

Follow-Up on Qualified Tuition Reduction Programs

Introduction

Several years ago, AACCS published a Legal Report on the subject of "qualified tuition reduction programs," i.e., tuition discounts. In that Report, we discussed the issue of Christian schools offering tuition discounts to the students of school employees. We concluded that these discounts must be offered as a "fringe benefit" to employees, and they must not be a payment for services rendered by employees.

We also discussed the fact that a "qualified tuition reduction program" had to meet other requirements established by the IRS. One of these requirements was that the tuition discount had to be offered to the employees of a tax-exempt **educational** organization. The earlier Report concluded that, if the tuition discount program met all of the requirements established by the IRS, then the discount would not result in taxable income to school employees.

The conclusions we reached in our earlier Report continue to be valid under current law. **Nevertheless, one question that we did not address in the earlier Report was whether a Christian school could offer tuition discounts to employees of the sponsoring church.** At the time we published our earlier Report, the IRS had not addressed this issue in a written opinion. Six years after our Report, the IRS has addressed the question of offering tuition discounts to church employees.

In particular, the IRS recently considered this issue in an opinion referred to as a *Private Letter Ruling*. Unfortunately, in its recent opinion, the IRS did differentiate between "school" employees and "church-only" employees in the area of tuition discounts. We will discuss the IRS Ruling below.

Please note at the outset, however, that it will be important for you to read this entire Legal Report to understand the implications of the recent IRS opinion. In particular, even though the IRS opinion is not favorable, it does provide a small amount of good news and direction. In addition, even though the Private Letter Ruling represents the current position of the IRS on this issue, the Private Letter Ruling itself is not binding on anyone other than the specific parties involved in the dispute that gave rise to the Ruling. The "binding effect" of the Private Letter Ruling is discussed at the conclusion of this Report.

Discussion

In its recent Private Letter Ruling, the IRS distinguished between **school** employees and **church-only** employees in addressing the issue of "qualified reduction tuition programs." In sum, the *Ruling* provided some bad news as well as some good news. The bad news is that the IRS has now taken the position—at least with respect to tuition discounts—that a religious school (and its employees) can be considered as a distinct entity from the sponsoring church, even if there is no separate incorporation. Potentially, this position could result in unfavorable results on other issues where it is

beneficial to consider all the ministries of the local church (and all employees) under one ministry umbrella.

The good news, however, is that the IRS upheld tuition discounts for school employees. In other words, the IRS did not take the position that, because the church/school employees were actually employees of the church, the tuition discount could not be offered to these employees. The opinion also did not prohibit giving tuition discounts to church employees who have some school responsibilities.

We will discuss the pros and cons of the *Private Letter Ruling* in more detail below. Before addressing this opinion, however, it may be helpful to review the basic elements of a "qualified tuition reduction program."

A. What is a "qualified tuition reduction program"?

A qualified tuition reduction program is a way for a Christian school to offer a tax-free fringe benefit to its employees. Under a qualified tuition reduction program, the school can offer a tuition discount to the students of its employees, and this tuition discount is not considered as taxable income to the employees.

Under one typical scenario, First Christian School charges \$2,000.00 per year in tuition and allows the students of its employees to attend the school for free. As long as this program meets certain requirements, the tuition benefit offered to school employees is not considered to be taxable income to the employees. Therefore, if an employee has one child in school, then the employee receives a \$2,000.00, tax-free benefit each year. Under our scenario, the benefit increases for each student a particular employee has enrolled in the school, and could result in a very significant tax-free benefit for employees with large families.

Please note, however, that before a tuition reduction program will be considered "qualified"—(and therefore, tax-free to the employee)—the program must meet certain requirements. These requirements were listed in our previous Legal Report, but for the sake of convenience, we have listed them again below.

- The educational institution offering the tuition reduction program must be a tax-exempt organization;
- The educational institution must maintain a regular faculty and curriculum, it must have a regularly enrolled student body in attendance at the place where its educational activities are regularly carried on, and it must operate at the primary, secondary, or college level;
- The tuition discount must be applied toward the education of the employee or the employee's spouse or dependent child;
- The tuition discount must be for education below the graduate level;

- The tuition discount must be available on substantially the same basis to each member of a defined group of employees, and the school should not discriminate in favor of "highly compensated employees" when offering the reduction;
- **The tuition discount must not be a payment for services rendered by the employee.** In other words, the school must pay the employee a certain salary and then offer the tuition discount as a fringe benefit in addition to the employee's salary. If the tuition discount is considered as compensation for services rendered by the employee, then it constitutes taxable income to the employee. **For this reason, a tuition discount should NOT be included in an overall "salary package," as this could be construed as taxable income to the teacher.**

If a tuition reduction program meets these requirements, then it will be considered "qualified," and therefore, tax-free to the employee.

B. The Private Letter Ruling

As noted above, the IRS recently considered the issue of tuition discounts in the context of a Catholic church operating a religious school system. The school system was not separately incorporated. In addition, certain individuals were considered to be **church** employees, and other individuals were considered to be **school** employees. The same tuition discount was offered to all employees, regardless of whether they were **church** employees or **school** employees.

1. The bad news. In considering whether there should be a distinction between **church** employees and **school** employees, the IRS noted that the relevant portion of the tax code stated that a qualified tuition discount is available only to employees of "educational organizations." The IRS further noted that this portion of the tax code did not extend the tuition discount to employees of "religious organizations."

Based on the language of the statute, the IRS concluded that only **school** employees could take advantage of the tuition discount being offered by the schools. In other words, if the schools offered the tuition discount to church employees, then the **church** employees were required to report this discount as taxable income.

2. The good news. As noted above, the *Ruling* does contain a silver lining. First, the IRS could have taken the position that all employees were employees of the church, and therefore, were prohibited from taking advantage of the tuition discount. The IRS did not reach this conclusion. To the contrary, the IRS confirmed that the tuition discount was available to all **school** employees, including secretarial, managerial, administrative, and support function employees.

In addition, the IRS did not address the issue of whether the discount would be available to **church** employees who also had some school responsibilities, e.g., a pastor who served as president of the school, or a youth director who taught one or two classes at the school. Accordingly, if a ministry employee has both church and school

responsibilities, then he or she may be entitled to take advantage of the tuition discount offered by the school.

C. What is the impact of a Private Letter Ruling?

As noted above, an IRS *Private Letter Ruling* sets forth the current position of the IRS with respect to a particular issue. Nevertheless, a *Private Letter Ruling* is not binding on any parties other than those specifically addressed in the Ruling, and it cannot be cited as precedent in other cases. **For this reason, the *Private Letter Ruling* that is discussed in this Legal Report is not binding on your ministry.** Please note, however, that if the conclusions reached in this Private Letter Ruling become part of a Revenue Ruling or a court decision, then the conclusions could become binding on your ministry.

This is an important point because the situation in your ministry may present certain factors that would cause the IRS to reach a different conclusion on this issue. In addition, your ministry may be able to make certain legal arguments that were not considered in connection with the *Private Letter Ruling* discussed above.

On the other hand, you should be on notice that—with respect to qualified tuition discounts—the IRS currently takes the position that school employees must be distinguished from **church-only** employees. Accordingly, you may want to make certain adjustments in your ministry based on the current position of the IRS concerning this issue.

Conclusion

Although the IRS has issued a Private Letter Ruling concluding that tax-free tuition discounts are not available to **church-only** employees, there is some good news. First, the IRS confirmed that qualified tuition discounts are available to employees of Christian schools, even if the school is operated under the umbrella of a church ministry and is not separately incorporated. In addition, the IRS did not address the situation in which a church employee has responsibilities at the school, leaving open the possibility that employees who have duties at both the **church** and the school may be able to take advantage of the tuition discount being offered by the school. Finally, because the conclusions of the IRS were issued in the context of a Private Letter Ruling, they are not binding on your ministry.