



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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Dear Mr. Pitt:

You requested guidance on July 21, 2008, concerning the employment tax consequences and proper reporting under the Internal Revenue Code of stipends and bonuses paid to participants in the Troops-to-Teachers Program. In response to your request, we offer the following general information on the treatment of the stipends and bonuses for information reporting, Federal Insurance Contributions Act, and income tax withholding purposes which we hope will be helpful to you.

Background

In 1992, the Department of Defense created the Troops-to-Teachers Program as part of the National Defense Authorization Act for Fiscal Year 1993. See Pub. L. No. 102-484, § 4441. The program was created to assist eligible members of the Armed Forces after separation from active duty in obtaining the necessary credentials to serve as elementary or secondary school teachers or teachers' aides. The program was also designed to facilitate the employment of those members in certain areas that were experiencing a shortage of qualified teachers. When initially created, the program provided that the Department of Defense would provide each participant with a stipend in an amount equal to the lesser of (a) \$5,000, or (b) the total costs of the type described in paragraphs (1), (2), (3), (8), and (9) of section 472 of the Higher Education Act of 1965 [tuition, fees, costs for rental/purchase of any necessary equipment, materials, supplies; books, supplies, transportation; room and board; expenses for dependent care; expenses related to a student's disability]. Under the terms of an agreement with the Secretary of Defense, participants in the program were required to obtain full-time employment as a teacher or a teacher's aide for a minimum of two school years after obtaining the necessary credentials. Subject to certain exceptions,

the failure to obtain the necessary credentials or fulfill the two-year minimum employment requirement would generally result in the participant having to reimburse the Secretary of Defense for the full stipend or some portion thereof. The provisions of the program were codified at 10 U.S.C. § 1151.

In 1999, Congress abolished the existing program by repealing 10 U.S.C. § 1151, created the "Troops-to-Teachers Program Act of 1999", and transferred jurisdiction of the program from the Department of Defense to the Department of Education. See Pub. L. No. 106-65, Title XVII, §§ 1701; 1707. Although the existing program was repealed, any agreements entered into by participants before the repeal were still valid. See Pub. L. No. 106-65, Title XVII, § 1707(a)(3). Thus, participants who received a stipend under the repealed version of the program still had an obligation to repay the stipend for failing to comply with the terms of the program.

Under the Troops-to-Teachers Program Act of 1999, the Secretary of the Department of Education assisted members of the Armed Forces in obtaining the necessary credentials to serve as elementary or secondary school teachers, or vocational or technical teachers. In addition, the Secretary facilitated the employment of those members in certain areas that were experiencing a shortage of qualified teachers. Participants in the program were required to obtain full-time employment as teachers for a minimum of four school years after obtaining the necessary credentials. Just like the previous version of the program, participants could receive a stipend in the amount of \$5,000. See Pub. L. No. 106-65, Title XVII, § 1705(a). Unlike the previous version of the program, however, the stipend amount was no longer determined as the lesser of \$5,000 or certain expenses enumerated in section 472 of the Higher Education Act of 1965; rather, all participants were eligible for a stipend of \$5,000.

In lieu of a stipend, participants could receive a bonus of \$10,000 if they agreed to accept a full-time position as an elementary or secondary school teacher or vocational or technical teacher for a minimum of four years at a school that was classified as a "high need school" (meaning that the school met certain criteria set forth in the statute). See Pub. L. No. 106-65, Title XVII, § 1705(b). Subject to certain exceptions, the failure to obtain the necessary credentials or fulfill the four-year minimum employment requirement would generally result in the participant having to reimburse the Secretary of Education for the full stipend or some portion thereof. Similarly, the bonus or some portion thereof had to be repaid if the participant did not fulfill the four-year minimum employment requirement at a "high need school." The provisions of the program were codified at 20 U.S.C. §§ 9301- 9309.

In 2001, Congress enacted the "No Child Left Behind Act of 2001," which repealed 20 U.S.C. §§ 9301- 9309. See Pub. L. No. 107-110, Title X, §1011(6). The No Child Left Behind Act of 2001 authorized a mechanism for the funding and the administration of the Troops-to-Teachers Program. See Pub. L. No. 107-110, Title II, § 2302. While Congress appropriates funding for the program to the Department of Education, the

Secretary of Education transfers funds to the Department of Defense; within the Department of Defense, the Defense Activity for Non-Traditional Education Support (DANTES) operates the program. See 34 C.F.R. § 230.1. The provisions of the program were codified at 20 U.S.C. §§ 6671-6677, and this is the version of the program that currently exists today. The current version of the program is identical in many respects to the version that was created in 1999; participants are still eligible for a \$5,000 stipend or a \$10,000 bonus and generally are required to repay some (or all) of the stipend or bonus for failing to comply with the terms of the program, but the commitment to teaching has been reduced from four years to three years.

### FICA and Income Tax Withholding Consequences

For purposes of the Federal Insurance Contributions Act (FICA), sections 3101 and 3111 of the Internal Revenue Code impose a tax on the wages paid by employers to employees with respect to employment. The FICA tax consists of two separate taxes: (1) sections 3101(a) and 3111(a) impose Old-Age, Survivors, and Disability Insurance taxes on employees and employers, respectively, and (2) sections 3101(b) and 3111(b) impose Hospital Insurance taxes on employees and employers, respectively. For FICA purposes, section 3121(a) defines "wages" as "all remuneration for employment," with certain specific exceptions. For example, section 3121(a)(18) provides that the term "wages" does not include any payment made, or benefit furnished, to or for the benefit of an employee if, at the time of such payment or such furnishing it is reasonable to believe that the employee will be able to exclude such payment or benefit from income under section 127. Similarly, section 3121(a)(20) provides that the term "wages" does not include any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117.

Section 3402 provides that every employer making a payment of wages must deduct and withhold income taxes from wages (commonly referred to as income tax withholding). Section 3401(a) defines wages for income tax withholding purposes as "all remuneration. . . for services performed by an employee for his employer," with certain exceptions. The income tax withholding definition of "wages" is similar to the FICA definition. In this regard, section 3401(a)(18) provides that the term "wages" does not include any payment made, or benefit furnished, to or for the benefit of an employee if, at the time of such payment or such furnishing it is reasonable to believe that the employee will be able to exclude such payment or benefit from income under section 127. Similarly, section 3401(a)(19) provides that the term "wages" for income tax withholding purposes does not include any benefit if at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude such benefit from income under section 117.

*Are Stipends Excludable Under Section 127?*

Because benefits excludable under section 127 are not subject to FICA or income tax withholding, we must examine whether the stipends paid pursuant to the Troops-to-Teachers Program are excludable under section 127. Section 127 provides that an employee's gross income does not include amounts paid or expenses incurred by the employer for educational assistance to the employee under a qualified educational assistance program. The maximum amount of educational assistance that an employee may exclude annually from gross income is limited to \$5,250. I.R.C. § 127(a)(2). To have a plan qualify as an educational assistance program, an employer must have a separate written plan for the exclusive benefit of his or her employees to provide such employees with qualified educational assistance. I.R.C. § 127(b)(1). The written plan must not provide employees with a choice between program benefits and other remuneration that is includible in gross income. I.R.C. § 127(b)(4). Tax-free educational assistance benefits include payments for tuition, fees and similar expenses, books, supplies, and equipment. I.R.C. § 127(c)(1)(A). Those benefits cannot, however, be used to pay for meals, lodging, transportation, or tools/supplies (other than textbooks) that the employee can retain after completing the course of instruction. I.R.C. § 127(c)(1).

When Congress initially created the Troops-to-Teachers Program in 1992, participants were eligible for a stipend in the amount of the lesser of \$5,000 or certain expenses enumerated by the Higher Education Act of 1965. Because the stipend could be used for transportation, room and board, the program did not qualify as an educational assistance program; there is no provision in section 127 to allocate a stipend between excludable and nonexcludable expenses. Thus, the entire amount of the stipend was not excludable from a participant's gross income under section 127.

*Are Stipends/Bonuses Excludable Under Section 117?*

Because benefits excludable under section 117 are not subject to FICA or income tax withholding, we must examine whether the stipends or bonuses paid pursuant to the Troops-to-Teachers Program are excludable under section 117. Section 117 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 section 170(b)(1)(A)(ii) (which generally describes a school, college, or university). An individual is a candidate for a degree within the meaning of section 117 if he or she is pursuing studies to meet the requirements for an academic or professional degree conferred by colleges or universities. In addition, a student who receives a scholarship for study at a secondary school or other educational institution is considered to be a candidate for a degree.

The term "scholarship" is used broadly to include an amount paid for the benefit of a student, whether an undergraduate or a graduate, to aid such individual in pursuing his or her studies. The term "qualified scholarship" refers to "any amount received by an individual as a scholarship or fellowship 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." I.R.C. § 117(b)(1). Section 117(b)(2) provides that qualified tuition and related expenses are tuition and fees required for the enrollment or attendance of a student at an educational institution, and fees, books, supplies, and equipment required for courses of instruction.

In general, one cannot exclude from gross income an amount received that represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship. See I.R.C. § 117(c)(1). The United States Supreme Court has described payments that are excludable under section 117 as "relatively disinterested 'no-strings' educational grants, with no requirement of any substantial *quid pro quo* from the recipients." Bingler v. Johnson, 394 U.S. 741, 751 (1969). A scholarship that is conditioned upon the performance of substantial past, present, or future services by the recipient, represents 'payment for services' for this purpose. Consequently, a scholarship that is includible in gross income under section 117(c) is considered "wages" for purposes of FICA and income tax withholding. See Notice 87-31, 1987-1 C.B. 475.

The fact that educational benefits under the Troops-to-Teachers Program are limited in their entirety to individuals who perform or have performed services as members and former members of the U.S. Armed Forces represents a substantial *quid pro quo* from the recipients that requires inclusion in income under section 117(c). This limitation is neither *de minimis* nor insubstantial, and indicates an employment or other compensatory purpose that is inconsistent with scholarship exclusion. A scholarship grant conditioned upon the performance of such substantial past or present services by the recipient represents "payment for services" for purposes of section 117(c), and is includible in the recipient's gross income as wages. Whether requiring a recipient of a stipend or bonus to obtain full-time future employment as a teacher or a teacher's aide for a specified period in exchange for the stipend or bonus is a *de minimis quid pro quo* is immaterial to the result; the stipend or bonus is only available to members and former members of the U.S. Armed Forces, and that service alone is enough to require inclusion of those amounts in income.

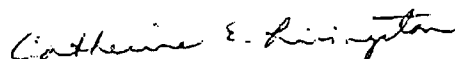
In conclusion, participants in the Troops-to-Teachers Program are not able to exclude the stipend or the bonus from gross income by virtue of sections 117 or 127. While there are many exceptions enumerated in section 3121 to the broad definition of "wages" for FICA purposes, we are aware of no other exception that would exclude the stipend or the bonus from wages. Similarly, we are aware of no other exception in section 3401 that would exclude the stipend or the bonus from wages for income tax withholding purposes. Consequently, the stipends and bonuses are subject to FICA and income tax withholding and must be reported on Form W-2. See I.R.C. § 6051.

If we have misinterpreted any aspect of the Troops-to-Teachers Program, please let us know as soon as possible, as it may have an impact on the above information. Note, however, that this letter is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2008-1, § 2.04, 2008-1 I.R.B. 1.

We understand that you may have received prior correspondence or oral advice from the Internal Revenue Service that indicated the stipends or the bonuses were to be reported on Form 1099-MISC. Please disregard any such previous correspondence or oral advice; the legal research described above sets forth the correct FICA and income tax withholding consequences and proper reporting. We regret any confusion that may have arisen from the previous correspondence or oral advice, and will share the information in this letter with the Internal Revenue Service's Office of Federal, State, and Local Governments.

We hope this information is helpful and apologize for any inconsistent information you may have previously received from the Internal Revenue Service. If you have any additional questions about this matter, please contact me or Lynne Camillo of my staff at (202) 622-6010.

Sincerely,



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Counsel, (Exempt Organizations/Employment  
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(Tax Exempt & Government Entities)