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TAXATION OF PAYMENTS TO MEDICAL
INTERNS AND RESIDENTS

Hembree v. United States,
464 F.2d 1262 (4th Cir. 1972)

Hembree, after receiving his doctor of medicine degree in 1966, served his internship and pursued his residency on a rotation schedule among three hospitals.¹ These hospitals provided him with stipends from which they withheld federal income taxes. Hembree sued for a refund, claiming the stipends qualified as fellowship grants excludable from gross income.² The district court granted the refund only as to the stipend from one of the hospitals, on the theory that this hospital's primary purpose was training doctors and, therefore, payments made by it to interns and residents were excludable.³ On appeal, the Court of Appeals for the Fourth Circuit *held*: all the stipends represented compensation for services performed and, therefore, could not be excluded as a fellowship grant.⁴

Under the 1939 Internal Revenue Code scholarship and fellowship funds were excludable from the recipient's gross income only if they qualified as gifts.⁵ In the 1954 Code, Congress changed the treat-

1. The rotation program involved three hospitals: The Medical College of South Carolina Hospital, The Veterans Administration Hospital, and the Charleston County Hospital. Fringe benefits included uniforms, laundry services, group health insurance and two weeks leave after a year of service. *Hembree v. United States*, 71-2 U.S. Tax Cas. 87,518 (D.S.C. 1971).

2. INT. REV. CODE OF 1954, § 117(a):

(a) General Rule—in the case of an individual, gross income does not include . . .

(1) any amount received . . .

(A) as a scholarship at an educational institution . . . or,

(B) as a fellowship grant

3. The district court decision was based on the determination that the primary purpose of the Medical College of South Carolina Hospital was training doctors. In support of this conclusion the court looked to the charter of the hospital, as well as to the legislative act which authorized the acquisition of the land for the hospital. Both the charter and the act emphasized that the hospital was to be a teaching hospital. *See Hembree v. United States*, 71-2 U.S. Tax Cas. 87,518 (D.S.C. 1971).

4. *Hembree v. United States*, 464 F.2d 1262 (4th Cir. 1972).

5. INT. REV. CODE OF 1939, ch. 1, § 22(b)(3):

(b) Exclusions from Gross Income—the following items shall not be included in gross income and shall be exempt from taxation under this chapter:

ment of scholarships and fellowships⁶ and provided a separate section to cover those funds.⁷ The 1954 Code did not, however, specify what funds were included under the section. To fill this definitional void, the Treasury Department promulgated regulations.⁸

(3) Gifts, Bequests, and Devises—The value of property acquired by gift, bequest, devise, or inheritance. . . .

A 1951 revenue ruling stated that, if a scholarship or fellowship furthered the training and education of an individual, it could be considered a gift. I.T. 4056, 1951-2 CUM. BULL. 8 (declared obsolete by Rev. Rul. 69-43, 1969-1 CUM. BULL. 310). Although the word "gift" is a generic term, it refers specifically to the receipt of financial advantages gratuitously given, or to the voluntary transfer of property without consideration as defined in § 22(b)(3) of the 1939 Code. See 47 C.J.S. *Internal Revenue* § 112 (1946). For cases applying the gift test under the 1939 Code, see note 15 *infra*.

6. See S. REP. NO. 1622, 83d Cong., 2d Sess. 17 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 16 (1954). Both reports emphasize a desire to eliminate the confusion and case-by-case determinations that had resulted from placing scholarships and fellowships under the gift section. For a pre-1954 case, see *Banks v. Commissioner*, 17 T.C. 1386 (1952).

7. INT. REV. CODE OF 1954, § 117(a). For a general discussion of the effect of the adoption of § 117, see Chommie, *Services Rendered, Not Donative Intent, Governs Exemption of Study Grants*, 4 J. TAX. 375 (1956); Gordon, *Scholarships and Fellowship Grants as Income: A Search for Treasury Policy*, 1960 WASH. U.L.Q. 144.

8. Treas. Reg. § 1.117-3(c) (1956):

- (c) Fellowship grants. A fellowship grant generally means an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research

Treas. Reg. § 1.117-4 (1956):

The following payments or allowances shall not be considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117:

- (c) Amounts paid as compensation for services or primarily for the benefit of the grantor.

- (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 benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

Initially, courts utilized the definition of a fellowship contained in section 1.117-4(c)(2) of the Treasury Regulations to determine whether a payment qualified for exclusion, developing what became known as the primary purpose test.⁹ In *Reese v. Commissioner* the court stated:

The primary purpose test requires a determination of the *raison d'être* of the payment. . . . Obviously such a determination depends upon whose purpose is adopted as the standard of measurement. Often more than a single purpose is involved.¹⁰

One variation of the primary purpose test emphasized the primary operational purpose of the institution making the payment rather than the purpose of the particular payment,¹¹ and it was this variation which the lower court applied to the payments made to Hembree.

In *Bingler v. Johnson*,¹² the first Supreme Court decision interpreting Treasury Regulation 1.117-4(c), the Court shifted the emphasis from section 1.117-4(c)(2), the section from which the primary purpose test was extracted, to section 1.117-4(c)(1).¹³ The

For the source of the Treasury Department's authority to promulgate regulations, see INT. REV. CODE OF 1954, § 7805(a).

9. In *Ussery v. United States*, 296 F.2d 582 (5th Cir. 1961), an employee of a state welfare department was given an educational leave of absence to obtain a master's degree in sociology. The employee received her previous salary, payments for educational expenses, and fringe benefits. The leave of absence stipulated that the employee work for the department twelve months for every year of schooling and that the purpose of the grant was to improve the efficiency of the department. The court held that the payments were not excludable since they were primarily for the benefit of the grantor. In *Reese v. Commissioner*, 45 T.C. 407 (1966), *aff'd per curiam*, 373 F.2d 742 (4th Cir. 1967), taxpayer was a candidate for a master of arts degree in teaching and was required to teach for one semester with full classroom responsibility. The court held that she received income. See also *Reiffen v. United States*, 372 F.2d 883 (Ct. Cl. 1967).

10. *Reese v. Commissioner*, 45 T.C. 407, 410-11 (1966), *aff'd per curiam*, 373 F.2d 742 (4th Cir. 1967).

11. See *Wroblewski v. Bingler*, 161 F. Supp. 901 (W.D. Pa. 1958). In finding the payments excludable, the court concentrated its attention on the overall purpose and function of the institution: "The essential business of the Institution, however, is not the care and treatment of patients." *Id.* at 904.

12. 394 U.S. 741 (1969). In this case, Westinghouse granted three employees an educational leave of absence so that they could attend class full time to obtain their doctorates. The employees received from seventy to ninety percent of their salaries, retained seniority status and employee benefits, and agreed to return to Westinghouse for two additional years after their leaves of absence.

13. The shift in emphasis is important because Treas. Reg. § 1.117-4(c)(1) requires a determination whether "such amount represents the compensation for past, present or future employment services" and contains none of the language of Treas.

question presented was whether payments to employees on an educational leave of absence qualified as fellowships. In deciding that the payments did not qualify, the Court stated:

The thrust of the provision [Treas. Reg. § 1.117-4(c)(1)] dealing with compensation is that bargained-for payments, given only as a *quo* in return for the *quid* of services rendered—whether past, present, or future—should not be excludable from income as “scholarship” funds.¹⁴

The essential issue of this test is whether payment is given in return for services. Courts utilized the same test under the 1939 Code to determine whether such a payment was a gift and thus an excludable fellowship.¹⁵ The *quid pro quo* test has been applied in most medical

Reg. § 1.117-4(c)(2), which requires a determination of the primary purpose of the grantor institution in making the grant. See note 8 *supra*.

14. 394 U.S. at 757. The Court accepted the government’s argument that Treas. Reg. § 1.117-4(c)(2) (1956) was merely an adjunct to Treas. Reg. § 1.117-4(c)(1) (1956). *Id.* at 758 n.32. Since § 1.117-4(c)(2) was the source of the primary purpose test, the Court implied that it was only of secondary importance to the *quid pro quo* test. The *quid pro quo* test is identical to the “indicia of compensation” test, developed by some lower federal courts, which focuses on whether the characteristics of the payments were those typically associated with compensation. See *Stewart v. United States*, 363 F.2d 355 (6th Cir. 1966); *Woddail v. Commissioner*, 321 F.2d 721 (10th Cir. 1963); *Evans v. Commissioner*, 34 T.C. 720 (1960); 31 OHIO ST. L. REV. 186, 191-92 (1970). *Woddail* and *Evans* actually contained language referring to both the primary purpose and indicia of compensation test. See, e.g., *Woddail v. Commissioner*, 321 F.2d 721, 724 (10th Cir. 1963). Generally, regardless of the test employed, courts held that if the grantor was not the employer of the grantee, payments could be excluded. If the grantee was not fully trained, his case for exclusion was also good. This latter generalization could not be applied to interns and residents, however. See 1A MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.42, at 153 (rev. vol. 1969).

15. For the basic statement of the gift test, see *Robertson v. United States*, 343 U.S. 711, 713-14 (1952): “The discharge of legal obligations—the payment for services rendered or consideration paid pursuant to a contract—is in no sense a gift.” For a case applying this test to scholarships and fellowships, see *George Winchester Stone, Jr.*, 23 T.C. 254 (1954). The majority held that the “fellowship award was not paid pursuant to a contract and was not a payment for services. It was a gift” *Id.* at 265. The dissent argued that “the performance of the services or the doing of the work agreed upon was a prerequisite, or the *quid pro quo*, for the money received.” *Id.* Though the crucial issue in the gift test was whether the payments were compensation for services, the majority also spoke of the intent of the payor in determining the issue. *Id.* at 259. For other cases applying the gift test to scholarships, see *Ti Li Loo*, 22 T.C. 220 (1954); *Ephraim Banks & Libby K. Banks*, 17 T.C. 1386 (1952). See also *Tabac, Scholarship and Fellowship Grants: An Administration Merry-Go-Round*, 46 TAXES 485, 493 (1968); 19 BUFF. L. REV. 441, 447 (1970).

Though the branch of the primary purpose test which emphasizes the *raison d'être* of the payment might permit exclusion of payments which have some characteristics of compensation by attempting to examine the subjective purpose of the payor, courts

intern and resident cases since *Bingler*, and courts have generally held that the payments represent compensation for services.¹⁶

In *Hembree*, the district court considered the primary purpose of each hospital's operation as the valid criterion for determining exclusion,¹⁷ and concluded the payments were excludable. The appellate court, however, held the lower court's interpretation of the primary purpose test erroneous in that the interpretation ignored the primary purpose of the payment to the taxpayer. Considering only this purpose, the court found that the teaching hospital paid Hembree because he had provided services which were of benefit to it.¹⁸ The court stated that an even more compelling reason for its decision was that under the *quid pro quo* test the payments represented compensation since Hembree had performed valuable employment services and all the indicia of an employer-employee relationship existed.¹⁹

utilizing this test have denied exclusion if the payments were made by the employer of the taxpayer. See *Littman v. Commissioner*, 42 T.C. 503 (1964); *Sweet v. Commissioner*, 32 T.C. 1117 (1959); 19 BUFF. L. REV. 441, 447 (1970). But see *Leathers v. United States*, CCH 1973 STAND. FED. TAX REP. U.S. TAX CAS. (73-1, at 80,116) ¶ 9139 (8th Cir. December 20, 1972).

16. *Rundell v. Commissioner*, 455 F.2d 639 (5th Cir. 1972); *Wertzberger v. United States*, 441 F.2d 1166 (8th Cir. 1971). In *Tobin v. United States*, 323 F. Supp. 239 (S.D. Tex. 1971), the court looked upon all payments given to Tobin as compensation even though he spent three months in the program with virtually no patient responsibility. In *Kwass v. United States*, 319 F. Supp. 186, 188 (E.D. Mich. 1970), the court stated:

In the case at bar there was indeed the requisite *quid pro quo* from the resident doctors. For the University Hospital was receiving substantial services from them in exchange for the salaries paid.

In *Quast v. United States*, 428 F.2d 750 (8th Cir. 1970), a career medical resident was paid more than the usual resident, and he contracted to remain at the hospital longer than the usual resident. His contract contained the word "employment" several times, and he held an Associate Grade classification under the Veterans Administration. He amended his complaint, stating that the part of his salary which a regular resident received should be excluded under section 117. The court rejected this theory. Cf. *Shuff v. United States*, 331 F. Supp. 807 (W.D. Va. 1971). Petitioner was a resident in hospital administration; he was not a doctor. Since the stated purpose of the program was strictly educational and since residents in the program primarily observed and performed little, if any, service for the hospital, the court found that the payment did not represent compensation for services.

17. *Hembree v. United States*, 71-2 U.S. Tax Cas. 87,518 (D.S.C. 1971).

18. *Hembree v. United States*, 464 F.2d 1262 (4th Cir. 1972).

19. *Id.* at 1264. Courts which have discussed both the primary purpose test and the indicia of compensation (*quid pro quo*) test have failed to make clear the relationship between the two. See *Hembree v. United States*, 464 F.2d 1262 (4th Cir. 1972); *Woddail v. Commissioner*, 321 F.2d 721 (10th Cir. 1963); *Evans v. Commissioner*, 34 T.C. 720 (1960).

Hembree leaves little doubt that the Fourth Circuit Court of Appeals will utilize the *quid pro quo* test in determining whether payments to interns and residents should be excluded under section 117. By adopting the *quid pro quo* test, the Court of Appeals for the Fourth Circuit has determined that it will look no further into the purposes of the payment once an employer-employee relationship has been established. Such a mechanical application of the *quid pro quo* or primary purpose tests renders the actual motivation of the payor irrelevant. Consequently, residents and interns are effectively precluded from qualifying for exclusion of payments from income under section 117. On the other hand, a recent decision from the Court of Appeals for the Eighth Circuit, in allowing payments to residents to be excluded from income, allowed consideration by a jury of further evidence on the actual motivation of the payor hospital.²⁰

Congress attempted to delete the gift test by enacting section 117.²¹ However, as long as courts apply Treasury Regulation 1.117-4(c) in a mechanical fashion, whether it be in the guise of the primary purpose of the payment test or the *quid pro quo* test, this congressional intent will not be realized. The resultant gift tests will persist, denying fellowship exclusions to interns and residents even though the services for which they are paid are an essential part of the training required for the completion of their medical education.²²

20. *Leathers v. United States*, CCH 1973 STAND. FED. TAX REP., U.S. TAX CAS. (73-1, at 80,116) ¶ 9139 (8th Cir. December 20, 1972). Significantly, the court of appeals refused to reverse the district court in admitting evidence on the educational purpose of the payor institution. But while the district court in *Hembree* used the evidence of the purpose of the institution's existence as a conclusive test on exclusion, the district court in *Leathers* allowed the evidence as merely further indication of the actual motivation of the payor. See *id.* at 80,121 n.1 (Lay, J., concurring). But see *id.* at 80,116, 80,125 (Bright, J., dissenting) (emphasis original), citing *Hembree v. United States*, 464 F.2d 1262 (4th Cir. 1972):

I am satisfied that where an *employment relationship* exists between an educational institution and a student, the motives of each do not become crucial in determining the tax status of the payments made by the school.

21. See S. REP. NO. 1622, 83d Cong., 2d Sess. 17 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 16 (1954).

22. Several commentators have pointed out that the primary purpose test is not found in the 1954 Code and that legislative history does not warrant its adoption. See 1 A. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.42, at 148 (rev. vol. 1969); Tabac, *Scholarship and Fellowship Grants: An Administrative Merry-Go-Round*, 46 TAXES 485, 493 (1968); 19 BUFF. L. REV. 441, 447 (1970). In Brief for Appellee at 18, *Hembree v. United States*, 464 F.2d 1262 (4th Cir. 1972), it is stated:

The distinguishing feature between the training of physicians and the training of historians and the like, is, of course, that medicine is an applied science,

which can only be learned by its application. It is doubtful that anyone would seriously contend that the trial and error method be employed in the training of physicians, or that a physician can obtain training solely from attendance of lectures and through reading textbooks. Obviously, that which is learned in the classroom must be applied and in the application thereof medical services necessarily are performed, but only incidentally to the primary purpose of training.