EMPLOYEE BENEFITS

Section 132(d) is worth a second look.

Employer-Provided Education Benefits

BY EDMUND D. FENTON JR.

EXECUTIVE SUMMARY

■ **MANY EMPLOYERS PROVIDE EMPLOYEES WITH TAX-FREE** education benefits. The two most common are scholarships and grants under IRC section 117 and education-assistance programs under section 127. There is, however, a third alternative: CPAs can recommend using the working condition fringe benefit of IRC section 132(d).

■ **SCHOLARSHIPS UNDER SECTION 117(a) ARE TAX-FREE** if the recipient is a degree candidate at a qualified education institution and uses the funds for tuition, fees, books, supplies and equipment required for instruction. If the scholarships represent payments for past, present or future employment services, the employee must include them in income.

■ **SECTION 127 ALLOWS EMPLOYERS TO OFFER** up to $5,250 annually per employee in tax-free education help as long as the benefits are provided by reason of their employment relationship. This benefit covers graduate as well as undergraduate education but requires a formal written plan that must be open to everyone. These plans can be costly and burdensome for employers to administer.

■ **UNDER SECTION 132(d) EMPLOYERS CAN OFFER** a tax-free working condition fringe benefit for any expense employees can deduct on their own tax returns under IRC section 162. This typically includes travel, meals and professional dues but also can include education that maintains or improves job skills or meets requirements for the employee to remain in his or her current position.

■ **PROVIDING EDUCATION BENEFITS UNDER SECTION 132(d)** is a good idea for employers because no written plan is required and there is no dollar limit on benefits. It is possible for employers to provide benefits under

several different code sections at the same time. In general, though, section 132(d) is the most flexible alternative.

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Most employers consider their employees an important investment both to accomplish the organization's current goals and to have the right people in place for the future. Companies look to hire the best and the brightest and then give them the experience and education they need to advance through the ranks. Along with irreplaceable on-the-job experience, many experts have identified formal education as an important way to improve skills and gain knowledge and exposure to new ideas.

Employers have several tax-free options available to encourage workers to take advantage of education opportunities. The two most common are scholarships and grants under IRC section 117 and education-assistance programs under section 127. While both help employees, section 127 imposes dollar limits, and both plans bring administrative burdens on employers. A third alternative, part of the "working condition fringe benefit" of IRC section 132(d), receives little fanfare but provides the most flexibility with the fewest administrative headaches. This article offers CPAs the information they need to understand the options and counsel employers on the best alternatives for paying employee education expenses.

All Help Appreciated

For the 2003–2004 academic year

- **The average cost of tuition and fees at a private four-year college was $19,710, up 6% from the previous year.**
- **Tuition and fees at the average public institution rose 14.1% to $4,694.**
- **The cost of attending a two-year public institution increased to $1,905, up 13.8%.**

Source: College Board, www.collegeboard.com.

SCHOLARSHIPS AND GRANTS

Despite their popularity, scholarships and grants come with some restrictions. To exclude them from income under section 117(a), the recipient must be a degree candidate at a qualified education institution and use the funds for tuition, fees, books, supplies and equipment required for instruction. Employers have some leeway as to the type of recipient; they may establish scholarships for employees, their spouses and children or even others not associated with the company, such as

residents of the community where the company is located. However, when the scholarships are for an employee, CPAs should recommend caution to prevent the funds from becoming taxable.

According to Treasury regulations section 1.117-4(c), if an employer pays for an employee's study or research, and those amounts represent payments for past, present or future employment services, the employee must include them in his or her income. Amounts that enable an employee to pursue studies or research primarily for the employer's benefit also are deemed taxable income. Using the terms "scholarship" or "fellowship grant" and funding education without some consideration of these rules may lead to undesired tax consequences. Indeed, the IRS found its own scholarship program to be a taxable benefit in revenue ruling 76-230 because its student-trainees were receiving the education in exchange for future services.

The courts found the taxpayers in *Kreis* (441 F2d 257 (1971)) and *Klein* (32 TCM 301 (1973)) to have taxable income because their education and research benefited their employers. In another situation employer-paid education was taxable and not considered a scholarship because future tuition assistance depended on continued employment (revenue ruling 76-352). CPAs must examine closely, then, the relationship of the education to the employee's job and the employer's possible advantage to determine the tax status of any scholarship.

Some companies establish and fund private foundations to offer education grants and scholarships, and have those foundations select the recipients and handle disbursements. In those instances the recipient may exclude the grant from income under section 117(a) if it is "awarded on an objective and nondiscriminatory basis" and also meets other requirements of the foundation (see IRC section 4945(g) and Treasury regulations section 53.4945-4(a)(3)(ii)).

EDUCATION-ASSISTANCE PROGRAMS

In addition to scholarships and grants, another well-known method of providing education opportunities for employees is the assistance program under section 127. It allows an employer to offer up to $5,250 annually of tax-free education help to any employee who is currently employed, on leave, retired, disabled or laid off, as long as the benefits are provided by reason of their employment relationship. (Spouses and dependents are not covered.) In earlier years the $5,250 benefit was available only for undergraduate education and expired every few years, only to be reinstated each time by Congress. But for tax years beginning after December 31, 2001, the benefit is permanent and covers graduate as well as undergraduate education. The extension to include graduate education is a welcome relief to many employees who want to pursue advanced or professional degrees using tax-free funds. Employees also do not have to be enrolled in degree programs, nor does the education have to be job-related.

Section 127 education-assistance programs can be quite costly and burdensome for employers to administer. For example, for each year of the program's existence, the employer must file form 5500 by the last day of the seventh month after the program yearend to report detailed plan information. The company also needs a formal, written plan, which qualifies only if the program meets all of these tests:

- It is not discriminatory, that is, set up to favor highly compensated employees.

- Not more than 5% of the program's benefits are for shareholders or owners.

■ It does not offer cash or other taxable benefits.

■ Reasonable notice of the program is given to eligible employees. (See IRS Publication 15-B, *Employer's Guide to Fringe Benefits (*January 2004).)

The requirement that the program be nondiscriminatory can make it costly depending on how many eligible employees take advantage of it. But section 127(b)(5) contains a relief feature: An employer is not required to fund an existing qualified education-assistance program. Thus, if a company has no available cash, it can put the plan on hold until cash flow improves. To reduce costs and influence the type of education workers pursue, a program may set certain eligibility requirements, such as covering only postgraduate education in its field of business, thereby limiting the number of employees eligible to participate. A recent letter ruling, for example, permitted a law firm to establish a plan that reimbursed the principal and interest on employees' law school student loans tax-free up to $5,250 per year under section 127 (letter ruling 200339017). The plan applied to all nonlawyer employees.

THE WORKING CONDITION FRINGE BENEFIT

A third alternative for providing education assistance is the working condition fringe benefit. While most of the tax-free education emphasis usually is on sections 117 and 127, the working condition fringe benefit is a choice that's actually much easier to implement and offers more flexibility as to which employees are eligible, what costs are covered and how companies can control them.

IRC section 132(d) allows employers to offer a tax-free working condition fringe benefit for any business-related expense that employees could deduct on their individual tax returns under IRC section 162 if they themselves paid it. CPAs must look to section 162 for guidance on using this alternative. If that code section says an employee can deduct it, then section 132(d) opens it up as a possible benefit.

In addition to allowing employees to deduct business expenses such as travel, meals and professional dues, section 162 permits a deduction for job-related education expenses. Under Treasury regulations section 1.162-5(a), these expenses must meet the very familiar requirements of (1) maintaining or improving existing job skills or (2) meeting the express requirements necessary for taxpayers to remain in their current positions.

Once an expense meets these requirements and the employee can deduct it, the employer may choose to offer tax-free reimbursement, as most do for business travel expenses. In the case of tuition, if the employee receives reimbursement, or if the employer pays the school directly, the taxpayer can't take a deduction on his or her own return, as with any reimbursed expense.

The two requirements described above have been the subject of numerous court cases and revenue rulings over the years. The most important theme that surfaces is that the education must be directly related to the employee's current duties rather than providing skills for a new position. An excellent case for CPAs to review is *Blair* (41 TCM 289 (1980)), where the court examined each course in an MBA program and found the costs of all but one deductible because they related to the taxpayer's current position as a personnel manager.

In *Beatty* (40 TCM 438 (1980)), the taxpayer, an aeronautical engineer with some management duties, was successful in deducting the cost of an MBA. But in

reviewing other cases, CPAs will find the courts denied most taxpayers the education deduction because the courses either did not relate closely to their current position or qualified the taxpayer for a new position. Making a connection between the education and the current job is crucial to using the working condition fringe benefit to provide education benefits.

The types of individuals considered employees for purposes of section 132(d) are somewhat limited, but contain a few surprises. Under Treasury regulations section 1.132-1(b)(2), they include any

- Individual the business currently employs.
- Partner who performs services for the partnership.
- Director of the employer.
- Independent contractor who performs services for the employer.

PRACTICAL TIPS TO REMEMBER

- To prevent funds from becoming taxable, recommend caution when employers offer scholarships to employees. If the amounts represent payments for past, present or future employment services, employees must include them in their income. Companies should consider setting up private foundations to award scholarships on an objective and nondiscriminatory basis.

- Point out to employers that qualified education-assistance programs under IRC section 127(b)(5) include an important relief feature. If the program already exists, the employer is not required to fund it. This means cash-strapped companies can put the plan on hold until better financial times return.

- Remind employers and employees that making a connection between the education and the current job is crucial to using the working condition fringe benefit. By reviewing past litigation, CPAs will find the courts have denied most education deductions either because the courses did not closely relate to employees' current positions or qualified them for new positions.

THE BENEFITS OF SECTION 132(d)

The working condition fringe benefit offers flexibility for employers that wish to implement a simple plan or are experiencing difficult financial times but still want to offer some education benefits to certain employees. The often overlooked time- and money-savers include

No written plan needed. There is no requirement for a written plan, nor must the employer notify employees about the benefit. The documentation is less than required for section 127 education-assistance programs, which require formal written plans and timely employee notification. Regulations section 1.132-5(c) says the only documentation necessary for reimbursing education expenses using section 132(d) is that which falls under the usual business-expense substantiation requirements of sections 162 or 274(d). This saves employers time in not having to draft, implement and maintain a formal written plan. It also means the company won't lose its plan qualification because it misses a procedure.

Discrimination feature. According to regulations section 1.132-5(q), the nondiscrimination rules applicable to other fringe benefit provisions do not apply to

the working condition fringe benefit. The employer, therefore, may choose which employees it wants to reimburse, including any highly compensated employees. A company could, for example, offer the benefit to employees it wants to single out for special treatment or move quickly up the corporate ladder. Since there are no reporting requirements, there's no need to spread the word to other employees.

No dollar limit. Under section 127 education-assistance programs, the maximum annual tax-free benefit is $5,250 per employee. However, section 162 requires only that expenses be "ordinary and necessary" as well as reasonable. That means a section 132(d) plan has virtually no limits. With today's high tuition costs, enrolling in just a few courses during the year may easily exceed $5,250. Thus the working condition fringe benefit gives employers the option of paying more.

Other education expenses allowed. Section 162 allows more types of expenses than education-assistance programs under section 127 or scholarships under section 117. Both those sections allow deductions for tuition, fees, books, supplies, tools and equipment, but Treasury regulations section 1.162-5(e) extends the deductible amounts to include meals, lodging and transportation expenses if the employee travels away from home to obtain education that qualifies for the deduction.

THE DRAWBACKS

No plan is perfect, though, and the working condition fringe benefit approach of section 132(d) does bring several special challenges for CPAs. From the employer's perspective, the first is the political issue of which employees should receive the benefit. The top management of large companies or the owners of smaller businesses will need to at least informally set the rules and conditions of who is eligible. This could be a problem in larger companies when managers of various divisions begin asking for the benefits to apply to certain of their employees. Even though there is no requirement to notify employees about the plan, word usually leaks out and the plan could become a negative influence on worker morale.

While companies don't need a written plan to offer education benefits under section 132(d) and the only necessary substantiation appears to be to meet the regular business deduction requirements (amount, time and date, place and business purpose), a close link to the employee's current job also is mandatory. In some cases the courts evaluate each university course to see whether it specifically relates to the employee's current position. CPAs must be ready to help employers and clients establish a "direct and proximate relationship" between the education and the current job requirements, as mentioned in *McAuliffe* (40 TCM 420 (1980)). Establishing such a relationship may involve reviewing and perhaps updating job descriptions so they present a more accurate and complete list of skills required for the position. These rules are much stricter than those for scholarships, grants and section 127 plans, which do not require that course work be closely related to job function.

Comparing Education Benefit Options

	Scholarshipsand grants section 117(a)	**Education assistance programs section 127**	**Working condition** fringe benefit section 132 (d)
Plan must be nondiscriminatory	Yes	Yes	No
Student must be	Yes	No	No

degree candidate			
Education must be job-related	No	No	Yes
Requires formal written plan	Yes	Yes	No
Requires employee notification	Yes	Yes	No
Imposes dollar limit	No	Yes	No
Covers travel expenses	No	No	Yes

INTERPLAY OF CODE SECTIONS

CPAs will find it is possible for an employer to fund employee education under more than one code section at the same time (see exhibit at left). In good financial times, employers with existing education-assistance programs under section 127 might wish to offer greater tax-free benefits than the $5,250 maximum. Fortunately, section 132 (j)(8) allows for the exclusion of payments in excess of the $5,250 maximum if they qualify as a working condition fringe benefit. Employers have the flexibility of using the working condition fringe benefit even when combining section 127 and section 132(d) programs (letter ruling 9418010). While employees in general are subject to the $5,250 annual section 127 maximum, certain ones may receive greater benefits under section 132(d). Alternatively, when the company doesn't fund section 127 programs during a particular year, it still may use section 132(d).

Tuition-reduction plans. Many colleges and universities allow employees and their families to enroll in courses at either reduced tuition rates or, more commonly, at no cost at all. These section 117(d) plans, however, represent a conflict with section 132. Section 117(d) says an institution's employees (including spouses and children) do not have to include tuition reduction below the graduate level in their gross income. Since only undergraduate tuition reduction is tax-free, some taxpayers were hoping graduate tuition reduction might qualify as a working condition fringe benefit much as excess payments above the section 127 maximum qualify. Field service advice (FSA) 200231016 addressed this issue and found graduate tuition reduction is not a working condition fringe benefit.

The IRS reasoned that a school offering free or reduced tuition when one of its own employees takes a course at the institution is not the same as an employer's actually paying cash under a section 127 education-assistance plan. This distinction is important because if, for example, a school pays cash to reimburse an employee for graduate tuition while he or she is enrolled at a different school, the reimbursement may be a working condition fringe benefit. On the other hand a school simply filling an empty graduate-level seat in one of its own classrooms as a noncash perk is not a working condition fringe benefit. One of the possible rationales in the FSA for this approach is that "there is little incentive to monitor whether graduate-level courses are job-related when the courses result in no additional cost to the employer." Actually paying cash to another school presumably results in greater scrutiny of the reasons for the payments and the relationship of the courses to the employee's job.

A FLEXIBLE BENEFIT

There are various ways employers can provide tax-free education help to employees—each with advantages and disadvantages. Scholarships and grants and section 127 education-assistance plans have limitations. However, using the working

condition fringe benefit provision offers employers flexibility and requires less time, paperwork and effort, especially in times of financial hardship or when the goal is to reward a small segment of employees. Flexibility and cost control from section 132 (d) plans may be just the incentive employers need to finance graduate degrees for select employees. The key to making the working condition fringe benefit method work is to ensure that the courses in which employees enroll are very closely related to their current jobs. Armed with this array of tax-free education benefit options, CPAs can advise employers and clients on the alternative that best meets their needs.
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