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May 12, 2009

*via email (seaster@capnhq.gov)
and by regular U.S. Mail*

Ms. Susan Easter
Civil Air Patrol – National Headquarters
105 South Hansell Street, Bldg. 714
Maxwell AFB, AL 36112

Re: Requirements for Scholarships/Grants

Dear Susan:

This letter is in response to your inquiries set out in Purchase Order #09-0207.

1. **Checks Issued to Teachers in Furtherance of Aerospace Education:**

It is my understanding that the Civil Air Patrol (“CAP”) is currently issuing checks to teachers who attend CAP sponsored events, with the purpose of the check being for the teacher to utilize the funds to support aerospace education in the classroom. These checks have been issued in the name of the teachers rather than the schools at which the teachers are employed. A 1099 has been issued because of no supporting documentation for the check. The questions over this procedure include whether or not this is the proper method for reporting these payments and whether or not there are other methods of making these payments without resulting in reportable income by the teachers.

As these payments are currently being made, they would be classified as a “prize or award” to the teachers and would be included in the gross income of the teachers pursuant to Internal Revenue Code (“IRC”) §74. Therefore, the payments would be reportable on 1099-MISC in Box 3 – “Other Income” to the extent that they exceed \$600 in any given tax year. There are very narrow exceptions to this rule (IRC §74(b) and (c)), but CAP does not fall into

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any of the exceptions. The IRC and the Treasury Regulations do not provide a lot of guidance in this area, making it difficult to determine alternate methods for handling these awards by CAP to the teachers to prevent their inclusion in the teachers' gross income. We reviewed how teacher grants are treated by other entities and what has been successful for avoiding this issue, including the Chicago Foundation for Education, the Utah Arts Council, the National Geographic Society Education and Children's Programs, and the NEA Foundation. Following is a synopsis of how each of the said entities deal with this issue:

(a) The Chicago Foundation for Education requires recipients of its teacher grants to provide receipts to the Foundation for all expenditures of the funds provided. Any amounts greater than \$5.00 for which a receipt is not provided or which are not returned to the Foundation are includible in the teacher's gross income and a Form 1099 is issued to the extent the funds exceed \$600 in any given year.

(b) The Utah Arts Council provides grants to organizations or individuals to participate in Folk Arts Master Classes/Workshops. Recipients are notified that the payments will be reported to the IRS as income to the recipient.

(c) The National Geographic Society Education and Children's Programs pays teachers grants directly to organizations (usually schools) who provide evidence that they are exempt from federal income taxes under IRC §501(c)(3) or an organization under §170(c)(2) to which contributions would be deductible. This prevents any payments directly to the teachers and relieves the Society from the reporting requirements.

(d) The NEA Foundation reports its grants to the IRS on Form 1099 unless it is designated on the application form that the payment is to go to a fiscal agent, which are usually non-profit organizations and are able to accept the funds without tax liability. In order to designate a fiscal agent, the agent must sign the application and the individual recipient must be authorized to represent and act in the name of the organization, specifically in the receipt, disbursement and oversight of the funds. The Foundation further requires that the fiscal agent maintain records of disbursements related to the grant, keep receipts for at least three years, make those records available to the Foundation upon request, disburse the funds in accordance with the purpose of the grant application and disburse the funds solely at the direction of the teacher/recipient.

If CAP modified its grants to teachers to require that 1) the recipients provide receipts for all of the funds received in accordance with the purpose of the grant, 2) the funds are paid directly to schools or other organizations providing evidence of qualification under IRC

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§501(c)(3) or §170(c)(2), or 3) require that the recipient designate a fiscal agent which is qualified under §501(c)(3) or §170(c)(2), this would eliminate the need to issue a 1099-MISC for the teachers receiving the funds. Otherwise, CAP will be required to issue a 1099-MISC to each recipient of a grant in excess of \$600 in any tax year. I am including herewith some of the information available online for each of the above discussed entities to give you a better understanding of how each one deals with this issue. If you would like further advice on how to establish one or another of these procedures, please let me know.

2. **Flight Scholarships for Cadets:**

You expressed concerns that the flight scholarships paid to cadets both at the national level and at the Wing levels would be considered a gift rather than a scholarship because the education received is not from an accredited institution. "Gifts" as defined by IRC §2501, deal with transfers by "any individual" rather than an organization. The more appropriate consideration is whether or not the flight scholarships are includible in the gross income of the recipients.

The general rule for determining if a payment is considered a scholarship or is includible in gross income is set out in Internal Revenue Code ("IRC") §117, which provides, "Gross income does not include any amounts received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii)." IRC §170(b)(1)(A)(ii) describes an educational organization as one "which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."

The above definition of an educational organization does not appear to include CAP. The pertinent language to be considered is "normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance." In Revenue Ruling 70-324 (dealing with exemption from excise taxes) specifically held that "the aviation education program of CAP meets the requirements relating to faculty, curriculum, and enrolled student body" required to allow exemption from excise taxes. The requirements for exemption of excise taxes contains the exact language of §170(b)(1)(A)(ii). However, Revenue Rulings are binding only for the specific facts presented when the ruling was requested. Therefore, you cannot rely on the holding in Revenue Ruling 70-324. You could, however, seek a new ruling that deals with the specific facts surrounding the flight scholarships granted to Cadets.

Even if CAP qualifies as an educational organization, it is also necessary to determine whether or not the flight scholarships would meet the definition of "qualified scholarship" under

§117(b). Subsection (b)(1) requires that this includes any amount received by an individual as a scholarship or grant “to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.” Subsection (b)(2) defines “qualified tuition and related expenses” to include “tuition and fees for the enrollment or attendance of a student at an educational organization defined in section 170(b)(1)(A)(ii), and ... fees, books, supplies and equipment required for courses of instruction at such educational organization.” “Related expenses” do not include items such as the cost of room and board, transportation, or other similar personal expenses. Further, the person receiving the funds must be an “individual who is a candidate for a degree.” Treasury Regulation §1.117-3 defines a candidate for a degree as an individual who “is pursuing studies or conducting research to meet the requirements for an academic or professional degree conferred by colleges or universities.” The study or research is not required to be conducted at an institution which actually confers the degree if the purpose of the study/research is to meet the requirements for a degree from a college/university that does confer degrees. A scholarship for study at secondary school also qualifies. I don’t see any way to qualify CAP under this requirement.

Based upon the above analysis, the flight scholarships would be includible in gross income of the recipients. CAP would be required to report this income on a Form 1099-MISC if this amount exceeds \$600 in any given tax year. On the 1099-MISC, the payments would be reported under Box 3 as “prizes and awards that are not for services performed.” Even if CAP just absorbed the cost of the flight training for certain Cadets rather than actual funds changing hands, Treasury Regulation §1.74-1(a)(2) requires that the fair market value of the goods or services provided also be reported as an award in Box 3 of 1099-MISC. Fair market value is defined as the amount that the recipient would have had to pay in cash to purchase the goods or services.

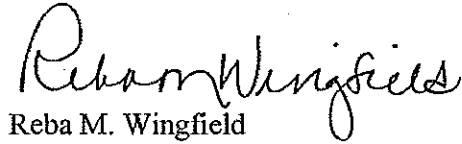
If you wish to avoid the requirement to report these scholarships on 1099-MISC, you could request a private letter ruling from the IRS, which would require a very detailed and exact recitation of the facts and could either hold in your favor (as Revenue Ruling 70-324 did) or could hold against you. Seeking such a ruling from the IRS could be a fairly expensive undertaking, would take many months and the outcome is far from certain. The easiest and surest method to avoid the requirement of reporting the flight scholarships on 1099-MISC would be to limit them to less than \$600 per recipient in any given tax year. Limitations on amounts of scholarships would include any scholarships paid by CAP National plus any scholarships paid to the same recipient at the Wing or Squadron level.

This written advice is not intended or written to be used, and it cannot be used by a taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

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If you need anything further information, please give me a call.

Sincerely,


Reba M. Wingfield

Enclosures: Cited sources.

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