

TAXING TUITION DISCOUNTS?

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Many churches operate schools. These churches also believe that their clergy and staff should send their children to the church operated school. However, a serious problem frequently arises: the compensation of the clergy and staff is too low to allow them to send their children to the church operated school. To solve this problem, the church frequently offers steep discounts to the clergy and staff. Since no cash changes hands, the church assumes that the discount is not taxable. Unfortunately, the tax laws are rarely so simple. This article will discuss when a tuition discount is taxable and when it is not taxable.

GENERAL RULE

Internal Revenue Code (“IRC”) Section 117(d) tells us the general rule; that is, schools may give tax free tuition discounts to its employees. The tax free tuition applies only to children that the employee may claim as a dependent on their tax return. The tuition discount plan must not favor highly compensated employees over lower compensated employees. The tuition discount plan must be in writing and communicated to all eligible employees. As with many tax rules, many qualifications and exceptions limit the application of this simple rule. If this rule (along with its qualifications and exceptions) does not apply, then the tuition discount is taxable to the employee.

WHAT IS A SCHOOL?

The general rule only applies to tuition discounts at “schools.” In IRS lingo, the term “school” differs from the common language usage. The IRS defines a “school” as “an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.” As you can see, this definition is activity oriented and not structure oriented. Any activity that qualifies as a school is eligible to provide the discounts, regardless of corporate structure. The general tuition discount rule applies only to schools from kindergarten through college.

For tuition discount purposes, the definition excludes graduate schools and day care centers. Day care center discounts are governed by IRC Section 129 instead of IRC Section 117, which allows a maximum tax free discount of up to \$5,000.00 per employee. IRC Section 129 has many other rules and qualifications that are beyond the scope of this article.

WHO IS AN EMPLOYEE?

The general rule applies only to workers where the employer issues a Form W-2. If the school is separately incorporated from any other activity, then the general rule clearly applies to school employees. Beyond this easy application, the application of the general rule gets fuzzy.

If the school is separately incorporated but shares staff with the church, the IRS will examine the particular employee's duties and responsibilities to determine whether that employee qualifies for a tax free tuition discount. If the employee works in the school's activities, called in tax lingo the same "line of business," then the tuition discount will be tax free. If the employee does not work in the school's activities, then the tuition discount is taxable.

For example, the youth minister is also required to teach full time in the church related high school. Since he or she works at the school, the tuition discount is tax free. In fact, the IRS has ruled that it is still tax free though all his or her compensation is paid from the church's budget and not the school's budget.

If the school is part of a corporation that has other activities (such as a church), the line of business test applies; that is, if the employee has material duties and responsibilities regarding the school, then the employee will be considered eligible for a tax free tuition discount. The employee need not teach to be eligible for the discount, but must have material duties and responsibilities related to the school's activities.

We do not have any guidance regarding the IRS definition of material duties and responsibilities. I suggest that the less time an employee spends on school activities, the less likely it is that the employee is eligible for a tax free tuition discount. The only safe route is to have the employee work entirely in the school's activities.

RECIPROCAL AGREEMENTS

A church school is free to make reciprocal tuition discount agreements with other church schools. The agreement must be in writing and not involve a discount that requires material additional costs to the school providing the education. For example, Church A operates an elementary school, while Church B operates a high school. Church A and Church B may agree to give employees of the other church the same discount as it does its employees.

NONDISCRIMINATION

Frequently, we are asked about applying different discounts to different classes of employees. The appropriateness of differing discounts is determined using two factors: (1) lines of business (discussed above) and (2) compensation. The employer may offer differing discounts based on the line of business test but not based on the amount of compensation. That is, the teachers in the school may receive a different tuition discount from the church workers. (Note: The discount would be taxable to the church workers, but not to the teachers). Since higher compensated employees should not receive larger discounts than lower paid staff, the church probably should not offer a discount only to clergy (its highest paid group).

CONCLUSION

Churches may validly give school tuition discounts to employees, but they must abide by the rules if they want the discount to be tax free. With a little planning, most school employees may enjoy tax free discounts.