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THE TAXATION OF PRIZES AND AWARDS—TAX POLICY WINNERS AND LOSERS

Bruce I. Kogan*

I. INTRODUCTION

The treatment for federal income tax purposes of economic prizes and awards has evolved over the more than seventy years since the

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ratification of the sixteenth amendment\(^1\) and the enactment of the modern individual income tax in 1913.\(^2\) The historical development of this tax microcosm discloses much about fundamental shifts in American values and policy over time.

Prior to the passage of the Tax Reform Act of 1986,\(^3\) section 74 of the Internal Revenue Code\(^4\) provided an incentive for the individual taxpayer to expend time and energy in the pursuit of objectives that would benefit society as a whole. The range of humanitarian or public activities so encouraged included religious, charitable, scientific, educational, artistic, literary, and civic achievement. If the winner had not solicited the prize and had no obligation to render future services, a tax benefit, in the form of an exclusion of the value of the award from gross income, was available.

The stimulation of altruistic endeavors, which was thought to be suitable and appropriate tax policy for decades,\(^5\) is apparently no longer central to current American values, at least as articulated by Congress in the Tax Reform Act of 1986.\(^6\) Tax policy now encourages productivity, economic efficiency, and competitiveness in the world marketplace.\(^7\) It is without doubt that promotion of the nation's economic welfare is a legitimate public goal and that changing economic

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1. U.S. Const. amend. XVI ("The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.").
   (a) General Rule.—Except as provided in subsection (b) and in section 117 (relating to scholarships and fellowship grants), gross income includes amounts received as prizes and awards.
   (b) Exception.—Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if—
      (1) the recipient was selected without any action on his part to enter the contest or proceeding; and
      (2) the recipient is not required to render substantial future services as a condition to receiving the prize or award.
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conditions will necessitate changes in the tax law. Nonetheless, noneconomic public needs and values are also worthy of promotion.

This article evaluates whether the recent emasculation of the exclusion for bona fide public achievement prizes or awards was justified. In order to accomplish the task, the article will begin by setting forth the applicable statutory provisions and tracing their historical development. Second, the policy implications of new section 74(b) will be analyzed in depth. Next, the article will offer an alternative that would effectively deal with the problem of compensatory employer to employee awards, while retaining the long standing policy of using tax incentives to encourage humanitarian or public contribution. The article concludes by arguing that Congress' shift to a tax policy that measures the welfare of society by economic productivity and not with reference to humanitarian and public values, such as charity, religion, science, education or cultural achievement, is short-sighted and mistaken.

II. EVOLUTION OF THE STATUTORY PATTERN

A. The Early Years (1913–1954)

The early federal income tax laws contained no separate provision governing the taxation of prizes and awards. Then as now, the term "income" was broadly defined. The 1913 definition of "net income" included gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business.


carried on for gain or profit, or gains or profits and income derived from any source whatever. . . . 11

With minor modification12 the broadly inclusive concept of income remained throughout numerous reenactments13 of the statute up to and including the Internal Revenue Code of 1939.14

A taxpayer seeking to exclude an item of positive economic value received during the taxable year had to establish the existence of statutory authority for the exemption or exclusion.15 At the outset of the federal income tax in 1913, there were very few exemptions or exclusions. The only sources of income which were specifically excluded or exempted from tax were interest on governmental obligations,16 salaries of state and local employees,17 compensation paid to the President of the United States and federal judges,18 the proceeds of life insurance

11. 1913 Act, supra note 2, § II(B), at 167.
15. The broadly inclusive definition of income set forth in the 1913 Act was prefaced by an exceptive clause: "That, subject only to such exemptions and deductions as are hereafter allowed, the net income of a taxable person shall include. . . ." 1913 Act, supra note 2, § II(B), at 167 (emphasis added).
16. The 1913 Act provided: "That in computing net income under this section there shall be excluded the interest upon the obligations of a state or any political subdivision thereof, and upon the obligations of the United States or its possessions. . . ." 1913 Act, supra note 2, § II(B), at 168. The general exclusion from gross income of interest on federal obligations lasted only until 1917. However, the exclusion for interest on state or local obligations has continued to the present (albeit with considerable restrictions added by recent tax acts including TRA86). See I.R.C. §§ 103, 141-150 (1987). For a general discussion on the doctrine of intergovernmental tax immunities, see 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS §1.2.8 (1981).
17. The 1913 Act also excluded from gross income "the compensation of all officers and employees of a State or any political subdivision thereof except when such compensation is paid by the United States Government." 1913 Act, supra note 2, § II(B), at 168. This exclusion was repealed by section 213 of the Revenue Act of 1918 which expanded the scope of gross income to specifically include salaries, wages, or compensation of "all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia. . . ." Revenue Act of 1918, Pub. Law No. 254, § 213, 40 Stat. 1057, 1065 (1919).
18. The concern about taxing the salaries of the President and federal judges related back to constitutional provisions prohibiting the diminution of their compensation during their continuance in office. See U.S. CONST. art. II, § 1, cl. 6; see also id. art. III, § 1. The Revenue Act of 1918 deleted the exclusion by expanding the definition of gross income to include the compensation of "the President of the United States [and] the judges of the Supreme and inferior courts of the United States." Revenue Act of 1918, Pub. Law No. 254, § 213, 40 Stat. 1057, 1065 (1919). This amendment was not, however, given retroactive effect so that federal judges appointed before 1918 continued to enjoy the exemptions. See, e.g., O'Malley v. Woodrough,

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policies paid upon the death of the insured\textsuperscript{19} and the value of property acquired by gift, bequest, devise, or descent.\textsuperscript{20} The gift and inheritance exclusion did not, however, extend to the income from the gratuitously transferred property.\textsuperscript{21}

Certain of the original 1913 exclusions have since been repealed\textsuperscript{22} and others have been added,\textsuperscript{23} but the exclusion from gross income of the value of property acquired by gift, bequest, devise, or inheritance has continued to the present.\textsuperscript{24} A number of critics over the years have questioned the wisdom of this exclusion\textsuperscript{25} which is now set forth in Code section 102.\textsuperscript{26} The reason initially offered for the exclusion from income tax of gifts and bequests was Congress' intention to tax
inter vivos and testamentary wealth transfers separately. The subsequent enactment of the federal estate and gift taxes carried this intention to fruition.

During the early period, when there was no specific statutory provision dealing with prizes and awards, one might have assumed (consistent with the comprehensive scope of the income concept) that the receipt of any valuable prize or award would be taxed as "income derived from any source whatever." In general, that assumption would have been correct. A wide variety of contest awards and sweepstakes, lottery, and door prizes were held to be taxable. There were, however, a number of instances where different prizes and awards were held to be gifts and, therefore, excluded from gross income. The determination of whether a particular prize or award constituted a constructive gift and was therefore exempt from taxation was made on a case by case basis. This ad hoc treatment of the prize and award cases gave rise to inconsistent results.

28. Title II of the Revenue Act of 1916 introduced the federal estate tax which is now found at I.R.C. §§ 2001-2210 (1987).
30. 1913 Act, supra note 2, § II(B), at 167.
31. See, e.g., Silver v. Commissioner, 42 B.T.A. 461, 463-64 (1940) (Irish Sweepstakes winnings held taxable); Riebe v. Commissioner, 41 B.T.A. 935 (1940) (lottery prize held taxable), aff'd 124 F.2d 399 (6th Cir. 1941); I.T. 1667, 2-1 C.B. 54 (1923) (lottery prize selected from meal checks of restaurant customers was taxable income to winner); I.T. 1655, 2-1 C.B. 54 (1923) (lottery prize given in newspaper advertising promotion taxable to recipient).
32. See, e.g., Wilkie v. Commissioner, 8 F.2d 953 (6th Cir.) (certain science and public service prizes found to be gifts and therefore not taxable), cert. denied, 317 U.S. 659 (1942).
33. An informative discussion of the early decisions may be found in Note, Fellowships and Scholarships, Prizes and Awards—Ante 1954, Post 1954, 7 Syracuse L. Rev. 130, 135 (1955).
34. The results were particularly inconsistent with regard to automobiles given away as door prizes at events ranging from baseball games to home shows. Prizes were held taxable in: Bonacker v. United States, 202 F. Supp. 14 (W.D.N.Y. 1961) (winner had purchased a $20 ticket for a convention dinner at which the car was given as a door prize); Downes v. Commissioner, 30 T.C. 396 (1958) (taxpayer's purchase of $5 chance resulted in taxability of automobile won as prize; fact that charity sponsored lottery was immaterial); Solomon v. Commissioner, 25 T.C. 936 (1956) (taxpayer's charitable motive in buying ticket at charity bazaar held immaterial as to prizes won); Sykes v. Commissioner, 24 T.C. 1156 (1955) (car won as door prize at a club dinner held taxable even though the ticket had been purchased for the winner by his host). In contrast, automobiles won in the following instances were held to be gifts and therefore not taxable: Glenn v. Bates, 217 F.2d 355 (6th Cir. 1954) (car received by random selection for visiting a dealer's showroom to see new models treated as a gift since taxpayer did not enter any contest and had not been required to do anything), aff'd 114 F. Supp. 445 (W.D. Ky. 1953); Lawton v. United
The Tax Court in *Washburn v. Commissioner*\(^{35}\) attempted to set down some guidelines to determine whether a prize or award qualified as a gift. During 1941, Mrs. Washburn’s telephone number was randomly selected and the radio program Pot O’Gold called and awarded her $900 for simply answering the phone. The check was delivered within a half hour by a messenger with a telegram that read: “Here-with draft for nine hundred dollars outright cash gift with our compliments presented by Tum’s Pot O’Gold program. Congratulations from Tommy Tucker and ourselves. [Signed] Lewis Howe Company, Makers of Tums.”\(^{36}\)

The court concluded that the radio show giveaway prize constituted a nontaxable gift since there was no expectation or effort on the part of the recipient, no subsequent obligation on her part to perform any services or to make any commercial endorsement, no wager made by the recipient, and since the prize transferor had denominated the payment as an “outright cash gift.”\(^{37}\) This case became known as the “Pot O’Gold” case. The criteria set forth by the court, including the donor’s subjective intention and the lack of effort or obligation on the part of the recipient, became standards by which subsequent courts analyzed the taxability of prizes and awards.\(^{38}\)

Using criteria similar to those developed in the “Pot O’Gold” case, the Tax Court in *McDermott v. Commissioner*\(^{39}\) found that where a recipient of an award had entered an American Bar Association contest by writing and submitting an essay,\(^{40}\) the prize given to the winner

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35. Washburn v. Commissioner, 5 T.C. 1333 (1945).
36. Id. at 1334.
37. Id. at 1335.
38. Valuable merchandise and money prizes won in connection with radio quiz shows were held to be nontaxable gifts in: Campeau v. Commissioner, 24 T.C. 370 (1955) (taxpayer received telephone call from radio show “Hollywood Calling—Film of Fortune” and correctly answered two questions thereby winning over $12,000 in cash and merchandise); Zemp v. United States, 51 A.F.T.R. (P-H) 1800 (D. Wyo. 1956) (jury verdict holding cash and merchandise won on radio quiz program to be gifts rather than compensation for services). But see Turner v. Commissioner, 13 T.C.M. (CCH) 462 (1954) (trip to Buenos Aires won as prize on radio “Name That Tune” quiz show held taxable; only issue involved determination of fair market value of the first class steamship tickets); T.T. 3987, 1950-1 C.B. 9 (stating Internal Revenue Service position that participation in radio quiz show resulted in taxability of prizes won therein).
39. 3 T.C. 929 (1944), rev’d, 150 F.2d 585 (D.C. Cir. 1945).
40. The contest sponsored by the American Bar Association (“ABA”) had been funded by a bequest from Erskine M. Ross who had died in 1928. His will had provided the sum of $100,000
was includable in gross income.\textsuperscript{41} The Tax Court based its decision on the facts that the recipient had entered the contest and submitted an essay to the judges and that the award could have been compensation for the writing of the essay.\textsuperscript{42} The case, known as the “Ross Essay” case, was appealed by the taxpayer. The United States Court of Appeals for the District of Columbia held that the award was a gift rather than compensation and therefore not includable in gross income.\textsuperscript{43} The appellate court recognized the guidelines established by the Tax Court, but did not find the fact that the recipient had entered the contest determinative on the issue of includability.

Although the winner had to write an essay and submit it to the American Bar Association, the prize was not found to be compensation for the writing of the essay, but rather an incentive to all of the contest entrants to pursue their best endeavors.\textsuperscript{44} The purpose of the contest benefactor was “to ‘give’ and to ‘incite’, not to employ or buy.”\textsuperscript{45} The analogy between this prize and a gift was noted by the court in that neither can be counted upon in advance and they may never recur.\textsuperscript{46} The court also found that while the contest prize might have directed and more or less increased the writer’s effort, this added motive was more a matter of prestige than of money.\textsuperscript{47}

While the gift versus compensation issue ultimately turned upon the intentions of the contest sponsor and winner, it is worth noting that the court recognized the existence and validity of tax incentives to encourage scholarly achievement that will benefit society as a whole:

The Commissioner does not say that taxes have ever been collected on Nobel prizes, Guggenheim fellowships, Rhodes scholarships, Ross prizes, or any of the many scholarships and prizes which, like these, have long been awarded . . . to scientists, scholars, or students. We think we may infer that the practice has been to the contrary. This long-continued administrative interpretation of the law is entitled to

to be invested and the income therefrom to be awarded annually as a prize for the best discussion on a topic to be selected each year by the ABA. Mr. McDermott’s winning essay was entitled “To What Extent Should Decisions of Administrative Tribunals be Reviewable by the Courts?” \textit{Id.} at 929.

\textsuperscript{41} \textit{Id.} at 932.

\textsuperscript{42} \textit{Id.} at 930–31.

\textsuperscript{43} McDermott v. Commissioner, 150 F.2d 585 (D.C. Cir. 1945).

\textsuperscript{44} \textit{Id.} at 587–88.

\textsuperscript{45} \textit{Id.} at 588.

\textsuperscript{46} The court noted: “An important characteristic of gifts is that, unlike many sorts of ‘income,’ they cannot be counted upon in advance and may never recur. The Ross prize has this characteristic. It is therefore within the policy which exempts gifts of principal from taxation as income.” \textit{Id.}

\textsuperscript{47} \textit{Id.}
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great weight.... Finally, requiring winners of scholarly awards to pay
taxes on them would conflict with the wise and settled policy of encour-
gaging scholarly work.48

The court of appeals placed great weight on the subjective inten-
tions of both the donor and the donee. While the outcome of the
"Ross Essay" case can be accepted in view of the court's determina-
tion that disguised compensation was not the motive for awarding the
prize,49 the reliance upon an amorphous subjective intention standard
to be applied on a case by case basis was likely to open up a flood gate
of litigation, and it did. During the late 1940's and early 1950's, win-
ders of essay contests,50 door prizes,51 lotteries, and sweepstakes52 all
disputed the taxability of their awards with mixed results.

In the midst of such confusion, it was reasonable to expect either
Congress or the United States Supreme Court to attempt to bring
order to the chaos. The Court acted first in 1952 in Robertson v.
United States.53 The taxpayer, Leroy J. Robertson, was a musician,
composer, and professor of music who between the years 1936 and
1939 had composed a symphony entitled "Trilogy." In 1945 Henry
H. Reichhold, a philanthropist and president of the Detroit Symphony
Orchestra, established a music award (the Reichhold Music Award)
offering cash prizes for the three best symphonic works written by
native-born composers of the western hemisphere. The terms of the

48. Id. An example of the settled administrative practice may be found at Gen. Couns. Mem.
5881, 8-1 C.B. 68 (1929) which acknowledged the policy of creating tax incentives to encourage
scholarly works. The awards receiving tax exempt status in 1929 were for achievement in science
and services in promoting the public welfare.
49. See McDermott, 150 F.2d at 588:

It is safe to say that the dominant motive of a normal contestant for this prize is not a
hope of immediate financial gain. He does not regard himself as exchanging his services or
his product for money. To one whose life is devoted to scholarship and whose position is
affected by his scholarly output, the publication of an outstanding essay is its own reward
and may lead to other rewards both tangible and intangible.

50. See, e.g., Amirikian v. United States, 100 F. Supp. 263 (D. Md. 1951), rev'd, 197 F.2d 442
(4th Cir. 1952) (prize held to be taxable payment in discharge of a contractual obligation where
taxpayer had written essay on naval dry docks and submitted it in a contest sponsored by the
Lincoln Arc Welding foundation); Waugh v. Commissioner, 9 T.C.M. (CCH) 309 (1950) (prize
won by taxpayer for essay on American farm economy held taxable as compensation for writing
effort); Stein v. Commissioner, 14 T.C. 494 (1950) (economist who submitted prize winning plan
for the post-World War II economy to contest sponsored by a brewing company had to include
the prize as compensation income); Rev. Rul. 55-642, 1955-2 C.B. 302 (amounts received as prize
in a contest that required the submission of word puzzle solutions were taxable). Subsequent
winners of the Ross Essay Contest were advised by the Internal Revenue Service ("IRS") that
51. See supra note 34.
52. See supra note 31.
53. 343 U.S. 711 (1952).
competition provided that none of the works submitted could have been previously published or performed and that the winning compositions would remain the property of the composer except that the Detroit Orchestra, Inc. would be granted certain limited performance and publication rights.54

Mr. Robertson submitted his symphony and won the $25,000 first prize during 1947. He included that amount in his 1947 income tax return as gross income. Thereafter, he filed a claim for refund on the ground that the award constituted a nontaxable gift. The Commissioner denied the refund claim and the taxpayer brought suit in the federal district court in Utah which held that the award was a gift55 and, therefore, not taxable.56

The district court, citing Washburn ("Pot O'Gold")57 and McDermott ("Ross Essay"),58 applied a subjective intention test in arriving at its conclusion. In the view of the district court, the competition sponsors were making a gift since they were not seeking to derive any profit from the contest nor from the taxpayer's participation in it. With respect to the composer's intention, the district court observed:

The taxpayer's dominant motive in composing the 'Trilogy' was not in the hope of financial gain primarily. Like a great poet who is inspired to write an immortal poem, the taxpayer, desiring to make an outstanding contribution to the field of music, wrote this 'Trilogy' with no thought of entering it in a contest or otherwise commercializing on it and not until long after it was written was he prevailed upon to enter it in the Reichhold contest and received eventually the prize-winning award.59

The United States Court of Appeals for the Tenth Circuit reversed.60 In holding that the award was taxable,61 the appellate court discounted the importance and utility of the subjective intention

54. Id. at 711–12.
56. The court relied upon section 22(b)(3) of the 1939 Code, supra note 14:
   (b) Exclusions from gross income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

   (3) Gifts, bequests, and devises.—The value of property acquired by gift, bequest, devise, or inheritance.
57. Washburn v. Commissioner, 5 T.C. 1333 (1945).
59. Robertson, 93 F. Supp. at 664.
60. United States v. Robertson, 190 F.2d 680 (10th Cir. 1951), aff'd, 343 U.S. 711 (1952).
61. Id. at 683 (the court treated the prize as compensation for the three years of professional effort put into writing the symphony).
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test set forth in *McDermott* ("Ross Essay").62 The court conceded that the taxpayer's purpose when he composed the symphony may have been to satisfy some creative urge and not to receive income from it. The court also conceded that the competition sponsors may not have received anything tangible or of necessarily equal value for giving the award. The possibility of a donative intent on the part of the award grantor and some nonpecuniary motive on the part of the winner were not held to be the controlling factors.63 Rather, the court characterized Robertson's receipt of the prize as the "result of his labors just as much as though he had sold [the symphony] or had been paid for its use."64

The main thrust of the appellate court's opinion in *Robertson* was to delineate the dividing line between nontaxable gift-awards and taxable compensation-awards. The policy issue raised by the court in *McDermott*, concerning the use of tax incentives to encourage scholarly or public achievement,65 did not, however, entirely escape attention in *Robertson*. The Tenth Circuit somewhat cynically offered the following view on this question:

Nor do we believe that we can say that one entering this sort of a contest does it purely for the advancement of art or scholarly pursuits, if so, the contestant could well refuse to accept the prize. We hold that when a person enters a contest, such as in this case, which offers a valuable award and the contestant wins and accepts that award, its value is taxable to him.66

This quotation, while couched in puritanical "virtue is its own reward" terms, discloses a rather mean spirited tax policy which Congress would reject three years later with the enactment of section 74 of the 1954 Code.67 The Tenth Circuit felt that the prestige of winning a prize or award given for a significant public achievement in art or scholarship was a sufficient reward alone and that no additional tax benefit was warranted. If the winner of a valuable award recognizing such past achievement did not want to be taxed on the prize, he could refuse it. This view would turn out to be astoundingly prescient of the prize and award provisions of the Tax Reform Act of 1986.68

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62. *Id.*
63. *Id.* at 682-83.
64. *Id.* at 683.
65. See supra text accompanying note 48.
67. See infra text accompanying notes 73-84.
68. See infra text accompanying notes 165-72.
With two federal circuit courts in conflict over the tax status of prizes given in competitions to recognize scholarly or artistic achievement, the Supreme Court granted certiorari in \textit{Robertson} and gained the opportunity to resolve the issue. Perhaps, if the Court had embraced directly either of the two competing views, it would have been unnecessary for Congress to subsequently address the subject as well. Unfortunately, Justice Douglas' opinion affirming the Tenth Circuit decision in \textit{Robertson} introduced a surprising new theory—the prize was taxable because it represented the discharge of a contractual obligation. The short opinion on this issue reads in its entirety as follows:

\begin{quote}
In the legal sense payment of a prize to a winner of a contest is the discharge of a contractual obligation. The acceptance by the contestants of the offer tendered by the sponsor of the contest creates an enforceable contract. See 6 Corbin On Contracts § 1489; Restatement, Contracts, § 521. The discharge of legal obligations— the payment for services rendered or consideration paid pursuant to a contract—is in no sense a gift. The case would be different if an award were made in recognition of past achievements or present abilities, or if payment was given not for services, see Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 730, 49 S. Ct. 499, 504, 73 L. Ed. 918, but out of affection, respect, admiration, charity or like impulses. Where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it. \\
The Supreme Court in \textit{Robertson}, like the \textit{McDermott} and \textit{Washburn} courts, was concerned with the subjective intention of the donor at the time of presentation of the award, but did not find it determinative. Rather, the Court restricted the exclusion to cases where the subjective intention was gratuitous and the donee had done nothing to bring about the award. The prize or award could not be excluded even though the donor received no economic benefit if the donee had rendered any services or performed any act that constituted acceptance of the “contractual” contest offer. Such efforts would be construed as evidence that the donor had not acted out of affection, admiration, charity, or any similar gift-related motive.
\end{quote}

\begin{itemize}
\item[69.] The D.C. Circuit in McDermott v. Commissioner, 150 F.2d 585 (D.C. Cir. 1945), held them to be nontaxable gifts and the Tenth Circuit in United States v. Robertson, 190 F.2d 680 (10th Cir. 1951), found them to be compensation. \textit{See supra} text accompanying notes 39–49, 53–67.
\item[70.] \textit{Robertson} v. United States, 342 U.S. 896 (1951) (granting certiorari).
\item[71.] \textit{Robertson} v. United States, 343 U.S. 711, 713–14 (1952).
\item[72.] \textit{Id.}
\end{itemize}
It is obvious that Congress needed to provide statutory guidance. With the comprehensive rewriting of the tax code in 1954, Congress had the chance to specifically address the taxation of prizes and awards. Section 74 of the Internal Revenue Code of 1954 was the result.

B. Section 74 of the 1954 Code

Congress’ intention in creating a separate section for prizes and awards was to establish a set of rational and administratively workable rules for distinguishing between taxable and nontaxable awards without resort to the gift versus compensation morass. By placing this section in Part II (“Items Specifically Included in Gross Income”) of Subchapter B of Chapter 1 of the Income Tax Subtitle of the Code, Congress was adhering to its long standing comprehensive definition of income. As a general rule, gross income was deemed to include the value of amounts or items received as prizes and awards. Particular prizes and awards would be excepted from this general rule only if the circumstances of their receipt complied with the requirements of a new objective test for excludability.

The policy underlying the exclusion, as provided in section 74(b), was to provide a reward in the form of a tax benefit to persons who had used their special talents for the betterment of society. The challenge for Congress in drafting the new provision was to create an incentive for individuals to pursue altruistic goals that could benefit society as a whole and, at the same time, to assure that game show giveaways, door prizes, sweepstakes, lottery prizes, and awards that were essentially compensatory in nature would be subjected to tax.


74. See supra text accompanying notes 11–21.


76. I.R.C. § 74(b) (1954).

77. 1954 H.R. Rep., supra note 73, at 4036, provides:

Your committee's bill includes in income subject to tax all prizes and awards except those made in recognition of past achievements of a religious, charitable, scientific, educational, artistic, literary, or civic nature, where the recipient was selected without any action on his part and is not required to render substantial future services. This exception is intended to exempt such awards as the Nobel and Pulitzer prizes.

The provision eliminates the confusion resulting from certain court decisions. The Pot O'Gold case and the Ross Essay Contest case are overruled insofar as these cases held the receipts not to be income under the code.
Drawing on elements identified in *Robertson*\(^7\) and the other earlier decisions,\(^9\) Congress restricted the exclusion to prizes and awards made primarily to recognize past achievement in seven specific fields: Religion, charity, science, education, art, literature, and civic affairs. Two additional requirements for excludability were provided: One, the recipient had to be selected without any action on his part to enter the contest or proceeding; and two, receipt of the award could not be conditioned on the rendering of substantial future services by the recipient.\(^8\) The obvious purpose of these additional requirements was to eliminate the tax-free receipt of disguised compensation.

The statute simply listed and did not define the seven areas that were considered significant enough to warrant exclusion, nor did the statute attempt to set forth additional guidelines. Almost immediately, however, the Treasury Department promulgated interpretative regulations\(^8\) which to a certain extent clarified the Code section and helped ensure that cases with like factual patterns would receive similar treatment.\(^8\) The regulations gave examples of both includable and excludable prizes and awards and guidelines for determining the value to be included in gross income.\(^8\) The regulations also set forth a three step

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\(^7\) See also 1954 S. REP., *supra* note 5, at 4813, which states that “[a]mounts received from radio and television giveaway shows, or as door prizes, or in any similar type contest would also not be covered by subsection (b).”

\(^8\) 78. Robertson v. United States, 343 U.S. 711, 71314 (1952).


\(^8\) 80. See I.R.C. § 74(b)(1)–(2) (1954).


\(^8\) 82. The Secretary of Treasury is given authority to promulgate interpretative regulations in I.R.C. § 7805(a) (1954). While interpretative regulations are entitled to a presumption of validity, they are not immune to attack from taxpayers on the grounds that they exceed or rewrite the statute under which they were promulgated. Standards for determining the validity of an interpretative Treasury regulation have been articulated by the Supreme Court in *National Muffler Dealers Assoc. v. United States*, 440 U.S. 472 (1979), and *United States v. Vogel Fertilizer*, 455 U.S. 16 (1982).

\(^8\) 83. Treas. Reg. § 1.74-1 (1955) provides:

(a) Inclusion in gross income. (1) Section 74(a) requires the inclusion in gross income of all amounts received as prizes and awards, unless such prizes or awards qualify as an exclusion from gross income under subsection (b), or unless such prize or award is a scholarship or fellowship grant excluded from gross income by section 117. Prizes and awards which are includable in gross income include (but are not limited to) amounts received from radio and television giveaway shows, door prizes, and awards in contests of all types, as well as any prizes and awards from an employer to an employee in recognition of some achievement in connection with his employment.

(2) If the prize or award is not made in money but is made in goods or services, the fair market value of the goods or services is the amount to be included in income.

(b) Exclusion from gross income. Section 74(b) provides an exclusion from gross income of any amount received as a prize or award, if (1) such prize or award was made primarily in recognition of past achievements of the recipient in religious, charitable, scientific,
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test to be applied to each prize or award to determine its excludability. The test was taken directly from the statutory language. The regulation provided further that prizes such as the Nobel Prize and Pulitzer Prize would be excludable, but that prizes and awards from an employer to an employee in recognition of an achievement in connection with his employment would be included in gross income.84

Section 74 as enacted in 1954 was an attempt to accomplish a number of valid purposes: To end the confusion that had reigned in the area of prizes and awards, to tax most prizes and awards, and to exempt from taxation only those prizes given to recognize significant humanitarian or public achievement. Congress was for the most part successful in restricting the tax benefit to worthy prize recipients while virtually eliminating the possibility of disguised compensation.

C. The Middle Years (1954–1986)

Section 74 was created to clarify the taxation of prizes and awards and to objectify the limited circumstances for excludability.85 The Code section and interpretative regulations promulgated thereunder set forth a seemingly uncomplicated three-prong test.86 A prize or award was excludable: One, if made primarily in recognition of one of the specified areas of public achievement; two, provided that the recipient did not enter any contest or otherwise seek the prize; and three, was not required to perform substantial future services as a condition of receiving it. Unfortunately, simply setting out a tripartite rule did not eliminate all areas of potential dispute in the application of the rule.

One additional area in need of amplification centered around whether the donor was awarding the prize or award for “past achievement” as required in Treasury Regulation 1.74-1(b).87 The Maria

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84. See supra text accompanying notes 73–77.
85. See I.R.C. § 74(b) (1954); see also Treas. Reg. § 1.74-1(b) (1955).
86. See supra text accompanying notes 73–77.
87. The requirement that the award be given for “past” achievement is not found in I.R.C. § 74(b) (1954) which allowed the exclusion for prizes and awards in recognition of one of the qualified forms of achievement. However, allowance of the exclusion for contemporary or future achievement (even in one of the qualified fields of endeavor) resembles compensation far too
Moors Cabot prize was found to be given for past achievements in journalism. The recipient of the Cabot award was required to have published something during the calendar year that had an effect on the general public's awareness of currently important events. The Pulitzer Prize had also been found to be in recognition of past achievements in editorial writing published in a United States newspaper. As a result of these early rulings, it was clear that where the recipient was honored for achievements already accomplished and the other criteria of section 74 were met, the award or prize would be deemed excludable.

Not only must the prize or award have been given for past achievement, but the statute limited the areas in which the recipient must have excelled. The areas recognized as entitled to the tax benefit were, presumably, ones which Congress then viewed as central to American values. The encouragement of these types of genuinely meritorious activities appears to have been viewed as valid and legitimate tax policy at that time. The parameters to be used in determining whether specific conduct for which an award was given fell within one of the seven specified areas of endeavor were developed over time in a series of cases and rulings. Among the types of achievements which have been recognized as falling within the statutorily enumerated categories are: Outstanding public service by a civilian in the federal government, outstanding over-all past service to the academic work of a...
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college, outstanding academic achievement and student citizenship, and outstanding past work in the field of chemistry.

A variety of other achievements for which prizes or awards were conferred have been found to fall outside of the categories enumerated in the statute, resulting in taxability for the winner. These include completing twenty-five years of service with a company, catching a particular fish, being selected most valuable player in the National Football League championship game, being selected most popular Continued
member of the Los Angeles Dodgers and outstanding professional athlete of the year, being an average American family, and winning a beauty pageant. A variety of incentive awards for attaining sales quotas or bringing in new business have also been held taxable for lack of sufficiently public achievement. It is clear from the above that the courts and the Internal Revenue Service ("IRS") have construed the seven areas listed in section 74(b) to be exhaustive and not illustrative.

98. Wills v. Commissioner, 48 T.C. 308 (1967), aff'd, 411 F.2d 537 (9th Cir. 1969). The taxpayer, Maury Wills, was a professional baseball player from 1951 through 1966. During 1962, taxpayer broke the major league record for the most stolen bases in one season; was voted "player of the game" in the 1962 All Star Game; was voted National League most valuable player; and athlete or man of the year by the Associated Press, Sport Magazine, the Baseball Writers, and the State of California. He also received a new MG for being elected most popular Dodger by the patrons at the final game of the season. In addition, he received the S. Rae Hickok gold and jewel encrusted belt for being selected outstanding professional athlete of 1962. In determining that the value of the car and belt were includable in taxpayer's income, the court of appeals cited Simmons, 197 F. Supp. 673, and Hornung, 47 T.C. 428, and observed:

In light of the above standards for characterizing an activity as a civic achievement, we cannot say that the Tax Court's finding that Wills received the car and belt for his popularity and athletic prowess and that these accomplishments did not constitute civic achievements, was clearly erroneous.


The significant public achievement prong of section 74 eliminated the possibility that a prize or award such as the Pot O'Gold prize in *Washburn* could be excluded from gross income. Although the winner in *Washburn* did not enter the contest, nor was she required to perform any future services to receive the money, such a prize would be taxed under section 74 since it was not given in recognition of any significant public achievement. Thus, Congress insured that the exclusion would only be available to those whose endeavors could benefit society as a whole, and not available to those who by the luck of the draw received income in the form of a valuable door prize, game show giveaway, sweepstakes or lottery winning.

A second area of controversy centered on prong two of the statute and regulations. In an effort to prevent extending tax-free treatment to prizes which were compensatory or quasi-contractual in nature, the statute required that the recipient be selected without any action on his part to enter the contest or proceedings or to otherwise submit himself or his work for consideration. Among the awards and prizes which were found not to qualify for exclusion on this ground were essay contests, puzzle solving competitions, all raffle, lottery or door prizes, any prize or award given by a radio or television game show, and awards where the recipient solicited the prize.

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103. See supra note 77.
108. See Wilson v. United States, 322 F. Supp. 830 (D. Kan. 1971) (winner of Miss America contest held taxable on cash and merchandise awarded where she had entered the contest proceedings); Rev. Rul. 65-161, 1965-1 C.B. 38 (winner of prize given for significant civic achievement held taxable because taxpayer initiated the result by entering the contest); Rev. Rul. 65-58, 1965-1 C.B. 37 (winner of "scholarship" prize offered by a business was not entitled to exclusion available under either section 74, because he entered proceeding, or section 117, because there was no requirement that the prize be used for education). But cf. Rev. Rul. 57-67, 1957-1 C.B. 33 (appearance by students, nominated by faculty, at an interview before selection of final winner of academic prize did not constitute "the participation in a contest or proceeding within the meaning of section 74 (b)").

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The final test that an excludable prize or award was required to meet was also designed to prevent the giving of disguised compensation. If receipt of the award or prize was conditioned on the recipient rendering substantial future services, the award would not qualify for the exclusion.\textsuperscript{110} The obligation to perform future services has resulted in the includability in gross income of prizes or awards to individuals ranging from research scientists\textsuperscript{111} to beauty contest winners.\textsuperscript{112}

The case law interpreting section 74 produced results consistent with the underlying reasons for its adoption.\textsuperscript{113} The specific areas of

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\item I.R.C. § 74(b)(2) (1954).
\item Mueller v. Commissioner, 41 T.C. 639, aff'd, 338 F.2d 1015 (1st Cir. 1964). Scientists selected, without effort on their part, by the Institute for Muscle Research to receive research award were denied section 74(b) exclusion since the award was not given for past scientific achievement, but to enable winners to conduct future research project:

While taxpayers were undoubtedly chosen initially on the basis of their experience and achievements, their selection was not based upon any formal competition, or as a result of any contest. Their research activity at the laboratory was required to be, according to the undisputed testimony of the Institute's director of research, "something which contributed to our common ideas." If it did contribute, the "awards" might continue indefinitely. On the other hand if performance failed to live up to the director's "expectations," or if a taxpayer chose to work elsewhere, his "award" terminated forthwith. 338 F.2d at 1016.
\item Rev. Rul. 68-20, 1968-1 C.B. 55. Taxpayer was a participant in and winner of a national beauty contest. The prizes included a four year "scholarship" to the college of her choice, fixed daily sums for personal appearances, fixed hourly amounts for modeling assignments, a new automobile, an expense allowance, and a variety of apparel and cosmetic items. Prior to competing in the national contest, taxpayer had signed a contract setting forth her duties as a participant in the national contest and as the possible national winner (such winner being obligated to accept employment by the contest sponsor for one year and to appear for the next year's contest as directed). The various prizes were held includable in income under section 74(a).
\item In addition to the cases and rulings discussed in supra notes 89–112, a number of other issues have arisen in connection with prizes and awards since the introduction of section 74 in 1954. Certain of these instances have involved questions of valuation of prizes won in kind. See Macri Corp. v. Commissioner, 35 T.C.M. (CCH) 1190 (1976) (fair market value of automobile won by taxpayer in raffle and sold by him within a few days of delivery for $2550 found by Tax Court to be $4000); McCoy v. Commissioner, 38 T.C. 841 (1962) (fair market value of automobile received as award in a sales contest which had cost donor $4452 and which winner disposed of within ten days for $3600 determined to be $3900); Rev. Rul. 58-347, 1958-2 C.B. 878 (producers of television game shows advised to issue Form 1099 to winners valuing merchandise prizes at manufacturer's suggested retail price). Cash prizes which were to be received in installments or at a deferred point in time have been considered. See Rev. Rul. 84-9, 1984-1 C.B. 22 (fact that otherwise excludable section 74(b) prize or award was to be received in annual payments for a fixed term or for life does not affect excludability); Rev. Rul. 62-74, 1962-1 C.B. 68 (value of cash prize placed in escrow with receipt deferred by fixed period calculated by normal present value discount methods). Also, attempts by persons selected as prize winners to assign the winnings to others have been the subject of concern. These have generally been resolved under traditional assignment of earned income doctrine. See Rev. Rul. 58-127, 1958-1 C.B. 42 (essay contest award won by parent but deposited for use of child towards child's
\end{enumerate}
achievement delineated in the Code were construed as exclusive and interpreted narrowly. Only prizes and awards for genuinely meritorious past achievement in areas that benefited humanity were considered as excludable under section 74. The cases and rulings did not recognize the donee's subjective reasons for entering a contest; entry dictated inclusion and therefore endless litigation was foreclosed. The chance of disguised compensation being received as a tax-free award was virtually eliminated since one could not perform any act of solicitation or be required to render any services subsequent to receipt of the prize. In fact, the case law seemed settled until a decision by the United States Court of Appeals for the Ninth Circuit created uncertainty in the area of employer awards to employees.\textsuperscript{114}

\textbf{D. Employer-Employee Awards: A Problem Area}

During the three decades following the enactment of section 74, the parameters governing its application developed in a fairly predictable fashion. Only in the area of employer awards to employees had any controversy developed during the period immediately preceding the tax reform efforts of the mid-1980's. The 1954 statute provided no specific guidelines to determine when an employer award to an employee would be excludable.\textsuperscript{115} However, reason would dictate that the same criteria developed in the cases and rulings discussed previously would be used.

Subsequent to the enactment of section 74, an interpretative regulation was promulgated by the Treasury Department that construed the statute to prohibit the exemption of awards by employers to employees in recognition of some achievement connected with their employment.\textsuperscript{116} Courts and the Internal Revenue Service consistently fol-


\textsuperscript{115} Compare the discussion of qualified employee achievement awards under section 274 for length of service, productivity, or safety achievement at \textit{supra} note 95.

\textsuperscript{116} See Treas. Reg. § 1.74-1(a)(1), (b) (1955).
owed this regulation until *Jones v. Commissioner*.\(^{117}\) In *Jones* the Court of Appeals for the Ninth Circuit reversed a decision of the Tax Court and held that the regulation was overly broad as applied to the facts and circumstances of that case.

Prior to the *Jones* decision the Service relied upon the regulation to establish a “bright-line” test.\(^{118}\) The test was simple. If a prize or award was presented by an employer to an employee in recognition of some employment related achievement, it was includable in gross income. Two early revenue rulings illustrate the effect of the regulation. The rulings involved awards to college faculty members for outstanding academic service to the employer institution. In both instances, the award was for past educational achievement and the recipients neither applied for consideration nor were they required to perform future services. The funding for each award came from an outside foundation. Where the selection of the winners was made by an executive committee of the employer institution for the purpose of supplementing the compensation of the recipient faculty members, the award was held taxable.\(^{119}\) However, where an independent selection process was utilized, the award was excludable from gross income as a section 74(b) educational achievement award.\(^{120}\) The distinction is that in the one case the direct employer-employee relationship made disguised compensation a distinct possibility, while the insulation of an independent selection process for the other award negated this possibility.\(^{121}\)

An even more obvious application of the regulation’s “bright-line” test is illustrated by Revenue Ruling 67-89.\(^{122}\) In that instance, an award received by a United States Army nurse selected by her commanding officer for outstanding performance in connection with her employment was deemed includable. Instead of government funds, the source of the award was a donation by an individual to honor his late wife who had been an army nurse. Nonetheless, the award was summarily included in the recipient’s gross income under Regulation section 1.74-1(b). This “bright-line” test, while not permitting a case by case examination of the equities, does, however, virtually eliminate

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\(^{117}\) 743 F.2d 1429 (9th Cir. 1984), rev’d 79 T.C. 1008 (1982).

\(^{118}\) Id. at 1433.


\(^{120}\) Rev. Rul. 57-19, 1957-1 C.B. 33 (committee of university students, alumni, and administrators selected the winner from a list provided by the graduating class and alumni).

\(^{121}\) Other instances where awards for superior teaching have been found taxable under the authority of Treas. Reg. § 1.74-1(b) (1955) may be found at Priv. Ltr. Rul. 86-40-034 (July 3, 1986) and Priv. Ltr. Rul. 84-42-027 (July 12, 1984).

the likelihood of tax-free receipt of disguised compensation in most employer to employee awards.\textsuperscript{123}

Prior to Revenue Ruling 67-89, the United States Court of Claims in \textit{Griggs v. United States}\textsuperscript{124} had considered whether an award made to a federal employee under the Government Employees' Incentive Awards Act\textsuperscript{125} should be taxed as income. The recipient, in the normal course of his employment, had formulated and negotiated a freight rate formula which saved the government millions of dollars for the transportation of rockets and rocket components. He was awarded approximately $8000 under the Incentive Awards Act. The court found that the award was given for an accomplishment in connection with taxpayer's employment and cited Regulation section 1.74-1(b), but did not rely on it. Rather, the court held that the award was in recognition of a technical not scientific achievement and for that reason not excludable under section 74.\textsuperscript{126}

The Tax Court, one year later, in \textit{Denniston v. Commissioner},\textsuperscript{127} was also faced with the issue of the taxability of awards given under the Government Employees' Incentive Awards Act. The taxpayer had, in the course of his employment, obtained substantial cost savings for the government on telephone and other communication services for which he received a $3000 incentive award. He maintained that the award was in recognition of civic achievement and that all of the elements of section 74(b) were present.\textsuperscript{128} The selection was made without any action on his part and he was not required to render substantial future

\textsuperscript{123} See also Priv. Ltr. Rul. 86-30-001 (Dec. 24, 1985) which denied the exclusion to the recipient of a foundation award for medical research productivity. Because officials of the recipient's employer (a medical college and hospital) comprised the foundation board and were involved in the selection process, the award was viewed as coming from employer to employee for some employment related achievement.

\textsuperscript{124} 314 F.2d 515 (Ct. Cl. 1963).


\begin{itemize}
  \item[(a)] The head of each department is authorized to pay cash awards to ... civilian officers and employees of the Government who by their suggestions, inventions, superior accomplishments, or other personal efforts contribute to the efficiency, economy, or other improvement of Government operations or who perform special acts or services in the public interest in connection with or related to their official employment.
  \item[(d)] A cash award under this section shall be in addition to the regular compensation of the recipient and the acceptance of such cash award shall constitute an agreement that the use by the Government of the United States or the municipal government of the District of Columbia of any idea, method or device for which the award is made shall not form the basis of a further claim of any nature upon the Government. . . .
\end{itemize}

\textsuperscript{126} \textit{Griggs}, 314 F.2d at 516-17.

\textsuperscript{127} 41 T.C. 667 (1964), aff'd per curiam, 343 F.2d 312 (D.C. Cir. 1965).

\textsuperscript{128} Id. at 670.
services as a condition of receiving the award. Although the Tax Court made reference to *Griggs*, the Tax Court chose not to base its decision on any semantic exercise such as the "technical" versus "scientific" distinction drawn by the Court of Claims.

The Tax Court found that the award to Denniston was compensatory in nature and fell directly within the provision of Regulation section 1.74-1(b). The taxpayer contended that the regulation was not a valid interpretation of section 74(b) or its legislative intent, since the wording of the statute omitted such a flat prohibition of the exclusion for any awards given in the employer-employee setting. In response, the Tax Court stated:

We do not read the regulations in question as setting forth the broad principle that under no circumstances can a payment by an employer to an employee come within the exclusion. Rather, such regulations provide that there can be no exclusion under section 74(b) where a prize or an award is given by an employer to an employee in recognition of some achievement in connection with his employment. Actually, the congressional committee reports in connection with the enactment of section 74 of the 1954 Code . . . specifically state that section 74(b) was not intended to exclude from income prizes or awards from an employer to an employee in recognition of some achievement in connection with his employment.

The Tax Court was clearly suggesting that a prize or award given by an employer to an employee for outstanding achievement outside of his employment could be excludable. This award, however, was given to the taxpayer to compensate him for his outstanding performance in connection with his employment and was, therefore, taxable. The Court of Appeals for the District of Columbia Circuit affirmed, per curiam, observing that the Government Employees' Incentive Awards Act by its own terms limited eligibility for the awards to those government employees who "contribute to the efficiency, economy, or other improvement of Government operations or who perform special acts or services in the public interest in connection with or related to their official employment."

The results reached in *Griggs* and *Denniston* were consistent, although the grounds upon which the decisions were reached were distinct. Awards given under the Government Employees' Incentive

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130. *Denniston*, 41 T.C. at 672.
131. Id. at 672-73 (emphasis in original).
Awards Act would be deemed taxable, precluding the possibility of tax-free receipt of disguised compensation.

The incentive award act involved in the two prior cases is not the only governmentally administered award program whose tax consequences have been the subject of dispute. The National Aeronautics and Space Act of 1958 provided for the Administrator of NASA to make monetary awards for any scientific or technical contribution to that agency which he determined to have significant value in the conduct of aeronautical and space activities. Recipients eligible to receive such awards include employees of the National Aeronautics and Space Administration ("NASA"), employees of a NASA contractor, employees of other government agencies, and third parties making significant contributions to the space program. Undoubtedly, the initiation of this particular incentive award program was spurred by the Soviet Union's launch on October 4, 1957, of the first earth-orbiting satellite, Sputnik I.

The question of whether an award made by NASA under section 306 of its enabling act could be excludable from gross income under Code section 74(b) was first considered in Revenue Ruling 69-129. That ruling reviewed the NASA award program noting that recipients of the awards were required to surrender all claims to any compensation, other than the award, for the use, by the United States, of their contribution. The awards were, therefore, in the Service's view, basically compensatory in nature. Somewhat surprisingly, Revenue Ruling 69-129 does not make reference to Regulation section 1.74-1(b) as additional authority.

In 1972, the correctness of the Service's position on these section 306 awards was tested in federal district court in Rogallo v. United States. In that case, a long term employee of NASA and his wife had received a section 306 award from NASA in the amount of $35,000 in connection with their invention and development of the parawing (a nonrigid flying structure ultimately used in space recovery devices and military vehicles). At the time of the award, the Rogallos

135. Id. at 35:

The awards granted under section 306 of the National Aeronautics and Space Act of 1958 are not made primarily in recognition of achievement within the meaning of section 74(b) of the Code. These awards are made on the basis of the value of the work done to the grantor, and the grantor's purpose in making them is to reward and provide incentive for contributions that advance its goals and interests.

were required to and did execute in favor of the government a nonexclusive royalty free license for use of their invention. The taxpayers and the government agreed that NASA selected the Rogallos for the award without any action or application on their part, they were not required to render substantial future services as a condition of receiving the award, the award was not made for an accomplishment in connection with Mr. Rogallo’s employment but was developed by the taxpayers on their own time, and the invention was in the scientific field of aeronautics.

In view of these agreed facts, the district court found the award to Mr. and Mrs. Rogallo to be excludable under section 74(b), notwithstanding the government’s assertion that the award had been given primarily in exchange for the royalty free license and not primarily in recognition of scientific achievement. In so ruling, the district court alluded, as had earlier courts, to the policy supporting tax benefits to encourage significant public achievement: “Lastly, it rubs across the grain of this court to ‘award’ something with one hand—unsolicited—for scientific achievement, and then reclaim 50% of the ‘award’ with the other.”

The Rogallo decision was appealed by the government to the Court of Appeals for the Fourth Circuit which reversed. The court of appeals disagreed with the district court as to the reason for the giving of the award:

The award received by the Rogallos was an honor, and the Rogallos could well have perceived it solely as such, so that we are sympathetic to their claim. But we conclude that, in fact and in law, the award was not “primarily in recognition” of their invention of the parawing. NASA made the award not primarily for their act of invention, but for their act of contributing the invention to NASA. Without this contribution and the royalty—free irrevocable license, there would have been no award. The award was not therefore gratuitous and should not be excluded from gross income under § 74(b).

After almost thirty years of cases and rulings denying the section 74(b) exclusion to employer awards to employees, we arrive at Jones v. Commissioner. Like the Rogallos, Mr. Jones was the recipient of an

137. Id. at 999-1000.
138. Id. at 1000.
139. See, e.g., McDermott v. Commissioner, 150 F.2d 585, 588 (D.C. Cir. 1945).
140. Rogallo, 341 F. Supp. at 1000-01.
142. Id. at 7.
143. Jones v. Commissioner, 743 F.2d 1429 (9th Cir. 1984).
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award from NASA pursuant to section 306. The issue again was whether the award was excludable under section 74(b). The Tax Court’s finding was consistent with prior law: The award received by Jones from his employer was taxable income. The case was appealed to the Court of Appeals for the Ninth Circuit which reversed Chief Judge Tannenwald’s decision and set in motion the chain of events leading to the amendment of section 74 in the Tax Reform Act of 1986.

The facts in Jones were undisputed. Robert Jones is an award winning aerodynamicist who had been employed by the federal government for over thirty years designing and improving aircraft. He designed the swept-wing jet aircraft and later invented the oblique wing aircraft. His contributions to the aerodynamics industry were unparalleled. In 1974 NASA officials submitted an application for a section 306 award to be given to Jones for the oblique wing design. NASA’s awards board initially considered giving Jones an award in the range of $1500 to $2000.

Before the awards board finalized its decision, the Technical Information Division of NASA (to celebrate Jones’ sixty-fifth birthday) compiled a volume of his scientific papers and articles entitled “Collected Works of Robert T. Jones.” After reviewing this volume, the awards board decided to give the taxpayer a $15,000 award for “the totality of his scientific contribution to the conduct of NASA pro-

144. The court of appeals recited a litany of Dr. Jones’ awards as follows:

Jones has received several other awards and honors. In 1946 he received the Sylvanus Albert Reed Award from the Institute of Aeronautical Science for his discoveries concerning airflow at subsonic and supersonic speeds. In 1971 the University of Colorado awarded him an honorary Doctor of Science degree. The German aerospace society, Deutsche Gesellschaft Fur Luft und Raumfahrt e.V., gave him its highest award in 1978. In 1981 he received the President’s Award for Distinguished Civilian Service and the Smithsonian Institution’s Langley Medal, one of only 17 such awards presented in this century.

145. The Tax Court described these accomplishments as follows:

The swept-wing design, which was a fundamental advance towards supersonic flight, involves wings which are at an acute angle to the fuselage of the aircraft. In the 1970’s, petitioner began serious work on the “Oblique-Wing Supersonic Aircraft,” a design in which the wing, mounted on top of the fuselage, pivots at the center. When the plane takes off, the wing is perpendicular to the fuselage; when it is in the air, the wing can be swiveled so it is almost parallel with the fuselage. Some time prior to August 12, 1974, petitioner assigned his patent rights in the oblique-wing aircraft to the United States of America as represented by the administrator of NASA.

146. Id. at 1011.

147. The majority of papers in this volume deals with aeronautics. However, papers on optics, relativistic kinematics, biomechanics, and violins also are included. Id. at 1010.
grams in aeronautics and space, and to advancement of scientific knowledge." Mr. Jones excluded the award from gross income, and the Service proposed a deficiency in tax leading to the Tax Court proceeding.

Before the Tax Court, the parties stipulated that Jones' aeronautical inventions, innovations, and discoveries qualified as scientific achievements, the award was made to him in recognition thereof, he did not take any action to solicit the award, and that he was not required to perform substantial future services as a condition of receiving it. The taxpayer therefore asserted that all requirements of section 74(b) had been met and that the money was properly excluded from gross income. In Jones' view, the award was "honorable rather than compensatory." The government countered with two alternative arguments: Either the NASA award program only had statutory authority to confer compensatory awards which, because of the quid pro quo involved, are not awards "primarily in recognition of" scientific achievement (the Rogallo argument); or the award was from taxpayer's employer in recognition of some achievement in connection with his employment (the Regulation section 1.74-1(b) argument).

The Tax Court found it unnecessary to resolve the Rogallo issue since it concluded that the award was essentially given in recognition of employment related activities and therefore taxable. This outcome was, of course, consistent with the "bright-line" test from Treasury Regulation section 1.74-1. While upholding the validity of the regulation in this case, the Tax Court, echoing its opinion in Denniston, indicated that it would not necessarily find every award from an employer to an employee to be disqualified from the section 74(b) exclusion.

Admittedly, the award had overtones of recognition of petitioner's lifelong achievements independent of his employment by NASA. However, petitioner's activities in respect of the oblique-wing design, incorporated in the patent which he assigned to NASA, were the cutting edge of the recommendation which led to the award, and it is clear to us that, but for these activities and his employment by NASA, the award would not have been made.

Denniston v. Commissioner, 41 T.C. 667 (1964), aff'd per curiam, 343 F.2d 312 (D.C. Cir. 1965); see supra text accompanying note 127.

He [Jones] argues that the provisions of section 1.74-1, Income Tax Regs. . . ., should not be interpreted as excluding from section 74(b) every award by an employer to an employee. We do not disagree with petitioner, but we do not think that it necessarily follows that he
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The Tax Court's decision in Jones was appealed by the taxpayer to the Ninth Circuit, which found the regulation was overly broad as written and devoured the statute. The court distinguished Rogallo, Griggs, and Denniston on the grounds that the awards therein were all compensatory in nature. It discredited Revenue Ruling 67-89 (the army nurse performance award) for having little reasoning and for being reflective of the "bright line" appeal of the regulation. If under the facts and circumstances of a given case it seemed that an employer's purpose was to disguise compensation, then the amount of the award was certainly includable in gross income. However, the court stated that "[w]hen an employer makes an award out of a desire to honor, or to show respect or admiration for, an employee, and the award is not compensation for some recent benefit to the employer, the award should be excluded under section 74 if it otherwise qualifies for exclusion." When this standard was applied to the Jones case the award was found to be excludable. In Revenue Ruling 86-31, the Service declined to follow the Ninth Circuit's Jones opinion and stated that it would continue to follow Treasury Regulation section 1.74-1(b) and Revenue Ruling 69-129.

While this decision was the first to allow an exclusion for an award by the government to one of its employees in recognition of achievements made in connection with employment, the criteria utilized were certainly not novel. More than thirty years earlier in Robertson, Justice Douglas set forth similar grounds which would justify excludability (i.e., award made in recognition of past achievements, not for services, and out of affection, respect, or admiration). Therefore, the Jones court did not create a new test, but simply declined to follow the "bright-line" test associated with the regulations.

In Jones, the Ninth Circuit was concerned with equity and fairness. It found the facts and circumstances did not give rise to a presumption

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155. Id. The court found that in Rogallo the inventors had been required to execute a license as a condition to the award and that the award was therefore compensatory. In Denniston and Griggs the employees had been performing their ordinary duties and had received monetary awards for the outstanding nature of their job performance. This also seemed to involve thinly disguised compensation.
156. Id.
157. Id.
160. Robertson v. United States, 343 U.S. 711, 713–14 (1952); see supra text accompanying note 71.
that the award was for services rendered.\textsuperscript{161} Therefore, to automatically tax the award because it was from an employer was unfair. In balancing fairness in the individual case with the need for judicial economy, fairness prevailed. The court observed that its “approach may make a little more work for the commissioner and the courts, but their job is to decide cases despite the inconvenience of doing so.”\textsuperscript{162}

Regardless of whether the Ninth Circuit’s \textit{Jones} decision was correct under the particular facts and circumstances involved, it threatened to open a loophole the Service had thought was closed by the “bright-line” test in Regulation section 1.74-1. The possibility that employers could disguise compensation as honorific awards which might be received tax-free by employees was one factor that led Congress to react in 1986.

\textbf{E. Tax Reform Act of 1986 Changes in Section 74(b)}

Section 74(b), while not eliminated from the Code, has been dramatically changed by the Tax Reform Act of 1986.\textsuperscript{163} Beginning January 1, 1987, the individual taxpayer can no longer economically benefit from the prize or award while having the added benefit of a tax exclusion for the amount received. The fair market value of the previously excludable prize or award must now be included in the recipient’s gross income unless the taxpayer assigns the prize or award to char-

\begin{itemize}
  \item[161.] \textit{Jones v. Commissioner}, 743 F.2d 1429, 1433 (9th Cir. 1984).
  \item[162.] \textit{Id}.
  \item[163.] TRA86, \textit{supra} note 3, § 122(a) amended Code section 74(a) and (b) to read:
  \begin{itemize}
    \item[(a)] General Rule.—Except as otherwise provided in this section or in section 117 (relating to qualified scholarships), gross income includes amounts received as prizes and awards.
    \item[(b)] Exception for Certain Prizes and Awards Transferred to Charities.—Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if—
      \begin{itemize}
        \item[(1)] the recipient was selected without any action on his part to enter the contest or proceeding;
        \item[(2)] the recipient is not required to render substantial future services as a condition to receiving the prize or award; and
        \item[(3)] the prize or award is transferred by the payor to a governmental unit or organization described in paragraph (1) or (2) of section 170(c) pursuant to a designation made by the recipient.
      \end{itemize}
  \end{itemize}
  Section 122(a) of TRA86 also added a new sub-section (c) to section 74. See I.R.C. § 74(c) (1987). This new subsection relates to employee achievement awards for length of service and safety achievement discussed \textit{supra} at note 95. Prior to the enactment of TRA86, such awards were excluded from gross income under Code section 102(a) as gifts from the employer. Section 122 (a) and (b) of TRA86 make it clear that henceforth such awards will be excludable, if at all, under the authority of new Code section 74(c).
\end{itemize}
The three prong test for excludability has now become a four prong test, with the final prong being the total relinquishment of the right to the benefit prior to the actual receipt of the prize or award.\textsuperscript{165} The assignee or alternate recipient of the prize or award must be a governmental unit or qualified charitable organization.\textsuperscript{166} Therefore, prizes such as the Nobel Prize or Pulitzer Prize (even though never taxed before) will be taxable to the winner unless given away.\textsuperscript{167}

This new rule harkens back to the Tenth Circuit's 1951 opinion in Robertson.\textsuperscript{168} To avoid being taxed on an award for a public or humanitarian achievement, the winner must refuse the prize. The taxpayer then will be left with the prestige of having been selected and the warm feeling of beneficence that a philanthropist gets from giving money to a favorite charity. It appears, at least on the surface, that Congress has adopted a tax policy of "virtue is its own reward."

All that remains of the long-standing and settled policy of encouraging scholarly, scientific, charitable, and similar public achievements is the self-satisfaction that one receiving an award or prize may experience by giving it away. The selective elimination of this particular tax preference can only be viewed as an implicit statement that rewarding members of society with tax exclusions, when they have been honored for their altruistic endeavors to better mankind, is no longer an inherent goal under the Internal Revenue Code. Since Congress has not

\textsuperscript{164} I.R.C. § 74(c) (1987).


In addition, in order to qualify for the section 74(b) exclusion as modified by the bill, the designation must be made by the taxpayer, and must be carried out by the organization making the prize or award, before the taxpayer uses the item that is awarded (e.g., in the case of an award of money, before the taxpayer spends, deposits, invests, or otherwise uses the money). Disqualifying uses by the taxpayer include such uses of the property with the permission of the taxpayer or by one associated with the taxpayer (e.g., a member of the taxpayer's family).

\textsuperscript{166} The types of entities to whom a prize winner may assign his award are restricted to those described in I.R.C. § 170(c)(1)-(2) (1987) which include:

(1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia . . . [and] (2) A corporation, trust, or community chest, fund, or foundation—

. . . .

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals. . . .


\textsuperscript{168} Robertson v. United States, 190 F.2d 680, 683 (10th Cir. 1951), aff'd, 343 U.S. 711 (1952).
chosen to eliminate tax preferences from the Code, it is worthwhile to analyze the tax reform process of the mid-1980's and the tax policy implications of new section 74(b) to see if its emasculation was justified.

III. ANALYSIS OF POLICY IMPLICATIONS OF NEW SECTION 74(b)

A. Background for Tax Reform

The federal income tax system initiated in 1913 was based upon a comprehensive concept of income includable in the taxable base. The drift to expand preferential treatment to certain kinds of income began in the 1920's. For many different and sometimes inconsistent reasons, various tax benefits, in the form of exclusions, exemptions, deductions or credits, have been added to the law over time. By the time of the 1954 codification, the tax laws had grown into a large and

169. A variety of exclusions, exemptions, deductions, and credits has remained in the Code despite the significant base broadening efforts of Congress in TRA86. See, e.g., I.R.C. § 101(a) (1987) (amounts received under life insurance contract by reason of death of insured excludable from gross income); id. § 107 (rental value or rental allowance for parsonage used by minister excluded from gross income); id. § 163(a), (h) (interest paid by taxpayer on mortgage indebtedness on primary and one other personal residence generally allowed as a deduction).

170. See supra text accompanying notes 10-14.

171. The very few tax preferences allowed in 1913 and described at supra notes 16-21 were considerably expanded over the next fifteen years. The Revenue Act of 1928, Pub. L. No. 562, § 22(b), 45 Stat. 791, 797-99 (1928) recognized exclusions for: One, life insurance death proceeds; two, amounts of annuity payments not in excess of taxpayer's investment in the contract; three, the value of property received by gift, bequest, devise or inheritance; four, interest received on state or federal obligations; five, amounts received through insurance, workers' compensation, litigation or settlement as compensation for personal injuries or sickness; six, amounts received as pensions or similar payments for military service or under a State employees pension system; seven, the first $300 of interest or dividends received from domestic building and loan associations; eight, the rental value of a minister's parsonage; nine, earned income from sources outside of the United States; and ten, the compensation received by teachers in the territories of Alaska and Hawaii. In addition, section 23 of the 1928 Act allowed as deductions from income: One, all the ordinary and necessary expenses incurred in carrying on any trade or business including: a) reasonable compensation for services actually rendered; b) traveling expenses, meals and lodging costs while away from home in pursuit of business; c) rental expense for property used in a trade or business; two, all interest paid or accrued on indebtedness owed by the taxpayer, except for indebtedness used to acquire tax-free United States government bonds; three, state and local taxes of all sorts; four, losses sustained by taxpayer and not compensated for by insurance of incurred in a trade or business, in a transaction entered into for profit, or in a casualty or theft; five, bad debts; six, reasonable allowances for depreciation and depletion; seven, charitable contributions; eight, dividends received from domestic corporations; and nine, personal and dependency exemption allowances. Id. § 23, at 790-800.

172. The intricacies and shortcomings of the tax legislative process have been discussed at length over the past decade. See, e.g., D. Davies, United States Taxes and Tax Policy 285-87 (1986); J. Peckman, Federal Tax Policy ch. 3 (4th ed. 1983); Surrey, The Federal Tax Legislative Process, 31 Rec. of NYCA 515 (1976).
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very complicated piece of legislation. The efforts of Congress to fairly and equitably distribute the tax burden and, at the same time, to promote economic and social welfare almost inevitably have led to statutory complexity.\(^\text{173}\) In addition, modifying the tax code to accommodate public support for specific activities has often proven more expedient than appropriating specific expenditures.\(^\text{174}\) A large number of special interest groups has been able to persuade Congressional leaders to introduce beneficial provisions in the Code.\(^\text{175}\) Most of these were relatively small items when considered separately, but when taken together they have reduced the tax base significantly.\(^\text{176}\)

Beginning shortly after enactment of the 1954 code, respected commentators on federal income taxation frequently attacked the variety of preferential provisions in the Code and called upon Congress to reverse the "erosion of the income tax base"\(^\text{177}\) caused by these special provisions. The call for a "comprehensive tax base" has come to be a central theme in almost all proposals for tax reform.\(^\text{178}\)


174. The "orphan drug" credit is a good example of the use of tax provisions rather than direct government expenditure. To promote the development and marketing of drugs to be used for treatment of rare diseases and conditions (so-called "orphan drugs"), Code section 28 allows a 50% tax credit for qualified clinical testing expenses paid or incurred after 1982. \textit{I.R.C. § 28(a)} (1987). This credit was scheduled to expire after 1987, but has been extended by section 232 of \textit{TRA86} to cover amounts paid or incurred through December 31, 1990. \textit{I.R.C. § 28(e)} (1987).

175. The powerful influence of lobbyists and political action committees ("PAC's") on the tax legislative process has been described as follows:

\begin{quote}
The same forces—the concentrated benefits and diffuse costs of tax favoritism—that produced the existing tax mess would make it difficult to sustain a coherent broad-based system if one were to be enacted. The same forces that gradually built the existing tower of confusion, exclusion by exclusion, deduction by deduction, credit by credit, will attempt to reconstruct a new edifice if the old one is torn down. Persuasive and well-paid advocates will present the case for just one more special provision for one more worthy cause as forcefully to Congress after reform as they did before. And each victory for favoritism paves the way for the next.

The power of special pleading to influence legislation is fueled by the dependency of elected officials on large campaign contributions by political action groups and individuals. The promise of campaign money in exchange for votes will not end merely because taxes are reformed; it will continue as long as congressional and presidential candidates depend on large campaign contributions.
\end{quote}


178. Numerous governmental studies have advocated the implementation of a comprehensive tax base as an essential element in any serious tax reform effort. \textit{See, e.g.,} House
A classic formulation of this tax reform proposal was contained in the Treasury Department's *Blueprints for Basic Tax Reform* released in 1977. The study advocated broadening the tax base by eliminating or substantially restricting tax reduction provisions. The augmented tax base would permit a lower basic rate structure with fewer brackets and lower marginal rates, an increased standard deduction, and larger personal dependency exemptions. Together, these measures would have a significant simplifying effect upon the tax law. Incentives for economic expansion would come from the net tax reduction resulting from the lowering of rates and from the use of certain incentives for capital formation and investment which would be continued.\textsuperscript{180}

Whatever merit the *Blueprints* plan and other similar calls for basic tax reform may have had, they were substantially ignored in the major tax bills that were enacted through 1984.\textsuperscript{181} Following President Reagan's first election in 1980, based on a platform of supply-side economics, modest individual and massive business tax reductions were enacted in 1981 to stimulate economic recovery.\textsuperscript{182} The 1982 and 1984 tax acts, while paying lip service to basic principles of equity, simplification, and efficiency, were primarily concerned with raising revenue and insuring more widespread compliance with existing tax laws rather than comprehensive reform.\textsuperscript{185}

\textsuperscript{179} COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., TAX REVISION COMPENDIUM OF PAPERS BROADENING THE TAX BASE (Comm. Print 1959); STAFF OF JOINT ECONOMIC COMM., 89TH CONG., 1ST SESS., FISCAL POLICY ISSUES OF THE COMING DECADE (Comm. Print 1965); see also S. Surrey, \textit{Pathways to Basic Tax Reform} (1973).

\textsuperscript{180} Id.

\textsuperscript{181} See generally D. Bradford, \textit{Untangling the Income Tax} 1–11 (1986); J. Witte, \textit{supra} note 27, chs. 10–11.

\textsuperscript{182} ERTA, \textit{supra} note 8, contained a variety of pro-business tax incentives, the most important of which were the introduction of the accelerated cost recovery system of depreciation, the sale of tax credits through "safe-harbor" leasing, reductions in tax for oil producers, increases in the tax credit for research and development, and the extension of investment tax credit for urban building and rehabilitation. Interesting insights into the operative forces leading to the passage of the 1981 tax act may be found in the now famous interview of David Stockman who was then the director of the Office of Management and the Budget. See Greider, \textit{The Education of David Stockman}, \textit{Atlantic Monthly}, Dec. 1981, at 27.


\textsuperscript{185} Even as Congress stopped short of enacting comprehensive and substantial tax reform in 1984, it did express concern about fundamental problems of the existing tax structure:

\begin{quote}
The committee believes that the current system of income taxation is unduly complex. The large number of tax preferences and special deductions, credits and exclusions increase
\end{quote}
While academics had been calling for overall tax reform for many years,\(^\text{186}\) it was not until the 98th Congress (1983–1984) that any credible efforts were made to introduce such a measure. During that term of Congress, members proposed a wide variety of bills aimed at substantially revamping the federal income tax system.\(^\text{187}\) Two of the better known and more detailed of the congressional proposals were the Democratic Bradley-Gephardt "Fair Tax Act of 1983"\(^\text{188}\) and the Republican Kemp-Kasten "Fair and Simple Tax Act of 1984."\(^\text{189}\) Both bills proposed lowering the tax rates and broadening the tax base by repealing many tax credits, deductions, exclusions, and other preferences.

Starting in 1984, the Reagan administration began to consider overall tax reform. In his State of the Union address on January 25, 1984, the President asked then Treasury Secretary Donald T. Regan to develop a "plan for action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly."\(^\text{190}\) The Treasury study

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\(^{190}\) N.Y. Times, Jan. 26, 1984, at B8, col. 3. President Reagan's statement on tax reform was:

There's a better way: Let us go forward with an historic reform for fairness, simplicity and incentives for growth. I am asking Secretary Don Regan for a plan for action to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly. And I believe such a plan could result in that "underground economy" being brought into the sunlight of honest tax compliance; and it could make the tax base broader, so personal tax rates could
was to be presented to the President after the 1984 presidential election.

During the 1984 presidential election campaign, tax reform was a central point of disagreement between the Republican and Democratic nominees. While both party platforms called for significant tax reform in general terms,¹ the public debate concerned whether or not a tax increase was needed to help reduce the growing federal deficit. Former Vice President Mondale insisted a tax increase was necessary, even inevitable, while President Reagan held steadfast in his opposition to raising taxes.²

Following President Reagan's landslide reelection,³ the Treasury Department in November 1984 presented the tax reform recommendations which had previously been requested by the President.⁴ The report set forth a variety of recommendations for reform of the existing tax system and a comparison of its recommendations to existing law and many of the leading congressional tax reform proposals. The initial Treasury report aroused a great deal of controversy among business, civic, and other special interest groups. Much of that public commentary was taken into account by the Treasury Department which, under the leadership of a new Secretary of the Treasury, helped the Reagan administration refine its proposals for tax reform.

On May 29, 1985, President Reagan sent Congress an extensive set of tax reform proposals.⁵ The proposals were transmitted with a brief message from President Reagan which challenged the Congress "to change our present tax system into a model of fairness, simplicity, efficiency and compassion, to remove the obstacles to growth and unlock the door to a future of unparalleled innovation and achievement."⁶ The President emphasized that the "present tax code is not

⁵ See PRESIDENT'S PROPOSALS, supra note 7.
⁶ Id.
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only unfair, it slows economic growth and job creation, and hinders technological advancement by interfering with free markets and diverting productive investment into tax shelters and tax avoidance schemes.” 197

The proposal summarized the problems of the existing tax system: It was unfair, too complicated, and it needlessly impeded economic growth.198 In the most general of terms, the report proposed reducing tax rates and lowering the number of tax brackets of individuals to only three, increasing the amount of the personal and dependency exemptions and the zero bracket amount, and comprehensive base broadening measures through the elimination or curtailment of a wide range of categories of preferential tax treatment.199 “Only a limited number of special deductions and exclusions would be retained—principally those that are widely used, and generally judged to be central to American values.” 200

After holding extensive hearings and considering various alternatives during the summer and fall of 1985, the House Committee on Ways and Means on December 3, 1985, reported out its tax reform bill.201 The House bill bore great similarity in general form to the President’s proposal, although there were numerous differences in detail. After passage by the House of Representatives on December 17, 1985,202 the measure went to the Senate Finance Committee for its consideration. The Senate Finance Committee’s amended version of H.R. 3838 (now called “Tax Reform Act of 1986”) was passed by the Senate on June 24, 1986.203

A Committee of Conference between the House and Senate was appointed to reconcile the differences between the two versions of the bill. The Conference Committee reached an agreement in principle on August 29, 1986,204 and reported out its version of H.R. 3838 on September 18, 1986.205 The Conference Committee’s proposal for tax reform was passed by the House and Senate on September 25 and 27,

197. Id.
198. Id. at 1–2.
199. Id. at 3–8.
200. Id. at 4 (emphasis in original).
1986, respectively. Finally, on October 22, 1986, after almost four continuous years of study and effort, President Reagan signed into law the most far-reaching revision of the federal income tax system since the passage of the 1954 Code. The changes wrought by the Tax Reform Act of 1986 were so substantial that the tax code is hereafter to be cited as the "Internal Revenue Code of 1986."

B. Reasons Offered for Changing Section 74(b)

None of the tax reform measures introduced during the 98th Congress had specifically addressed the exclusion provided for public achievement prizes and awards in section 74(b). The first specific suggestion that the exclusion be modified appears in the November 27, 1984, Treasury report on tax simplification and reform. Among the many base broadening measures enumerated therein was the proposal to disallow the exclusion, even for the traditionally excludable notable achievement prizes and awards such as the Nobel prize, unless the individual recipient designated that the prize or award go to a tax exempt charitable organization. The reasons offered by Treasury to justify the change were as follows:

Prizes or awards increase an individual's ability to pay tax the same as any other receipt that increases an individual's economic wealth. In effect, the failure to tax all prizes and awards creates a program of matching grants under which certain prizes or awards also bestow the government-funded benefit of tax relief. Basing this program in the tax code permits it to escape public and legislative scrutiny and causes benefits to be distributed not according to merit but to the amount of tax the individual would otherwise owe.

Repeal of the exclusion for certain prizes and awards will affect the tax liability of only a few taxpayers, but it will reduce the complexity of the tax laws and preclude attempts to characterize income as a tax-exempt award.

209. A number of those proposals did, however, purport to eliminate almost all exclusions and deductions in an effort to simply define a comprehensive income tax base which would be subjected to a low flat rate of tax. See, e.g., H.R. 5711, 98th Cong., 2d Sess. (1984); S. 557, 98th Cong., 2d Sess. (1984) (introduced in the House by Richard C. Shelby (Democrat-Ala.) and in the Senate by Dennis DeConcini (Democrat-Az.).)
211. Id.
212. Id.
The President's May 29, 1985, proposals to the Congress for tax reform\textsuperscript{213} contain a nearly identical explanation.\textsuperscript{214}

A somewhat expanded explanation of the proposal to amend section 74(b) is found in the House Ways and Means Committee Report on H.R. 3838\textsuperscript{215} and the subsequent Senate Finance Committee Report.\textsuperscript{216} In addition to the factors identified in the Treasury's and President's reports, the congressional reports added the following explanation of the change:

The questions of what constitutes a qualifying form of achievement, whether an individual took action to enter a contest or proceeding, and whether or not the conditions of receiving a prize or award involve rendering "substantial" services, have all caused some difficulty in this regard. Finally, the present-law exclusion may in some circumstances serve as a possible vehicle for the payment of disguised compensation.

At the same time, the committee recognizes that in some instances an award recipient may wish to assign the award to charity, rather than claiming it for personal use. Accordingly, the bill provides that a prize or award meeting the present-law exclusion requirements under section 74(b) is excludable from gross income if the prize or award is transferred by the payor, pursuant to a designation made by the winner of the prize or award, to a governmental unit or to a tax-exempt charitable organization contributions to which are deductible under section 170(c)(1) or section 170(c)(2), respectively.

\ldots \ldots In such case, the prize or award is not included in the winner's gross income, and no charitable deduction is allowed to the winner or to the payor. \ldots \ldots

For purposes of determining whether a prize or award that is so designated qualified as excludable under the bill, the present-law rules concerning the scope of section 74(b) are retained without change. In order to qualify for the exclusion, the designation must be made by the taxpayer, and carried out by the party making the award, before the taxpayer uses the item that is awarded (e.g., in the case of an award of money, before the taxpayer spends, deposits, or otherwise invests the money). Disqualifying uses by the taxpayer include use of the property

\textsuperscript{213}President's Proposals, supra note 7.
\textsuperscript{214}Id.; General Explanation of TRA86, supra note 6, at 59.
\textsuperscript{216}1986 S. Rep., supra note 165, at 47-54.
with the permission of the taxpayer or by one associated with the taxpayer (e.g., a member of the taxpayer's family). 217

On the basis of these reports, 218 Congress amended section 74(b) by adding new subsection (b)(3) which contains the additional requirement for exclusion that the prize or award must be assigned to charity.

C. Critique of Legislative Rationale

The reasons offered by Congress and the Reagan administration for the amendment of section 74(b) may be summarily listed as follows: One, the exclusion found therein was an unnecessary source of complexity in the Code; two, problems had arisen in the past in applying the tri-partite test of excludability; three, only a few taxpayers utilized the tax benefit it conferred; four, there was a possibility that the exclusion could have been used to disguise compensation as a tax exempt award; five, valuable prizes or awards were economic income that should have been taxed like any other form of income; and, six, the exclusion constituted a tax expenditure no longer justified in the context of comprehensive tax reform.

By analyzing each one of these proffered reasons carefully, it may be seen that they simply do not justify the change that was made to the statute.

1. Undue Complexity

There is some surface appeal to the notion that section 74(b) as enacted in the 1954 Code added undue complexity to the tax laws. The presence of the exclusion, like that of all of the other exclusions and tax preferential provisions, results in a more complicated statute than one in which all forms of income would be comprehensively included in the tax base and no preferences of any sort would exist. Conceding that point, however, does not necessarily validate this rationale as a justification for the Tax Reform Act of 1986 amendment to section 74(b). For one thing, the new code, in toto, is not significantly less complex than its predecessor. Even more importantly, section 74(b), as amended, is more complicated after the reformation than before. A subsection with four specific requirements for exclusion is just not as simple as one with only three requirements. For purposes of deter-

218. The Conference Committee report conformed to the earlier House and Senate Committee reports with respect to the change in the treatment of prizes and awards. See CONFERENCE REPORT, supra note 205, at II-17 to 19.
mining whether a future prize or award transferred to charity will qualify for the new section 74(b) exclusion, all of the old ostensibly complicated rules governing the scope of the section have been retained. Complexity must not have created great concern!

2. *Past Problems in Applying Section 74(b)*

As was noted previously, the early case law interpreting section 74(b) produced generally predictable results which were consistent with its legislative purposes. The specific areas of achievement delineated in the Code were construed as exhaustive and were applied narrowly. For more than thirty years, the exclusion was limited to prizes and awards for significant public achievement. Only in the area of employer awards to employees had a problem recently developed, as illustrated by the Jones case. It seems rather disingenuous for the House and Senate reports to suggest that difficulty had arisen in the past in applying *all* of the requirements of section 74(b).

3. *Limited Number of Taxpayers Affected*

The Treasury Department report correctly observes that only a few taxpayers would be affected by changing section 74(b). They would, of course, be the recipients of unsolicited prizes and awards recognizing past achievement in one of the enumerated fields of public contribution who were not required to perform substantial future services as a condition of receipt. Acknowledging the limited availability of the exclusion does not, however, necessitate its vitiation. This is true even where an express goal of the tax reform effort is to retain only a limited number of special deductions and exclusions. The relatively small number of taxpayers who might have been qualified to use the section 74(b) exclusion means that very little revenue could be gained by adding these prizes and awards to the tax base. That

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219. See supra text accompanying notes 85–162.

220. See supra text accompanying notes 143–62.

221. See supra text accompanying note 217.

222. 2 TREASURY REPORT, supra note 194, at 60, provides: “Repeal of the exclusion for certain prizes and awards will affect the tax liability of only a few taxpayers, but it will reduce the complexity of the tax laws and preclude attempts to characterize income as a tax exempt award.”

223. See supra text accompanying note 200.

224. The Treasury Report and President's Proposals estimated the change in federal tax receipts occasioned by the amendment to Code section 74(b) to be negligible for the five fiscal years following the passage of the Tax Reform Act. See 1 TREASURY REPORT, supra note 7, Appendix B, at 245; PRESIDENT'S PROPOSALS, supra note 7, Appendix C, at 453. The House, Senate, and Conference Committee estimates of revenue impact combined the effect of the change in section 74(b) with the changes made in the area of employee achievement awards. See supra note 95. When so combined, the estimate of revenue impact shows a revenue loss. See.
being the case, the question should not be how few taxpayers utilize the exclusion, but rather whether the endeavors it seeks to encourage are "central to American values." 225

4. Disguised Compensation

The Jones case clearly was a motivating force behind the change in section 74. Even though the various administration and congressional reports only make a single footnote reference to the Jones case, 226 they all allude to the circumstances under which the exclusion could serve as a possible vehicle for disguised compensation. 227 Until 1984, the case law consistently followed the underlying rationale of section 74 and the "bright-line" test of the Regulations and held employer awards to employees for all employment related achievements to be taxable. The likelihood of disguised compensation escaping taxation through section 74(b) was insignificant. The Jones case opened the door for possible abuse. Congress, however, could have closed the door without denying deserving award recipients tax exclusion. Had it so chosen, Congress could have simply and directly denied the exclusion to any award from an employer to an employee under any circumstances. 228

5. Prizes as Economic Income

No one can dispute the observation in the House and Senate reports that "the receipt of an award for scientific or artistic achievement in

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225. See supra text accompanying note 200.

226. H.R. REP. No. 426, supra note 215, at 103 n.3; accord 1986 S. REP., supra note 165, at 47 n.3, which provides:

(3) Treas. Reg. sec. 1.74-1(b). But see Jones v. Comm'r, 743 F.2d 1429 (9th Cir. 1984), holding that an award from an employer to an employee can qualify for the present-law section 74(b) exclusion under extraordinary circumstances. The court held that the exclusion applied in the case of a prominent scientist who was rewarded by the National Aeronautics and Space Administration (NASA) for lifetime scientific achievement, only part of which was accomplished while the scientist was employed by NASA. No inference is intended as to whether the decision of this case is correct under present law. Similar language appears as a footnote in the GENERAL EXPLANATION OF TRA86 issued May 4, 1987 by the Joint Committee on Taxation. See GENERAL EXPLANATION OF TRA86, supra note 6, at 30 n.12.

227. See supra text accompanying note 217.

228. See infra text accompanying notes 284–92.
the amount of $10,000 increases the recipient's net worth and ability to pay taxes to the same extent as the receipt of $10,000 in wages, dividends, or prizes and awards that are taxable under current law.**229 That conclusion was true for the more than seventy years prior to the enactment of the Tax Reform Act of 1986. Perhaps the argument that public achievement prizes should be taxed the same as all other forms of economic income would be more persuasive if Congress had, in fact, fashioned a completely comprehensive tax base in the 1986 legislation. Instead, Congress continued many existing tax preferences230 and created some additional ones.231 That being the case, the economic income rationale begs the fundamental tax policy question of whether the exclusion's tax benefit is still justified.

6. Exclusion as Tax Expenditure

It is not entirely clear from the portions of the Treasury and President's reports which address the central tax policy issue whether they constitute an indictment of this particular tax incentive or the entire system of tax expenditures sprinkled throughout the Code.232 The tax expenditure argument is premised on the concerns that the tax benefits may receive less public and legislative scrutiny than directly appropriated expenditures; that they distort choices of the marketplace; that they permit windfalls by paying taxpayers for what they would do anyway; and that, because of the progressive rate structure of the income tax, they may be worth more to the high income taxpayer than

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230. See, e.g., I.R.C. § 101 (1987) (certain life insurance proceeds and other death benefits); id. § 103 (interest on qualified state and local bonds, although TRA86 substantially restricted qualification); id. § 117 (amounts received as qualified scholarship, also substantially restricted qualification); id. § 121 (one-time exclusion of up to $125,000 of gain from sale of principal residence by individuals aged 55 or older); id. § 127 (amounts paid by employer for employee's education under a non-discriminatory educational assistance plan); id. § 132 (qualifying employee fringe benefits).
231. See, e.g., I.R.C. § 108(g) (1987) (discharge of indebtedness income realized by certain farmers whose farm loans are reduced in loan work-out agreements with their lenders may be excluded subject to making basis adjustment under I.R.C. § 1017); id. § 131 (amounts received by foster care providers providing care to adults placed with them by the appropriate governmental agency); id. § 162(m) (self-employed persons allowed to deduct a portion of the cost of health insurance for themselves, their spouses, and dependents).
232. See 2 TREASURY REPORT, supra note 194, at 60; PRESIDENT'S PROPOSALS, supra note 7, at 59:
In effect, the failure to tax all prizes and awards creates a program of matching grants under which certain prizes or awards also bestow the government-funded benefit of tax relief. Basing this program in the tax code permits it to escape public and legislative scrutiny and causes benefits to be distributed not according to merit but to the amount of tax the individual would otherwise owe.
the person of modest income. All of these features have been examined in great depth in the now extensive body of scholarly literature on tax expenditures. Without seeking to refuel the fires of that debate, it may safely be said that tax expenditures still abound throughout the Internal Revenue Code of 1986 and that the staffs of the Joint Committee on Taxation, Treasury Department, and the Office of Management and Budget all seem to have the ability to attach estimates of revenue gains and losses to specific provisions of the law. Furthermore, the reduction in the tax rates in the Act and the compression of the bracket structure from as many as fifteen to two or three tax brackets, depending on how one counts, substantially undercut the argument that the tax benefit conferred by the exclusion would be distortively distributed.

D. Tax Policy and Economic Efficiency

The reasons offered in the legislative history do not answer the fundamental tax policy question of why after more than seven decades Congress would see fit to render impotent a settled policy of using tax incentives to encourage gifted persons to use their talents in ways that would benefit society as a whole. Outstanding individual achievements in the fields of religion, charity, science, education, art, litera-

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233. Much has been written about the tax expenditure concept. A description of the development of the initial Treasury analysis may be found in S. Surrey, Pathways to Tax Reform (1973); see also S. Surrey & P. McDaniel, Tax Expenditures (1985); Surrey & McDaniel, The Tax Expenditure Concept: Current Developments and Emerging Issues, 20 B.C.L. REV. 225 (1979); Bittker, Accounting for Federal “Tax Subsidies” in the National Budget, 22 NAT’L TAX J. 244 (1969); McIntyre, A Solution to the Problem of Defining a Tax Expenditure, 14 U.C. DAVIS L. REV. 79 (1980).

234. See, e.g., GENERAL EXPLANATION TRA86, supra note 6, at 1353–79; see also S. Surrey & P. McDaniel, Tax Expenditures 202 (1985) providing: “[T]he current exclusion for certain prizes and awards is itself a tax expenditure (presumably it has not been shown on tax expenditure lists because of the small amount of revenue involved).”

235. Beginning in 1988, the rate structure will provide for two tax rate brackets—15% and 28%. However, the benefit of the 15% bracket will be phased out for taxpayers having taxable income exceeding certain specified levels. As a result of the phaseout, some taxpayers will face a 33% tax rate on some of their income. A five bracket transitional rate structure will apply for the year 1987. See GENERAL EXPLANATION OF TRA86, supra note 6, at 20–21.

236. The tax expenditure argument has traditionally criticized the “upside-down” effect of tax preferences taking the form of exclusions or deductions. That is to say, an exclusion or deduction of a fixed amount will produce a larger tax savings for the high income-high tax bracket individual than for an individual with low or moderate income. Prior to passage of TRA86, the lowest rate of tax on taxable income above the zero bracket amount was 11% and the highest rate was 50%. The difference in the value of the same tax preference item between high and low bracket taxpayers was substantial. Now, with the spread of tax rates ranging only from 15% to 28%, there is less disparity between the worth of the same tax preference item between high and low bracket individuals.

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ture, and civic affairs have the potential to endow mankind with significant value,\textsuperscript{237} even if not susceptible to exact measurement in monetary or economic terms. Recognizing, as the Treasury's and President's reports do,\textsuperscript{238} that excluding public achievement prizes and awards from taxation bestows a government-funded tax benefit in addition to the award itself does not at all explain or justify the termination of that benefit.

The explanation for this change must be found elsewhere. It is the opinion of this author that the overriding concern of the President and the Congress for increased economic productivity and competitiveness in world markets\textsuperscript{239} has unduly influenced their judgment on this particular tax policy issue. The perceived need to foster economic effi-

\textsuperscript{237} During the mid-1970's, the Treasury Department supported a study on private philanthropy and public needs through a Commission chaired by John H. Filer. Among the research papers sponsored by the Commission was a study that attempted to identify and define public and private values and needs in contemporary American society. The list of basic public needs recognized by that paper included: health; economic well-being; justice, security, and freedom; education; science; religion, philosophy, and idealism; peace and social integration; “culture” and entertainment; recreation/relaxation; emotional expression; participation; ecological balance; social welfare; social change; and, international perspective. While more extensive than the areas of endeavor addressed by section 74(b), there are obvious areas of congruity. For example, the paper defined religion, philosophy, and idealism as:

The need for religion in the broadest sense reflects a concern for the ultimate value and meaning of human existence in the universe. This need must be interpreted broadly to include not only worship, religious education and missionary work of the traditional theologies and religions, but also the newer and sometimes secular philosophies, ideologies, moralities, and world views. Whether old or new, these ideologies all speak to the human condition and to the problems of what is good, right, valuable, and worth doing. In this sense they all represent different approaches to idealism as it applies to human behavior and human ends. As such, they all reflect in some way a concern for altruism and the public interest.


\textsuperscript{238} See \textit{2 Treasury Report}, \textit{supra} note 194, at 60; \textit{President's Proposals, supra note 7}, at 59.

\textsuperscript{239} The President's Proposals criticized the pre-TRA86 tax system as follows:

(3) The current system needlessly \textit{impedes} growth.

—By encouraging investment for purposes of tax reduction rather than for independently worthy economic purposes, it prevents the market from allocating resources as efficiently and productively as it might. 

—By taxing workers' earnings at excessive rates—or by being perceived as taxing unfairly—it discourages work, saving, productivity, innovation, and growth.

—Thus, it prevents workers and the economy from reaching their full potential.

\textit{President's Proposals, supra note 7}, at 2. This concern for economic efficiency is also reflected in the \textit{General Explanation of TRA86, supra note 6}, at 9-10.
ciency and growth infuses all of the administrative and congressional tax reform reports with an eerie green glow.\textsuperscript{240}

The present concern for economic efficiency is not limited to discussions of tax reform and tax policy. According to the adherents of the economic analysis of law,\textsuperscript{241} the theories and empirical methods of the social science of economics may be applied across the board to the legal system. Particular laws and legal institutions are now to be evaluated on the basis of whether they are economically efficient. The economic analysis suggests that law, to be valid, must effect an allocation of economic resources in such a way that societal wealth is maximized.\textsuperscript{242} This economic theory is, of course, related to the popular moral theory of utilitarianism, which holds that actions and institutions must be judged in relation to their contribution to the general welfare or happiness. Traditional utilitarian theory as espoused by Jeremy Bentham\textsuperscript{243} and John Stuart Mill\textsuperscript{244} required that one act so as to promote the greatest happiness, or utility, for the greatest number.\textsuperscript{245} When the interests of different members of society come into conflict, this philosophy suggests that we should serve the greater aggregate interest, taking into account all the benefits and burdens that might result from the available alternative choices.\textsuperscript{246}

\textsuperscript{240} The unbridled economic drive of the fictitious pool-hustler Eddie Felson has been chronicled in two motion pictures starring Paul Newman, \textit{The Hustler} (Twentieth Century Fox 1961) and \textit{The Color of Money} (Touchstone Pictures 1986). Mr. Newman's performance earned him the Academy of Motion Picture Arts and Sciences Award for Best Actor in a leading role during 1986. Presumably, future Oscar winners will have to include the fair market value of the statuette in gross income.


\textsuperscript{243} Philosopher Jeremy Bentham (1748–1832) received a legal education and was admitted to practice law in 1769. Bentham, however, wrote about law as it ought to be rather than actually practicing law as it was. His most well known work, \textit{An Introduction to the Principles of Morals and Legislation}, was initially published in 1789. \textit{See generally J. Steintager, Bentham 11–18 (1977).}

\textsuperscript{244} John Stuart Mill (1806–1873), British diplomat, politician, and political philosopher of the nineteenth century, published \textit{On Liberty} (1859) and \textit{Utilitarianism} (1863). \textit{See generally The Great Legal Philosophers} 364–65 (C. Morris ed. 1959).

\textsuperscript{245} \textit{Id.} at 367

\textsuperscript{246} Bentham's articulation of the utilitarian calculus is as follows:

By the principle of utility is meant that principle which approves or disapproves of every action whatsoever, according to the tendency which it appears to have to augment or diminish the happiness of the party whose interest is in question: or, what is the same thing
This assumes that the relevant effects of the different choices on specific individuals can be compared quantitatively. In the area of moral decision making, it may very well be impossible to make such “interpersonal comparisons of utility.” Therefore, the economic philosophers tell us to stop worrying about the promotion of societal happiness, something we cannot measure, and, instead, urge us to act as if we had a duty to maximize societal wealth, something that is susceptible to econometric calculation.

The leading spokesman for economic jurisprudence is Judge Richard A. Posner. Judge Posner has addressed the subject of tax preferences in general and the pre-1987 section 74(b) exclusion for prizes and awards in particular:

The exclusion of any real [income] from taxable income reduces the tax base, creates incentives to substitute activities that yield the excluded form of income, and may, depending on the wealth of those who receive the excluded form of income, increase inequality. The broadest definition of income would be all pecuniary and nonpecuniary receipts, including not only leisure and (other) nonpecuniary income from household production but also gifts, bequests, and prizes.

The present tax law distinguishes between prizes won in a contest (which are taxable) and other prizes (such as the Nobel Prize), which are not. The distinction is unsound. To fail to tax prizes in contests would induce people to substitute the entering of contests for other forms of productive activity. But not taxing Nobel Prize winnings and other honors has a similar effect. The existence of these prizes affects research and other decisions by people in eligible occupations and even the choice of occupations.

in other words, to promote or to oppose that happiness. I say of every action whatsoever; and therefore not only of every action of a private individual, but of every measure of government.

By utility is meant that property in any object, whereby it tends to produce benefit, advantage, pleasure, good, or happiness, (all this in the present case comes to the same thing) or (what comes again to the same thing) to prevent the happening of mischief, pain, evil, or unhappiness to the party whose interest is considered: if that party be the community in general, then, the happiness of the community; if a particular individual, then the happiness of that individual.


Talented individuals who ignore available paths to immediate commercial or economic reward and instead seek to contribute to mankind's store of knowledge or to lift up the human condition through art, literature, education, charitable work, or the like are being told they made the wrong choice. Or, at least, they are being told that society will not endorse their choice to pursue publicly-oriented endeavors by allowing them to receive any prizes or awards for their activities free of tax. The message of this myopic tax policy is that potential poets should be writing advertising jingles on Madison Avenue, potential research chemists should give up the university laboratory and seek employment at Du Pont, and perhaps even that future Elie Wiesel's should go into investment banking on Wall Street.

Posner's criticism of the exclusion which previously was available under section 74(b) is consistent with his view that law, including tax law, ought to simulate a free market economy and encourage individuals to order their affairs so as to maximize societal wealth. The question of whether people should necessarily accept and follow market simulating rules as the foundation for law has recently been addressed by legal and political philosophers who disagree with the proponents of the economic analysis of law. If Judge Posner is correct, then the only legitimate concerns of the tax laws would be to raise the minimal amount of revenue necessary to operate the essential functions of government and to encourage economic objectives that maximize societal wealth.

250. Elie Wiesel, who survived the Nazi Holocaust to become a voice of its victims and a champion of dignity for all people, was named the winner of the 1986 Nobel Peace Prize on October 14, 1986. Now age 58, Mr. Wiesel has written 25 books on the Nazi extermination of European Jewry. His first work, Night, published in 1958, described his experiences in the Auschwitz and Buchenwald Concentration camps where his mother, father and sister died. Through his writing and public activities, Mr. Wiesel has provided eloquent testimony to the horror of past events and an indictment of contemporary violations of human rights, including the plight of Soviet Jews. See N.Y. Times, Oct. 15, 1986, at A1, col. 2.

251. Professor Ronald Dworkin refutes the wealth maximizing views of the economic jurisprudents as follows:

History provides no useful evidence for this supposition. It does not confirm that the best way to make a community happier on average is to make it richer on the whole with no direct constraints of distribution; that thesis remains an article of faith more popular among the rich than the poor. No doubt people on average have better lives, at least according to conventional views of what makes a life better, in prosperous nations than in very poor ones. But the present question is different. Do we have any reason to think that average happiness is generally improved in prosperous nations by still more prosperity, measured by the sums its citizens are collectively willing and able to pay for the goods they make and trade? Or that happiness could not be improved even more if citizens accepted other standards of personal responsibility, standards that sometimes ignored prosperity for other values? I think not; these claims may be true, but we have no persuasive evidence that they are.

E. Tax Policy and Social Objectives

The use of the tax system has never been limited to simply addressing economic objectives. Scores of tax provisions have found their way into the Code to encourage or discourage particular kinds of social behavior. The clearest example of this is the section 170 deduction for charitable contributions. This incentive was added to the tax laws in 1917 to encourage private philanthropic support for organizations which were dedicated to addressing broad public needs such as religion, charity, science, education, literature, and the arts. (This theme has a certain familiar ring to it, does it not?) While this kind of tax preference has been criticized using traditional tax expenditure arguments, it has generally been defended on grounds of pluralism and anti-bureaucraticism. That is to say, the tax incentive promotes private decision making about what kinds of charitable work ought to be done without undue interference from a behemoth government bound in red tape.

One might ask why the section 170 deduction for charitable contributions of money or property was spared in recent tax reform efforts to arrive at a more comprehensive tax base. Aside from the fact that

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252. Taxes imposed upon the consumption of alcohol and tobacco do raise significant amounts of revenue. However, the taxes have frequently been supported for the reason that they discourage people from ingesting potentially harmful substances. Commenting on this subject, Professor Lon Fuller wrote:

Tax laws are not just like other laws. For one thing, they enter more directly into the planning of one's affairs. Moreover—and much more importantly—their principal object is often not merely to raise revenue, but to shape human conduct in ways thought desirable by the legislator. . . . What shall we say of the tax on alcoholic beverages? Was its purpose to discourage drinking or was it to raise revenue by imposing a special levy on those whose habits of life indicate that they are especially able to help defray the costs of government? There can be no clear answers to questions like these.


253. I.R.C. § 170(a)(1) (1987) provides: “General rule.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.” See also I.R.C. § 170(b) (1987) (limitations on the amount of charitable contribution deduction taxpayer may claim); id. § 67(b)(4) (contribution deduction limited to taxpayers who itemize).

254. Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917) (deduction limited to 15% of donor's taxable income); see I.R.C. § 170(c)(1)-(2) (1987) (statutory descriptions of organizations which may be the recipient of tax-deductible charitable contribution).


publicly supported charities lobby very effectively,\textsuperscript{257} there is a substantial body of theoretical and empirical literature documenting the effectiveness of the deduction in promoting contributions, particularly among the wealthy.\textsuperscript{258}

Interestingly, the deduction under section 170 has never been allowed for the value of services volunteered to a qualified charity, only for money or property contributed. While the language of the statute does not restrict the deduction to contributions which take the form of the transfer of property or money,\textsuperscript{259} the administrative and judicial interpretations for more than sixty years have done so.\textsuperscript{260} The primary reason for this restriction appears to be the tax administration problems involved in verifying and measuring the value of volunteer

\textsuperscript{257} Notwithstanding the fact that I.R.C. §§ 170(c)(2)(D), 501 (c)(3) (1987) contain substantial restrictions on the ability of qualified charities to engage in attempts to influence legislation or to participate in political campaigns on behalf of any candidate for public office, certain limited lobbying and "grass roots" expenditures are permitted under I.R.C. § 170(h) (1987). Needless to say, supporters of public charities have been very effective in making their views on proposed tax legislation known to members of Congress.


\textsuperscript{259} See I.R.C. § 170(a)(1) (1987); id. § 170(c) (defining "charitable contribution" as "a contribution or gift to or for the use of" any one of a number of qualified governmental or charitable entities described in sections 170(c)(1) and (2)) (emphasis added).

\textsuperscript{260} Since 1920, the Treasury Department and the courts have consistently disallowed deductions for the value of services rendered to a charity. See O.D. 712, 3 C.B. 188 (1920); Rev. Rul. 162, 1953-2 C.B. 127 (donation of blood is a service and, therefore, nondeductible); Korda v. Commissioner, 30 T.C.M. (CCH) 888 (1971) (research work in connection with trade relations between United States and Hungary amounted to a nondeductible service). Also, the Treasury Regulations provide:

\begin{itemize}
  \item (g) Contributions of services. No deduction is allowable under section 170 for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services also are deductible.
\end{itemize}

Treas. Reg. § 1-170A-1(g) (1972). The above cited references seem to suggest that it is relatively easy to distinguish between contributions of property and services. This has not always been the case. See, e.g., Goss v. Commissioner, 59 T.C. 594 (1973) (essays prepared by economist and donated to qualified charity were held to be property, rather than services, and deduction in amount of $500 permitted).
service donations. In addition, the disparity in the value of personal services among taxpayers, as well as the questions of whether or not the donor has actually parted with anything when he donates his personal services, provide more foundation for this position. An analogy can be drawn between this aspect of section 170 and section 74(b). However, the exclusion of the Nobel Prize or similar award would present no similar measurement or verification problems.

If the tax code may be used to influence social behavior, the question then is whether this particular tax preference had the intended effect of encouraging humanitarian or public-oriented endeavor. Without the benefit of statistically verified social science studies on this point, this writer is not in a position to draw any empirically defensible conclusions. There are, however, good reasons to doubt that the tax exclusion directly induced extraordinary conduct on the part of any fledgling author, scientist, scholar, or humanitarian whose achievements might have been recognized later with a valuable prize or award. The small likelihood of ever winning such a prize and the temporal delay between performing the meritorious behavior and receiving recognition lead to conjecture that the actual effect of the section 74(b) exclusion was remote and indirect at best. One other important factor tending to make the incentive effect of the exclusion remote was the requirement of section 74(b)(1) that the recipient be selected without any action on his part to enter the contest or the selection proceeding. Economists would characterize the behavioral response of these individuals to the tax benefit as being relatively inelastic.

It is, of course, possible that members of Congress decided to discard the section 74(b) exclusion because they believed it to be ineffec-


263. Judge Posner suggests that the section 74(b) exclusion may have caused individuals to substitute the described activities (religious, charitable, scientific, etc.) for others. As he put it, “[t]he existence of these prizes affects research decisions by people in eligible occupations and even the choice of occupations.” R. Posner, Economic Analysis of the Law 464 (3d ed. 1986).

264. The term “elasticity” as used in economics means the proportionate change in one variable caused by changes in another variable. Here we are interested in the elasticity of the number of people choosing to engage in publicly-oriented behavior with respect to the tax status of prizes given for such activity. If response to changes in the tax status was highly elastic, now, following the virtual elimination of the section 74(b) exclusion, we should observe many individuals leaving the fields of religion, charity, education, science, the arts, literature and civic affairs. Since that is not likely to occur, we may conclude that response to changes in the tax status of such prizes and awards is relatively inelastic.
tive. In this regard, it should be noted that the Court of Appeals for the District of Columbia Circuit more than forty years ago in the "Ross Essay" opinion characterized the use of the tax exclusion to encourage scholarly work as "wise" and "settled." The Congress in the 1954 Code specifically ratified that policy by writing section 74(b) into the statute. One would think that Congress, after thirty years' observation, would announce that it eliminated the provision for ineffectiveness, if that were the true reason.

Even assuming that the exclusion previously available for qualifying awards lacked operative economic efficacy, consideration must be given to the question of whether the exclusion should have been retained for its indirect or symbolic value. In order to answer this question in any meaningful fashion, it is necessary to address the larger question of whether statutory pronouncements which seek to inspire beneficial conduct, but which do not obligate its performance, are valid or are even laws. Exhaustive discussion of the essential nature of law and the relationship between law and morality is beyond the scope of this article. Nonetheless, it may be worthwhile briefly.

266. See supra text accompanying notes 73–84.
267. The assumption that the prior exclusion for prizes like the Nobel Prize did not affect individual behavior is inconsistent with the tax expenditure criticism of old section 74(b). The tax expenditure concept is premised on the notion that tax preferences do cause a substitution of the favored activity for other activity. Professors Surrey and McDaniel offer a technical explanation of this effect as follows:

The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. These provisions compose the revenue-raising aspects of the tax. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class of persons.


268. Law is often defined simply as a command backed up by the coercive power of the state. This theory of law is usually referred to as legal positivism because it takes law as something posited by the state and enforced through sanctions imposed by such sovereign authority. While Thomas Hobbes and Jeremy Bentham made earlier contributions to this view of law, it was John Austin (1790–1859) who is usually identified with the development of legal positivism through a series of lectures on jurisprudence which he delivered at London University commencing in 1832. More recently, the noted British philosopher H.L.A. Hart has been regarded as a principal spokesman for the positivist view of the law. See H.L.A. Hart, The Concept of Law 18–25 (1961).

269. For comprehensive works on the relationship between law and morality, see R. Dworkin, supra note 251; J. Fishkin, Beyond Subjective Morality (1984); L. Fuller, supra note 252; H.L.A. Hart, supra note 268; D. Lyons, Ethics and the Rule of Law.
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to discuss the influence of moral ideals on the development of the law and the legitimacy of rewards for exemplary behavior.

Nearly all legal philosophers, from Aristotle\textsuperscript{270} to Ronald Dworkin,\textsuperscript{271} have recognized some connection between accepted social morality and the authority of law.\textsuperscript{272} In both fields we consider matters of obligation, duty, and rights.\textsuperscript{273} The law concerns rights and responsibilities, duties and obligations, and fairness and justice. It claims authority to lay down rules and to enforce them.\textsuperscript{274} Morality on the other hand concerns the making of individual and collective value judgments about human conduct and distinguishing between what is right and wrong.\textsuperscript{275}

In \textit{The Morality of Law}, Professor Lon L. Fuller discerns the existence of two primary moralities: The morality of duty and the morality of aspiration.\textsuperscript{276} The morality of duty lays down basic rules without which an ordered society is impossible. Violation of those rules will result in the imposition of some sanction or penalty which serves to evidence society’s disapprobation. An individual whose behavior has conformed to the minimum conditions of social living is left alone since that is all that can be required of him in a duty oriented approach.\textsuperscript{277} In contrast, Fuller’s conception of the morality of aspiration...
ration is hortatory rather than obligatory. It seeks to bring out the fullest realization of human potential. The morality of aspiration utilizes reward and praise to recognize the attainment of excellence toward which all mankind should strive.\textsuperscript{278}

The form of reward for meritorious behavior may vary. It may be tangible or intangible. Tangible rewards would include money prizes and other awards having substantial economic value. Intangible rewards would include the public acclaim emanating from having one's achievements recognized. However, rewards can also be distinguished in another way. They may be either external or internal. External rewards are endowed by others upon the recipient, and may be tangible or intangible. Internal rewards arise from the satisfaction which an individual derives for himself from the accomplishment. The nineteenth century German philosopher Rudolf von Ihering described these internal rewards as "that satisfaction which a work itself affords; such is the delight in intellectual work \textit{per se}, the charm of proving one's power, the joy of discovery, the pleasure in creating, the consciousness of having done a service to the world, of having utilized one's faculties for the welfare of humanity."\textsuperscript{279}


\textsuperscript{278} There remains for brief mention one final manifestation of the distinction between the morality of duty and that of aspiration. I refer to the way in which that distinction finds tacit recognition in our social practices concerning penalties and rewards.

In the morality of duty it is understandable that penalties should take precedence over rewards. We do not praise a man, or confer honors on him, because he has conformed to the minimum conditions of social living. Instead we leave him unmolested and concentrate our attention on the man who has failed in that conformity, visiting on him our disapproval, if not some more tangible unpleasantness. Considerations of symmetry would suggest that in the morality of aspiration, which strives toward the superlative, reward and praise should play the role that punishment and disapproval do in the morality of duty.

\textit{L. Fuller, supra} note 252, at 30; \textit{see also} H.L.A. Hart, \textit{supra} note 268, at 176-80 (similar conception of "moral ideals").

While von Ihering valued nonmaterial rewards far more than material or monetary ones, in our discussion of tax policy and section 74(b) we must concentrate on the material reward which an exclusion from gross income confers. Is it appropriate to reduce the tax burden of a money prize recipient, thereby increasing the tax burden of all other taxpayers, simply because he happened to have received the award in recognition of a significant public achievement? Since so few individuals could be eligible for this preference, this is essentially a political or moral question rather than an economic one.

The tax laws make political statements on all manner of social and public welfare matters. For example, the exclusion from an employee's gross income for the value of employer provided health and life insurance represents a paternalistic political decision to encourage employers to provide those forms of benefits rather than higher levels of monetary compensation. In purely economic terms, the employer should not prefer one form of compensation over the other. Congress, however, sought to prevent or at least minimize the personal or family hardship that would arise in the event of illness or death.

**F. Tax Laws as Symbols of National Values**

Even if it was only symbolic, was the salutary effect of the exclusion previously available under section 74(b) sufficient justification for its retention? If we accept the assertion that law is properly influenced by the moral ideals and the view that law is to perform a constructive function, then the answer is clearly in the affirmative. Congress can

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280. I.R.C. § 106(a) (1987) presently provides: "(a) In general.—Gross income does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to his employees for personal injuries or sickness." TRA86 added a new section 89 to the Code setting forth a variety of nondiscrimination rules that will apply to almost all employee benefit plans including accident or health plans. The rules will become effective no later than December 31, 1988. At that time, section 106(a) is to be amended to read: "[g]ross income of an employee does not include employer-provided coverage under an accident or health plan." See TRA86, supra note 3, § 1151(f)(2), (K).

281. I.R.C. § 79(a) (1987) allows an employee to exclude from gross income the cost paid by his employer for up to $50,000 of group term life insurance on the employee's life. Key employees of the employer may only use this exclusion if the plan under which the insurance coverage is provided meets the present nondiscrimination requirements of I.R.C. § 79(d) (1987) and, ultimately, the nondiscrimination requirements of I.R.C. § 89 (1987). See TRA86, supra note 3, § 1151(c)(1), (K).

282. See supra text accompanying notes 270–79.

283. In the closing paragraph of Law's Empire, Professor Dworkin summarizes the constructive nature of his "law as integrity" concept:

Law's attitude is constructive: it aims, in the interpretative spirit, to lay principle over practice to show the best route to a better future, keeping the right faith with the past. It is,
and should use the tax laws to make a statement about the kind of society we should become, not just to prescribe minimum standards of economic conduct.

Any utopian construct of an ideal society would include incentives for individuals to expend effort in pursuit of objectives that would benefit society as a whole. For more than seventy years our tax laws contained such an incentive in the exclusion from gross income of prizes and awards for significant public achievement. Even if the effect of that incentive was more symbolic than real, it reflected American policy that valued cultural and humanitarian achievement at least as much as economic productivity.

For most of this century, the United States was viewed generally as the world's preeminent society—both economically and morally. The recent decline in our economic position justified revisions to the tax code to improve our productivity and competitiveness in world markets. However, it was not necessary for us to sacrifice our moral leadership in order to regain the economic high ground. Section 74(b) as it existed before the Tax Reform Act of 1986 spoke rather eloquently to Americans and to the international community about our values and moral aspirations. As a nation, we acknowledged the achievements of our award winning scientists, educators, artists, and humanitarians by bestowing upon them the added reward of a tax benefit. Congress took a giant step backward by destroying the section 74(b) exclusion.

IV. AN ALTERNATIVE PROPOSAL

The reasons advanced by the executive and legislative branches explaining the change made to section 74(b) do not justify its emasculation. The underlying purposes which led Congress in 1954 to add this exclusion to the Code are no less viable today than then. This is not to say that Congress did not have a legitimate concern about circumstances like Jones and the possibility of disguised compensation in the form of employer to employee awards. However, that concern could have been answered by denying the exclusion to any award from an employer to an employee. It was not necessary for Congress to adopt the requirement that the prize be transferred to charity in order to solve the Jones problem. If Congress was seeking to encourage the assignment of valuable prizes to charity, then it should have extended finally, a fraternal attitude, an expression of how we are united in community though divided in project, interest, and conviction. That is, anyway, what law is for us: for the people we want to be and the community we aim to have.

R. Dworkin, supra note 251, at 413.
the exclusion for any prize so assigned regardless of the nature of the award.

The *Jones* problem centers on the uncertainty created in Regulation section 1.74-1 which denied the exclusion only to those awards “from an employer to an employee in recognition of some achievement in connection with his employment.”\(^{284}\) It is, no doubt, possible that an employer might choose to honor an employee with a valuable prize or award for some nonemployment related achievement, but it is much more likely that an award coming from an employer has at least some significant element of compensation. The problem with the Regulation’s test was that it required the IRS and the courts to discern the subjective intent of the employer in giving the award. That, of course, was the unsatisfactory state of affairs that existed prior to the enactment of section 74 in 1954.\(^ {285} \)

The disguised compensation problem raised by the *Jones* case could have been addressed by providing that no prize or award from an employer to an employee could qualify for the exclusion available under section 74(b). While broad denial of the exclusion for employee awards would go beyond the test of Regulation section 1.74-1(b), the subject of dispute in *Jones*, it is a workable solution to the disguised compensation problem. In this instance, the resurrection of a “bright-line” test would be welcome. Had Congress chosen to address only the problem presented by *Jones*, rather than adopt the diversion to charity approach found in the Tax Reform Act of 1986, then it would have reaffirmed the long standing policy of encouraging humanitarian or public achievement.

If an award recipient or prize winner refuses the prize or award before it is used or enjoyed, then it is not taxed to the winner regardless of the nature of the prize.\(^ {286} \) Whether door prize or Pulitzer Prize, if you turn it down flat, then you have not realized income. What if instead of refusing the prize, an individual requests that the prize be given to a particular charity? Prior to the Tax Reform Act of 1986, the Code did not directly address that situation. If the prize involved was of the section 74(a) variety (door prize, gameshow prize, lottery or sweepstakes, and so on), then the assignment to charity would not have prevented the winner from being taxed on the value of the prize.\(^ {287} \) There would, however, have been allowed an offsetting

\(^{284}\) See Treas. Reg. § 1.74-1 (1955) (emphasis added); see also supra note 83.

\(^{285}\) See supra text accompanying notes 30-72.


\(^{287}\) Rev. Rul. 58-235, 1958-2 C.B. 26 (the executive director of a tax-exempt charitable organization was held taxable on the amount of money which he won on a television game show
deduction under section 170 for the charitable contribution subject to the percentage limitations of section 170(b).\textsuperscript{288}

In the case of a charitable gift of a section 74(b) prize prior to the Tax Reform Act of 1986, the winner was entitled to the exclusion and probably was also entitled to the section 170 deduction for the contribution. Certainly, that would have been the outcome if the excludable prize was first accepted and subsequently contributed to charity. The legislative history suggests that henceforth if a winner of a prize for notable achievement assigns that prize to charity, only the exclusion will be available and not also the contribution deduction.\textsuperscript{289}

In the legislative history to the Tax Reform Act of 1986, the House\textsuperscript{290} and Senate\textsuperscript{291} recognized the possibility that the winners of formerly excludable prizes might still wish to assign the award to charity and, so as not to discourage them from doing so, continued the exclusion for public achievement prizes diverted to charity. Presumably, Congress was willing to extend the exclusion for such transferred prizes because the winner was willing to forego personal use or consumption of the prize. If the winner is willing to forego personal use or consumption so that a charity might be benefitted, what difference does it make whether the prize or award was given for meritorious past achievement or for correctly guessing the hidden phrase on “Wheel of Fortune”?

The circumstances surrounding the winning of the award should not be taken into account so long as the winner transfers the prize to charity before using or enjoying it. When the winner is willing to forego the personal benefit and have the prize transferred directly to charity, then the exclusion should be available regardless of what type of prize is involved. Use of the exclusion for prizes diverted to charity would preclude the claiming of a contribution deduction under section 170. However, that result would probably be preferred since the section 170 deduction is limited under most circumstances to fifty percent

\textsuperscript{288} I.R.C. § 170(b) (1987) generally limits the amount an individual may deduct as a charitable contribution to 50% of adjusted gross income for the year. Under certain circumstances, the percentage limitation can be as low as 30% or even 20% of adjusted gross income. Carryovers of excess contributions are provided for in I.R.C. § 170(d). See also Sykes v. Commissioner, 24 T.C. 1156 (1955) (an individual who had won an automobile as a door prize which he then donated to the YWCA was required to include the fair market value of the car in gross income and claim an offsetting deduction as a charitable contribution).

\textsuperscript{289} See supra text accompanying note 217.

\textsuperscript{290} See supra text accompanying notes 216-17.

\textsuperscript{291} Id.
Taxation of Prizes and Awards

of adjusted gross income and, after the Tax Reform Act of 1986, can only be claimed as an itemized deduction.\footnote{292. See I.R.C. § 67(b)(4) (1987).}

If the suggestion to expand the exclusion for any prize or award diverted to charity and the earlier proposal regarding employer awards to employees were to be favorably considered by Congress, then section 74(b) would read as follows:

(b) Exception for Certain Prizes and Awards.—

(1) Notable achievement prizes and awards.—Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational artistic, literary or civic achievement, but only if—

(A) the recipient was selected without any action on his part to enter the contest or proceeding;

(B) the recipient is not required to render substantial future services as a condition to receiving the prize or award; and

(C) the prize or award is not from an employer to an employee.

(2) Prizes and awards transferred to charity—Gross income does not include amounts received as prizes and awards if the prize or award is transferred by the payor to a governmental unit or organization described in paragraph (1) or (2) of section 170(c) pursuant to a designation made by the recipient.

V. CONCLUSION

Following the Jones case in 1984 which was perceived as opening up the possibility that employers might make widespread attempts to disguise employee compensation as notable achievement awards excludable from gross income, it was inevitable that Congress would consider revision of Code section 74(b). In the Tax Reform Act of 1986, Congress added an additional requirement to that section so that henceforth awards for significant public achievement such as the Nobel Prize will be excludable from gross income only if the recipient assigns the prize to charity prior to using or enjoying it. While this change is consistent with the general base broadening efforts of the Act, it is submitted that the reasons offered by Congress do not justify the emasculation of a seventy-year-old policy favoring the use of tax incentives to encourage humanitarian or public achievement in the fields of religion, charity, science, education, art, literature, and civic affairs.

While some may argue that the tax laws should only be used to promote economic goals such as making our nation more productive and competitive in the global marketplace, it is not uncommon for
provisions to be added to or retained in the Internal Revenue Code for the purposes of promoting social or political objectives. The exclusion from gross income which used to be available under section 74(b) for significant public achievement prizes and awards made an important symbolic statement about the value Americans placed on culture, altruism, spirituality, and scientific progress. It was not necessary for Congress to destroy the exclusion in order to prevent the abuses which were perceived to arise in the wake of the *Jones* decision. Therefore, the author urges Congress to consider reinstating the exclusion for notable achievement prizes except in the employer-employee setting. So as not to discourage prize and award winners from supporting their chosen charities, the author also proposes amendatory language that would exclude from gross income the value of all prizes or awards assigned to charity.