Smith v. Commissioner, 61 T. C. 288 (1973)

Payments to students under a cooperative education program are not excludable from gross income as scholarships if primarily for the benefit of the employer.

Summary

In Smith v. Commissioner, the court ruled that payments received by a student under General Motors' cooperative education program with General Motors Institute (GMI) were taxable income, not scholarships. Michael Smith, a GMI student, received payments from the Oldsmobile Division of GM while working at GM during alternating periods of his study. The key issue was whether these payments were scholarships under IRC Section 117. The court found that the payments were primarily for GM's benefit, as the program was designed to train future employees, and thus not excludable from gross income. This case highlights the distinction between scholarships and compensation for services under cooperative education arrangements.

Facts

Michael Smith enrolled in the General Motors Institute (GMI), an accredited undergraduate college of engineering and management, in 1965. GMI was incorporated as a non-profit but operated under the financial and administrative control of General Motors (GM). Smith's admission to GMI required sponsorship by a GM unit, in his case, the Oldsmobile Division. The cooperative program alternated 6-week periods of study at GMI with work at the sponsoring GM unit. During work periods, Smith was paid at standard hourly rates established by GM for GMI students. In 1967, he received $3,504. 02 from Oldsmobile, which he reported as a scholarship and excluded from his gross income. The IRS determined this amount was compensation and thus taxable.

Procedural History

The IRS determined a deficiency in Smith's 1967 income tax due to the inclusion of the payments received from GM in his gross income. Smith petitioned the Tax Court to challenge this determination, arguing that the payments were scholarships excludable under IRC Section 117.

Issue(s)

1. Whether payments received by Smith from the Oldsmobile Division of General Motors during his work periods at GM are excludable from gross income as scholarships under IRC Section 117.

Holding

1. No, because the payments were primarily for the benefit of General Motors, not

as scholarships for Smith’s education.

Court’s Reasoning

The court applied IRC Section 117 and the related regulations, particularly Section 1. 117-4(c)(2), which excludes from scholarships any payments made primarily for the benefit of the grantor. The court found that GMI and the cooperative program were structured to train engineers and administrators specifically for GM’s needs. The fact that 90% of GMI graduates worked for GM post-graduation underscored this primary benefit to GM. The court also cited Bingler v. Johnson, which upheld the regulations, and Lawrence A. Ehrhart, where similar payments were deemed compensation rather than scholarships. The court concluded that the payments to Smith were for services rendered under GM’s direction and supervision, primarily benefiting GM, and thus not excludable as scholarships under Section 117.

Practical Implications

This decision clarifies that payments in cooperative education programs cannot be treated as scholarships if they primarily benefit the employer. Legal practitioners should advise clients involved in such programs to treat these payments as taxable income. This ruling impacts how universities and corporations structure cooperative education programs to ensure compliance with tax laws. Businesses must carefully design their educational sponsorships to avoid unintended tax consequences for students. Subsequent cases like Ehrhart have followed this precedent, emphasizing the importance of the primary benefit test in distinguishing scholarships from compensation.

