

ATTORNEYS AT LAW

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**MEMORANDUM**

**To:** Mordechai Biser, Esq.  
Associate General Counsel  
Agudath Israel Of America

**From:** Kevin Babitz

**Re:** Qualified Tuition Reduction Programs

**File #:** 998001.00039

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**General Introduction**

Pursuant to Section 117(d)(1) of the Internal Revenue Code, under certain circumstances an employee of an educational organization can receive from his employer a tuition reduction for his children's tuition such that the amount of the reduction does not constitute taxable income to the employee. This can be done if the employer provides the employee with a "qualified tuition reduction" (hereafter called a "QTR") as part of a QTR program. A QTR is defined as a reduction in tuition provided to an employee of an educational organization<sup>1</sup> for education (below the graduate level) at that or another educational organization.

A QTR is a very attractive benefit for yeshivos, day schools and other Jewish educational institutions. When a school provides an employee with a tuition reduction, its cost is generally far less than the value of the reduction to the employee.

The requirements for providing a QTR are as follows:

- The QTR must be provided by an educational organization (defined below), for attendance at it or at another educational organization.
- The QTR must be part of a program in which similarly classified employees (defined below) receive substantially the same benefits. The program cannot discriminate in favor of owners or officers or certain other employees of the organization.
- The QTR must be a fringe benefit and not a payment in lieu of salary.

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<sup>1</sup> As described in Code Section 170(b)(1)(A)(ii).

## Specific Questions and Issues

### **1. What sort of educational institution is permitted to have a QTR program?**

Only educational organizations may offer qualified tuition reduction programs. An employer is considered to be an educational organization if it meets all of the following conditions:

- (1) its primary function is the presentation of formal instruction;
- (2) it normally maintains a regular faculty and curriculum; and
- (3) it normally has a regularly enrolled body of students in attendance at the place where its educational activities are carried on.<sup>2</sup>

If a school offers qualified tuition reductions for attendance at another institution, the other institution must also meet these requirements.

For most yeshiva katanas, yeshiva gedolahs<sup>3</sup>, Bais Yaakov seminaries, and day schools, these requirements will not be difficult to satisfy.<sup>4</sup> A pre-school<sup>5</sup>, an afternoon kiruv school, and the like would also appear to qualify. It appears that QTR payments may also be made to yeshivos and seminaries in Israel.<sup>6</sup> However, an organization such as a shul that runs a nightly beis medrash program cannot offer a QTR program, even to its full-time employees, since its primary function is not the presentation of formal instruction.

### **2. Who is entitled to receive a QTR?**

A QTR can be provided to any person ‘treated as an employee’ according to the Internal Revenue Code. Individuals in the following categories are treated as employees:

- (1) A current employee;
- (2) A former employee who retired or left on disability;
- (3) A widow or widower of an individual who died while an employee;
- (4) A widow or widower of a former employee who retired or left on disability; or

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<sup>2</sup> Treasury Regulation § 1.170A-9(b).

<sup>3</sup> However, see question 11, which states that QTR payments for graduate education (such as kollel) are much more limited.

<sup>4</sup> The IRS has stated explicitly that religious schools are eligible to offer QTR programs. See PLR 200149030.

<sup>5</sup> A facts and circumstances test will apply to pre-schools to make sure they are sufficiently educational. In San Francisco Infant School, Inc. v. Commissioner, 69 TC 957 (1978), the court ruled that a preschool was indeed an educational organization, because it had qualified teachers and a formal curriculum. However, General Counsel Memorandum 38731 (1981) ruled that an institution for mentally handicapped children was not an educational organization because it did not have the proper indicia of education.

<sup>6</sup> While there is no direct authority on this point, Rev. Rul. 82-143 discusses a “foreign university described in 170(b)(1)(A)(ii)” in the gift tax context, thus indicating that foreign schools can be 170(b)(1)(A)(ii) institutions. See also PLR 9018068 and PLR 9510045.

(5) A dependent child or spouse of any person listed in (1) through (4).<sup>7</sup>

### 3. Does a school have to include all of its employees in its QTR program?

No. An employer has significant flexibility in designing a program that meets employees' needs while limiting its own costs. Thus, even though there is a very broad class of people who *may* be covered under a QTR program, an employer may decide to limit the covered group in order to keep costs down. However, in doing so, the employer cannot discriminate against individual employees within the same classification, as explained below in question 5.

*Example: a school can choose to only provide QTR benefits to full-time employees who have been working for the school for three or more years, but having done so, it must make the benefits available to all of its full-time employees who have been with the school for three or more years.*

### 4. Can the QTR be an amount deducted from an employee's salary?

No. The QTR must be a fringe benefit provided by the employer to the employee and not a payment for services rendered by the employee.<sup>8</sup> In other words, the school must set a certain salary for each classification of its employees and then offer the QTR as a fringe benefit in addition to each employee's salary.

To the extent that different teachers in a school receive significantly different salaries, it would be highly advisable for all schools with QTR programs to maintain records that demonstrate the

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<sup>7</sup> Additionally, a child of deceased or divorced parents may also benefit from a QTR program. If both of a child's parents have died, but one of them qualified as an employee under (1) through (4) above, their child, if under the age of 25, can qualify to receive a tuition reduction from his or her parent's former employer. The child will then be permitted to exclude the amount of the QTR from his or her own income. A dependent child of divorced parents is treated as the dependent of both parents.

<sup>8</sup> Generally, all financial benefits are included in a taxpayer's gross income (Code Section 61 defines gross income as all income from whatever source derived). Fringe benefits are thus included as income unless they are specifically excluded under the Code, and Section 117(d) explicitly excludes qualified tuition reductions from an employee's taxable income. Treasury Regulations Section 1.132-1(f)(1) indicate that the 117(d) exclusion is considered to be a fringe benefit. The regulation states that the requirements of Section 132 (which deals with taxable fringe benefits) do not apply to particular fringe benefits that are expressly provided for in other sections. The Regulation specifically mentions the Section 117(d) QTR as an example of a fringe benefit not subject to the Section 132 rules because it is provided for by another section. A payment for services rendered, on the other hand, cannot be a fringe benefit. Therefore, if an institution were to deduct tuition payments it makes for an employee's children from the salary of the employee, this reduction will not constitute a fringe benefit, but taxable income to the employee. Additionally, even if the employee were to receive a discounted rate of pay, this would not constitute a reduction of tuition, but just an adjustment of the taxpayer's salary. This distinction was discussed by the Tax Court in 1994 in *Rasmussen v. Commissioner*, T.C. Memo. 1994-311, in which the Court approved a QTR program, stating that "the amounts [of the tuition reductions] were not subtracted from the petitioners' respective salaries." This statement implies that had the amount been deducted from employees' salaries, they would not have been permitted to exclude it from their income.

basis for their salary structure so that their QTR payments cannot be construed by the IRS as payments in lieu of salary.

*Example: Rebbe A and Rebbe B both teach fourth grade for Yeshiva Y. If Rebbe A gets a \$35,000 salary and no QTR (because he has no school-age children), whereas Rebbe B (who has four children enrolled in schools) gets a \$25,000 salary and \$10,000 in QTR payments to the schools his children attend, the QTR payments to Rebbe B are likely to be construed as taxable salary and not a tax-free fringe benefit. But if the school had a written salary policy, that is uniformly adhered to in practice, that all teachers who have five years or more seniority (such as Rebbe A) are paid \$35,000, whereas newer teachers (such as Rebbe B) get \$25,000, then the QTR payments for Rebbe B's children would be justifiable as a fringe benefit.*

## **5. Can different rebbeim or teachers receive different amounts of benefits under a QTR program?**

QTR benefits must be made available on substantially the same terms to each member of a group of employees that is defined under a “reasonable classification” set up by the employer.<sup>9</sup> A classification will be reasonable if established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classifications include specified job categories, nature of compensation (i.e. salaried or hourly), geographic location, seniority, full-time vs. part-time status, and job description.<sup>10</sup>

Therefore, rebbeim or teachers who have greater seniority, or who teach a longer school day, can receive more QTR benefits than those with less seniority or those who are more part-time.

Once a school establishes its classification of employees for QTR purposes, it has considerable discretion as to the details of the QTR benefits it provides to each class of employees. For example, a school can establish a total dollar cap on QTR (e.g., we will pay up to \$10,000 in tuition payments for the benefit of each full-time employee), a per child cap (e.g., we will pay up to \$2,500 in tuition for every child of a full-time employee), a cap on the number of children or other dependents whose tuition will be paid, et cetera. As long as employees within each classification are eligible for substantially the same benefits, the QTR program will not be discriminatory.

## **6. May an employer, as part of a QTR plan, also pay tuition at other educational institutions?**

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<sup>9</sup> Code Section 117(d)(3).

<sup>10</sup> Treasury Regulations Section 1.410(b)-4. See also PLR 200137041.

Yes. An employer may extend its QTR program to include other educational institutions. It should be noted, however, that this would likely cause the employer to incur additional costs, as it will need to pay full or partial tuition to the other institution. One way this additional cost can be abated is if the institutions enter into a reciprocal agreement, in which each institution agrees to provide a discounted tuition to children of employees at the other institution.

### **7. Can a QTR program offer full tuition payments for a school's employees?**

Yes. While a QTR plan need not provide employees with full tuition assistance, the employer may provide a reduction ranging anywhere from 1 percent to 100 percent.<sup>11</sup>

### **8. What do the regulations mean when they say that a QTR program cannot be discriminatory?**

A QTR program cannot discriminate in favor of "highly-compensated employees"<sup>12</sup>, owners or officers.<sup>13</sup> This means that the organization must make available tuition reduction benefits to

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<sup>11</sup> Depending on the goals of the program, there are advantages and disadvantages to having a higher or lower reduction rate. A partial reduction program, if limited to the employer-institution, offers a significant potential monetary advantage to an institution. This is because such a program would not only encourage employees and their families to enroll at the institution, but also pay partial tuition to the school. Since the additional cost of extra students in a class is generally quite low, the employer-institution stands to gain from receipt of even partial tuition. If the benefit were extended to other institutions, the employer would not have to pay out as much as if it were providing full tuition. The benefit of a full reduction program, on the other hand, is that it would be more attractive to employees and prospective employees.

<sup>12</sup> "Highly compensated employee" (HCE) is defined in Code Section 414(q)(1) as an employee who either was a 5% owner at any time during the tax year or the preceding year; or for the preceding year had compensation exceeding \$85,000 (in 2001, but adjusted for inflation in later years) and, if the employer so elects, the employee was in the top 20% in compensation in the organization. On the other hand, if the number of HCEs eligible for tuition reduction under the organization's plan is substantially higher than the number of eligible non-HCEs, then the HCEs must include in income the entire value of the benefit received (Letter Ruling 9041085). Even in these cases, however, the non-HCEs who receive a tuition reduction can still exclude the benefit from their own income, as this provision only applies to HCEs.

<sup>13</sup> The plan will need to satisfy one of two percentage tests set out in the Treasury Regulations at Section 1.410(b)-4(c)(2) and (3). However, even if these two tests are not satisfied, the IRS may still rule that a QTR plan is nondiscriminatory and therefore valid, if it believes that the number of eligible non-highly compensated employees is sufficient. See PLR 9621033; PLR 9710022.

The IRS illustrated the application of these provisions in PLR 9728017. In this ruling, the Service considered a university's QTR plan. The plan covered all faculty and staff employees who had five years of full-time service and part-time staff with six or more years of service. The IRS ruled that the plan satisfied the prohibition against discrimination in favor of highly compensated employees because the classification of the employees was based upon a combination of length of service, full-time employment and position. More recently, the IRS considered the validity of a plan that covered a more limited class of employees in PLR 200137041. This plan provided tuition reductions to eligible employees and their dependents for university degree-granting programs. To be eligible for

other employees on “substantially the same basis” as it does to highly compensated employees, owners, and officers, assuming that the other employees are in the same classification. In other words, the salary level of employees itself cannot be the basis for a classification.

**9. What is the tax effect of a QTR for the employee? Does the value of the QTR need to be recorded on the employee’s W-2 form?**

An employee who receives benefits under a QTR plan is not required to include any amount of the value of the QTR in his gross income. The value of the benefit is not reported on the employee’s W-2, and no withholding or other taxes are paid on the QTR.

This will be the case whether the employee himself or a member of his family derives the benefit of the QTR.

**10. How should a school make tuition payments to other schools under a QTR program?**

The school, after classifying its employees into categories and establishing a policy as to what QTR benefits it will provide to those within each category, should simply make tuition payments payable directly to the educational institutions that its employees’ children attend. Of course, detailed records should be kept of these payments.

**11. Can QTR’s be used to pay for graduate level education?**

A tuition reduction for graduate education can also be tax-free, but only under much more limited circumstances. The recipient of the reduction must be a graduate student who performs teaching or research activities for that institution. The QTR may only be for education furnished by the institution itself, not for any other school. It also may not represent payment for services rendered by the student.<sup>14</sup>

**12. Can a volunteer worker qualify for QTR benefits?**

Probably not. This is because any fringe benefit, such as a tuition reduction, must be offered to an employee *in addition* to salary and not *in lieu* of salary. Since a volunteer worker receives no salary, then any tuition benefit he or she receives will not be in addition to anything. The result of this is that the tuition break that the volunteer is receiving will really be in compensation for services provided, and this sort of compensation is generally considered to be income.

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this program, employees needed both to have completed five or more years of full-time service and also be active members of the employer-sponsored 401(a) or 403(b) retirement plans. The IRS ruled that these restrictions did not cause the plan to be discriminatory.

<sup>14</sup> IRC §117(d)(5).

In such cases, then, a tuition reduction that a school provides to a volunteer worker should be considered taxable income to the volunteer. The institution will thus need to include the volunteer on its payroll, provide him or her with a W-2, and make the appropriate withholding.

**13. If a shul or other charitable organization runs a school in addition to engaging in other activities, may its employees who do not work for the school receive a qualified tuition reduction?**

No. The IRS has recently ruled<sup>15</sup> that only actual school employees may benefit from a QTR. Other employees who work for the organization running the school cannot claim this tax benefit. This ruling will be relevant to congregations or other organizations that may run a school in addition to other activities. For example, all employees of a school run by a shul could receive a QTR (including secretarial, managerial, custodial, and other employees), but employees whose work is solely for the shul's office could not. While the organization is free to offer a tuition reduction to its other employees, the benefit would be a taxable fringe benefit for them.

**14. Can a QTR program pay tuition for individuals not specified in the Internal Revenue Code as eligible for QTR benefits?**

A school can pay tuition for others not listed (under question 2 above) as eligible for QTR benefits, such as other family members, relatives, or friends of the employee, but the amount of such tuition will constitute taxable income to the employee.<sup>16</sup>

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<sup>15</sup> PLR 200149030.

<sup>16</sup> PLR 200137041.