Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200452027**
Release Date: 12/24/2004
Index Number: 61.09-18, 117.02-04, 3121.01-00, 3306.02-00, 3401.01-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:4
PLR-147124-03

Date:

LEGEND:

Taxpayer =
State =
Nursing School =
Hospital =
date 1 =
date 2 =
date 3 =
date 4 =
date 5 =
date 6 =
date 7 =
date 8 =
u = $
v = $
w = $
x = $
y = $
z = $

Dear :

This is in reply to your request for a ruling dated , concerning the Taxpayer's participation in the Hospital's (the "Program") as discussed below.

FACTS

On date 1, the Hospital in conjunction with the Nursing School initiated the Program in order to assist students in overcoming the costs of pursuing a career in nursing. The

purpose of the Program was to address the imbalance between the demand for patient care and the inadequate supply of nurses. The Hospital also wished to attract and retain nurses to work in its low-income, inner-city environment. On date 2, the Taxpayer enrolled as a full-time student at the Nursing School.

The Taxpayer was offered an option to participate in the Program and receive loans from the Hospital to cover the cost of 2 years of tuition at the Nursing School. The loans could not be used for food, housing, or any other non-tuition expenses. The Taxpayer could either repay the loans in cash or seek loan forgiveness by making a commitment to work at the Hospital as a registered nurse for a period of 2 years after graduating from the Nursing School.

Pursuant to the Program, the Hospital promised to pay the Taxpayer's tuition in an amount not to exceed $u directly to the Nursing School. On date 3, the Hospital paid tuition in the amount of $w to the Nursing School. On date 4, the Hospital paid additional tuition in the amount of $x to the Nursing School. Each tuition payment was evidenced by the Taxpayer signing a Student Loan Nurse Agreement (the "Promissory Note").1

The Program sets forth conditions for loan forgiveness eligibility: the Taxpayer must pass a state licensing examination for nurses; must commence employment with the Hospital within 6 weeks after graduating from the Nursing School; must complete a 90 day probationary period; and must agree to accept employment as a registered nurse at the Hospital for a period of at least 2 years.

The Program further provides that there shall be no pro rata forgiveness of the amount loaned for any period of service for less than 2 years. Thus, if the Taxpayer fails to work for the Hospital as a registered nurse for a period of 2 years, the Taxpayer would be in default under the Program. In the event of default, the amount loaned by the Hospital to the Nursing School on the Taxpayer's behalf becomes immediately due in accordance with the terms of the Promissory Notes.

If the Taxpayer defaults under the Program, then the two Promissory Notes require that the Taxpayer repay the entire amount of tuition paid by the Hospital to the Nursing School on the Taxpayer's behalf. If the Taxpayer pays the full amount due within 10 calendar days after the Hospital mails written notice to the Taxpayer of the default, the Hospital will not charge any interest on the loan; otherwise, the Hospital will charge interest in the amount of 12 1/2 percent. The Promissory Notes also provide that the

1 The note signed on date 3 was amended on date 5 to reduce the principal amount owed by the Taxpayer to $y to reflect the Hospital's receipt, on the Taxpayer's behalf, of an outside scholarship grant in the amount of $z.

Hospital may recover collection costs, including attorneys' fees, in the event of the Taxpayer's non-payment.

Supplemental information furnished , states that for all tuition loans made to the Nursing School students after September 2004 the Promissory Notes will be amended to reflect an interest rate that is equal to or greater than the Applicable Federal Rate, as determined by the length of such loans. Interest will begin to accrue under the Promissory Notes as of the date each loan is made. If a new student defaults under the Program (and all principal and interest becomes immediately due and payable), the interest will continue to accrue until such time as the amount loaned by the Hospital is fully paid. However, if the student successfully completes 2 years of employment by the Hospital as a registered nurse, all principal and accrued interest will be forgiven.

The Taxpayer commenced employment with the Hospital on date 7, and will be eligible for loan forgiveness on date 8.

The Taxpayer makes the following representations: (1) the Taxpayer's participation in the Program was voluntary, (2) the Taxpayer's participation was not a condition of acceptance into the Nursing School, (3) the Taxpayer was not required to accept employment at the Hospital following graduation as a condition of acceptance into the Nursing School, and (4) the Taxpayer was never in possession of, nor in control over, the disposition of funds advanced on the Taxpayer's behalf from the Hospital to the Nursing School under the Program.

RULINGS REQUESTED

The Taxpayer requests the following rulings:

1. Amounts paid under the Program by the Hospital to the Nursing School on behalf of the Taxpayer do not constitute scholarships or grants under § 117 of the Internal Revenue Code; are not wages of, or other income to, the Taxpayer upon receipt of tuition payments by the Nursing School; and are considered loans for federal income tax purposes.

2. The loan amount paid under the Program by the Hospital to the Nursing School on behalf of the Taxpayer is not includible in the Taxpayer's gross income until the taxable year in which such loan amount is forgiven by the Hospital.

LAW AND ANALYSIS

Scholarship Issue

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).

Section 1.117-4(c) of the Income Tax Regulations provides that any amount paid or allowed to, or on behalf of an individual to enable that individual to pursue studies or research shall not be considered to be an amount received as a scholarship or fellowship grant, if such amount represents compensation for past, present, or future employment services or represents payment for services that are subject to the direction or supervision of the grantor, or if such studies or research are primarily for the benefit of the grantor.

The Supreme Court of the United States has described scholarships as relatively disinterested "no-strings" educational grants, with no requirements of any substantial quid pro quo from the recipients. Bingler v. Johnson, 394 U.S. 741 (l969). If a grant is made with a clear expectation that its recipient will render future services to the grantor, it is made primarily for the benefit of the grantor and is not a scholarship described in § 117.

In Rev. Rul. 76-122, 1976-1 C.B. 42, various Iowa health care organizations joined in developing a family nurse practitioner project in order to increase the availability of health care services in rural areas of the state. Practicing registered nurses were recruited and enrolled in clinical training at a university. The project paid for the nurses' tuition, room and board, books, transportation costs and a stipend of $1,000 per month while they practiced under a selected physician in a rural area. Because the nurses were expected to accept employment in the rural clinics after they completed the training, the revenue ruling determined that the grants were made primarily for the benefit of the grantor. According, the ruling concludes that the stipends (including tuition, room, board, and transportation costs) are not excludable from the nurses' gross incomes as scholarships under § 117, but are taxable compensation for services under § 61(a)(1).

In the Taxpayer's situation, the amounts advanced by the Hospital to the Nursing School to pay the Taxpayer's tuition were made with the expectation that the Taxpayer, following graduation, would work for the Hospital as a registered nurse for 2 years in its low-income, inner-city environment. Thus, while the amounts paid by the Hospital on behalf of the Taxpayer furthered the education of the Taxpayer, they were made primarily for the benefit of the Hospital. Accordingly, the amounts paid for the

Taxpayer's tuition at the Nursing School are not excludable from the Taxpayer's gross income as a scholarship or grant under § 117.

Loan Issue

Under §§§ 61(a)(1), (4) and (12) gross income includes income from compensation for services, interest, and discharge of indebtedness, respectively.

If the amounts advanced by the Hospital to the Nursing School to pay the Taxpayer's tuition are considered loans, then such amounts would not constitute "income" to the Taxpayer. Gross income includes all income from whatever source derived, encompassing all accessions to wealth, clearly realized, and over which the Taxpayer has complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (l955). However, the proceeds of a loan do not constitute income to a borrower because the benefit is offset by an obligation to repay. United States v. Rochelle, 384 F.2d 748, 751 (5th Cir. 1967), cert. denied, 390 U.S. 946 (l968). A true loan situation is indicated when there is a legally binding promissory note executed, with a legal obligation for repayment, whether in cash or through the performance of services. In Rosario v. Commissioner, T.C.M. 2002-70, a hospital advanced funds to a doctor to meet an income guarantee in exchange for the doctor's agreement to practice surgery in a rural area for at least 3 years and join the medical staff of the hospital. Under both a practice agreement and a promissory note, if the doctor failed to meet these conditions he was required to repay the amounts advanced plus interest. The Tax Court found that the negotiations between the hospital and doctor were at arm's length; the terms of the promissory note showed that at the time the payments were received the doctor intended to repay the amounts advanced, and the hospital intended to enforce payment. Accordingly, the court held that the amounts advanced to the doctor constituted a loan and were not taxable income.

Prearranged conditions of cancellation do not necessarily invalidate a loan for federal income tax purposes. In Rev. Rul. 73-256, 1973-1 C. B. 56 (as modified by Rev. Rul. 74-540, 1974-2 C. B. 38), a State advanced amounts to a medical student under the State's Medical Education Loan Scholarship Program. The purpose of the program was to increase the number of doctors in its rural areas. The State paid the student's tuition and other fees directly to the particular school selected by the recipient. The student and a board appointed to administer the program entered into an agreement, under which the student promised to repay the amounts advanced in five annual installments commencing one year after the completion of his medical education. Further, for each year that the recipient practiced medicine in a rural area of the State, the installment due that year was to be cancelled. The revenue ruling concluded that the amounts advanced were not excludible from gross income under § 117 as a scholarship, but

were loans that were includable in gross income under § 61 in each taxable year to the extent that repayment of a portion of the loan was no longer required.

In the Taxpayer's situation, both the Program and the two Promissory Notes legally obligated the Taxpayer to repay the amount of tuition advanced by the Hospital to the Nursing School on the Taxpayer's behalf, whether in cash or through the performance of services as a registered nurse in the Hospital for a period of 2 years. The Promissory Notes also evidenced the Hospital's intent to seek repayment in the event of the Taxpayer's default. Accordingly, the tuition amounts advanced by the Hospital to the Nursing School on the Taxpayer's behalf constituted loans that are includible in the Taxpayer's gross income in the taxable year in which such loans are forgiven by the Hospital.

Wage Issue

Section 3402(a) requires employers paying wages to deduct and withhold income tax on wages. For income tax withholding (ITW) purposes, § 3401(a) provides that the term "wages," with certain exceptions, means all remuneration for services performed by an employee for an employer. Excise taxes under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) are imposed on the employer under §§ 3111 and 3301 in an amount equal to a percentage of the wages paid by that employer. Under § 3101, FICA tax also is imposed on the employee. Under §§ 3121(a) and 3306(b), the term "wages" for FICA and FUTA tax purposes means, with certain exceptions, all remuneration for employment. Under §§ 3121(b) and 3306(c), "employment" is defined as any service, of whatever nature, performed by an employee for the person employing him.

Sections 31.3121(a)-1(c), 31.3306(b)-1(b), and 31.3401(a)-1(a)(2) of the Employment Tax Regulations provide that payments are wages for purposes of employment taxes if paid as compensation for services performed by the employee for his employer, and the name by which the remuneration for services is designated is immaterial.

In the Taxpayer's situation, the amounts paid under the Program by the Hospital to the Nursing School on behalf of the Taxpayer are considered loans for federal income tax purposes at the time the Taxpayer entered into the Program. A loan in this situation does not create any employment tax liability. At that time there was no employment relationship between the Taxpayer and the Hospital; the Taxpayer did not provide any services to the Hospital in exchange for the loans. Therefore, the loans do not constitute wages for purposes of FICA, FUTA, or WTI.

Upon successful completion of the Nursing School, the Taxpayer faced an employment decision. The Taxpayer could either accept employment at the Hospital for 2 years in

exchange for the Hospital's forgiveness of the Taxpayer's debt, or the Taxpayer could interview with different employers for a job with the knowledge that, if the Taxpayer accepted employment with another employer, the Hospital would not release the Taxpayer from the obligation to repay the loan. The loan forgiveness thus will represent compensation paid by the Hospital in exchange for the Taxpayer's agreement to perform services as an employee of the Hospital.

When the Taxpayer accepted employment with the Hospital, this created an employer-employee relationship. The employer will provide the loan forgiveness to the employee in exchange for the employee providing 2 years of services as a registered nurse to the employer. It is immaterial that the Taxpayer entered into the Program prior to the employment. Thus, on date 8, when the Hospital forgives the tuition paid the Nursing School on the Taxpayer's behalf, the Taxpayer will have received income under § 61. Such debt relief or loan forgiveness will constitute wages for purposes of employment taxes irrespective of the name by which it was designated, because it will be paid as remuneration for services performed by the employee for the employer. Accordingly, we conclude that the loan forgiveness will be considered wages for purposes of ITW, FICA, and FUTA under §§§ 3401, 3121, 3306.

CONCLUSIONS

We conclude as follows:

1. The tuition payments made under the Program by the Hospital to the Nursing School on behalf of the Taxpayer do not constitute scholarships or grants under § 117; are not wages of, or other income to, the Taxpayer upon receipt of tuition payments by the Nursing School; and are considered loans for federal income tax purposes.

2. The tuition payments made under the Program by the Hospital to the Nursing School on behalf of the Taxpayer will not be includible in the Taxpayer's gross income until the taxable year in which such loan amount is forgiven by the Hospital.

CAVEATS

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the Taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)