Chapter 37

Education Assistance Benefits

Introduction

During the last 50 years, participation has grown in higher education in the United States. One reason has been the demand for more skilled workers to meet the challenges of high technology industries. Another factor was passage of the World War II GI bill, which entitled World War II veterans to a higher education—previously virtually impossible for low-income veterans. In the late 1950s and in the 1960s, higher education also became more accessible to minorities and low-income individuals as a result of government grants and job and loan programs, most of which were established under the Higher Education Act of 1965.

Higher education is more expensive today than it has been during any previous period in U.S. history. College tuition inflation in the past 30 years has averaged approximately 2–3 percentage points higher than general price inflation and is showing no signs of slowing down (Ma and Fore, 2002). Many individuals who cannot afford to finance their education in full look to federal loan or grant programs for financial assistance. However, some of these programs are only available to students who are enrolled at least half time. Many part-time students, therefore, are not eligible to receive government assistance. For these individuals, there are three formal education assistance programs that employers may sponsor for their employees: tax-favored educational reimbursement programs, educational assistance programs, and qualified scholarship programs. In addition to these formal programs, employers sponsor informal educational opportunities for their employees, for example, in-house training and courses involving continuing education, personal development, and literacy enhancement. These informal courses are focused on expanding or improving an employee's job-related functions, and as such are part of normal business operations and do not require a separate tax-advantaged account or other structure to be established.

Educational Reimbursement Programs

Educational reimbursement programs (ERPs) are the most commonly offered education assistance programs by employers. These programs are also known as *tuition reimbursement* programs or *tuition assistance* programs. ERPs are designed to assist employees with the cost of tuition, books, and fees. Employers usually pay for ERPs from their organizations' general revenues on a pay-as-you-go basis.

Taxation of Benefits—Employers may reimburse employees for any type of educational expense, provided that it meets either of the two following "job-related" criteria, as specified under Sec. 162 of the tax code: The education must maintain or improve the skills that employees are required to perform on their jobs, or the education is required by the employer or by law for the employees to remain in the occupation or to keep the same status or rate of compensation. These benefits are considered "working condition fringe benefits" by the Internal Revenue Service (IRS), and are therefore excludable from an employee's gross income and deductible for employers as ordinary and necessary business expenses. These expenses also are exempt from income tax withholding and payment of employment taxes (FICA and FUTA) (International Foundation of Employee Benefit Plans, 2000a).

In addition, working condition fringe benefits are exempt from nondiscrimination rules. Employers may reimburse all employees or discriminate in favor of certain categories of employees (information technology workers, for instance), but if they do, they need to be aware of potential morale issues within their work force.

Plan Design—Employers usually limit their benefit costs in some way: by reimbursing less than 100 percent of expenses, by setting a dollar maximum on the reimbursement, or by limiting the number of courses an employee may take per semester or year. Many employers require the employee who receives educational assistance to obtain a certain grade upon completion of the course he or she is taking before the cost will be reimbursed. Others reimburse a greater proportion of the cost for a higher grade. Some employers require the employee to stay with the firm for a certain number of years after completing the course or to repay the course costs.

An employer may elect to pay some of the expenses directly, such as paying tuition expenses to the institution where the classes were held, or indirectly by reimbursing the employee in cash. If the employee is reimbursed in cash, the expenses must be substantiated with receipts.

Educational Assistance Programs

Educational assistance programs were originally legislated through the Revenue Act of 1978, Internal Revenue Code (IRC) Sec. 127. An educational assistance program is a separate written plan that provides educational assistance only to employees of the organization. The program qualifies only if all of the following tests are met (Internal Revenue Service, 2006a):

- The program is required to be a "separate written plan of an employer for the exclusive benefit of the employees to provide such employees with educational assistance."
- The plan cannot discriminate in favor of officers, shareholders, or the highly compensated.
- No more than 5 percent of annual educational assistance benefits can be paid out to shareholders or owners (or their dependents) who own more than 5 percent of the company.
- A plan cannot provide employees with a choice between educational benefits and other taxable benefits.
- Reasonable notification must be provided to the employees regarding the terms and availability of the program.

Eligible Employees—In addition to current employees, a former employee who is retired, left on disability, or was laid off is eligible to participate in a Sec. 127 educational assistance program. Leased employees are eligible to participate provided they performed services on a substantially full-time basis for at least a year if the services are performed under the primary direction and control of the employer. A sole proprietor, and a partner who performs services for a partnership, are also eligible participants.

For purposes of Sec. 127 nondiscrimination rules, a highly compensated employee is defined as an employee who meets one of two tests: (a) the employee was a 5 percent owner at any time during the year or preceding year; (b) the employee received more than $100,000 in pay for the preceding year and was among the top 20 percent of employees when ranked by pay for the preceding year (Internal Revenue Service, 2006).

Taxation of Benefits—The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made permanent the exclusion from income for employment-based educational assistance benefits under Sec. 127. EGTRRA extended the exclusion to graduate level and well as undergraduate level courses for courses beginning after Dec. 31, 2001. Any amounts provided over $5,250 are taxable to the employee. When an employee has multiple jobs, the annual limit applies to educational assistance from all employers (Internal Revenue Service, 2006).

Plan Design—Educational assistance expenses include tuition, fees, books, certain supplies, and equipment. Education expenses do not include meals, lodging, transportation, or the cost of tools or supplies (other than textbooks) that the employee is allowed to keep at the end of the course. Expenses do not include the cost of a course or other education involving sports, games, or hobbies, unless the education:

(a) Has a reasonable relationship to the business, or

(b) Is required as part of a degree program.

Scholarship Programs

Although scholarship programs are not a commonly offered benefit, some employers establish them for the dependent children of active employees, the active employees themselves, and/or their spouses. Employers can place limitations on this benefit, such as service requirements, annual dollar limits, and number of yearly awards. These scholarships can cover tuition, fees, books, supplies, and necessary equipment. The scholarships are excludable from income for the employee provided that they are outside the pattern of employment, meaning they cannot be compensation for past, present, or future employment services. The scholarships cannot be confined to areas of study or research primarily benefiting the employer.

Sec. 529 Plans

States have begun developing their own aid programs to help residents meet the growing cost of a college education for their children, and Congress has provide these plans with special tax status under Sec. 529 of the Internal Revenue Code (IRC), from which the plans take their name. These savings programs are established and administered by states for the purpose of setting aside savings for "qualified higher education expenses."

There are two basic types of Sec. 529 plans: a savings plan and a prepaid plan. A prepaid plan allows individuals to prepay college education expenses at today's prices, while the savings plan allows an individual to set aside some money and earn a variable rate of return on the assets.

Tax Status—Although Sec. 529 plans were first established in 1988 by the state of Michigan (Michigan Education Trust), it was not until 1996 that Sec. 529 was added to the federal tax code to clarify the plans' federal tax treatment (Ma and Fore, 2002). Prior to enactment of EGTRRA, contributions to a Sec. 529 plan were not deductible from federal income tax although the earnings were allowed to grow tax-deferred until withdrawn to pay for college-related expenses. Since states sponsor these plans, they have included incentives such as making the contributions deductible against state income tax and/or exempting the earnings from state income tax.

Under EGTRRA, starting on Jan. 1, 2002, the earnings on qualified withdrawals from state sponsored plans have been exempt from federal income tax. It is believed most states will go along with the federal tax provisions. The Pension Protection Act of 2006 made permanent the exclusion of 529 plans. Under current law, these provisions are due to expire in 2010. At that time (assuming no other changes to Sec. 529 have occurred), the federal tax status of Sec. 529 plans will revert to pre-Jan. 1, 2002, status (Ma and Fore, 2002).

Prepaid Plans—Participation in Sec. 529 plans is not subject to income limitation. The only limitation placed on participation in prepaid plans is state residency: Most of these plans require participants to be residents of the sponsoring state. The beneficiary of a prepaid plan can be anyone, even the individual making the contributions. Contribution limits to prepaid plans generally are set at the purchase of up to four years' worth of tuition at certain in-state schools. The assets of prepaid plans may be used to pay for tuition, fees, room and board, books, supplies, and equipment at almost any college or university (Ma and Fore, 2002).

Savings Plans—Participation in savings plans is open to any individual, with no residency requirement. As with prepaid plans, the beneficiary can be anyone, even the individual making contributions, and the assets may be used to pay for tuition, fees, room and board, books, supplies, and equipment at almost any college or university. Savings plans are subject to a lifetime limit on contributions per beneficiary, on account balances (the sum of contributions and earnings less fees and expenses), and in some cases on gross contributions. Lifetime contribution limits vary widely among states. Currently, the lowest limit on gross contributions is $100,000 and the highest is $251,000. The lowest limit on account balances is $122,484 and the highest is $265,620 (Ma and Fore, 2002).

Transfers from one Sec. 529 plan to another are permitted once every 12 months without having to change the beneficiary. (Before the tax law changes, if an account owner decided to transfer assets from one 529 plan to another, he or she could do so only by changing the beneficiary.) EGTRRA also allows for the transfer of account balances from one cousin to another (in addition to sibling to sibling transfers, as were previously permitted)—a benefit to grandparents who contribute to 529 plans for their grandchildren. Nonqualified withdrawals are subject to regular income tax plus a 10 percent penalty (Ma and Fore, 2002).

In response to EGTRRA, employers are seeing Sec. 529 plans as a new employee benefit. In an e-mail survey conducted by Hewitt Associates LLC in November and December 2001 (in which more than 160 companies participated), 19 percent of surveyed employers plan to assist employees to save for college expenses through payroll deductions or direct contributions to Sec. 529 plans. An additional 46 percent of surveyed employers were considering such moves (Hewitt Associates LLC, 2001).

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Additional Information

American Society for Training and Development
1630 Duke Street
Alexandria, VA 22313
(703) 683-8100
www.astd.org

College Savings Plan Network
Affiliate of the National Association of State Treasurers
P.O. Box 11910
Lexington, KY 40578
(859) 244-8175
www.collegesavings.org

Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224
(202) 622-5000
www.irs.gov

National Institute for Work and Learning
1875 Connecticut Avenue, NW
Washington, DC 20009
(202) 888-8186
www.niwl.org