

**Qualified Tuition Reduction Plans:
Fact & Fiction Regarding Using Pre-Tax Dollars for Your Child's Education**

Judah I. Kupfer, Esq.

Introduction

As an Orthodox Jewish parent with children attending a yeshiva or *Bais Yaakov*, what is your single greatest financial expense? Presumably, tuition. Most families find the ever increasing cost of tuition to be their single greatest financial burden. It doesn't get any easier – as costs keep rising, so does tuition. To be fair, despite tuition hikes and various fundraising measures, yeshivos are suffering financially and literally struggle to survive.

The financial reality has led many parents to seek out ways to pay their tuition obligations while at the same time alleviating their financial burden. One means of obtaining this end has been the possibility of saving on one's tax liability by deducting tuition payments as charitable contributions – but this method has failed. Current law is clear that tuition payments, even for *limudei kodesh* studies alone, are not deductible.

Recognizing that rabbeim and teachers earn far less than what schools are able to pay, in attempt to assist their employees financially, many schools have adopted the practice of directing teacher compensation on a pre-tax basis toward the costs of tuition for their children, either at the same school by allowing children of employees to attend at a reduced rate, if not for free, or by writing checks directly to the institutions where such children attend. While there is a basis for this practice under current law, it is important to understand the confines of this doctrine, what is allowed and what is not.

At the outset, it is important for the reader to understand a tax rule that is simple in nature, yet seemingly unknown to many. Generally, payments in any form including cash, property or other benefits, made to an individual as compensation for services rendered (whether the person is working in the capacity as employee or as an independent contractor) are taxable to the individual regardless of whether the cash, property or benefits are paid directly to the employee or are directed elsewhere by the employee. It is, thus, irrelevant whether the employee actually receives the benefit or if he directs it to benefit someone else and never actually sees or benefits from the payment – in either case, the baseline is that this constitutes taxable compensation to the employee.

Given this rule, it should then be obvious that, generally, compensation earned by a teacher ought to be taxable to the teacher regardless of whether it goes directly to the teacher's bank account or whether the teacher directs such monies toward her mortgage, her grocery bill or to another school to pay for her child's tuition. In all cases, the general rule applies: such monies are taxable compensation to the employee.

If you are a teacher, you may be wondering how you may not be paying tax on the part of your salary that your school provides directly to pay for your child's tuition. The answer lies in whether your school is making such payments as part of, and pursuant to, a Qualified Tuition Reduction Plan. If you meet all of

Judah I. Kupfer, Esq. is a staff counsel at Agudath Israel of America. Mr. Kupfer received his B.A. from Touro College, his J.D. from Brooklyn Law School and LL.M. in taxation from New York University School of Law. To contact the author, please email ykupfer@agudathisrael.org. Questions and comments are welcome.

the requirements set out by law, those payments may rightfully be tax-free. If not, prepare to write a larger check to Uncle Sam. This article seeks to clarify these requirements.

What is Qualified Tuition Reduction?

Let's first identify what it is we are talking about. Section 117(d) of the Internal Revenue Code allows for Qualified Tuition Reduction, or QTR for short. It is a program a qualified educational institution, such as a school, may adopt in which it agrees to pay a specified sum toward the tuition at the same or another educational institution, incurred by certain relatives of a designated class of employees which will be tax-free to the employees (for all federal, state and local taxes – including FICA) as a fringe benefit of employment. But, QTR may not be a payment in lieu of salary – it must be a fringe benefit of employment paid in addition to salary. That sounds like a mouthful – so let's take each of these requirements in turn.

Which institutions may have a QTR program?

Most employers are *not* eligible to institute a QTR program. For example, commercial businesses are not eligible. Rather, to be able to offer a QTR plan, the employer must be an educational institution that (a) has as its primary function the presentation of formal instruction, (b) normally maintains a regular faculty and curriculum, and (c) normally has a regularly enrolled body of students in attendance at the place where its educational activities are carried on.

Most *yeshiva katanas*, *yeshiva gedolahs* and day schools would meet this definition. Depending on how educational it is, a pre-school may also qualify. As for *batai medrashim* or *kollelim*, given the variety of structures these entities take on, each *bais medrash* and *kollel* interested in instituting a QTR plan should seek professional guidance to determine on an individual basis whether it meets this definition.

It is conceivable that teachers may send their children to the same school in which they are employed or to different schools. If the child attends a school other than the one in which the teacher is employed, both schools must meet the definition for educational institution. The recipient school, i.e. the school that the child is attending, may be located inside the U.S. or overseas – so payments given to yeshivos and seminaries in Israel (i.e. child of the teacher is studying in yeshiva or seminary in Israel) should qualify so long as those institutions meet the above definition as being an educational institution.

As an aside, it should be noted that if not for §117 of the Tax Code, allowing an employee's child to attend the same school for free or at a reduced rate would be a taxable benefit to the employee. Thus, QTR's applicability is equally in effect both when the employee's child attends the same school or a different school.

For whom may QTR be paid?

The education the QTR is funding must generally be for undergraduate studies, which includes elementary, high school and college (undergraduate) level. Graduate level classes may also qualify in the limited circumstance where the person whose tuition is being paid attends the same institution and is performing teaching or research activities for that institution and the QTR tuition amount is not payment for services rendered by the student.

Who is Eligible to take part in a School's QTR Program?

Only an *employee* is eligible to take part in an employer's QTR program. Thus, a volunteer worker will not qualify. The school may allow for any employee to take part in its program – it is not limited to teachers or any other kind of employee. However, the school need not make its program available to all employees but may limit its program to a specific class or classes of employees so long as such classification is reasonable and not “discriminatory.” Classification based on seniority, part-time vs. full-time, salaried vs. hourly, type of job e.g. teachers vs. secretaries, geographic location e.g. all teachers in a certain branch of the school – are all examples of reasonable classifications. The classification, however, may not be based on salary alone. For example, the school can choose to only provide QTR benefits to full-time employees that have been with the school for three years. But it may not choose, for example, to only include teachers earning above a certain salary or teachers whose relatives are school board members or large contributors.

The school can also choose to cap the maximum amount of benefits to allow per eligible employee. It may, for example, allow for the payment of full tuition or only a portion of tuition; it can pay for all children or only a certain number of children per employee; it can also cap the benefit at a certain dollar amount per employee. As long as employees within each classification are eligible for substantially the same benefits, the QTR program will not be unlawfully “discriminatory.”

The school should be very clear as to who is eligible and the amount of the benefit for which such employees are eligible. The plan should be clearly written and made known to its employees. If schools find themselves making QTR payments to each other, the schools may find it helpful to create a reciprocal agreement with each other so that actual money may not need to change hands.

May QTR be part of salary or must it be in addition to salary?

The qualifications outlined thus far probably seem reasonable and even doable. The requirement that leads to the most errors is this next one. QTR is limited to payments made in addition to the employee's salary, not part of the employee's salary. In other words, part of the employee's salary may not be diverted to pay for QTR – a base salary must be set and any QTR benefits offered must be in addition to that salary. For example, if the agreement with the employee is that he will be paid \$40,000, any QTR benefit offered must be given to pay tuition *in addition to* the \$40,000. Once the salary is set, should the school offer to pay the teacher \$30,000 with the additional \$10,000 going toward tuition, the entire \$40,000 is taxable income to the teacher as that \$10,000 is not being given pursuant to a QTR program but is instead ordinary compensation which is taxable.

This requirement clearly reflects the IRS position as set forth in Publication 970: “You must include in your income any tuition reduction you receive that is payment for your services.” Additionally, after the IRS claimed QTR payments made in lieu of compensation constituted taxable income, a court agreed with the IRS finding the salary reduction to be taxable income basing its conclusion on the treasury regulations, which states: “Any amount deducted by an employer from the remuneration of an employee is considered to be a part of the employee's remuneration and is considered to be paid to the employee as remuneration at the time the deduction is made.” *Marquette University v. United States*, 645 F. Supp. 1007 (E.D. Wis. 1985). In addition to classifying the QTR payments as taxable income to the employee, the court in that case concluded that the college should have reported such amounts on the employee's W-2 as taxable wages and withheld taxes on the salary reductions.

Moreover, a noted tax lawyer who has published extensively on tax issues relating to religious and educational institutions writes the following: "...can the employee pay for [QTR] with pretax dollars through a salary reduction arrangement? The answer is no. Salary reductions can reduce taxable income only if specifically authorized by law. For example, federal law specifically authorizes the payments of contributions to a 403(b) plan (tax sheltered annuity) or to a cafeteria plan to be made through salary reductions. No authorization is given to pay for tuition expenses through salary reductions." RICHARD R. HAMMAR, 2010 CHURCH & CLERGY TAX GUIDE 212 (2010). Furthermore, in *Rasmussen v. Commissioner*, T.C. Memo. 1994-311, the Tax Court approved a QTR program stating that "the amounts [of the tuition reductions] were not subtracted from the petitioners' respective salaries." The implication is that had the amount been deducted from employees' salaries, it would have been subject to income tax.

The practice of establishing a set salary and subsequently reducing the salary based on the desired amounts of QTR payments requested by the teacher violates this qualification. Alternatively, setting salaries with QTR in mind e.g. teacher would receive \$40,000, but because s/he requests \$10,000 of QTR, his/her salary for the year will be reduced to \$30,000, is also problematic.

Certainly, employers possess the discretion to pay their employees different salaries. There is no requirement that all similarly situated teachers be paid the same amount. If, however, the disparity among the salaries of similarly situated teachers is apparent and the QTR benefit being received accounts for that discrepancy, it will be obvious to any auditor that the QTR benefit was, in fact, part of salary and, thus, should be taxable income. It is, therefore, incumbent on any school that maintains different salaries for its employees, to keep detailed records of its salary structure to be able to justify that any QTR benefit is not a payment in lieu of salary.

Based on the foregoing, it should be clear that while the QTR benefit a school offers may not cost it much in terms of out-of-pocket expense when the child of an employee attends the same school for free or at a reduced rate, it will most certainly cost the school when the child attends a different school – as that will require the school to draft a check to the other institution; money it would otherwise not be required to pay if not for this additional benefit it is providing.

One final note on this requirement: Although this appears to be the current status of the law and the IRS' position, a more aggressive tax position in this area that favors teachers has been articulated and some institutions have followed that position. Each institution would, thus, be well advised to rely on the professional advice of its own professional in advancing its QTR benefit program.

Are any taxes paid on QTR?

The amounts properly paid as part of a QTR benefit (assuming all requirements are met) are exempt from federal, state and local income taxes as well as payroll taxes such as FICA. The amounts of QTR do not belong on a form W-2, as they are exempt from taxes and are not included in gross income. They will also not be considered "earned income" for purposes of the earned income and child tax credits.

Payments to other institutions or the value of reductions in the same school's tuition that do not fall within the requirements for QTR as set out, should be reported as taxable income, listed on the employee's form W-2 and the employer should withhold taxes as required.

Conclusion

While a QTR program provides a significant benefit to school employees, it is important to keep in mind the various requirements necessary to qualify for this benefit. These rules are not new but may seem novel due to misinformation and a lack of understanding of the requirements. These requirements place a significant cost on the school providing the benefit – a benefit that goes a long way to any employee on the receiving end, but at the same time is, no doubt, an additional cost to the school providing it. It is incumbent upon each employer eligible to offer a QTR program to recognize the true nature of the QTR rules in consultation with its own tax professional and consider the financial costs prior to implementing a QTR plan.

This note is provided for general information and educational purposes. Neither its distribution to any party nor any statement or information it contains is intended to or shall be construed as establishing an attorney-client relationship or to constitute legal advice. Readers also are cautioned that the information in this note may not apply to all situations. Consequently, readers must not rely upon this note or information it contains as a substitute for competent individualized legal advice about the specific circumstances of the readers. Attorney advertising, prior results do not guarantee a similar outcome.

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter that is contained in this document.