MEMORANDUM OF LAW

DATE: November 4, 1997

TO: Ed Ryan, Auditor and Comptroller

FROM: City Attorney

SUBJECT: Taxability of Tuition Reimbursement

QUESTIONS PRESENTED

1. Under 26 U.S.C. 127 what qualifies as a taxable, or nontaxable, educational assistance reimbursement?

2. When education reimbursements do not qualify for tax exclusion under 127, may such reimbursements be excluded from an employee's gross income under any other provision of the Internal Revenue Code?

SHORT ANSWERS

1. 26 U.S.C. 127 exempts from taxable income an employer's reimbursement of tuition for undergraduate college and technical courses. However, graduate level educational expenses incurred by an employee and reimbursed by the employer are taxable.

2. Education reimbursements may be excluded from an employee's gross income under 26 U.S.C. 132 as a working condition fringe benefit if certain requirements are met.

BACKGROUND

Section 127 of the Internal Revenue Code has historically provided that qualified employer educational assistance, including City of San Diego tuition reimbursements pursuant to

San Diego Administrative Regulation 70.30, may be excluded from an employee's gross income. This exclusion expired for taxable years beginning after December 30, 1994. However, 127 was amended in 1996, and the income tax exclusion for qualified educational assistance was retroactively extended to January 1, 1995. Consequently, no actual lapse in the availability of tax exclusion occurred. The amended 127 also reinstated another provision: educational assistance for graduate level work begun before June 30, 1996, can be excluded from gross income. In addition, the 1996 amendment provides that tuition reimbursements for all other courses begun after June 30, 1997, could no longer be excluded from an employee's gross income. However, in 1997 the Internal Revenue Service once again amended its rules and extended 127 coverage to all courses, other than graduate level courses, begun before May 31, 2000.

Tuition reimbursements under San Diego Administrative Regulation 70.30 must be taxed in accordance with the Internal Revenue Code. However, the frequency and variety of amendments to 127 have created confusion regarding which courses are tax exempt and which are not. For that reason, you have requested a memorandum clarifying the current state of the law.

ANALYSIS

Education Assistance Tax Exclusion Under Internal Revenue Code 127

Internal Revenue Code 127 provides that the gross income of an employee does not include amounts paid or expenses incurred by the employee for educational assistance if the assistance is provided pursuant to a qualified educational assistance program.[1] 26 U.S.C. 127(a)(1). Education includes any form of instruction or training that improves or develops the capabilities of an individual. 26 C.F.R. 1.127-2(c)(4). Education paid for or provided under a qualified program may be furnished directly by the employer, or through a third party such as an educational institution. 26 C.F.R. 1.127-2(c)(4). As used in 127, education is not limited to courses that are job-related or part of a degree program. 26 C.F.R. 1.127-2(c)(4). With certain restrictions, educational assistance consists of payments by an employer for education expenses incurred by or on behalf of an employee including tuition, fees, books, supplies, and equipment. 26 U.S.C. 127(c)(1)(A). Accordingly, reimbursements for the costs of tuition, fees, books, supplies, and equipment for graduate level courses begun prior to June 30, 1996, and all other courses begun prior to May 31, 2000, may be provided on a tax-free basis.

Education Assistance Taxable Under 127

Tuition reimbursements for graduate level courses beginning after June 30, 1996, are taxable. 26 U.S.C. 127(d). A graduate level course is any course taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if that course can be taken for credit in a program leading to a law, business, medical, or other advanced degree. 26 C.F.R. 1.127-2. Additionally, reimbursements for meals, lodging, and transportation are taxable. 26 U.S.C. (c)(1)(B). Education assistance does not include payments for courses or other education involving sports, games, or hobbies. Id. Although the statute extends tax-exempt status to payments for books, supplies, and equipment, reimbursement for supplies does

not include payments for tools and supplies which may be retained by the employee after the completion of the course of study. 26 U.S.C. 127(c)(1)(B).

Exclusions Under Other Revenue Code Sections

The provisions of 127 do not affect exclusions from gross income of education reimbursements that are paid or received, under either 117 or 162 of the Internal Revenue Code. 26 U.S.C. 127(c)(6). Educational assistance in the form of qualified scholarships and tuition reduction may be excluded under 26 U.S.C. 117. Pursuant to 26 U.S.C. 162, ordinary and necessary trade and business expenses may be excluded from an employee's gross income as a "working condition fringe." 26 U.S.C. 132, 162.

Qualified Scholarships and Tuition Reductions

An employee's gross income does not include any amount received as a qualified scholarship or qualified tuition reduction. 26 U.S.C. 117(a), (b)(1). Qualified scholarship means any amount received by an individual as a scholarship or fellowship grant if such amount is used for tuition, fees, books, and supplies required for enrollment or attendance in an educational institution. 26 U.S.C. 117(b)(2)(A)-(B). The educational institution must normally maintain a regular faculty and curriculum and must have a regularly enrolled student body in attendance. 26 U.S.C. 170(b)(1)(A)(ii). Similarly, a qualified tuition reduction is any amount of reduction in tuition provided to an employee of such an institution. 26 U.S.C. 117(d)(2). Any amount paid to an employee to enable the individual to pursue education or research is not considered a qualified scholarship if the amount paid represents compensation for past, present, or future employment services or the course of study was undertaken primarily for the benefit of the employer. 26 C.F.R. 1.117-4(c).

Working Condition Fringe

Section 132 of the Internal Revenue Code provides that gross income does not include any fringe benefit that qualifies as a working condition fringe. 26 C.F.R. 1.132-1(a)(3). An employer-provided education assistance program qualifies as a working condition fringe to the extent that if the employee paid for the benefit, the amount paid would have been deductible as an ordinary and necessary trade or business expense. 26 C.F.R. 1.132-1(f)(1). Educational expenses are deductible as trade or business expenses if the education is necessary to maintain or improve skills required by the individual in his or her employment, trade, or business, or the education meets the express requirements of the individual's employer, or the education is required by law or regulation. 26 C.F.R. 1.162-5(a). Such education expenses are deductible even though they may lead to a degree. 26 C.F.R. 1.162-5(a). Educational expenses that may be deductible from an employee's gross income as a working condition fringe benefit include:

tuition and fees.[2]
books, supplies, tools, and equipment.[3]
travel expenses, including meals and lodging, expenses for travel as a form of education to the extent such expenditures are attributable to a period of travel directly related to the individual's employment duties.[4]

refresher courses, courses dealing with current events, academic and vocational courses.[5] research expenses.[6]

Education Required to Maintain and Improve Skills

Expenses incurred by an individual to maintain and improve skills required by the individual's employer, trade, or business include refresher courses or courses dealing with current developments as well as academic or vocational courses and are deductible from an employee's income. 26 C.F.R. 1.162-5(c). To satisfy the requirement of improving or maintaining skills required in an individual's employment, the expenses must improve skills that bear a proximate or direct relationship to the individual's trade or business. Love Box Co. Inc., v. Comm'r, 842 F.2d 1213 (10th Cir. 1988). Educational expenses that improve general skills are insufficient to meet the requirements of this provision. Id. Thus, in Love Box Co., a business's presentation of seminars to its employees teaching individual freedom, responsibility, integrity, hard work, thrift, and honesty were not sufficiently related to the company's production and sale of wood products and therefore the seminar expenses did not qualify for deduction as an ordinary and necessary business expense. Love Box Co., 842 F.2d at 1217. Although the seminars in Love Box Co. emphasized attributes that would be beneficial in any line of work, the court found the relationship between the attributes emphasized in the seminar and the specific job skills required by the company was too tenuous to qualify for deduction under 162. Id. It follows that for an employee's education expenses to be job-related, the education must improve or maintain skills that are a specific requirement of the individual's employment.

Employer and/or Legally Imposed Educational Requirements

Educational expenditures required to meet the minimum educational requirements for qualification in an individual's employment, trade, or business are judged by the requirements of an individual's employer, applicable laws and regulations, and the standards of the profession, trade, or business involved. 26 C.F.R. 1.162-5(b)(2)(i). Only the minimum education necessary to retain the established employment relationship, status, or rate of compensation is considered as undertaken to meet the express requirements of the taxpayer's employer and thus as deductible as a working condition fringe benefit. 26 C.F.R. 1.162-5(c)(2) (emphasis added). Education to meet the minimum requirements for qualification in a taxpayer's employment, and education qualifying an individual for a new trade or business, are personal expenses and consequently are nondeductible.

Requirements imposed for a bona fide business purpose, either to meet the express requirements of an employer or to meet the requirements of applicable law or regulation, may also be excluded from an employee's gross income. 26 C.F.R. 1.162-5(c)(2). An individual may not deduct educational expenditures as ordinary and necessary business expenses if the expenditures are personal or constitute an inseparable aggregate of personal expenditures. 26 C.F.R. 1.162-5(b)(1).

For example, a taxpayer in Wentworth v. Comm'r, 33 TCM (CCH) 128 (1974), applied and was admitted to the Student Highway Technician Program developed by the Michigan Department of State Highways. At the time of his enrollment in the program, the taxpayer was classified as a grade 03 Student Highway Technician, and later a grade 05 technician under the

state's civil service program, and was enrolled in and attending courses in civil technology. Id. at 129. After completing his course of study, the taxpayer was promoted to Highway Technician grade 07. Id. The taxpayer in Wentworth gained eligibility for the promotion by completing the civil technology courses in which he had been enrolled. He then attempted to deduct his enrollment expenses from his taxable income pursuant to 162. Id. However, to be eligible for a promotion to a grade 07 highway technician, it was only necessary to have either an associate's degree in social science or civil technology, or junior status in a college of engineering and six months' work experience in the state's traffic division. Id. The tax court found that the cost of attending college was nondeductible because a degree was only necessary to meet the minimum requirements for the higher grade civil service job, not the job the taxpayer currently held. Id. at 130-131. Moreover, the taxpayer met the minimum job requirements for his position as a grade 03 Highway Technician when he was initially hired. Id. at 129. The additional education the taxpayer undertook was for his own personal benefit, rather than an express job requirement necessary for job retention, and was therefore nondeductible. Id. at 131.

An additional area of nondeductible educational expenses are those incurred by an individual for education that is part of a program of study that will qualify a taxpayer for a new trade or business. If an educational program qualifies a taxpayer to engage in a new trade or business, that education goes beyond maintaining or improving skills required in the taxpayer's existing trade or business. 26 C.F.R. 1.162-5(b)(3)(i). For example, a taxpayer who specialized in taxation and business planning decided to attend law school to improve skills required in his taxation and business planning practice. Danielson v. Quinn, 482 F. Supp. 275 (D.V.I. 1980). After law school, the taxpayer continued his tax and business planning practice and claimed a deduction as ordinary and necessary business expenses, for his expenses in attending law school. The deduction was disallowed. Id. at 277.

In reaching its decision, the court noted that the regulations do not rely on the taxpayer's intent when engaging in a course of study, and found the taxpayer's expenses were not deductible expenses. Danielson, 482 F. Supp. at 279. The court found that the taxpayer's law school expenses expensesl were nondeductible because they qualified him to practice law, a new trade, even though he continued his taxation and business planning practice. Id. at 279. Like courses required to meet the minimum requirements of an individual's employer, expenses that qualify an individual for a new trade or business are personal expenses and reimbursements for such education must therefore be taxed accordingly.

Accountable Educational Expenses

An employee may also deduct ordinary and necessary business expenses incurred by an employee for the sole benefit of his employer. 26 C.F.R. 1.162-17(b)(1). Expenses incurred by the employee pursuing the employer's trade or business fall into this category. Rev. Rul. 76- 71, 1976-1 CB 308. Ordinary and necessary business expenses incurred solely for the benefit of an employer may be excluded from an employee's gross income, if the employee is required to account to his employer for such expenses, and the employee is paid advances or reimbursed for them. 26 C.F.R. 1.162-17(b)(1). Such expenses include the cost of education, transportation, and other travel-related expenses, so long as the expenses were incurred for the sole benefit of the employer's business. Rev. Rul. 76-71, 1976-1 CB 308.

CONCLUSION

Educational expenses incurred by a taxpayer and reimbursed pursuant to a qualified employer-provided educational assistance program will continue to qualify for exclusion from an employee's gross income under 127 until May 31, 2000. However, education expenses for graduate level courses may only be excluded from an employee's income if the course was begun prior to June 30, 1996.

Additionally, an employee receiving education assistance from his employer may benefit from income tax exclusion under 117 or 162 of the Internal Revenue Code. The most significant exclusion is under 162, under which education expenses may be excluded from gross income as a working condition fringe, so long as the expenses for education are ordinary and necessary business expenses, rather than personal. Further, an employee who is required to account to his employer for education expenses may also benefit from income tax exclusion if the required accounting is made for such an exclusion. The exclusion for ordinary and necessary business expenses is limited in that the education must be job-related. Unlike reimbursements under 127, reimbursements for education under 162 are taxable if provided for general education.

Because 132 permits exclusion from a taxpayer's gross income of amounts received by a taxpayer as a working condition fringe, an employer need not include education expenses that could be deducted by the employee under 162 in an employee's gross income. So long as an employee is required to account to the City for ordinary and necessary business expenses, or education is undertaken to maintain or improve job-related skills, or to meet the express requirements of the City or applicable law, the City may continue to reimburse its employees under San Diego Administrative Regulation 70.30 without withholding Federal and State taxes.

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