Tuition Remission: If the Plan Discriminates, the Tax Consequences are Brutal

BY CESIRA NEWCOMB • MAY 12, 2020

One of the great perks of working at a private educational institution—university, college, or independent school—is the tuition remission for employees and their families. You know how expensive school tuition has become. So tuition remission can save you a ton of money. Even better, most school employees don't have to pay income taxes on the discount for themselves or their family members.

Let's take a step back and review one policy underlying our income tax system. It is this: anything of value given to an employee by an employer is taxable income. Employers cannot give gifts to their employees. Well, they can, but no matter what the motivation, the value, the fair market value, of that "gift" is supposed to be reported by the employer to the IRS and to the employee. And the employee pays income taxes on it—unless there's a tax break

Happily, tuition remission programs enjoy an excellent tax break. Section 117 of the Internal Revenue Code is entitled "Qualified Scholarships." Section 117(d) is called "Qualified Tuition Reduction." 117(d) is short and clear, "Gross income shall not include any qualified tuition reduction." A qualified tuition reduction means any reduction in tuition provided to an employee (or spouse or dependent child) at the employing educational institution or at another educational institution.

However, and this is what I am here to point out to you: the tax benefits of qualified tuition reduction apply to highly compensated employees only if the reduction does not discriminate in favor of the highly compensated employee. For 2020, a highly compensated employee is someone who earns more than $130,000.

It is not uncommon for senior executives of educational institutions to get a better tuition remission deal than other employees—it is sometimes called "preferred financial aid." For example, most people get 50% of their children's tuition remitted, but the head of school or president gets full remission, 100%, for her children.

That's a discriminatory policy.

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What are the consequences?

The tax break, the exclusion from taxable income, doesn't apply for a highly compensated employee who receives a more favorable discriminatory reduction.

You might think that the Head of School or the President would owe income taxes on the difference between the remission provided to rank and file employees the remission provided to her children. That makes sense.

But that's not the law. Section 117 says that the reduction will not apply in that case, so no reduction, no tax break, income taxes are owed on the entire amount of the remitted tuition.

This rule is relatively obscure. Mostly, discriminatory tuition reduction arrangements are not spotted. Not by the CFO and, surprisingly, not by the school's outside accountants and auditors. That can be partially explained by the failure to report anything about remission programs, on the assumption that they are universally tax exempt, and the failure of the auditors and accountants to ask. As a result, when it is discovered by an alert auditor or CFO, the error may have been going on for years.

If you have a tuition remission program that might be discriminatory, you should check with your CFO, accountants, auditors, or legal counsel. The consequences to the beneficiaries of the discriminatory plan, the senior-most executives at your school, may find themselves owing tens of thousands of dollars in unanticipated income taxes and interest.

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