

# Tuition Reduction Programs

## Introduction

Many of our member Schools offer some type of tuition reduction for the children of their teachers and staff. For those Schools offering this type of program, questions often arise as to who can take advantage of the program, and how the program should be structured.

The typical scenario and questions go like this: The tuition at First Christian School is \$2,000.00 per year and a teacher has a child who attends the School tuition-free. Therefore, the teacher receives a "benefit" of 2,000.00 per year. Must the School report additional income of \$2,000.00 per year on the teacher's W-2 Form? What if the person receiving the tuition reduction is not a teacher, but is simply a volunteer worker? Should the School give the volunteer worker a W-2 Form at the end of the year showing the value of the tuition? Or, what if the teacher's child is not a student at First Christian School, but instead, is attending a Christian college? Can First Christian School make pre-tax tuition payments to the college as a fringe benefit for the teacher?

These questions cannot be answered without considering a number of important factors concerning tuition reduction programs. In this Legal Report, we will discuss these factors, as well as attempt to answer the questions that you have been asking concerning tuition reduction programs.

## Discussion

Tuition reduction programs *can* operate as a tax-free benefit to your teachers and staff. Before you stop reading, however, you need to realize that tuition reduction programs must meet certain requirements before they can be considered as "qualified" programs. More importantly, tuition reduction programs must be "qualified" before the value of the tuition can be excluded from an employee's taxable income. You also should be aware of the fact that tuition reduction programs may have different tax consequences for volunteer workers.

In preparing this Report, we thought the best way to address this subject would be to discuss three main issues of concern. These issues are set forth below.

**Issue #1: If a paid employee's children are allowed to attend the School tuition-free, does this result in taxable income to the employee?**

**Answer: No. As long as your tuition reduction program meets certain requirements and the tuition reduction is given to a paid employee as a fringe benefit, then it should not result in taxable income to the employee.**

Under the Internal Revenue Code, an employer may offer certain fringe benefits to its employees which can be excluded from the employees' income. One of these fringe benefits is known as a **qualified tuition reduction**. A **qualified tuition reduction** is

simply a reduction in tuition that is provided by a school to an employee of the school for the purpose of educating the employee, or for the purpose of educating a dependent child or spouse of the employee.

In order for a tuition reduction program to be "qualified," however, it must meet certain requirements. Here is a checklist of those requirements:

- 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 reduction must be applied toward the education of the employee or the employee's spouse or dependent child;
- The tuition reduction must be for education below the graduate level;
- The tuition reduction 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 reduction 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 reduction as a fringe benefit in addition to the employee's salary. If the tuition reduction is considered as compensation for services rendered by the employee, then it constitutes taxable income to the employee. For this reason, a tuition reduction should NOT be included in an overall "salary package," as this could be construed as taxable income to the teacher.

In addition to these requirements, you should be aware of three other points concerning qualified tuition reductions:

- First, the discount level for the tuition reduction can range from 1 percent to 100 percent;
- Second, because a qualified tuition reduction is not considered as income to the employee, the School should not withhold any taxes on the value of this benefit;
- Third, the School can offer the tuition reduction to a former employee who retired or left on disability, or to a widow or widower of an individual who died while an employee or who retired or left on disability while an employee.

**Issue #2: If a volunteer worker's children are allowed to attend the School tuition-free, does this result in taxable income to the volunteer worker?**

**Answer: Probably so. Unlike the situation with a teacher, a volunteer worker may have a problem claiming the tuition reduction as a fringe benefit, especially if no other form of compensation is being paid to the volunteer for services being rendered to the School.**

In some situations, a volunteer worker at a School will receive no salary, but he or she will receive free tuition in exchange for services rendered to the School. The Internal Revenue Service takes the position that a fringe benefit, such as a tuition reduction, is a form of compensation offered to an employee that is in addition to, and not in lieu of, the salary being earned by the employee. If a volunteer worker receives no salary, then he or she may have difficulty in claiming the tuition reduction as a fringe benefit because the tuition "break" being given to the volunteer worker is not in addition to a salary being paid to the worker.

The point here is that the "compensation" the volunteer worker is actually earning is the amount of tuition he or she otherwise would be paying to send a child to the School. This type of compensation is generally considered to be "income." Of course, if such an arrangement results in income to the volunteer worker, then the School should give the worker a W-2 Form at the end of the year and withhold taxes on the value of this type of compensation.

**Issue #3: If a member School sets up a program to pay a portion of the tuition for an employee's child who attends a Christian college, will the value of these payments result in taxable income to the employee?**

**Answer: *It depends.* As long as the program meets the requirements set forth above and the School is not using part of the employee's salary to make the tuition payments, then the value of the payments may not constitute taxable income to the employee.**

Some high schools have set up programs whereby they give financial assistance to their employees who have college-age children for use in defraying college expenses. While at least one court has held that this type of financial assistance results in taxable income to the employees, it may be possible to establish a program under which this type of financial assistance can be excluded from an employee's taxable income.

To understand this type of program, you should know that, even though many tuition reduction programs involve a School reducing its own tuition for the children of its teachers, the Internal Revenue Code does not require that a student attend the School where his or her parent actually teaches. For example, if one of the teachers at First Christian School had a child at another private school ("School B"), and "School B" offered a tuition reduction for the child, then this benefit would not be counted as taxable income to the teacher at First Christian School.

Given the fact that the Internal Revenue Service will recognize a tuition reduction benefit even when a child is attending a different school, your School may be able to set

up a program whereby it can give financial assistance to those employees who have children in Christian colleges. Before this type of financial assistance could be excluded from an employee's taxable income, however, it would need to meet the requirements for qualified tuition reduction programs set forth above. In addition, the financial assistance could be used only for tuition, fees, books, supplies or equipment. If the money is used for other expenses, such as room and board or travel to and from school, then the employee must count the financial assistance as taxable income.

More importantly, the financial assistance must not constitute compensation for services rendered by the employee. Both the Internal Revenue Code and the relevant court cases are clear that a payment for services rendered is not a fringe benefit to an employee, and therefore, such a payment constitutes taxable income to the employee.

For that reason, the School could not reduce an employee's salary and then pay an amount equal to that reduction to the Christian college in pre-tax dollars. The Internal Revenue Service would take the position that this type of financial assistance constitutes taxable income to the employee. Instead, all employees would need to be paid on the same scale, and the financial assistance would need to be offered in addition to the employee's salary.

## **Conclusion**

As you can see from this discussion, if your school allows the children of a paid employee to attend the School tuition-free, then this arrangement can be treated as a tax-free fringe benefit to the employee. This fringe benefit is commonly referred to as a **qualified tuition reduction**. Before a tuition reduction can be excluded from an employee's income, however, the tuition reduction program must meet certain requirements established by the Internal Revenue Service.

On the other hand, the law is less clear as to whether a tuition reduction for the children of a volunteer worker is a fringe benefit, or whether such a reduction results in taxable income to the volunteer worker. Unfortunately, it appears that if the volunteer worker is receiving no salary, then the tuition "break" being given to the volunteer worker should be considered as taxable income to the worker, and the appropriate withholdings should be made.