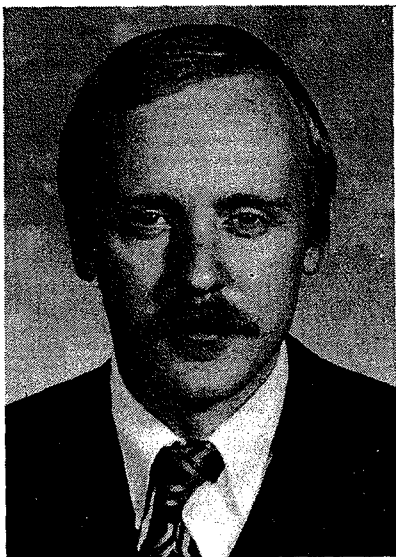


CANCELLED STUDENT LOANS: SCHOLARSHIPS OR TAXABLE INCOME?

By William R. Ferrell

Federal involvement in individual student financial aid is a relatively recent phenomenon. Congress, at the prodding of the 1957 Russian Sputnik, passed the National Defense Education Act of 1958. This legislation established a federal loan program for students demonstrating financial need. Various cancellation provisions were attached to the statute. Students receiving loans could have up to 50 per cent cancelled by teaching full time in public or non-profit elementary or secondary schools. This provision included teaching in an institution of higher education. The Act was modified somewhat in 1972 to allow cancellations of up to 100 per cent for those teaching in public schools having a high enrollment of students from low-income families.

Since 1958 several other federal loan programs have appeared. The Omnibus Crime Control and Safe Streets Act of 1968 provided for the establishment of the Law Enforcement Education Program to help educate people entering law enforcement careers. Loans are provided which may be cancelled at the rate of 25 per cent for each year that the student works with a publicly financed criminal justice agency. The Comprehensive Health Manpower Training Act of 1971 offered the possibility of the cancellation of federal loans for health professionals practicing in shortage areas. The Nurse Training Act followed in the same year, establishing provisions whereby federal nursing loans may be cancelled depending on the number of years the recipient works as a professional nurse, teacher of nurses, consultant, administrator or supervisor in a field of nursing in any public or non-profit hospital or agency. In addition to the above, the federal government operates a loan program for Cuban students which has the same cancellation provisions as those of the National Defense Student Loan regulations enacted in 1972.



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State governments have been quick to follow the federal precedent. At present, some 18 states have loan programs which approximate the cancellation provisions of the federal plans. Such projects vary from state to state but most are designed to serve as an incentive to get students to settle and practice in areas experiencing shortages in the medical, mental health, dental, veterinary or teaching professions.¹

It probably never occurred to the proponents of these many loan programs that cancellations of all or part of the loans would be considered taxable income. That is, however, exactly what happened. Since 1973, the Internal Revenue Service has considered all educational loan cancellations, where specific duties or employment is required, as taxable income.

The United States Congress and the state legislatures, in creating these programs which would eventually involve hundreds of thousands of students, never thoroughly considered their relationship to the Internal Revenue Service. If they did, the assumption must have been that such loan cancellations would be considered as scholarships or grants under section 117 of the Code.²

There were ample reasons for such a consideration. One such reason was based on a Tax Court decision in 1960. The Aileene Evans case involved a monthly stipend paid by the Tennessee Department of Mental Health. The stipend paid on the basis of need assisted recipients in completing their degree programs, thereby remedying a shortage of trained personnel in the mental health field. If the student upon graduation did not work in a mental hospital or mental health center supported in full or in part by the Tennessee Department, all funds received were to be repaid to the state. The Tax Court held that the stipend was excludable from the taxpayer's income on the grounds that no services were performed during her training and the funds paid were not related to future services.³

A second reason was a ruling by the Internal Revenue Service, Revenue Ruling 61-65 which dealt with a recipient of a loan through the National Defense Education Act of 1958. In it the Service stated that

"since the stipend. . . was paid. . . under the provisions of the title IV of the National Defense Education Act of 1958 to aid him in pursuing his studies at an educational institution and since the grant did not obligate the son, the University, or the United States Government in any way with regard to present or future employment of any kind, it is held that this stipend qualifies as a scholarship as defined in section 1.117-3 (2) of the Regulations and is, therefore, excludable from the recipient's gross income."⁴

¹ Peter J. Egllick, "Taxation of Forgiven Student Loans," *Georgetown Law Journal*, Vol. 62 (1973-1974), pp. 1245-45.

² See: Donald G. Sparrow, "Taxation of Educational Grants," *North Carolina Law Review*, Vol. 48 (December 1969), pp. 149-154.

³ Evans, Vol. 34. *Tax Court Reporter*, (1960), p. 720.

⁴ Revenue Ruling 61-65. *Internal Revenue Service Cumulative Bulletin*, 1961-1, p. 37.

If the above decisions were considered in creating the loan cancellation provisions of the various programs, they were abruptly discarded by the Service's Revenue Ruling 73-256. An unnamed state had created a Medical Education Scholarship program whereby it advanced qualified residents up to \$10,000 to aid them in attending medical schools. Tuition and fees were paid to the schools with the excess going to the students. The students in turn agreed to repay the amounts in five annual installments beginning one year after completing their education. It was further provided that for each year the recipient practiced medicine in a rural area, the installment due that year would be cancelled. The Internal Revenue Service, in reviewing the program, traced the definition of a Scholarship under section 117 (a) of the Code "as an amount paid or allowed to an individual for the primary purpose of furthering the education and training of the recipient in his individual capacity." The Service then scrutinized section 1.117-4 (c) of the Income Tax Regulations which states that

"any amounts paid to or on behalf of an individual to enable him to pursue studies or research shall not be considered to be an amount received as a scholarship or fellowship grant if such studies or research are primarily for the benefit of the grantor."⁵

Following the above reasoning, the Service unexpectedly concluded that as the loans were cancelled primarily for the benefit of the grantor or the state in this case, then the amounts cancelled are includible in the recipient's gross income for the year or cancellation. In making such a decision, the Service relied heavily on a Supreme Court decision of 1969. In the *Bingler & Johnson* case, the Court concluded that employees of Westinghouse who received payments while on leave of absence to finish their Ph.D work could not exclude such payments as scholarships. The Court held that a scholarship or fellowship is a "relatively disinterested 'no strings' educational grant involving no substantial *quid pro quo* arrangement between grantor and grantee."⁶ Since Westinghouse subsidized the students, approved their dissertation topics, reviewed their records, and required that they return to the Company upon finishing the degree, the money involved was not defined as a scholarship under section 117.

With this judicial support, the Service has indicated that it will apply Revenue Ruling 73-256 to the federal loan programs. Considerable sums of money are involved in this decision. Since 1960, loans through the National Defense Education Act alone have totaled nearly 1.6 billion dollars. Of this total, Office of Education estimated that 46% of the borrowers are entitled to partial or total forgiveness on loans amounting to \$700 millions of taxable income.⁷ The individual application of this ruling would mean, for example, that an unmarried individual with a taxable income of \$10,000 normally paying \$1313 in income tax would, with a yearly cancellation of \$1000, pay an additional tax of \$212.

⁵ Revenue Ruling 73-256, *Internal Revenue Service Cumulative Bulletin*, 1973-1, p. 56.

⁶ Robert E. Cattanach Jr., "Taxation - Scholarship and Fellowship Exclusion — Forgiveness of Educational Loans," *Wisconsin Law Review*, Vol. 1974, pp. 240.

⁷ Caroleen C. Boe, "Cancelled Student Loans: For the Benefit of the Grantor," *Albany Law Review*, Vol. 39 (April 1974), p. 39.

In such a case, the IRS would be working against the maximum benefit of the tax money it was created to collect. Assuming that loans cancelled by the federal and state governments are income distorts reality. The Supreme Court, in the 1969 Binger-Johnson case, dealt with a private profit-motivated enterprise. That is a far cry from federal and state governments which do not require that the people in question work for them at some future date. A recent critic has argued that such a policy favors inefficient public spending:

“aid will be taxable to the recipient if the state designs its program to insure accomplishment of its goal through the mechanism of debt forgiveness. However, the recipient will escape taxation if the state chooses to render its assistance as an immediate gift without guaranteeing that the skills developed at public expense will be used in a way to maximize their impact on public benefit.”⁸

The recent Tax Reform Act of 1976 exempted cancelled loans from income tax until January 1, 1979.⁹ Until that time, it will be next to impossible to determine if loan recipients will face the prospects of having a loan cancellation defined as taxable income. In addition, most students receiving such loans are not permitted to utilize the educational expense deductions. They undertake higher education primarily for a personal purpose. According to the Regulations “general educational aspirations” constitute such a purpose.¹⁰ Expenses incurred thereby are not deductible.

Nevertheless, certain employed older students may find some relief under the educational expense deduction provision. As an example, consider a teacher who attends summer school at a university for the primary purpose of maintaining or improving skills required in employment as a teacher and thus qualifies for an educational expense deduction. The teacher applies for and receives a National Direct Student Loan for \$200 to cover the cost of tuition and books. At summer's end the teacher returns to the job and meets the provisions for cancellation. The teacher will find that 15 per cent or \$30 is cancelled for the first year of teaching. The IRS, however, under Revenue Ruling 73-256 states that this person must recognize the \$30 as additional taxable income. Likewise, the \$30 represents money deductible under Treasury Regulations 1.162-5 permitting educational expense deductions. According to the Columbia, South

⁸ Cattanach, “Taxation-Scholarships,” p. 250.

⁹ *NACUBO*, (National Association of College and University Business Officers), Vol. 10 (November 1976), p. 7.

¹⁰ Richard C. Spencer, “The Deductibility of Educational Expense: Administrative Construction of a Statute”, *Buffalo Law Review*, Vol. 17 (1967-68), pp. 154-55. See also Carlucci, Vol. 370, *Tax Court Reporter*, (1962), p. 695. In this case an industrial psychologist took evening courses toward his Ph.D. Even though the courses were not required by his employer, the court ruled that the work was for the purpose of improving his skills required by his employment. The expenses for such courses were, therefore, deductible as education expenses.

Carolina office of the IRS, the teacher could deduct the amount of the loan in the year that school was attended. The teacher would face the additional income in future years, but would have the amounts negated by the earlier deduction.¹¹

This unusual situation will apply only to a few thousand graduate students. Nationally it is, however, an example of the failure of the IRS to understand the ramifications of its actions. A final word might be given by a critic of IRS policies who in writing before the 1973 decision pointed to the eventual solution:

“Section 117 should be read in a way that denies the exclusion only where payment is made by an employer for employment activities that are designed to advance the business.”¹²

¹¹ The results of a telephone conversation with the Columbia, South Carolina office of the Internal Revenue Service on November 19 and 20, 1976. The discussion considered the failure of the IRS to specify when a scholarship may be excluded in section 117. It is not stated clearly that a scholarship recipient must be in school the year that aid is received in order to qualify for an exclusion. No firm decision was forthcoming on the above.

¹² Sparrow, “Educational Grants,” p. 154.

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