Office of Chief Counsel
Internal Revenue Service

Memorandum

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date: April 07, 2004

to: Revenue Agent

from: LYNNE CAMILLO
Chief
CC:TEGE:EOEG:ET2

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subject: **Request for technical assistance on FICA refund claim**

This Chief Counsel Advice responds to your memorandum dated May 06, 2003. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

LEGEND

College =

EFFECT OF A PRIVATE LETTER RULING

You have asked for advice on dealing with College's refund claim. College filed a refund claim for Federal Insurance Contributions Act (FICA) taxes, asserting that amounts paid to non-National Research Service Award (NRSA) research fellows were not wages for FICA tax purposes. The purpose of this memorandum is to assist you in developing the relevant facts in order to process the refund claim. The following provides a discussion of the law regarding the income and employment tax treatment of stipends paid to research fellows, and suggestions regarding factual development in this case.

The Office of Chief Counsel issued PLR 200013026 (Jan. 4, 2000) to College, ruling that amounts paid to non-NRSA fellows were noncompensatory and thus not wages for employment tax purposes. Thus, College's refund claim must be examined based upon the standards under which private letter rulings may be relied upon by taxpayers. Rev.

Proc. 2004-1, § 11, 2004-1 I.R.B. 45, describes the effect of a letter ruling. Section 11.01 provides that a taxpayer ordinarily may rely upon a letter ruling received from the Office of Chief Counsel subject to certain conditions and limitations. Section 11.03 provides that, in examining a taxpayer's return and determining the taxpayer's liability, the field office must ascertain whether (1) the conclusions stated in the letter ruling are accurately reflected in the return; (2) the representations upon which the letter ruling was based reflected an accurate statement of the controlling facts; (3) the transaction was carried out substantially as proposed; and (4) there had been any change in the law that applies to the period during which the transaction or continuing series of transactions were consummated.

If, when determining the liability, the field office finds that a letter ruling should be revoked or modified, the findings and recommendations of the field office will be forwarded through the appropriate director to the appropriate Associate office within the Office of Chief Counsel for consideration before further action is taken by the field office. Such a referral to the Associate office will be treated as a request for technical expedited advice and the provisions of Rev. Proc. 2004-2 relating to requests for technical expedited advice (TEAM) will be followed, except that no consensus among field office, taxpayer and Associate office will be required to make the request subject to TEAM procedures. Otherwise, the letter ruling is to be applied by the field office in the determination of the taxpayer's liability. Appropriate coordination with the Associate office must be undertaken if any field official having jurisdiction over a return or other matter proposes to reach a conclusion contrary to a letter ruling previously issued to the taxpayer.

FACTS

The relevant facts are generally set forth in College's PLR submission and PLR 200013026 (Jan. 4, 2000) (copies enclosed).

The refund claim relates to stipends paid to research fellows participating in programs described by College as mirroring the NRSA program. It is necessary to understand the nature and characteristics of NRSA fellowships in order to determine whether the non-NRSA fellowship grants at issue in the refund claim in fact mirror NRSA fellowships. The following describes NRSA fellowships.

NIH Grants and NRSA Awards

NIH issues two types of awards: individual awards and institutional awards. NIH conducts a national competition to choose individual recipients of research training awards in specific health-related areas. The guidelines for individual awards provide that the major emphasis of the application for an individual grant should be the research training experience and broadening of scientific competence. The individual applicant must identify a sponsoring institution and an active investigator who will supervise the

research. NIH provides funds to the institution for distribution to the recipients. Fellows must provide progress reports to NIH with all applications for continuing support.

The NIH guidelines for institutional awards provide that NIH will award NRSA Institutional Training Grants to eligible institutions to develop or enhance research training opportunities for individuals, selected by the institution, who are training for careers in specified areas of biomedical and behavioral research. The guidelines further provide that the purpose of the NRSA program is to help ensure that highly trained scientists are available in adequate numbers and in appropriate research areas and fields to carry out the Nation's biomedical and behavioral research agenda. The institution's research training program director is responsible for the selection and appointment of trainees and the overall direction of the training program. Awards may not be used to support residencies in a medical specialty. Any clinical services must be confined to those that are part of the research training.

The following terms of appointment generally apply to fellows working under either an individual grant or an institutional grant. Generally, no individual may receive more than five years of NRSA support at the pre-doctoral level, and three years of NRSA support at the post-doctoral level. Fellows are required to pursue research training on a full-time basis, defined as 40 hours per week or as specified by the sponsoring institution. Fellows are paid stipends in amounts determined by NIH. Stipends may be supplemented by an institution from non-Federal funds, provided the individual is not required to perform additional services. Fees resulting from clinical practice, professional consultation, or other comparable activities performed pursuant to the purposes of the award may not be retained by the fellow. Such fees are assigned to the grantee institution for disposition. A fellowship may be terminated if NIH determines that the individual materially failed to comply with the terms and conditions of the award or its purpose.

The NIH provides certain rules on the use of NIH funds to provide certain employee benefits. Fellows are entitled to the normal vacations and holidays available to individuals in comparable training positions at the grantee or sponsoring institution. NRSA fellows receive 15 days of paid sick leave per year. Individuals may receive up to 30 days of parental leave per year. NIH funds may not be used to provide retirement benefits. NIH permits NIH funds to be used to pay for the individual's health insurance if health insurance is required of all individuals in similar training positions, but not health insurance for the individual's family.

NIH provides certain rules on the use of research findings. Fellows are encouraged to have their research findings published, but must acknowledge NIH support in publications. An NRSA fellow is free to copyright any publications developed from the research; however, the Government retains the right to a royalty-free, nonexclusive, and irrevocable license to reproduce, translate, publish, use, and dispose of publications. No fellowship grant may contain any provision giving the Government any patent rights to inventions made by the fellow.

NRSA post-doctoral fellows receiving NRSA support for more than 12 months must "payback" the NIH by performing certain services upon completion of their fellowship. There is no payback requirement for pre-doctoral fellows. For post-doctoral fellows, NIH generally requires either 12 months post-doctoral service for the Government, or 12 months of health related research, training or teaching at least 20 hours per week.

LAW

Income Tax Treatment

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

Under § 117(b), the term "qualified scholarship" means any amount received by an individual as a scholarship or fellowship grant to the extent that the recipient establishes that, in accordance with the grant, such amount is used for qualified tuition and related expenses. Section 117(b)(2) provides that qualified tuition and related expenses are tuition and fees required for the enrollment or attendance of a student at an educational institution, and fees, books, supplies, and equipment required for courses of instruction at such an educational organization. Amounts received for room, board, travel, and incidental living expenses are not related expenses. Thus, scholarship receipts that exceed expenses for tuition, fees, books, supplies, and certain equipment are not excludable from a recipient's gross income under § 117.

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

Fellowship stipends paid to non-degree candidates for general living expenses generally do not meet the requirements of § 117(b); thus, such fellowship stipends are generally includable in gross income.

Employment Tax Treatment

Sections 3101 and 3111 impose FICA taxes on "wages," as that term is defined in § 3121(a). The term "wages" is defined in § 3121(a) for FICA purposes as "all

remuneration for employment," with certain specific exceptions. Section 3121(b) defines "employment" for FICA purposes as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Under § 3306(c)(8), tax-exempt organizations described in § 501(c)(3) are not subject to Federal Unemployment Tax Act (FUTA) tax.

Section 3402(a), relating to income tax withholding, generally requires every employer making a payment of wages to deduct and withhold income taxes from the wages. Section 3401(a) provides that "wages" for income tax withholding purposes means "all remuneration . . . for services performed by an employee for his employer," with certain specific exceptions.

Sections 3121(a)(20), and 3401(a)(19), provide that for purposes of FICA tax and income tax withholding, respectively, the definition of "wages" does not include any benefit provided to or on behalf of an employee if, at the time such benefit is provided, it is reasonable to believe that the employee will be able to exclude such benefit from income under § 117.

For purposes of determining whether a fellowship grant is wages for employment tax purposes, the Service examines whether the grant is compensatory or noncompensatory. A fellowship grant will generally be includable in gross income under § 117(b) because such grants are generally provided for living expenses, not tuition and fees. However, in determining whether a fellowship grant is wages, the standard is not merely whether the grant is excludable under § 117; instead, a fellowship grant is wages for FICA and income tax withholding purposes only if the grant is "remuneration for employment" within the meaning of §§ 3121(a) and 3401(a). Whether a fellowship grant is compensatory or noncompensatory is determined based upon the standards of § 117(c). Notice 87-31, 1987-1 C.B. 475. Notice 87-31 provides that a scholarship or fellowship grant that compensatory within the meaning of § 117(c) is wages for FICA and income tax withholding purposes.

Section 1.117-4(c) of the regulations provides that the following are not considered amounts received as a scholarship or fellowship grant:

> (1) . . . any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount 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.
>
> (2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.
>
> However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent

> compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefits to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

Section 117(c) was enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514. Proposed Income Tax Regulations § 1.117-6(d)(2), interpreting § 117(c), provides:

> 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 requirement that a recipient furnish periodic reports to the grantor for the purpose of keeping the grantor informed as to the general progress of the individual, however, does not constitute the performance of 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.

Prop. Reg. § 1.117-6(d)(5) provides examples applying this rule:

> EXAMPLE (2). B receives a $10,000 scholarship from V Corporation on June 4, 1987, for academic year 1987-1988. As a condition to receiving the scholarship, B agrees to work for V after graduation. B has no previous relationship with V. The $10,000 scholarship represents payment for future services for purposes of this section. Thus, the $10,000 scholarship must be included in B's gross income as wages.
>
> EXAMPLE (3). On March 15, 1987, C is awarded a fellowship for academic year 1987-1988 to pursue a research project the nature of which is determined by the grantor, University W. C must submit a paper to W that describes the research results. The paper does not fulfill any course requirements. Under the terms of the grant, W may publish C's results, or otherwise use the results of C's research. C is treated as performing services for W. Thus, C's fellowship from W represents payment for services and must be included in C's gross income as wages.

Case Law

There is extensive case law involving application of § 117 in cases where amounts are paid in connection with research activities. The courts have found the following facts and circumstances relevant in determining whether such payments represent compensation for services.

- Whether the services of the researcher were directly related to the fulfillment of a contractual commitment under a specifically sponsored project? Zolnay v. Commissioner, 49 T.C. 389 (1968); Littman v. Commissioner, 42 T.C. 503 (1964); Fulton v. Commissioner, T.C. Memo 1979-265.

- Whether the work performed by the fellow was materially different from the work of other research associates who work in the laboratory. Woodfin v. Commissioner, T.C. Memo 1972-49.
- Whether the researcher had a past employment relationship with a provider of research funds, or was expected to be employed by the provider of any research funds. Bingler; Harper v. Commissioner, T.C. Memo 1972-106.
- Remuneration paid to the fellow relative to remuneration paid to other non-fellows performing similar research services for the payor. Woodfin v. Commissioner, T.C. Memo 1972-49; Zolnay.
- Hours worked, and whether hours worked varies depending upon workload. Woodfin; Zolnay; 49 T.C. 397-98.
- The amount of clinical services performed, and whether any clinical services were directly related to the research project. Biebersdorf v. Commissioner, 60 T.C. 114 (1973); Kammerer v. Commissioner, 35 T.C. Memo 1976-11.
- Whether the results of research must be turned over to the grantor. Langley v. Commissioner, T.C. Memo 1982-460; and whether rights to intellectual property are real and not merely remote and speculative. Faloona v. Commissioner, T.C. Memo 1975-40; Krupin v. United States, 439 F. Supp. 440 (E.D. Mo. 1977).
- The nature and extent of progress reports. Littman.
- Participation in retirement and health benefit plans. Zolnay.

Service Rulings

Rev. Rul. 73-564, 1973-2 C.B. 28, ruled that a research grant received by a college professor was not excludable under § 117 as a fellowship grant. In reaching this conclusion, the ruling identifies the following as relevant facts and circumstances: (1) the grant was contingent upon the taxpayer remaining a researcher; (2) the taxpayer's past experience was a significant factor in receiving the grant; (3) the grantor approved the proposed research; and (4) the grantor reserved rights to patents. "In particular, the reservation of rights in patents and inventions does not further an educational purpose with respect to an individual grantee and thus contradicts any such claimed purpose." See also Rev. Ruls. 74-95, 1974-1 C.B. 39 (amounts received were primarily for the benefit of the grantor where the grantor retained a nonexclusive license to the results of the research); 73-255, 1973-1 C.B. 54 ("Although there was no guarantee that the work product of the taxpayer would be of value to the hospital, the hospital had the right to that work product in case it was. Thus, the hospital extracted a quid pro quo from the taxpayer and the primary purpose of the grant was for the benefit of the hospital-grantor."); 72-263, 1972-1 C.B. 40 (amounts received were primarily for the benefit of the grantor where the amount of the grant was based on the recipient's level of experience, and grantor reserved the royalty-free use of copyrighted material and patent rights arising from research).

Background on the Taxability of NIH/NRSA Grants

Rev. Rul. 72-263 holds that a stipend paid by NIH to a physician for post-doctoral research training at a medical school is not excludable from gross income as a scholarship or fellowship grant. The Service found there to be a substantial quid pro quo because, among other reasons, the researcher was selected based on his potential for research, the amount of the stipend was based on his relevant experience, and the NIH reserved copyright and patent rights.

Rev. Rul. 77-319, 1977-2 C.B. 48, held that NRSA grants were compensatory and thus not excludable under § 117. The ruling found that the Government required a substantial quid pro quo for two reasons. First, the Government required "payback" to be made through post-fellowship service in the National Health Service Corp., or in a health maintenance organization in a medically underserved area. Second, the Government reserved the right to royalty-free use of any copyrighted materials produced as a result of the research performed during the award period.

At issue in Krupin v. United States, 439 F. Supp. 440 (E.D. Mo. 1977) (AOD 1978-86, 1978 AOD Lexis 163), was whether amounts received under an NIH research fellowship were excludable under § 117. The district court concluded that the fellowship amounts were excludable. In reaching this conclusion, the court noted the following facts: (1) the NIH is statutorily required to "collect and make available through publications and other appropriate means, information as to, and the practical application of, such research"; (2) the purpose of NIH fellowships is to promote training for research in health and health-related entities; (3) the NIH specifically provides that the grantee is not an employee of the NIH; (4) the recipient did not submit progress reports to the NIH; (5) the recipient was limited by the terms of the fellowship to spending no more than ten percent of his time teaching; (6) the recipient performed only a negligible amount of patient care; (7) the recipient's research had no practical application, and served only to benefit the academic community as a whole; (8) although the NIH reserved certain patent and copyright rights, no reserved rights had ever been enforced, or were ever expected to be enforced, and it was anticipated that no patentable or copyrightable work would be produced. The court found not to be probative the facts that the recipient competed for the position, and pursued the research activities on a full-time basis.

OBRA '81 modified the payback requirement referred to in Rev. Rul. 77-319. The payback requirement was eliminated for the first twelve months of awards. Further, the payback requirement became limited to the recipient engaging in health research or teaching, or any combination thereof, which is in accordance with the usual patterns of academic employment for the specified period. Service

was no longer required in the National Health Service Corp., or in a health maintenance organization in a medically underserved area.

The Conference Report to OBRA '81 provides:

> The conferees recognized that the jurisdiction of the permanent tax exemption for NRSAs remains with the House Ways and Means and Senate Finance Committees. However, as the purpose of the awards – a matter directly in the purview of the conferees – is at the heart of the dispute, the Conferees feel obligated to clarify their intent regarding the primary purpose of the NRSA program. National Research Service Awards are not made for the purposes of receiving services designated by the grantor. Rather the payback requirement offers benefits to the Nation from the participation of NRSA recipients in the research enterprise. As the Committee does not believe that the payback requirement is a quid pro quo, the tax exemption should be applicable.

H.R. Conf. Rep. 97-208, 804 (1981). Thus, Congress's basis for concluding that NRSA grants are noncompensatory was that the awards benefit the nation as a whole. Krupin and Faloona offered a similar rationale in concluding that NRSA grants are noncompensatory.

Following OBRA '81, the Service issued Rev. Rul. 83-93, 1983-1 C.B. 364, obsoleting Rev. Rul. 77-319. The only rationale provided by the ruling is that Rev. Rul. 77-319 was being obsoleted in light of OBRA '81. Thus, The Service has no published position on whether NRSA grants in their current form are noncompensatory. However, the Service's administrative position is that NRSA grants are noncompensatory within the meaning of § 117(c).

The amounts that are the subject of the present refund claim were not derived from NRSA grants. However, the authorities dealing with NRSA and NIH grants are instructive in identifying the facts and circumstances relevant in determining whether the grants at issue were substantially similar to NRSA fellowship grants, and whether the non-NRSA fellowship grants were compensatory. To the extent the grants were distinguishable from NRSA fellowship grants in ways that show a benefit to the grantor or to another person (such as a provider of research funding), the grants may have been compensatory within the meaning of § 117(c). For example, if rights to intellectual property benefited the grantor, or another person, and not merely the scientific community as whole, the grants may have been compensatory. In addition, if clinical services, or other service not directly connected to research training, were required, the grants may have been compensatory.

Based on the relevant facts and circumstances discussed in the above authorities, the following provides advice for factual development in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The following suggestions are organized to help you understand the purpose of the questions asked and information requested. The bracketed material is intended to explain the purpose of the question or request for information.

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This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-6040 if you have any further questions.

Attachments (3):
College's private letter ruling request submission
Private Letter Ruling 200013026
NRSA Guidelines