

GROUP ON GRADUATE RESEARCH, EDUCATION AND TRAINING (GREAT) GROUP
2005 ANNUAL MEETING

Ft. Myers, Florida

October 15-17, 2005

Tax Issues in Graduate Education

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- I. Distinguishing Between a Fellowship and Compensation for Service Rendered
- A. Under section 117 of the Code, the tuition, fees, and books component of a scholarship or fellowship is excluded from the recipient's gross income. In addition, section 117(d) provides that qualified tuition waivers provided by a university to its employees are also excludable, provided that the waiver is for undergraduate education. Section 117(d), however, allows an exclusion for tuition waivers granted to graduate TAs and RAs. The non-tuition/fees/books part of the scholarship or fellowship, however, is taxable to the recipient. Importantly, it is treated as a taxable scholarship/fellowship, not as a taxable wage payment.
- B. The fact that a grant may be denominated a "fellowship," or the payment called a "stipend" instead of a wage, does not mean that the IRS will necessarily treat the payment as a fellowship for tax purposes. Instead, the IRS and the courts look to the substance of the relationship between the school and the individual to determine whether the grant will be treated as a fellowship or a wage
- C. In the research area, the factors that the IRS and the courts use to distinguish a fellowship from compensation for services rendered are as follows:
1. Whether the individual's services are directly related to the fulfillment of a contractual commitment of the university.
 2. Whether the individual's services are subject to supervision, are geared to planned time schedules, and require progress reports.
 3. Whether the individual is required to devote full-time to the project or work a certain number of hours a week.
 4. Whether the grant is relatively small (indicative of a fellowship) or relatively large (indicative of a wage).

5. The manner in which the university treats the individual; that is, are the amounts paid reported as wages or as a fellowship? Did the person receive faculty privileges? Is the person eligible for health and other employee benefits?

D. Treatment of NRSA Grantees

1. At one time, the IRS held that grants made by the NIH to its NRSA grantees represented taxable wage income because the grantees were required to perform significant post-grant services that benefited NIH. Thus, the grants were treated as taxable wages and subject to FICA tax.
2. In 1981, however, the IRS reversed its position and held that NRSA grants qualify as bona fide “fellowships.” Therefore, while the stipends paid to these grantees are taxable fellowships because they do not qualify for the section 117 tuition/fees/books exclusion, they are not taxable wages. Because the FICA tax is imposed only on wages, the NRSA grant stipends are not subject to FICA tax.
3. In addition, the IRS has issued several rulings holding that stipends paid under grant programs that are modeled on the NRSA program are also fellowship payments, even though the grant program is not, technically speaking, a NRSA program. Thus, these stipend payments are likewise not subject to FICA tax.

II. The Student FICA Exception

- A. As noted, the FICA tax is imposed on wages only. If the payment made to the individual is not a wage, it is not subject to FICA tax, even though the payment may represent taxable income to the individual, e.g., a taxable fellowship.
- B. For those employees of a college or university who are also students of the institution, the Code carves out an exception from the FICA tax. This is the so-called “student FICA exception.”
- C. The IRS has always taken the position that the student FICA exception does not apply to all student-employees, but only where the educational aspects of the student-employee’s relationship to the school predominates over his or her employment relationship.
- D. For example, the full-time undergraduate student who works 10 hours a week in the library is eligible for the student FICA exception, but the full-time university controller who is enrolled in a 3-credit art history class is not.
- E. In early 2005, the IRS issued final regulations relating to the student FICA exception. It also published a Revenue Procedure that set forth certain “safe harbor” rules that, if met, will assure that the student-employee is eligible for the exception.

- F. If a student-employee meets the safe harbor test under the Revenue Procedure, he or she is automatically exempt from FICA tax. If, however, the safe harbor test is not met, the individual can still look to the overall facts and circumstances test in the regulations to determine eligibility for the FICA tax exemption.
- G. Unfortunately, the Revenue Procedure, in describing which student-employees could use the safe harbor test and which could not, included the following statement:

The standards contained in this revenue procedure do not apply to employees who are postdoctoral students, postdoctoral fellows, medical residents, or medical interns because the services performed by these employees cannot be assumed to be incident to and for the purpose of pursuing a course of study. The employment activities of these individuals overlap with the activities arguably comprising a course of study, and thus it is not appropriate to apply the standards of this revenue procedure to these individuals.

III. The Science Magazine Article

- A. Some college and university officials interpreted the underscored language in the Revenue Procedure as meaning that postdoctoral students and fellows, including NRSA grantees, are no longer eligible for the student FICA exception.
- B. This conclusion was reflected in an article that appeared on April 1, 2005, in Next Wave, an online publication of Science Magazine, as well in a subsequent April 8 article in the magazine itself.
- C. The problem with this conclusion, however, is that the statement clearly says that only “employees” who are postdoctoral fellows cannot use the safe harbor test. Thus, it presumes that the postdoc has already been determined to be an employee. But these new rules did not impact in any way the IRS long-standing position that NRSA grantees are not employees. Therefore, the quoted statement is irrelevant to NRSA postdoc grantees because they are not employees in the first place.
- D. The student FICA exception only comes into play if the payment made to the individual is a wage that is subject to the student FICA exception in the first place. The IRS has not changed its position that NRSA grants (and grants made under programs modeled after the NRSA program) are bona fide fellowships, not wages.
- E. Therefore, the conclusion reached in the Science Magazine was wrong, and after many discussions with tax professionals and the IRS, the editors realized their mistake and published a correction on June 2.
- F. Attached are copies of the April 1 and April 8 articles and the June 2 correction.