donor is not negated merely because the gift requires the donee to meet some condition, unless the condition is of direct economic benefit to the donor. For example, a

164. The Legal Services Corporation, for example, which funds hundreds of legal aid societies throughout the country, was established by Congress in 1974 and received a $400 million appropriation by Congress in 1994. It received another $242 million from other sources of which about $48 million were donations from individuals or non-governmental charities. *See* LEGAL SERVICES CORPORATION, 1994 ANNUAL REPORT 7 (1994).

In addition, the Legal Aid Society of New York is the largest provider of both civil and criminal legal services to the poor in New York City. *See* LEGAL AID SOCIETY, 1993 ANNUAL REPORT 9 (1993). Its total funding for 1993 was $137.7 million, of which only $6.4 million came from private donations. *Id.* at 57.

165. *See supra* notes 29-35 and accompanying text.

166. *See supra* note 55.

167. *See supra* notes 33-35 and accompanying text.

168. 102 T.C. 394 (1994) (holding that postdoctoral research grant to geologist was a fellowship and not subject to employment payroll taxes, though fellowship was taxable because taxpayer was not a degree candidate).

169. *See id.* at 406.

prenuptial transfer of valuable property on condition that the recipient marry the transferor is excludible as a gift.[170] Payment of $5000 to a nephew for fulfilling a promise to refrain from drinking, smoking and swearing until age twenty-one is excludible as a gift rather than taxable as compensation, because the conditions are for the benefit of the donee rather than the donor.[171] The fact that payment may be pursuant to an enforceable contract is no barrier to gift treatment. For example, payment of an enforceable pledge to a charity is a gift qualifying for the deduction under I.R.C. § 170(a) even if actual payment is pursuant to contract or even made under coercion after a change of mind.[172] The origin of the claim is a promise which is donative.

Similarly, bequests are excludible under I.R.C. § 102(a) even if the beneficiary must fulfill conditions precedent or subsequent. For example, a bequest is tax-free even if subject to a condition that the beneficiary must marry, or not marry, or join the marines, or any other condition which is of no economic benefit to the testator. If the bequest is in effect the payment of a debt for valuable services performed, however, it is not taxfree but rather includible as compensation.[173]

Essentially the same tests of disinterested intent and lack of valuable *quid pro quo* apply to determine whether a donation is deductible under I.R.C. § 170(a) as a charitable contribution.[174] Restricted or conditional

170. This is true even if the gift imposes a further condition that the bride must abandon marital rights to the transferor's property. *See* Rev. Rul. 67-221, 1967-2 C.B. 63. This remains true even though such a transfer is outside the literal terms of I.R.C § 1041 enacted in 1984 which treats transfers between spouses and former spouses incident to divorce as gifts.

171. *See* Hamer v. Sidway, 27 N.E. 256 (N.Y. 1891); *see also* Smith v. Commissioner, 14 T.C.M. (CCH) 706 (1955), *aff'd* 249 F.2d 218 (5th Cir. 1967) (holding parent's transfer of farmland to son enforceable where conditioned on son's finishing school, abandoning plans to play professional football, and agreeing to develop land).

172. *See* Commissioner v. RailJoint Co., 61 F.2d 751, 752 (1932).

173. *See* Wolder v. Commissioner, 493 F.2d 608, 612 (2d Cir. 1974) (holding that decedent's bequest of corporate stock to lawyer in exchange for prior legal services performed was taxable compensation, applying *Duberstein* test).

174. The House and Senate Reports on § 170 of the 1954 Code both define "gifts" for purposes of the deduction for charitable contributions as payments "made with no expectation of a financial return commensurate with the amount of the gift." S. REP. NO. 1622, 83d Cong., 2d Sess. 196 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. A44 (1954).

The courts have applied interchangeably both the subjective intent test of *Duberstein* and an objective *quid pro quo* test. Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971) (allowing deductions for donor's bargain sales to churches, hospitals, and the Red Cross because donor's motive was to foster donee's charitable activities but denying contributions are quite common and do not endanger the deduction in the absence of an economic *quid pro quo*. For example, it is unquestionable that one may deduct the value of a painting donated to a museum on condition that the museum restore it or maintain it on display, despite the fact that the condition imposes a requirement of services to be performed. The services are for the benefit of the museum and the public, and provide no economic *quid pro quo* to the donor.[175] Similarly, a gift to a university to establish a professorial chair in a particular field of learning does not constitute a forbidden *quid pro quo* even if the donor's name is memorialized or favorite cause is furthered.[176] The donor's satisfaction from a restricted gift is altogether irrelevant[177] unless it has the character of an economic return.[178] For example, in Revenue Ruling 81-307,[179] the IRS held that a gift to a police department was deductible although it was made to provide a reward for the apprehension of the murderer of the donor's child, on the ground that the reward served a public purpose and the benefit to the donor was "incidental."[180] Similarly, the millions of dollars that Michael Milken has reportedly donated to foundations for research on prostate cancer of which he is himself a victim are deductible

---

deduction for selling sewing machines to schools at a discount because donor's predominate motive was to encourage students to use taxpayer's products in future years). There, the Court of Claims stated that the subjective approach of disinterested generosity need not be wrestled with and that the proper test is whether "the benefits received, or expected to be received, are substantial, and meaning by that, benefits greater than those that inure to the general public. . . ." *Id.* *Cf.* Hernandez v. Commissioner, 490 U.S. 680, 690 (1989) (stating that the words "'contribution or gift'. . . [are] intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services.")

175. *Cf. Singer*, 449 F.2d at 423 (stating that artists cannot deduct donations of paintings to museums from income tax if the transfer provides benefits so substantial that it creates *quid pro quo* to the donor).

176. *See* 2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS ¶ 35.1.3 (2d ed. 1990).

177. It has been argued that the charitable contribution is questionable precisely because such non-financial satisfactions and honors should be treated as a form of compensation, but this is not the law. *See generally* Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far from Ideal World*, 31 STAN. L. REV. 831 (1979).

178. Treating such restrictions as if they were an economic *quid pro quo* might arguably undermine the deduction under I.R.C. § 170(a) altogether because it is an implied condition of all charitable contributions that the recipient will use the gift for one of its legitimate charitable aims.

179. 1981-2 C.B. 78.

180. *See* Joan O'C. Hamilton, *Milken vs. Cancer*, BUS. WK., Jan. 9, 1995, at 36-37.

gifts even if his primary motive is to save his own life. An LRAP which is intended solely to provide legal services to the needy seems more selfless and charitable than the above examples, and should be regarded *a fortiori* as donative in nature.

By contrast, if the donor receives a direct financial benefit as a *quid pro quo*, an otherwise qualifying gift is nondeductible.[181] For example, a contribution to a qualifying private school is not deductible if it is in effect a payment of tuition for the benefit of the donor's child.[182]

If the *quid pro quo* test for scholarships under I.R.C. § 117(c) is interpreted as equivalent to and *in pari materia* with that of I.R.C. § 170(a) and *Bingler v. Johnson*, as I think it should be, an illuminating comparison can be made between the tax treatment of the grantor and the grantee of a law school LRAP. It is beyond question that an individual donor is entitled to deduct as a charitable contribution a gift to a qualifying law school which is earmarked for the funding of LRAPs, because the donor receives no economic value in exchange and is merely specifying a charitable aim.[183] It would then be a direct contradiction to assert that the LRAP recipient should be taxed for fulfilling a *quid pro quo* to that grantor, because the deduction is allowed only on condition that no such *quid pro quo* exists.

Of course the private donor is only one grantor of the LRAP, and the law school which selects the recipients and administers the grants is another. Salaries are taxable even when paid by a nonprofit institution out of previously deducted contributions. That an individual's endowment of a law professorship may be deductible as a charitable gift does not prevent the professor's salary from being taxable compensation. In the case of an LRAP, however, it is difficult to see why the law school stands in any different position than the individual grantor. If, say, NYU cancels tuition loans in exchange for a graduate's employment for a California public defender's office, it receives no more economic *quid pro quo* than Melvyn and Barbara Weiss who provided the other half of the funds. Both

---

181. I.R.C. § 6115, enacted by the Omnibus Budget Reconciliation Act of 1993, now requires charities to disclose and value any *quid pro quo* contribution in excess of $75. I.R.C. § 6115(b) defines a *quid pro quo* contribution as a contribution partly in consideration for goods or services provided to the payor by the donee organization. Intangible religious benefits are exempt if they are generally not sold in a commercial transaction outside the donative context. Pub. L. No. 103-66, tit. XIII, § 13173(a), 107 Stat. 312, 456.

182. Rev. Rul. 83-104, 1983-2 C.B. 46.

183. Unless the gift is earmarked for the donor's own child, and is merely an attempt to deduct tuition by laundering the funds through a charitable organization. *See id.*

grantors share the identical purpose of improving legal services to the poor, and neither receives any other return than the satisfaction of doing so.

D. *Financial Need*

The courts have often regarded financial need tests as a factor pointing toward eligibility as a scholarship and also as evidence of disinterested charity. For example, in *Lange v. Commissioner,*[184] a stipend from Antioch School of Law was held to be a tax-free scholarship despite the fact that the student was required to perform services in a legal-aid clinic. The Tax Court based its decision upon the fact that all students had to perform similar services as part of the curriculum, and that financial aid was awarded strictly on the basis of need.[185] Conversely, in *Jamieson v. Commissioner,*[186] the Tax Court found that payments to a teaching assistant were compensation rather than a scholarship chiefly because the payments were in return for services and without regard to financial need.[187]

The fact that public interest LRAPs are in large part based upon financial need helps to support their characterization as scholarships. Nearly all scholarships today are need-tested at the front end.[188] Students who have the income or assets to pay the full price of higher education at the time of admission are generally required to do so, and this ineligibility generally applies to cancelable LRAPs as well.[189] However, financial need, like commitment to public service, is more accurately measured after the student's education is completed. If the student enters low-paying work upon graduation, the burden of repayment is greater, and the justification for need-based, tax-free, educational loan relief is greater than that for an initial outright grant. If a student becomes suddenly wealthy after graduation, an outright grant which might have funded a needy student instead has in effect been wasted.

184. 41 T.C.M. (CCH) 1421 (1981).

185. *Id.* at 1422.

186. 51 T.C. 635 (1969).

187. *See also* Rockswold v. United States, 620 F.2d 166 (1980) (holding that medical fellowship was taxable as compensation for services in part because payments not based on financial need); Weissfisch v. Commissioner, 33 T.C.M. (CCH) 391 (1974) (same regarding medical residency).

188. *See generally The Nation*, THE CHRONICLE OF HIGHER EDUCATION ALMANAC, Aug. 28, 1991, at 3, *cited in* Joseph Dodge, *Scholarships Under the Income Tax Act*, 46 TAX LAW. 697, 709 n.64 (1993).

189. *See generally* NAPIL REPORT, *supra* note 23.

The point is particularly applicable to legal education. Senator Bumper's explanation of Senate Bill 914 makes the point very clearly.[190] The median salary of 1991 law graduates who took public service work was $25,000, while those who went into private practice earned a median salary of $51,000.[191] The enormous burden of law school loans is a great deterrent to those who might otherwise enter public interest work, and this is the principal reason why so many law schools have instituted LRAPs.[192]

The chief problem with characterization of an LRAP as a scholarship is that the financial aid is provided after the student's graduation, and sometimes many years afterwards. This problem is the subject of the next Part.

E. *Timing: Can Postgraduate Aid be a Scholarship?*

Treasury Regulation § 1.117-3 defines "scholarship" as "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."[193] The IRS might take the position that financial aid paid long after graduation is neither 'paid to a student' nor 'intended to aid the student in pursuing his studies' because the studies have long been completed. There is apparently no published authority on this timing question regarding scholarships, although there is one ruling in the related area of employer-provided educational assistance under I.R.C. § 127.[194] In PLR 8714035,[195] the IRS ruled that tuition loan cancellations

190. 139 CONG. REC. S5647-5648 (daily ed. May 6, 1993) (statement by Sen. Bumpers); *see supra* text accompanying notes 8-13.

191. *Id.* at S5648.

192. *Id.* (citing figures supplied by NAPIL REPORT, *supra* note 23).

193. The proposed regulations intended to apply to grants made after 1986 define "scholarship" in much the same way. *See* Prop. Treas. Reg. § 1.117-6(c)(3), 53 Fed. Reg. 21,688 (1988) (first sentence).

194. I.R.C. § 127 grants an exclusion of up to $5250 per year of employer-provided educational assistance provided that it is pursuant to a written plan and is nondiscriminatory. I.R.C. § 127 expired by its terms on Dec. 31, 1994. However, Congress may reinstate the provision retroactively, as it has done several times in the past.

The exclusion was repealed in 1988 for graduate-level courses which might lead to an advanced degree by § 4001(a) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3643, but this restriction was lifted two years later by § 11403 of the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, 1473.

195. Jan. 2, 1987.

provided by a college to a full-time teacher did not qualify for the exclusion under I.R.C. § 127 because (among other reasons) the cancellations took place after the teacher had already completed her Master's degree and therefore did not provide any incentive for her to continue her studies.[196] It appears significant that the ruling did not state as an additional ground that the timing of the loan cancellations prevented scholarship treatment.[197] The ruling is unlikely to present a significant obstacle to excludibility of LRAPs as scholarships because the timing issue is probably not the same as it relates to I.R.C. §§ 127 and 117. For example, loan cancellation could be used to circumvent the annual exclusion limit of $5250 by deferring the excess to a later year through a loan to be forgiven when the employee will be within that dollar limit. Congress has demonstrated concern for this issue in the legislative history of I.R.C. § 127.[198]

The IRS has never shown any concern for the timing issue as it relates to scholarships. Disallowance of the scholarship exclusion for the Mississippi and NDEA plans was based solely upon the *quid pro quo* issue without mention of any timing problem.[199] Both plans involved loan forgiveness which took place long after the participants' education was completed. Under both plans, as under law school LRAPs, the forgiveness takes place during the participants' professional working career. In effect the loan-cancellation scholarships were treated as equivalent to outright grants, and correctly so because there is little if any economic difference between an outright grant which must be repaid if a

---

196. It also did not qualify because it was not pursuant to a written plan as required under I.R.C. § 127(b).

197. Priv. Ltr. Rul. 8714035 (Jan. 2, 1987) also ruled that the loan cancellations were not a scholarship because they were provided in exchange for services as a full-time employee, and in fact the college reported the amounts as wages on a Form W-2.

198. *See* H.R. REP. No. 1049, 98th Cong., 2d Sess. 6, 7 (1984) which states:

> The committee recognizes that an employee cannot avoid the [then] $5,000 limit by electing to forego receipt of reimbursements to another taxable year because the employee is in constructive receipt of the amounts in the current year. In addition, the committee intends that employers will report to an employee, who separates from service with the employer during the taxable year, the value of the educational assistance benefits received by the employee during the year.

Id.

199. *See supra* text accompanying notes 57-67.

condition subsequent is not met, and a loan which will be canceled if the condition is met.[200]

Proposed Regulation § 1.117-6(c)(3) states that "[a] scholarship or fellowship grant also may 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." This provision has no analog in the former regulations, but it does not appear intended to make any change in prior law.[201]

For example, a tuition loan which converts to a grant upon the achievement of a required grade average, or successful completion of studies, would clearly have been excludible under any version of prior law. The current express recognition of loan cancellation as a means of awarding scholarships, without any explicit concern over timing, suggests that the exclusion applies even if the forgiveness takes place after graduation, and perhaps even if long afterwards.

The phrase 'owed to an educational organization' may raise more difficult questions, however. If the law school forgives amounts which are owed to itself, the forgiveness seems clearly within the proposed regulations. Typically, however, the law school itself is not the holder of the note representing the original student loans, but rather a financial institution which has disbursed funds to the school and/or the student at the direction of the school. The law school either makes the graduate cancelable interim loans with which to make payments on the original student loans, or outright grants of cash for the same purpose.

Taking the interim-loan format first, such loans are 'owed to an educational institution,' but they raise another timing question because they are not merely forgiven many years after graduation, but also advanced after the student's studies are completed. Thus it might be questioned whether the interim loan forgiveness is a reduction of an amount owed "for tuition, room and board, or any other fee." On the other hand, LRAP interim loans are in effect simply a refinancing of the original student loans and can plausibly be regarded as relating back to them. A good analogy may be found in the rules for deducting qualified home mortgage interest under I.R.C. § 163(h). Qualifying acquisition

200. Except for a different timing problem: for tax purposes, a non-qualifying scholarship grant is taxable in the year of receipt, but a non-qualifying scholarship loan is not taxable until the year in which it is canceled.

201. Nor does the change in the regulations defining "scholarship" which formerly referred to "student" and now to "individual." The immediately preceding first sentence of Prop. Treas. Reg. § 1.117-6(c)(3) which defines "scholarship or fellowship" reads: "(i) *In general.* Generally, a scholarship or fellowship grant is a cash amount paid or allowed to, or for the benefit of, an individual to aid such individual in the pursuit of study or research."

indebtedness under I.R.C. § 163(h)(3)(B)(i) includes any refinancing of such indebtedness even though the refinancing is not for the purpose of acquiring a residence because the residence is already owned. The refinancing replaces the original acquisition loan and is quite sensibly treated as relating back to it as a substitute. Similar treatment for interim-loan LRAPs seems reasonable, if not compelling.

A related problem is raised by the fact that LRAP cancellation is not ordinarily made pursuant to the terms of the original student loan, in contrast to the Mississippi and NDEA plans and as required under I.R.C. § 108(f)(1). Presumably the purpose of this limitation[202] is to ensure that the loan forgiveness relates directly back to the educational assistance which was "to aid [the] individual in the pursuit of study or research," and is not a merely an employment arrangement. However, this should not present an insuperable problem if the LRAP is already in place at the time the student begins law school. There is no apparent reason why the student cannot rely upon the LRAP program when incurring the independent student loans and in effect look to the LRAP as present assurance of financial aid for current studies. It should be noted, however, that this argument may weaken the case for exclusion for students whose LRAP programs allow them to participate even if they had already graduated before the LRAP program was instituted.

Cash grants should be treated in the same way as interim-loan cancellation and reduction of original debt because all three have the same economic effect. Assurance that cash grants and interim loans will actually be used to pay down the educational debt is generally provided by limiting eligibility to participants who are currently in compliance with their loan obligations.[203] If loan funds are provided by a lending institution at the direction of a law school, the benefit to the student is the same whether the LRAP makes payments directly to the participant or to the lending institution on behalf of the participant. Either way, from the participant's perspective, the cash payments are economically equivalent to a reduction of debt held by the law school itself. From the law school's point of view the result is also the same. If the school has already received funds from a third-party lender on the student's behalf and refunds the amounts either to the lender or to the student, it has simply provided a rebate and retains the remaining net proceeds (if any) as the final price of tuition. If the school itself holds the debt and reduces

202. Assuming that it has any purpose at all other than to loosely identify the Mississippi, NDEA, and similar plans to which it applies.

203. *See* NAPIL REPORT, *supra* note 23. Note also that for scholarships generally, there is no need to trace particular grant dollars to particular expenditures for qualified tuition. Prop. Reg. § 1.117-6(e).

it, the school will similarly end up with recovery of the remaining debt (if any) as the final price.

1. Exclusion Limited to Tuition

The scholarship exclusion for LRAPs must be limited to loans for tuition, and possibly for law school tuition alone. If the LRAP also pays down loans for living expenses, there is no argument for the exclusion because after 1986, I.R.C. § 117(b)(2) has limited the exclusion to tuition and fees. Some LRAP programs include financial assistance for undergraduate loans as well. To the extent such loans were made for living expenses there is again no argument for exclusion under I.R.C. § 117.

This is true despite the fact that I.R.C. § 108(f) has not been amended to conform to I.R.C. § 117(b)(2), so that loan cancellation programs which qualify under I.R.C. § 108(f) apparently still permit exclusion of forgiven loans for living expenses. Congress seems to have erred in failing to conform the two provisions.[204]

Whether LRAP forgiveness of undergraduate tuition loans might qualify for the scholarship exclusion is a more difficult question. There is no reason in principle why a law school cannot grant a scholarship for undergraduate education, and if a scholarship may be granted for legal education after graduation, the same should arguably be true for undergraduate tuition. On the other hand, the timing issue makes this doubtful. It seems difficult to argue that post-J.D. LRAPs further the participant's *undergraduate* education which was already completed years earlier. Certainly it would be unusual for an undergraduate to know of and rely upon a law school LRAP for current financial aid in college, assuming arguendo that such reliance is a proper test for the exclusion.[205] On the other hand, LRAP benefits for undergraduate

204. This difference cannot be defended, and is probably an oversight due to the original error of not codifing I.R.C. § 108(f) at I.R.C. § 117 where it belongs. *See supra* note 71. Note that Senator Bumpers' proposed amendments to I.R.C. § 108 would have allowed LRAP recipients a bigger exclusion than is available under I.R.C. § 117. *See* 139 CONG. REC. S5647 (daily ed. May 6, 1993).

205. The definition of "scholarship" under the regulations as aid to "further" the recipient's studies can be read as implying that an element of inducement to study is required. It is by no means clear, however, that any such requirement exists. For example, scholarships are often awarded in situations where it is clear that the recipient will engage in the contemplated studies in any event, and the aid is intended merely to lure the student from one school to another. Also, the "honoraria" type of scholarship which civic groups give to high school students ordinarily cannot influence the recipient's educational choices because the amounts are usually too small and the timing too late. But their exclusion as scholarships has never been questioned.

tuition loans may be regarded as furthering the participants' *legal* education, because willingness to take on law school indebtedness is likely to be influenced in part by the level of their college debts. The case for exclusion is less strong than for law school tuition indebtedness, but it is still good.

2. Allocation to Law School Tuition

Because the exclusion under I.R.C. § 117(b)(2) applies only to LRAP benefits to the extent they are allocable to qualified tuition and fees, an allocation problem arises where the LRAP pays down loans incurred for living expenses as well. If LRAP assistance for undergraduate tuition loans also does not qualify for the exclusion, a second allocation problem arises.

If LRAPs want to maximize the exclusion for their participants, it would appear advisable for them to stipulate that loan forgiveness and/or cash payments apply first to law school tuition loans, then to undergraduate tuition loans, and finally to loans for living expenses. This would be possible in cases where the LRAP does not cover the full amount of a participant's current obligations. For example, suppose that the participant's current obligations are $600 per month, of which $400 is for law school tuition loans, $100 for law school living expense loans, and $100 for undergraduate tuition loans. If the participant qualifies for $200 per month in LRAP benefits, it would be desirable for the participant and the school to allocate the entire $200 of benefits to the law school tuition loans.[206]

On the other hand, if the LRAP pays the full amount of the participant's current obligations, such a stipulation would have no effect because the participant must make payments currently on all loans at once. To determine the correct amount of the exclusion, it would be necessary to make a pro-rata allocation of the LRAP assistance among the various loans. Using the preceding example, if the participant qualifies for $600 of monthly benefits, the $400 allocable to law school tuition would be excludible, and probably the $100 of college tuition as well, but not the $100 allocable to living expenses.

Even if the exclusion is limited to law school tuition loan assistance, it would still be a very valuable benefit because it appears that at least two-thirds of the average law graduate's indebtedness is due to law school

206. This approach might be permissible under Prop. Reg. § 1.117-6(e), *supra* note 203. However, the IRS might demand a pro-rata allocation. The most effective way to avoid this result would be for the LRAP to pay the entire benefit directly to the holder of the law school tuition loan.

tuition loans.[207] Thus even if LRAP aid were allocated to all of a graduate's student debts on a pro-rata basis, the exclusion would probably shield an average of at least two-thirds of the assistance.

F. *Is an LRAP a Tax-Free Price Adjustment?*

A bargain purchase of goods or services is ordinarily taxfree provided that it is not a disguised payment of compensation. A subsequent rebate of purchase price is also generally tax-free as a return of capital. Where the rebate arises from a sale of property on credit and takes the form of a reduction of debt, no income from cancellation of indebtedness arises and the reduction is treated as a tax-free adjustment to the purchase price under I.R.C. § 108(e)(5).[208] Although there appears to be no authority on point, there is no reason why a price rebate for services should not be treated in the same way. Thus a reduction of purchase-money debt by a seller of services should generally be taxfree. Scholarships may be regarded as a subset of such transactions.

If loan forgiveness under an LRAP fails to qualify as a scholarship, it is presumably taxable only if it is COD income under I.R.C. § 61(a)(12). Whether tuition loan forgiveness is taxable as COD is very problematic, however, for at least three closely related reasons: (1) it is unclear whether cancellation of debts incurred for services alone rather than money or property are taxable as COD; (2) even if debts incurred for services are subject to the COD rules, the value of tuition (and many other services) is so uncertain as to render doubtful the proper measure of income; and (3) forgiveness of tuition debt is more plausibly viewed as a price reduction than as an accession to wealth.

The essential reason for taxing COD is that if the taxpayer has borrowed money taxfree and fails to repay it, the taxpayer is wealthier to the extent of the untaxed loan proceeds. It follows that unless the borrower has received valuable loan proceeds in exchange for the debt, cancellation of the debt does not result in any enrichment, and the courts

---

207. At Stanford Law School, for example, average indebtedness for 1994 graduates was $55,000, of which $45,000 was for law school and $10,000 for undergraduate education. Of the $45,000 law school debt, 87% or $39,150 was for tuition loans. Thus 71% of total indebtedness was for law school tuition. Telephone Interview with Frank Brucato, Associate Dean of Stanford Law School (Mar. 2, 1995). If the analysis in text is correct, at least 71% of LRAP benefits would be excludible on a pro-rata basis even without making special allocations of benefits to law school tuition. Graduates of New York Law School appear to have a similar average breakdown of indebtedness, and the same is probably true at most law schools. The largest item of indebtedness by far is law school tuition.

208. *See supra* notes 125-127 and accompanying text.

have generally agreed.[209] It is clear that money and property count as loan proceeds for this purpose, but there are no reported cases of COD income arising from debts incurred for services, and it is uncertain whether I.R.C. § 61(a)(12) should apply at all in this situation.[210] The enjoyment of services does not result in any increase in the taxpayer's wealth or ability to pay tax, and for that reason cancellation of a purchase-money debt for services is arguably not a taxable enrichment either.[211]

Furthermore, the value of services is often not ascertainable in any objective manner. The fact that a price has been agreed upon between buyer and service provider does not necessarily fix the value of services, especially where the provider may charge vastly different prices to different customers for the same services.[212] A public figure may charge a "standard" speaking fee, but will often cut the price in half or to nothing at all depending on the audience addressed. General Colin Powell is reported to charge speaking fees of $60,000,[213] but it is impossible to determine the objective value of his speeches, or of anyone else's. For tax purposes its value can only be whatever the buyer actually pays. Physicians and surgeons often charge vastly different fees for identical services depending upon the patient's ability to pay. Tuition is very similar. The "sticker price" for tuition at a private college may be, say, $20,000, but only the wealthy actually pay it. Middle-class students may

---

209. *See generally* Richard C.E. Beck, *Is Compromise of a Tax Liability Itself Taxable? A Problem of Circularity in the Logic of Taxation*, 14 VA. TAX REV. 153, 165-173 (1994).

210. The American Law Institute's Draft of a Federal Income Tax Statute proposed a codification of the COD income rules which would have defined "indebtedness" as including only those obligations which are incurred for cash, or for the acquisition of property where the debt was included in basis. *See* Stanley S. Surrey & William C. Warren, *The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness*, 66 HARV. L. REV. 761, 815-16 (1953).

211. It is unclear whether a receipt of unearned services should be included in the tax base at all, whether directly or by way of debt cancellation. A promotional prize of cash or property is unquestionably taxable, but it seems doubtful whether a promotional free movie, dinner, or massage should be taxed if it is nontransferable. *See* Dodge *supra* note 188, at 708 n.59. A receipt of services should of course be taxable if the services have produced some asset which can be transferred for value, or if the taxpayer has a real or implied option to take cash instead (barter), as for example if the services are earned (nonqualifying fringe benefits).

212. For example, some airlines offer "compassion" fares which are half or less than regular fares in order to enable people to visit relatives on short notice in an emergency. The price reduction is certainly not income.

213. *See* Sam Howe Verhovek, *Powell Deftly Deflecting Questions on Presidency*, N.Y. TIMES, Feb. 1, 1995, at A12.

routinely receive "scholarships" based on need which reduce the price to, say, $10,000, and a poor but able student may be charged nothing at all. The purpose of all such cases of differential pricing is to capture consumer surplus.[214] The agreed price has no necessary relation to objective value.

Cost to the school provides no clear measure of value either. All tuition, both public and private, is subsidized by private endowment or public taxes so that not even those who pay the full sticker price actually pay the full cost of higher education.[215] No one believes that such subsidies are taxable, but they do not differ in substance from a scholarship.[216]

The exclusion for scholarships is thus justifiable on a ground which is wholly independent of the exclusion for gifts. The actual price paid, net of scholarship, should be regarded as the true price of tuition for tax purposes and any discount, whether hidden or explicit, should be ignored altogether.[217] It is noteworthy that this view has been explicitly adopted by the Office of Management and Budget which dropped scholarships from its list of tax expenditures, explaining:

> from a strictly economic point of view, scholarships . . . are either gifts not conditioned on the performance of services, or they are "rebates" of educational costs by the institutions in which students are enrolled. Thus . . . the exclusion is not a tax

---

214. One cannot ask the well-off to pay more than the "sticker price," and so it must be artificially increased to the maximum that the richest customers are willing to pay. In the tuition example, it would be more realistic to say the "true" price is $10,000 if that is what most students actually pay.

215. On the other hand, the government's measurement of such subsidies apparently makes a pro-rata allocation to each student of the entire cost of the educational institution, including the salaries of professors who are engaged largely in research and the cost of libraries and laboratories which are necessary for their research. *See* DIGEST OF EDUCATION STATISTICS, NATIONAL CENTER FOR EDUCATIONAL STATISTICS (1987), *cited in* Charlotte Crane, *Scholarships and the Federal Income Tax Base*, 28 HARV. J. ON LEGIS. 63, 71 n.25 (1991). It may be questioned whether the subsidy is in fact the other way around, for there is no clear reason why students should pay for research which may be of little or no direct value to themselves. To the extent this may be true, tuition is overcharged rather than subsidized.

216. *See* Crane, *supra* note 215, at 71. Professor Crane rightly points out that it is difficult to justify taxing tuition which is actually charged but not paid when the "invisible subsidy" is tax-free.

217. *See* Dodge, *supra* note 188, at 701-11. Professor Dodge believes that although gifts should be taxable, scholarships should not be taxable because they are merely a "bargain purchase."

> expenditure; the reference law does not include either gifts or price reductions in a taxpayer's gross income.[218]

If this is so, it follows that cancellation of a debt for tuition simply adjusts the purchase price and should not be taxable quite apart from I.R.C. § 117. According to this point of view, after Congress repealed the scholarship exclusion in 1986 for amounts other than qualified tuition and fees, there may no longer be any need for I.R.C. § 117(a) at all.[219]

A reduction of tuition debt by the school as lender and holder of the note should clearly qualify as a tax-free price reduction. The school has advanced nothing except its own services and facilities of unascertainable value. The case is not different if the rebate is in cash, however, because a purchase-money tuition loan from a third-party lender has still provided no cash to the borrower. The school receives the borrowed money, and the borrower has again received nothing except the school's services.

The price-rebate argument would not apply, however, to the extent the rebate is earned by the recipient's barter of services in exchange.[220] This would appear to reopen the entire *quid pro quo* question which has plagued I.R.C. § 117. However, if the price-rebate approach provided an opportunity to reexamine the question without the accumulated baggage of erroneous law under I.R.C. § 117, the results might be very different. A taxable barter should be found only where the recipient performs valuable services for the direct economic benefit of the grantor (or seller, under the price-rebate analysis), as is the law for charitable contributions and gifts generally. The public interest (or low-income) conditions which LRAP participants must meet simply do not fit this description.

---

218. OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES, FISCAL YEAR 1985, at G-28, *quoted in* Crane, *supra* note 215, at 68.

219. The price-paid argument would not apply to cash scholarships which are used for living expenses, because the face amount of cash is of course its value, unlike the face amount of tuition. Pre-1986 I.R.C. § 117 therefore provided a valuable exclusion for such amounts. But scholarships for such amounts are no longer excluded by current I.R.C. § 117, and the price-reduction theory is therefore now coterminous with the scholarship exclusion except for the exclusion under § 117(b)(2)(B) for books, supplies, and equipment.

220. *See* Rev. Rul. 79-24, 1979-1 C.B. 60 (holding that barter of legal services for housepainting services is taxable on both sides to the extent of fair market value of services received).

G. *Is an LRAP a Gift?*

The scholarship exclusion requires donative intent, or at least the same absence of any *quid pro quo* as for gifts and charitable contributions, and LRAPs appear to meet this.[221] The question may then arise, why should an LRAP not be excludible as a gift under I.R.C. § 102(a) in case it fails for some other reason (*e.g.*, timing) to qualify as a scholarship? According to the Treasury Regulations § 1.117-3(a) and (c), the terms "scholarship" and "fellowship" do not include amounts provided by an individual where the grantor is motivated by family or philanthropic considerations.[222] Such grants are excludible as gifts under I.R.C. § 102(a),[223] however, which is a more favorable treatment because it removes the grant from the restrictions of I.R.C. § 117.[224] The evident purpose of the regulation is twofold: (1) to protect intra-family gifts which happen to be for educational expenses from the limitations of I.R.C. § 117; and (2) to safeguard the limitations of I.R.C. § 117 from end-run claims that ordinary institutional grants are fully excludible gifts. And yet the regulations do not state that all institutional grants must be tested by the scholarship rules alone. Although tax-free gifts are ordinarily made by individuals out of personal affection or charity, there is no statutory barrier to prevent an institution such as a law school from making gifts which might be excluded under I.R.C. § 102(a). For example, the Supreme Court held in *United States v. Kaiser*[225] that strike benefits paid by a union to a nonunion striker were tax-free gifts where there was no requirement that the recipient perform any services such as picketing, and where the benefits were made out of charitable concern that the recipient had no means of supporting himself.[226] Nor is the fact that LRAP

221. *See supra* notes 165-183 and accompanying text.

222. The same statement appears in Prop. Treas. Reg. § 1.117-6(c)(3), 53 Fed. Reg. 21,688 (1988) which is intended to apply to post-1986 scholarships.

223. *See* Rev. Rul. 61-66, 1961-1 C.B. 19 (holding that grant by individual to a university to disburse to a particular professor while on leave without pay in order to enable him to pursue research is excludible in full as a gift, and is not a fellowship because university merely acted as a conduit for individual's gift to another designated individual).

224. Such as the limitations to degree candidates and to qualified tuition and fees under I.R.C. §§ 117(a) & (b). On the other hand, such a grant may be subject to gift tax to the extent the educational expense exclusion under I.R.C. § 2503(e)(2)(A) does not apply.

225. 363 U.S. 299 (1960).

226. *Compare* Osborne v. Commissioner, 69 T.C.M. (CCH) 1895 (1995) (holding that strike payments were not gifts because, *inter alia*, they were not made on the basis of financial need).

payments are made pursuant to contract a necessary barrier to gift status because, as noted above, a payment pursuant to an enforceable promise may still be a gift, as in the case of a charitable pledge.[227]

Tax-free gifts may also be made by means of cancellation of debt, as for example when a father cancels a debt owed to him by his son. The IRS has ruled at least twice, in Revenue Ruling 78-46,[228] and in PLR 8839026,[229] that cancellation of debts to governmental agencies is nontaxable for reasons of general public welfare when the reason for cancellation is relief of hardship.[230]

On the other hand, although LRAP payments are based on financial need, they are not for relief of hardship or poverty as in the above cases. Moreover, even though LRAP benefits would probably pass the test of "detached and disinterested generosity," they are recurrent sources of funds upon which the recipient can rely and might thus be vulnerable to the analysis applied to tips and tokes: the recipient can and probably does regard them the equivalent of additional compensation.[231] Tips are paid to the service provider by the beneficiary of the services, however, unlike the LRAP situation in which the payor receives no benefit. Also, the mere fact that the LRAP takes the form of a recurrent allowance should not of itself prevent gift status. For example, if a wealthy patron were to support an artist by means of a fixed allowance, this should be excludible provided that no services are required in return.

And yet if LRAP benefits were treated as gifts, the entire amounts would presumably be taxfree, including amounts reflecting loans for student living expenses. In view of the general resemblance of LRAPs to scholarships, it seems unlikely that a court would permit the limitations of I.R.C. § 117(b) to be circumvented in this way. Thus it appears that the only really good argument that LRAPs are not gifts is that they are

---

227. *See supra* note 172 and accompanying text.

228. Rev. Rul. 78-46, 1978-1 C.B. 22 (waiving requirement to repay interim benefit of $3000 paid to surviving dependent of law enforcement officer under the Public Safety Officers' Benefits Act after determination of ineligibility for final benefit of $50,000 for officers killed in the line of duty held taxfree because it was in the nature of relief payment for the purposes of general welfare).

229. Priv. Ltr. Rul. 8839026 (June 29, 1988) (holding waiver by Veterans Administration of taxpayer's repayment obligation of $15,784 on a defaulted VA-insured home mortgage pursuant to its authority to do so in hardship cases held tax-free, citing as support Rev. Rul. 78-46.).

230. Governmental aid to the poor is generally taxfree, such as Aid to Families with Dependent Children and foodstamps. Some commentators think the exclusion unjustified, however. *See* Jonathan Barry Forman, *The Income Tax Treatment of Social Welfare Benefits*, 26 U. MICH. J.L. REF. 785 (1993).

231. *See* BITTKER & LOKKEN, *supra* note 30, ¶ 10.2.2.

scholarships. This conclusion reinforces the analysis that LRAPs are excludible, because the government should not be able to have it both ways, denying gift status on the ground of preemption by I.R.C. § 117, and denying scholarship status on the ground of timing. If an LRAP is not a scholarship, it is a gift.[232]

H. *Horizontal Equity*

It might be objected that from the point of view of the participant, the enjoyment of loan reduction or its cash equivalent is simply additional compensation for public interest employment. If LRAP participants are not taxed, co-workers who receive the same salary for the same work but no LRAP assistance will be overtaxed by comparison, thus violating horizontal equity. The argument has some merit, but it would apply equally well to many other tax benefits which are fully justifiable even though they are not evenly distributed.

LRAP payments, even as cash grants, cannot be considered compensation from the public interest employer because the employer neither receives them nor has any control over them. The employer cannot, for example, reduce the LRAP payments and put them to other uses such as hiring additional personnel. In many cases the employer could not pay the amounts to participants even if received directly because it would violate fixed salary scales governing much public employment.

The horizontal equity argument thus boils down to whether the exclusion is unfair merely because it is not universal. This argument would call into question the fairness of I.R.C. § 117 itself, because not all students receive scholarships, and the same student might be eligible for quite different amounts at different institutions. If these inequalities do not offend horizontal equity, neither should the identical inequalities entailed by LRAPs. Scholarship status should not be denied to an LRAP just because not all schools offer them, or because those which do so offer them in varying amounts.

Exclusion of public-service LRAPs for tuition loans is not only justifiable under existing law, it is good policy as well, because taxing them undercuts carefully targeted incentives to provide much-needed public services to the poor in favor of the far more diffuse public interest of the fisc.

---

232. *See generally* Laura Duncan, *Books Hit Back For Some Lucky Students*, CHI. DAILY L. BULL., Dec. 11, 1992, at 3. At least one LRAP probably is excludible as a gift rather than a scholarship. The student body of the University of Minnesota Law School voted to establish an LRAP funded by its own surplus funds. This would appear to be a gift from fellow students rather than an institutional grant.

I. *Compliance*

Because of the uncertainty as to whether LRAPs are taxable, and if so to what extent, compliance is probably very low in this area. As pointed out above,[233] some law schools report LRAP assistance on Form 1099 and others do not. In principle, it is the recipient who must determine whether the assistance qualifies as a scholarship, and it seems likely that many participants simply do not report the assistance unless they receive a Form 1099. If the IRS would issue a clear ruling on the taxability of LRAPs it would then be in a position to insist upon compliance.

The conclusions above suggest that LRAP assistance should be treated as a tax-free scholarship at least to the extent of amounts allocable to law school tuition loans. The IRS should issue a ruling to this effect, and then insist that law schools send Forms 1099 reflecting only such loan forgiveness or cash grants as may exceed the amount allocable to tuition. As matters now stand, it appears that some LRAP participants are overtaxed, and others undertaxed. If the IRS does not publish a ruling which exempts at the very least the LRAP amounts allocable to law school tuition, Congress should consider remedial legislation as it did following Revenue Ruling 73-256.[234]

IV. CONCLUSIONS

LRAP benefits should be excludible from income under current I.R.C. § 117 as scholarships to the extent they are a rebate of qualifying tuition and fees. Even apart from I.R.C. § 117, LRAPs (and scholarships generally) should be excludible on the ground that such price reductions do not properly belong in the tax base at all. The fact that the grantor

233. *See supra* note 4 and accompanying text.

234. *See supra* notes 68-72 and accompanying text.

may place conditions on the scholarship or rebate should be irrelevant except to the extent such conditions provide a direct and measurable economic benefit to the grantor, as under current law governing the deductibility of charitable contributions.[235]

235. These conclusions do not apply to LRAPs which are provided directly by public interest employers to their own employees, however, such as the cash LRAP benefits provided by NAPIL to its own staff. This is because the recipient is providing employment services directly to the grantor, and the LRAP is in effect a nonqualifying fringe benefit. Even Senator Bumper's proposed legislation would not cover this situation. *See* 139 CONG. REC. S5647, S5649 (daily ed. May 6, 1993).

I.R.C. § 127 which grants an exclusion of up to $5250 per year of employer-provided educational assistance might apply, however, assuming that Congress reinstates I.R.C. § 127 which by its terms expired December 31, 1994. On the other hand, PLR 8714035 provides some authority to the contrary on the issue of timing. *See supra* notes 194-198 and accompanying text.