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District Director

Taxpayer's Name

and Address:

Taxpayer's EIN:

Years Involved: T/Y/E:

Date of N.O. Conference:

LEGEND:

M =

ISSUES:

(1) Whether certain educational benefits provided by the Taxpayer are qualified scholarships excluded from gross income under section 117(a) of the Internal Revenue Code and whether the benefits are excluded from wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA) and income tax withholding.

(2) If the benefits are subject to employment taxes, whether the Taxpayer is entitled to relief under section 7805(b) of the Code.

FACTS:

The Taxpayer is a voluntary employees' beneficiary

association (VEBA) under section 501(c)(9) and was created in 1945 under a collective bargaining agreement with the employers in a particular industry. Employers contribute a specified percentage of gross payroll, on a monthly basis, to fund the VEBA. VEBA funds are used to pay life, sickness, accident, and other benefits to members. Members of the VEBA are the bargaining-unit employees (and their dependents) of the participating employers.

In 1974, the Taxpayer created the M scholarship program to provide scholarships to the children of its employee-members for undergraduate studies. The program is an activity of the VEBA and not a separate fund or organization. All applicants receive scholarships.[1] However, applicants are ranked in order of need, and the amount of the individual awards varies greatly depending on need. Some applicants receive an additional award, based on grades. Except in certain layoff situations, if an employee's employment, and therefore participation in the VEBA, terminates, the scholarship grant ceases. Tuition paid for the current term does not have to be refunded, but any remaining grant is canceled and the student is not eligible to apply for further grants.

The Taxpayer has requested that the holding of this memorandum, if adverse, be applied without retroactive effect. The Taxpayer provided information showing that, in 1979, a technical advice memorandum (TAM) was requested by its local district director on the issue of whether scholarships are a proper benefit to be provided by a VEBA. Regulations issued in 1980 under section 501(c)(9) resolved that issue in the Taxpayer's favor, and the Taxpayer later received a favorable determination from the IRS that it continued to qualify as a VEBA and the benefits under the M scholarship program would not jeopardize its status. The issue of whether the Taxpayer had any FICA or withholding obligation with respect to the scholarship benefits was never raised. The Taxpayer considered the favorable determination to be an indication that its procedures, which treated the benefits as nontaxable, were approved by the IRS. Only when the Taxpayer's current General Counsel started in 1996 was the taxation of the scholarship benefits questioned.

APPLICABLE LAW AND ANALYSIS:

Under section 61 of the Code, gross income means all income

[1] A small number of applicants did not receive scholarships in the years at issue, primarily because they failed to complete the application process.

from whatever source derived, unless excluded by applicable law. Section 61(a)(1) specifies that gross income includes compensation for services, including fringe benefits.

Section 1.61-21 of the regulations deals with the taxation of fringe benefits. Under section 1.61-21(a)(3) and (4), a fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation for services, and a taxable fringe benefit is included in the income of the person performing the services. However, section 1.61-21(a)(2) provides that, to the extent that a particular fringe benefit is specifically excluded from gross income under another section of the Code, that section will govern the treatment of the fringe benefit.

Section 117 of the Code provides an exclusion for certain scholarships and fellowship grants. Section 117(a) provides that gross income does not include any amount received as a scholarship or fellowship grant by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii) (describing, generally, a school), to the extent such amount is used for qualified tuition and related expenses.

Generally, amounts paid to or for the benefit of employees are compensatory in nature and includible in gross income as wages. Where educational grants are made available to or for the benefit of employees on a preferential basis, such preferential grants suggest an intent to provide additional compensation or an employment incentive. Bingler v. Johnson, 394 U.S. 741 (1969), 1969-2 C.B. 17. See also Ohio Teamsters Educational and Safety Trust Fund v. Commissioner, 77 T.C. 189 (1981), aff'd 692 F.2d 432 (6th Cir. 1982); Newspaper Guild of New York v. Commissioner, T.C.Memo. 1989-314, 57 T.C.M. 812; and Rev. Rul. 85-175, 1985-2 C.B. 276. These suggestions are not dispelled simply because the grantor is an independent third party, such as a private foundation or a VEBA.

To be accorded scholarship treatment under section 117, educational grants awarded in an employment context must generally be shown to fall outside the pattern of employment.[2]

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[2] We have also considered the application of other Code provisions under which employer-provided educational benefits can be excluded from income, such as section 127 (educational assistance programs) or 132(a)(3) (working condition fringe), but none applies.

Rev. Proc. 76-47, 1976-2 C.B. 670, provides guidelines for determining whether grants made by private foundations under employer-related scholarship programs to employees and/or children of employees will be treated as scholarships or fellowship grants subject to the provisions of section 117(a) of the Code. Rev. Proc. 76-47 by its terms applies only to scholarships awarded by private foundations. However, the guidelines set forth in the revenue procedure serve to illustrate the type of analysis involved in determining whether grants awarded under employer-related programs fall outside the pattern of employment. For example, section 3 of Rev. Proc. 76-47 provides that the availability of grants to employees or their children under the program must be controlled and limited by substantial nonemployment related factors to such an extent that the preferential treatment derived from employment does not continue to be of any significance beyond an initial qualifier.

Under Rev. Proc. 76-47, educational grants will be considered to fall outside the pattern of employment and subject to the provisions of section 117(a) only if certain conditions and at least one of two percentage tests in the revenue procedure are satisfied. For example, under section 4.05 of Rev. Proc. 76-47, a scholarship grant may not be terminated because the recipient or the recipient’s parent terminates employment with the employer subsequent to the awarding of the grant regardless of the reason for the termination of employment. In addition, if a grant is awarded for one academic year and the recipient must reapply for a grant for a subsequent year, the recipient may not be considered ineligible for a further grant simply because that individual or the individual’s parent is no longer employed by the employer.

Under the percentage tests, the number of grants awarded under the program to children of employees must not exceed 25 percent of the children who (i) were eligible for such grants, (ii) were applicants for the grants, and (iii) were considered by the selection committee making such grants, or 10 percent of the number of employees' children who can be shown to be eligible for grants (whether or not they submitted an application) in that year.

If a taxpayer meets all of the conditions set forth in the revenue procedure but is unable to show that it meets one of the percentage tests, the program's grants can still be subject to the provisions of section 117(a) if all the relevant facts and circumstances show that the purpose of the grant is to educate grant recipients rather than provide extra compensation. However, the facts and circumstances are considered in the context of the probability that a grant will be available to any eligible applicant.

In the present case, the Taxpayer's awards program falls significantly short of the facts and circumstances needed to evidence that the program falls outside the pattern of employment. In particular, awards are made to all applicants, an outcome that does not begin to satisfy either of the percentage tests in Rev. Proc. 76-47. Additionally, the program does not pass the substitute facts and circumstances analysis because there is great probability that a grant will be available to any particular applicant.[3] Furthermore, the program does not satisfy the requirement that a grant not be terminated simply because the employee terminates employment. The scholarships are therefore not excluded from gross income under section 117(a).[4]

Sections 3101, 3102(a), and 3111 of the Code provide that every employer making payment of wages is required to withhold and pay FICA taxes. Section 3301 imposes the FUTA tax on an employer that pays wages. Similarly, section 3402(a) provides that every employer making payment of wages is required to deduct and withhold federal income tax from such amounts paid to its employees.

Section 3401(d) of the Code provides that, for purposes of income tax withholding, the term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of that person, except that if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term “employer” means the person having control of the payment of wages. For example, section 31.3401(d)-1(f) of the Employment Tax Regulations provides that, where wages are paid by a trust and the person for whom the services were performed has no legal control over the payment of such wages, the trust is the “employer.”

Neither the FICA nor FUTA provisions contain a definition of employer similar to the definition contained in section 3401(d) of the Code. However, Otte v. United States, 419 U.S. 43 (1974), 1975-1 C.B. 329, holds that a person who is an employer under

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[3] We have considered the facts and circumstances analysis even though the Taxpayer’s program does not satisfy all of the other conditions under Rev. Proc. 76-47.

[4] Because these requirements are not met, it has not been necessary for us to analyze whether the program satisfies the other conditions for excludability.

section 3401(d)(1) for income tax withholding purposes is also an employer for purposes of FICA withholding under section 3102.

The Otte decision has been extended to provide that the person having control of the payment of wages is also an employer for purposes of the employer share of FICA under section 3111 and for purposes of FUTA, provided the person meets the requirements of section 3306(a)(1)(A), or (a)(3). In re Armadillo Corp., 410 F.Supp 407 (D. Col. 1976), aff'd, 561 F.2d 1382 (10th Cir. 1977), holds that the Otte rule applies to the employer's FICA tax and to FUTA as well. In re Laub Baking Co., 642 F2d 196 (6th Cir. 1981), and STA of Baltimore –ILA Container Royalty Fund v. United States, 621 F.Supp. 1567 (D.C.Md 1985), aff'd 804 F.2d 296 (4th Cir. 1986), reached similar conclusions.

In this case, the Taxpayer has the legal control of payment of the scholarships and is therefore the employer within the meaning of section 3401(d)(1). The Taxpayer is therefore responsible for complying with any employment tax requirements that apply to the scholarships.[5]

Section 3121(a) of the Code provides that, for purposes of FICA, the term "wages" means all remuneration for employment unless specifically excepted. Sections 3306(b) and 3401(a) contain similar definitions for purposes of FUTA and income tax withholding.

Section 3121(a)(20) of the Code provides that, for FICA purposes, the term "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 section 117 of the Code. Sections 3306(b)(16) and 3401(a)(19) provide similar exceptions from the definition of wages for purposes of FUTA and income tax withholding. See also sections 31.3121(a)-1T, 31.3306(b)-1T and 31.3401(a)-1T of the temporary Employment Tax Regulations.

The exclusion from wages found in sections 3121(a)(20), 3306(b)(16) and 3401(a)(19) of the Code is not triggered merely by an employer's assertion that it applies. If an employer seeks

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[5] We note that wages paid by the common law employer are taken into account in applying (1) the wage base under section 3121(a)(1), which applies for purposes of the OASDI portion of FICA (see sections 3101(a) and 3111(a)) and (2) the wage base under section 3306(b)(1), which applies for purposes of FUTA.

to rely on the exclusion, it is obligated, at a minimum, to have ascertained the applicable law and to have applied it to the particular facts. In this way, the existence of a reasonable belief for excluding the benefits is based on a reasoned judgment. See American Airlines, Inc. v. United States, 40 Fed. Cl. 712 (1998), applying an "objective standard" in determining whether it was reasonable for an employer to believe that a fringe benefit would be excludable from an employee's gross income. Although that decision was reversed in part and remanded on a factual issue, the application of the objective standard was affirmed by the Court of Appeals in American Airlines, Inc. v. United States, 204 F. 3rd 1103 (Fed. Cir. 2000).

The Taxpayer in the instant case has not met this burden. Accordingly, the scholarships were not excluded from wages under section 3121(a)(20), 3306(b)(16) or 3401(a)(19).

CONSIDERATION OF SECTION 7805(b) RELIEF:

Section 7805(b) of the Code provides that the Secretary may prescribe the extent, if any, to which any ruling or regulation relating to the internal revenue laws may be applied without retroactive effect.

Section 17.02 of Rev. Proc. 2000-2, 2000-1 I.R.B. 73, at 97, provides, in relevant part, that a holding in a TAM that is adverse to the taxpayer is applied retroactively unless the Associate Chief Counsel (Domestic) or (Employee Benefits and Exempt Organizations), as appropriate, exercises the discretionary authority under section 7805(b) to limit the retroactive effect of the holding.

Section 18.01 of Rev. Proc. 2000-2, at 98, indicates that the appropriate Associate Chief Counsel may prescribe the extent, if any, to which a TAM will be applied without retroactive effect. Section 18.03 of the revenue procedure discusses the general procedures for taxpayers requesting such relief.

Section 17.06 of Rev. Proc. 2000-2, at 98, lists the following factors to be considered in determining whether a holding in a TAM should be applied without retroactive effect:

(1) there has been no misstatement or omission of material facts;

(2) the facts at the time of the transaction are not materially different from the facts on which the letter ruling ("PLR") or TAM was based;

(3) there has been no change in the applicable law;

(4) [relates to previously issued PLRs; not applicable here];

(5) the taxpayer directly involved in the PLR or TAM acted in good faith in relying on the PLR or TAM, and the retroactive modification or revocation would be to the taxpayer's detriment.

The factors listed in Rev. Proc. 2000-2 in connection with section 7805(b) generally relate to the situation in which the Internal Revenue Service ("IRS") previously issued a favorable PLR or TAM to the taxpayer and the earlier PLR or TAM is being revoked by the current TAM. In this case, however, no PLR or TAM was issued to the Taxpayer on the issues presented here. The Taxpayer suggests that it relied on an IRS determination letter dealing with the effect of the scholarship program on its status under section 501(c)(9) as a basis for believing that the scholarship benefits were excludable under section 117.

The circumstances in this case do not justify limiting the effect of the current TAM under section 7805(b). The information provided shows that the income and employment tax treatment of the scholarship benefits was never raised in the process leading up to the issuance of the determination letter to the Taxpayer. In addition, under section 1.501(c)(9)-6(b) of the regulations, whether an income tax exclusion applies to benefits provided by a VEBA is determined by the statutory provision granting the exclusion and the regulations and rulings thereunder, not by the permissibility of the benefit paid. The example in section 1.501(c)(9)-6(b) states that the fact that educational benefits constitute "other benefits" does not of itself mean that such benefits are eligible for the exclusion of either section 117 or section 127 of the Code.

For these reasons, extension of section 7805(b) relief is not warranted in the present circumstances, and the holdings in this memorandum may be applied with retroactive effect.

CONCLUSIONS:

(1) The educational benefits paid by Taxpayer to children of employees/members under the M scholarship program are not qualified scholarships excludable from gross income under section 117(a) of the Code, but, rather, are wages for FICA, FUTA and income tax withholding purposes.

(2) Section 7805(b) does not apply to limit the retroactive effect of the previous conclusion.

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

-END-

Enclosures:
Copy of this memorandum
Copy for section 6110 purposes