Graduate Education and the Taxation of Tuition Reductions

Erik M. Jensen

Case Western University School of Law, emj@case.edu

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by Erik M. Jensen

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Erik M. Jensen is the Coleman P. Burke Professor Emeritus of Law at Case Western Reserve University.

In this report, Jensen argues that much of the resistance to the proposed repeal of section 117(d) was misguided because the effects on graduate students would have been far more limited than claimed, and the real impact of repeal would have been on the tax treatment of undergraduate tuition waivers.

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The House bill that led to the Tax Cuts and Jobs Act of 2017 (P.L. 115-97)¹ would have repealed section 117(d) of the code, dealing with the tax treatment of tuition waivers provided by educational institutions to their employees and some family members of the employees.² The proposed repeal generated hysteria on university campuses and in the press, but as was true with many other provisions in the House bill (like the proposed repeal of section 127, another education-related section³), the repeal of section 117(d) didn’t happen.⁴ Nevertheless, on the theory that section 117(d) may come under attack again (and section 127, too), it’s important to understand what a repeal would — and wouldn’t — have done.

In this report I explain why I think much of the commentary on the proposed repeal was overwrought⁵ and some of it was just wrong. That’s not to say that section 117(d) deserved to expire; it’s only to say that commentators, including university administrators, should have focused on what really would have happened in a world without section 117(d).

Most of the news stories and pronouncements of university administrators characterized the proposed repeal as an attack on graduate education in that it would have made taxable (or so it was argued) tuition waivers provided to graduate students who serve as teaching or research assistants.⁶ (From now on I’m going to use “TAs” as an umbrella term to refer to both

¹Or whatever we’re supposed to call the legislation after the reconciliation process. The official, ungainly title is “An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018,” P.L. 115-97, signed by the president on December 22, 2017.
²H.R. 1, 115th Cong., 1st Sess., section 1204(a)(3).
³See H.R. 1, section 1204(a)(2). Section 127 provides an exclusion of up to $5,250 for amounts paid or incurred by an employer in providing educational assistance to an employee if specified requirements are met. (That $5,250 figure isn’t indexed for inflation and has been on the books for years.)
⁴The Senate bill contained no provision to repeal either section 117(d) or section 127 (see S. Amdt. 1855, 115th Cong., 1st Sess. (2017)), and neither repeal survived conference committee deliberations.
⁵Not all the commentary, of course. See, e.g., Patrick W. Thomas, “GOP Raises Taxes on Graduate Students . . Or Does It?” Surly Subgroup Blog, Nov. 6, 2017.
⁶See, e.g., Eric Kelderman, “How the Republican Tax Plan Could Hurt Graduate Students and American Research,” The Chronicle of Higher Education, Nov. 17, 2017, at A19 (quoting several graduate students and faculty as if a repeal of section 117(d) would have horrible effects on graduate education and would affect no one else); and Kelderman, “How the House GOP Tax Plan Would Affect Grad Students,” The Chronicle of Higher Education, Dec. 1, 2017, at A22 (noting the effect of repeal on some undergraduate tuition waivers — i.e., for those students who are resident assistants — but focusing on graduate students).
teaching and research assistants.) That’s very misleading.

Section 117(d) makes it possible, in some circumstances, for an employee of an educational institution to exclude from gross income the amount of a tuition reduction provided to the employee, the employee’s spouse, or a dependent child of the employee. In fact, the purportedly “general” rule of section 117(d)(1) is that “gross income shall not include any qualified tuition reduction.” But not all tuition reductions are qualified. For one thing, the exclusion can apply, in general, only to tuition reductions for education “below the graduate level.” By its terms, section 117(d) at first glance therefore seems to have no application at all to graduate students. But section 117(d)(5) provides a special rule for graduate students who are TAs and are getting tuition waivers: “In the case of the education of an individual who is a graduate student at [a qualifying educational institution] and who is engaged in teaching or research activities for such organization, paragraph (2) shall be applied as if it did not contain the phrase ‘(below the graduate level)’” (emphasis added).

If section 117(d) had been repealed, section 117(d)(5) would obviously have gone down with the ship. For reasons I don’t understand, it was doing away with that special treatment of TAs that generated most of the controversy about section 117(d)’s possible repeal. The idea that repealing section 117(d) would have unfortunate consequences for graduate education, and only graduate education, both overstated the significance of section 117(d)(5) and understated the significance of section 117(d) as a whole, which is in no way an expansive exclusion for graduate-level tuition waivers.

I don’t blame the graduate students who organized to fight the repeal of section 117(d), successfully as it turned out (at least for now). They were told that this proposed change targeted them, and they had no reason to think otherwise. (Few graduate students are tax professionals or tax-professionals-to-be, after all, and many of the educational institutions didn’t help the grad students with statutory interpretation.) And under the circumstances, the grad students had reason to be scared about the possible economic effects of a repeal. TAs were led to believe that if their tuition waiver is nominally $50,000, say, they would be taxed on $50,000 if section 117(d)(5) disappeared — a frightening thought for those subsisting on ramen noodles. (If the TAs are employees of the university, as they presumably are, section 127 might have provided for a limited exclusion of up to $5,250 per year for educational assistance, assuming the requirements of that section are satisfied. That would have helped the TAs a bit, but no more than that. In any event, the House bill would have repealed section 127 as well as section 117(d).)

The repeal of section 117(d) might not have made any sense to begin with — I’m not sure where the proposal came from — but I argue that the reasons given in most of the commentary for resisting repeal were often suspect. (We saw a lot of — dare I say it? — fake news.) And the reasons against repeal that should have been mustered often weren’t. Most important, as I discuss in Section I, is that doing away with section 117(d) would have affected tuition waivers that have no connection whatsoever to graduate education. Section II analyzes the effects of a section 117(d)

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8 The applicable standard should be, “When in doubt, look at the statute.” And that’s a good idea even if you’re not in doubt.
9 See supra note 3. Among the requirements is that there be a “separate written plan of an employer for the exclusive benefits of his employees to provide such employees with educational assistance.” Section 127(b)(1). If a university doesn’t have such a document, it could easily create one. And the plan can’t discriminate in favor of highly compensated employees (section 127(b)(2)), but a plan directed at TAs surely would satisfy the nondiscrimination requirement. Discussions about section 127 generally assume that an educational assistance plan is one in which an employer pays to send employees to educational institutions, which of course is the case for most employers that aren’t educational institutions themselves. But an “employer’s provision of education to an employee” can be part of an educational assistance program. See reg. section 1.127-2(c)(1)(ii); and infra notes 57-58 and accompanying text.
10 See supra note 3.
11 It’s been suggested that the proposed repeal was part of a partisan attack on higher education, and there may be something to that. But I suspect most members of Congress were, like the graduate students, clueless about all this. The House and Senate bills were massive documents, and the repeals of sections 117(d) and 127 were hardly focuses of the House bill.
impossible dream.\textsuperscript{16} As an official of the American Council on Education put it — an organization that recognized that the effects of repealing section 117(d) would have gone far beyond graduate students — “The janitors are collateral damage.”\textsuperscript{17}

If the university where you work has a stated undergraduate tuition of $50,000 and that tuition is waived when your child attends the university (with no expectation that the kid perform services for the school), under section 117(d)(1), that benefit wouldn’t be taxed to you. Do away with section 117(d), however, and you would suddenly have a bump up in taxable income of as much as $50,000 (if that’s the appropriate measure of income\textsuperscript{18}). (For reasons I discuss later, that benefit almost certainly couldn’t be treated as a tax-free scholarship, and, with a couple of very limited exceptions, it’s hard to imagine any other justification for excluding the value of the benefit from the gross income of the university employee.)

To a low-income college employee, that result could be catastrophic. In those circumstances, as a last resort it might make more economic sense to send the kid to Big State University and pay full tuition (or borrow to pay full tuition) rather than have him or her attend the employee’s home institution and receive a sizeable taxable tuition benefit. (And maybe the kid can get a tuition reduction at Big State — or some other institution for which no one in the family works — that can be treated as a good old-fashioned nontaxable

\textsuperscript{16} For purposes of this report, I’m generally ignoring tuition benefits provided for employees to send their kids to other schools, but the possibility of an excludable tuition waiver being partly or wholly tax-free exists in that situation as well. See section 117(d)(2) (exclusion can apply to “any reduction in tuition provided to an employee of an organization described in section 170(b)(1)(A)(ii) for the education (below the graduate level) at such organization (or another organization described in section 170(b)(1)(A)(ii)) of the employee or another person described in section 132(b) (emphasis added)). The affected educational institutions include any “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.” Section 170(b)(1)(A)(ii). (Somebody should write an article on why Congress thought it necessary to list “pupils” and “students” separately in that last passage.)

\textsuperscript{17} Quoted in Melissa Korn, “Universities, Companies Fight to Keep Tax-Free Tuition Assistance,” The Wall Street Journal, Dec. 11, 2017. That news story was one of the unusual ones in which it was noted that the repeal of section 117(d) wouldn’t have affected only graduate TAs, and it discussed the possible repeal of section 127, also included in the House bill. See supra note 3.

\textsuperscript{18} Which it shouldn’t be. See infra notes 68-71 and accompanying text.
scholarship, a benefit that would be immune from the effects of a repeal of section 117(d).

If employees of educational institutions can take advantage of undergraduate tuition waivers, they benefit economically with section 117(d) in the code, and so do the institutions. A tax-free undergraduate tuition benefit makes it possible to recruit at least some staff (and maybe faculty, too) at lower salaries than would otherwise be required. The additional undergraduate students attributable to a nontaxable tuition waiver program generally impose small costs on a school (assuming the students’ beer consumption doesn’t lead to destruction of school property), even if those students generate little or no tuition revenue.

And it’s not as though repealing section 117(d) would have been a big revenue raiser for Treasury. One of the effects of taxing undergraduate tuition waivers would have been that university employees wouldn’t have taken advantage of those waivers nearly as much. Doing away with section 117(d) would have generated some tax revenue, to be sure, but it would have been a drop in the federal bucket.

II. Effects on Graduate Students

So the repeal of section 117(d) would probably have made undergraduate tuition waivers (those that aren’t scholarships) taxable, and that would have been a big deal by itself. But let’s get back to the graduate student situation. Section 117(d) generally doesn’t apply to tuition reductions at the graduate level, but section 117(d)(5) does provide for the possibility of a graduate-level tuition waiver being tax-free, at least in part, for TAs.

A. Graduate Tuition Reductions: Five Situations

What would be the tax treatment of graduate-level tuition reductions if there were no section 117(d)? I examine five situations involving graduate students who get tuition breaks. (You almost certainly can come up with variations that are worth discussion, but I think I’m covering the most important possibilities.)

1. The graduate student has had no prior employment relationship with the university and will not work for the university as a TA (or anything else) during the time as a graduate student. Nor does anyone else in the student’s family have such an employment relationship (that is, the student’s not getting a tuition reduction because Mom, Dad, or a spouse works for the university). The student simply receives a tuition reduction for graduate study.

2. The same as case 1, except that the tuition reduction is conditioned on the student’s serving as a TA.

3. The graduate student’s tuition is reduced because Mom, Dad, or the student’s spouse works for the university, and the student isn’t a TA.

4. The graduate student’s tuition is reduced, not because a family member works for the educational institution, but because and only because the student is a TA — an employee of the university herself.

5. The graduate student’s tuition is reduced because Mom, Dad, or the student’s spouse works for the university, but the student also serves as a TA. The tuition reduction is conditioned on the student’s being a TA.

I consider these possibilities one by one.

1. The plain old scholarship.

If a graduate student in a degree program is paying less than the full sticker price (as is true for almost all graduate students in the United States who aren’t in professional programs and, for that matter, for quite a few professional students as well), the student isn’t working for the university as a TA or otherwise, and the student’s family

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19 See section 117(a); and infra notes 21-24 and accompanying text.

20 At least that’s true if the students are occupying seats in the classroom that would otherwise have been unoccupied. Of course, even if that’s so, an additional student isn’t completely cost-free. There are all those individual meetings with students, exam grading, and paper reading that faculty must do. On the other hand, the faculty aren’t likely to be paid more because of those additional students, and the administrative costs associated with a few additional students shouldn’t be large.

21 That’s true for law students for sure and for many MBA students as well. See Kelsey Gee, “Hey, Bargain-Hunters: An M.B.A. Is Cheaper Than You Think,” The Wall Street Journal, Jan. 3, 2018 (noting that for the Harvard Business School’s class of 2019, the average annual tuition paid is $35,000, when the sticker price is $72,000).
members are also not employed by the university, there should generally be no gross income associated with a tuition “reduction.”

That tuition reduction looks and quacks like a scholarship, the tax treatment of which should be governed by section 117(a). That section excludes a qualified scholarship from gross income to the extent it covers “qualified tuition and related expenses.” (If that’s the case, any valuation issues go away. Whatever the value of the nontaxable benefit, it’s excludable from gross income.) To be a qualified scholarship, the tuition reduction can’t be compensation for a family member’s performing services for the university, and the student must be in a degree program.

Assuming those requirements are satisfied, the scholarship is tax-free. And the basic scholarship rules of section 117(a) don’t distinguish between undergraduate and graduate scholarships. In either case, they’re tax-free up to the level of qualified tuition and related expenses.

The special rules in section 117(d) are therefore irrelevant if the student is getting a straightforward scholarship, and the repeal of section 117(d) would have had no effect on graduate students in those circumstances.

2. ‘Qualified scholarship’ but services required.

Although section 117(a) generally excludes from a student’s gross income any qualified scholarship, up to the level of qualified tuition and related expenses, the exclusion may not apply in full if a student is performing services as a condition of receiving the scholarship. As is true with a qualified tuition reduction under section 117(d), to the extent the tuition reduction from the scholarship is “payment for teaching, research, or other services by the student required as a condition for receiving the . . . qualified tuition reduction,” the exclusion wouldn’t apply. As a result, all or part of a tuition reduction called a scholarship could be taxable compensation for services. But the part of an otherwise legitimate scholarship that doesn’t compensate for services remains tax-free for graduate students and undergraduate students.

The repeal of section 117(d) wouldn’t have changed any of this.

3. Tuition reduction because of family member’s employment, no TA arrangement.

Now, if the student gets the graduate tuition reduction because Mom or Dad (or spouse) is an employee of the university, the student almost certainly wouldn’t be treated as receiving a scholarship. A scholarship is in the nature of a gift, with no expectation of benefit in return, and in this scenario, the tuition benefit is part of the compensation package for the employee (not the student). There’s a quid for the quo. The exclusion of section 117(d)(1) for a qualified tuition reduction also couldn’t apply because the waiver is at the graduate level and has nothing to do with the student’s being a TA, thus making section 117(d)(5) irrelevant.

On these facts, once again the repeal of section 117(d) wouldn’t have mattered. The benefit would almost certainly have been taxable regardless of whether section 117(d) is in effect. It’s not the graduate student who would be taxed on the

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22 I put “reduction” in quotation marks just because it doesn’t seem to be much of a reduction if most other graduate students at the institution are paying little or nothing. I’ll come back to that point in discussing what the amount of income to be taxed should be if the affected student (or the associated family member) isn’t able to exclude the value of the tuition benefit. See infra notes 68-71 and accompanying text.

23 Qualified tuition and related expenses generally includes tuition and fees and the cost of “books, supplies, and equipment for courses of instruction” at the educational institution. Section 117(b)(2). If the financial aid covers more than qualified tuition and related expenses — meals and lodging perhaps — the excess amount wouldn’t be tax-free under section 117(a).

24 If the tuition reduction is compensation for a family member — i.e., a quid quo pro is involved — the tuition reduction is unlikely to be treated as a scholarship. See infra note 27 and accompanying text. In that case, we’d have to look at section 117(d). (Could a tuition reduction to the dependent child of a university employee ever be a scholarship? Maybe, if the student is selected to receive the scholarship by a disinterested group that is unaware of the employment relationship with the university. But that’s not the norm.)

25 With exceptions, “subsections (a) [dealing with qualified scholarships] and (d) [dealing with qualified tuition reductions] shall not apply to that portion of any amount received which represents payment for teaching or other services by the student required as a condition for receiving the qualified scholarship or qualified tuition reduction.” Section 117(c)(1). For these purposes, the term “payment” should be interpreted expansively. All or part of a reduction in tuition could be treated as a payment.

26 If a scholarship student performing services is treated as an employee of the university, section 127 might exclude up to $5,250 of otherwise taxable income, assuming the requirements of that section are satisfied. See supra note 9.

27 See reg. section 1.117-4(c); see also Bingler v. Johnson, 394 U.S. 741 (1969). It’s been noted that proposed regulations issued in 1988 under section 117 are a bit more generous in characterizing what can be a qualified scholarship. Prop. reg. section 1.117-6. But I see no reason to give authoritative weight to 20-year-old proposals that were never finalized and that — as far as I know — no one is working on anymore.

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benefit, but the family member employed by the university (unless you can come up with some other theory for exclusion — a probably impossible task).  

4. Tuition reduction not caused by family member’s employment but conditioned on student’s being a TA.

Next, what if the graduate student receives a tuition reduction not because of any family member’s employment with the university, but because the student is serving as a TA? In that case, section 117(d)(5) might apply, making it possible for the tuition reduction at the graduate level to be treated as a qualified tuition reduction. Or the tuition reduction might be considered a qualified scholarship, despite the student’s also having an employment relationship with the university.

But either way, the exclusion wouldn’t apply to the extent the waiver is compensation for services. This is an important point that was overlooked in much of the discussion about the possible repeal of section 117(d). It has never been the case that the full amount of a qualified tuition reduction is necessarily tax-free. To the extent the student benefitting from the reduction is receiving “payment for teaching, research, or other services by the student required as a condition for receiving the . . . qualified tuition reduction,” the exclusion from gross income doesn’t apply. So, regardless of the special treatment of TAs in section 117(d)(5), the student might be taxed on the value of the benefits provided to compensate the student for services, assuming no other authority for excluding the benefit exists, and that value could include all or part of the reduced tuition.

So, even with section 117(d) in force, an exclusion of the full value of a tuition reduction attributable to a graduate student’s being a TA wouldn’t result from that section. And obviously the possible partial exclusion attributable to the interplay between section 117(d)(1) and section 117(d)(5) would be gone if 117(d) as a whole had been repealed.

That might sound ominous, but it simply means that, with or without section 117(d), we should look for alternative theories for exclusion. And the TA would be an employee, wouldn’t she? If so, section 127 would likely apply (unless it was repealed, as was also provided for in the House bill), exempting up to $5,250 of income associated with an educational assistance program provided by employers to employees from an employee’s gross income, assuming that the employer has a qualifying program in place.

Even more important, however, the benefit seems to be a working condition fringe, as defined in section 132(d), excludable from an employee’s income under section 132(a)(3). A working condition fringe is generally a benefit provided by an employer to an employee that if it had been paid for by the employee would have been deductible to that employee under either section 162, the ordinary and necessary business expense provision, or section 167, dealing with allowances for depreciation.

If the student is also an employee, as a TA would be, and the student-employee paid tuition for further training in the field in which she is a TA, wouldn’t she satisfy the requirements of section 162, as set out in reg. section 1.162-5? For an employee to be able to treat educational expenditures as ordinary and necessary business expenses, the regulation generally requires that the expenditures maintain or improve skills
required in the employee’s employment, 35 not be a minimum educational requirement “for qualification in his employment,” 36 and not qualify the person for a new trade or business. 37

Most TAs, at least those in nonprofessional programs, should meet those requirements. If you’re a TA in physics doing work toward a master’s or a PhD in physics and you’re paying for the education that will improve or maintain your skills in physics, you’d be able to characterize the tuition as an ordinary and necessary business expense. 38 You’re doing physics already, and you’re studying for an advanced degree in physics. That study will improve your skills as a physicist, and it’s not necessary for a physicist to have an advanced degree to be employed as a physicist — that is, the degree wouldn’t be a minimum educational requirement for the business or qualify you for a new trade or business. Yes, a PhD might open up some academic (and other) positions that would otherwise be closed to you, but there’s no generally applicable requirement that one have a PhD to do physics in an educational (or any other) setting. 39 What will you be doing if you later become an assistant professor of physics somewhere? Teaching and research, just what you’re doing now, but with your skills enhanced by the graduate education received while an employee of the university.

Now it may be that because of other limitations on deductibility, the student-employee would in fact be unable to deduct the full sticker price for tuition if she had actually paid it herself. Employee business expenses are itemized deductions. Moreover, they’re miscellaneous itemized deductions — that is, they’re expenditures that meet the requirements of section 162 for potential deductibility but that have long been subject to stringent limitations on deductibility. 40 And as a result of the TCJA, for tax years from 2018 through 2025, miscellaneous itemized deductions aren’t deductible at all under the regular income tax (as has been the case under the alternative minimum tax anyway). 41 But limitations of that sort aren’t considered in determining whether a benefit is a working condition fringe. 42 The only question is whether the threshold requirements for deductibility under section 162 (or section 167) would be satisfied if the employee had made the expenditure herself. 43 If so, the benefit provided by the employer to the employee seems to be a working condition fringe.

Although I’d like to, I can’t ignore the cryptic section 132(l), which could throw a monkey wrench into the machinery of the regulation. 44

35 Reg. section 1.162-5(a)(1). The regulation provides an alternative test: demonstrating that the education meets express requirements of the employer, or of applicable law, to retain an already existing position. See reg. section 1.162-5(a)(2).
36 Reg. section 1.162-5(b)(2)(i) and -5(a).
37 Reg. section 1.162-5(b)(3) and -5(a).
38 One might reasonably question whether all educational expenditures that meet the requirements of reg. section 1.162-5 are really expenses rather than capital expenditures. Many educational expenditures have significant future benefits (or so one hopes). And capital expenditures are generally not deductible, unless Congress provides specific authority to make them deductible. If we were starting from scratch in thinking about the deductibility of education expenditures, the expense-versus-capital-expenditure issue might be a reasonable one to raise. But it has long been taken for granted that expenditures that meet the stated requirements of the regulation are ordinary and necessary business expenses. For example, the costs of getting an LLM in taxation are generally deductible for someone who is already a tax lawyer, even though the expenditure will have effects on the rest of that lawyer’s professional career.
39 It might be necessary to have a PhD to get a faculty position as a physicist at many universities, but it’s not a requirement at all academic institutions. And it’s certainly not a requirement for positions in physics more generally. In contrast, a law degree does qualify a person for a new trade or business, or so the regulation suggests. See reg. section 1.162-5(b)(3)(ii), Example 2. As a result, the cost of a JD program isn’t deductible, even if the reason for getting the degree is to improve skills in a non-lawyer position — being a law librarian, for example.
40 See TCJA section 11045 (addition subsection (f) to section 67).
41 See section 56(b)(1)(A)(i).
42 See reg. section 1.132-5(a)(1)(vi) (noting that “the limitation of section 67(a) (relating to the two-percent floor on miscellaneous itemized deductions) is not considered when determining the amount of a working condition fringe”); and supra note 39.
43 That’s how the working condition fringe rules had been understood under prior law, under which miscellaneous itemized deductions, including employee business expenses, were deductible only to the extent of amounts exceeding 2 percent of AGI. If that’s not the way the provision is interpreted now, the working condition fringe category would largely be gone, except for benefits that if paid for by the employee would have been deductible to the employee under section 167, the depreciation provision. The reference in section 132(d) to section 162 (“if the employee paid for such . . . services, such payment would be allowable as a deduction under section 162”) would be surplusage, at least if the regulations are correct in providing that the language doesn’t apply to a hypothetical payment that “would be allowable as a deduction with respect to a trade or business of an employee other than the employee’s trade or business of being an employee of the employer.” Reg. section 1.132-5(a)(2)(i). As we all know, Congress never includes surplus language in legislation.
wrench into the above analysis. Except for de minimis fringes — a category that should be irrelevant for tuition reductions anyway — section 132(l) provides that section 132 “shall not apply to any fringe benefits of a type the tax treatment of which is expressly provided for in any other section of this chapter.” (Perhaps Congress could have come up with fuzzier language, but doing that would have required effort.) Educational benefits of the tuition reduction sort are expressly provided for in other provisions, including sections 117 and 127, and section 132(l) might mean that a tuition reduction provided by an educational institution to an employee — a fringe benefit to the employee — can’t be a working condition fringe.

My understanding is that one intention of section 132(l) was to prevent a tuition reduction provided to a university employee (or spouse or dependent child of an employee) from being treated as a no-additional-cost service (as defined in section 132(b)), excludable from the employee’s gross income under section 132(a)(1). If a university has empty seats in the program in which an employee is taking classes, the benefit might seem to be an excess-capacity service, like an airline employee’s occupying an otherwise empty seat on a flight or a hotel chain employee’s occupying an otherwise empty hotel room — the quintessential no-additional-cost service. But if section 132(l) controls — and it probably does under current law — an employee occupying otherwise empty seats in a university’s classrooms, and therefore perhaps imposing no substantial additional costs on the university, can’t exclude the benefit from gross income for that reason. (In many cases, however, particularly with graduate students, the costs to the university attributable to additional students receiving tuition reductions may be substantial, in which case the possibility of a no-additional-cost service would disappear anyway.)

Similarly, because of section 132(l), a tuition reduction isn’t supposed to be treated as a qualified employee discount for services, therefore excludable from gross income under section 132(a)(2) to the extent the discount doesn’t exceed “20 percent of the price at which the services are being offered by the employer to customers.”

Commentators have maintained that section 132(l) might also preclude treating a tuition reduction as a working condition fringe, and there is some evidence in unpublished IRS rulings and advice (now dated, often unclear, and sometimes pointing in different directions) to support that position. But because of the requirement that there be a sufficient connection between the nature of the benefit and the employee’s trade or business as an employee — the requirement that either section 162 or section 167 would have applied if the employee had paid for the fringe benefit — the working condition fringe seems to be qualitatively different from qualified employee discounts and no-additional-cost services. It’s

46 At least in some fields, graduate students cost the institution a lot — laboratory expenses, for example. And even in less capital-intensive fields, having an additional graduate student paying little or no tuition makes economic demands on the institution, particularly because of the generally close relationship between grad students and faculty mentors. It’s not the same as having an additional undergraduate sitting in a lecture hall with 300 other students.

47 Section 132(c)(1)(B).

48 See, e.g., LTR 9040045 (paraphrasing, but not precisely quoting, reg. section 1.132-1(f)(1) to the effect that “because section 117(d) provides for the tax treatment of tuition reductions, the exclusions under section 132 generally do not apply to free or discounted tuition waivers provided by an educational institution to its employees, whether the tuition is for study at or below the graduate level” (emphasis added)). In that private letter ruling, the word “generally” was added to the regulatory language, and the ruling noted the possibility of graduate tuition benefits being treated as a working condition fringe so long as the tuition benefits “relate to the employee’s trade or business as an employee of the employer providing the benefits.” Twelve years later, in FSA 200231016, the IRS advised that a “tuition reduction provided by a university may not be excluded from an employee’s gross income as a working condition fringe benefit,” and it suggested that working condition fringe treatment is available only if the employer “pays” something, which is not the case with a qualified tuition reduction. Further, the 2002 field service advice suggested that the 1990 letter ruling was intended to conclude that working condition fringe treatment might be available only to the extent that (1) the employer pays something to another organization for an employee’s education and (2) either section 127 wouldn’t apply at all, or the expenses exceed the $5,250 annual exclusion.
hard to see why a tuition reduction that meets the definition of working condition fringe should automatically fail to qualify for the exclusion.

In any event, some educational benefits provided by employers to employees may well be working condition fringes. In 1989 Congress specifically provided, in what is now section 132(j)(8), that “amounts paid or expenses incurred by the employer for education or training provided to the employee which are not excludable from gross income under section 127 shall be excluded from gross income under this section if (and only if) such amounts or expenses are a working condition fringe.”\(^\text{49}\) At a minimum, that provision seems to approve the possibility of working condition fringe treatment in connection with “amounts paid or expenses incurred” by the employer under section 127 programs that exceed the $5,250 cap. Not all, or even most, benefits provided in a section 127 program will be working condition fringes, because there’s no requirement under that section that the education be in the same trade or business that the employee is currently working in. But if, for a particular employee, the educational assistance is sufficiently connected to the employee’s existing trade or business and the other requirements of reg. section 1.162-5 are satisfied, the benefit is a working condition fringe.

In its guidance to employers on the tax treatment of fringe benefits, the IRS assumes that an educational benefit can be a working condition fringe even if section 127 would apply in part. The agency has accepted the proposition that an educational benefit that is not excludable under section 127, or that exceeds the dollar limitation in that section, may still be a working condition fringe.\(^\text{50}\) Indeed, the IRS states straightforwardly that “property or a service provided is a working condition benefit to the extent that if the employee paid for it, the amount paid would have been deductible as a business or depreciation expense.”\(^\text{51}\) (Yes, services provided can be a working condition fringe even if the employer incurs few, if any, out-of-pocket costs.) Another quote: “Examples of working condition benefits include an employee’s use of a company car for business, an employer-provided cell phone provided primarily for compensatory business purposes, and job-related education provided to an employee.”\(^\text{52}\) The critical question is, as always, whether the employee would have been able to deduct the cost under section 162 if he had paid it himself.

No, an IRS publication isn’t a definitive statement of the law, but neither are private letter rulings and similar authority from years ago. And I know that at least some universities take the position that the value of graduate-level tuition reductions should not be taxable to employees if the requirements for a working condition fringe are satisfied — an example being a tuition waiver provided to someone to earn an MBA at the university’s business school, if the person already holds a high administrative position at the university.\(^\text{53}\) If that understanding is wrong, a lot of educational institutions have been violating the law.\(^\text{54}\)

It’s been suggested that working condition fringe treatment should be available for a tuition reduction only if the university has established an educational assistance program under section 127 and the program applies only to the extent of “amounts paid or expenses incurred” for an employee’s educational assistance.\(^\text{55}\) (The same phrase is used in section 132(j)(8).\(^\text{56}\) And if the university itself is providing the education, the

\(^\text{49}\) Section 132(j)(8).
\(^\text{50}\) IRS Publication 15-B, “Employer’s Tax Guide to Fringe Benefits,” at 22 (2017) (providing that “certain job-related education you provide to an employee may qualify as a working condition benefit,” as long as the expenditures would meet the requirements for deductibility under reg. section 1.162-5 if the employee had paid the expenses him or herself); and id. at 9 (educational assistance to employees under a qualifying educational assistance program may be excluded under section 127 up to $5,250; excess amounts must be treated as wages, “unless the benefits are working condition benefits”).
\(^\text{51}\) Id. at 10.
\(^\text{52}\) Id. at 21.
\(^\text{53}\) For example, the question generally asked with tuition waivers for employees to attend MBA programs of the university is whether the employee is already in a relatively high administrative position. If yes, the benefit is a working condition fringe. (MBAs don’t generally qualify a person for a new trade or business in that it’s unnecessary to have an MBA to be an administrator.) In contrast, for a secretary, say, the connection between the MBA and the skills required in the secretary’s current trade or business is tenuous.
\(^\text{54}\) Even though the tax liability would ultimately be the employee’s, the university has reporting and withholding obligations that would not have been met if a university has been wrong on this issue.
\(^\text{55}\) Section 127(a)(1).
\(^\text{56}\) See supra text accompanying note 48.
university will pay little and incur few expenses in educating its own employees.

Should it matter that with a tuition reduction, the university doesn’t seem to have any amounts paid or expenses incurred? It can’t be the case, can it, that expenditures made by a university for an employee’s graduate-level education at another institution can be excluded from the employee’s income under section 127 (up to the cap, of course) and, beyond the cap, perhaps further excluded if the benefit is a working condition fringe (as suggested by section 132(j)(8)), but that an employee who receives graduate-level education at a bargain price at his own university wouldn’t get the limited protection of section 127 and might not even have the rest of the benefit characterized as a working condition fringe? What sense would that make? Yes, Congress can enact nonsensical statutes, but we should try to interpret congressional enactments in a sensible way, unless it’s just impossible to do so.

In this situation, I have no difficulty interpreting section 127 to cover educational assistance provided to a university employee at the university itself as eligible for the exclusion (assuming the other statutory requirements have been satisfied) and eligible for working condition fringe treatment as well if the connection between the education and the employee’s existing trade or business is sufficient. If that’s so, once again, section 117(d) seems to be irrelevant — or at least largely so — for TAs. The repeal of that section should change none of this.

And maybe I’m making this harder than it should be. Remember that, if enacted in its original form, the House bill would have repealed both section 117(d) and section 127. If that had happened, section 132(l) (“This section [132] shall not apply to any fringe benefits of a type the tax treatment of which is expressly provided for in any other section of this chapter”) would no longer be problematic, or so it seems. The argument that a tuition reduction can’t be a working condition fringe because of section 132(l) depended on the existence of other provisions in the code that deal specifically with tuition reductions as compensation. Do away with both sections 117(d) and 127, however, and the problem goes away with them. As a result, a tuition reduction provided by an employer to an employee might be a working condition fringe, regardless of any prior understanding to the contrary. For that matter, if both sections 117(d) and 127 had been repealed, the tuition reduction might also be a no-additional-cost service (although that isn’t clear for graduate students), and it might be nontaxable, in part, as a qualified employee discount.

In short, if the repeal of section 117(d) would have had any effect in this situation, it would have been only to clarify that the tuition benefit might be treated as a fringe benefit potentially excludable from an employee’s gross income under at least one of the subsections of section 132.

5. Tuition reduction from family member’s employment but also conditioned on student’s being a TA.

Finally, let’s suppose the tuition reduction is attributable to the grad student’s having a parent or spouse employed by the university, but the student is also obligated to serve as a TA. (Maybe all grad students in a particular department are obligated to do TA service.) This situation presumably can’t be a qualified scholarship, even in part, because the tuition waiver is part of the compensation package for the family member. Under section 117(d), the graduate-level tuition waiver isn’t tax-free, even in part, unless section 117(d)(5) would kick in. And it ought to, except for any part of the tuition reduction that is compensation for the student’s services. But take away section 117(d), and the full value of the benefit would be taxable to the family member unless some other theory for exclusion can be found.

57 See id.

58 Cf. Commissioner v. Idaho Power Co., 418 U.S. 1, 16-17 (1974) (concluding that the phrase “paid out” in section 263(a) can encompasses the depreciation allowance available for an asset in the current year, even though nothing is actually paid in that year).
In this case, section 117(d) may matter a lot. It may be only because of the special treatment for TAs in section 117(d)(5) that this benefit at the graduate level is potentially tax-free, at least in part. Even so, however, remember that the exclusion for qualified tuition waivers doesn’t apply to the extent the TA is being compensated for services that were part of the tuition reduction package.\textsuperscript{63}

There doesn’t seem to be a possibility of treating this tuition reduction as a working condition fringe. The TA’s tuition waiver is attributable to the family member’s being an employee of the university. It’s that person who will be taxed on the benefit if no exclusion from gross income applies, and the family member’s not going to be able to argue plausibly that if he had paid Sonny’s tuition, the expenditure would be an ordinary and necessary business expense of the family member.

Yes, Sonny is treated as an employee for purposes of the tuition waiver rules of section 117(d). That section says to treat as an employee for purposes of section 117(d) “any person treated as an employee (or whose use is treated as an employee use) under the rules of section 132(h).”\textsuperscript{64} And those rules treat spouses and dependent children as employees, but only for purposes of the no-additional-cost service and qualified employee discount provisions of section 132, not for the working condition fringe rules.\textsuperscript{65}

But as was true with case 4, if both section 117(d) and section 127 had been repealed, perhaps that would have opened up the possibility of the benefit being tax-free, at least in part, as a no-additional-cost service (assuming the education provided is in fact an excess-capacity service\textsuperscript{66}) or as a qualified employee discount, if the relevant requirements of section 132 are satisfied.

B. The Bottom Line in the Five Hypotheticals

In three of the cases considered, most graduate-level tuition reductions should not be taxable under one theory or another, whether or not section 117(d) is in place. For case 3, the benefit would probably be taxable (but to the family member, not the student) regardless of whether section 117(d) is around. A few graduate students — those whose tuition reductions are attributable to a family member being an employee of the university and who are TAs as a condition of the tuition reduction — had legitimate reasons to be concerned about the repeal of section 117(d). That’s case 5, although even there a possibility exists for exclusion under an alternative theory.\textsuperscript{67}

For most graduate students, therefore, the repeal should have made no difference. And when a tuition reduction, whether at the graduate or undergraduate level, is taxable to someone in whole or in part, the consequences shouldn’t be nearly as horrific as many contended in the discussions about the effects of section 117(d) repeal. That’s the subject of Section III.

III. The Measure of Income

Suppose a particular tuition reduction is taxable, in whole or in part, to someone. How much taxable income is there? The assumption in much of the commentary about section 117(d)’s possible repeal assumed that the dollar amount of any tuition reduction — the reduction in the sticker price — would be the measure of income. That’s why many graduate TAs went ballistic. They assumed that if they were receiving a 100 percent tuition waiver, and if the sticker price for tuition was $50,000, they would have income of $50,000 on which they would have to pay taxes. Or, if the person taxed on a full tuition waiver is the student’s mom, Mom would have a $50,000 bump of gross income.

That makes no sense to me. The measure of income associated with any benefit should be the fair market value of the benefit, not the sticker price. If a used car dealer transfers a car, at no cost, to an employee — pretty clearly there’s compensation for services in that case\textsuperscript{68} — the measure of income should be the value of the car, because of section 102(c), a transfer from an employer to an employee can’t be treated as a nontaxable gift, no matter how benevolent the employer’s purposes for the transfer were.

\textsuperscript{63} Id.

\textsuperscript{64} Section 117(d)(2)(B).

\textsuperscript{65} See id.

\textsuperscript{66} Because of section 102(c), a transfer from an employer to an employee can’t be treated as a nontaxable gift, no matter how benevolent the employer’s purposes for the transfer were.
not the figure marked on the windshield. The value isn’t $5,000 just because that’s the amount the dealer would like to be able to sell the clunker for. We all know that the $5,000 is, for most car dealers, a starting point for negotiation, not a hard and fast price.

And that’s just as true these days for stated tuition figures at most colleges and universities in this country. Of course, every institution would like to be able to get $50,000 (or more) per year from each student, but the actual amount paid will on average be far less than that. College administrators talk about the “discount rate” for their tuition — a discount rate of 50 percent means that the college receives half the revenue it would have had if all students had paid the full sticker price. But most colleges couldn’t come close to filling their entering classes with students paying the stated price. But most colleges couldn’t come close to filling their entering classes with students paying the stated price — at least not students who can read and write. That’s always been true, but it’s particularly true now since, in the last few decades, stated tuition figures have gone up much faster than inflation.

All of that is to say that sticker prices are suspect measures of value.

The used car dealer who sells the car marked $5,000 for $1,500 may say he has a discount rate of 70 percent, but in fact he got full value for the car. If the average student at University A is paying only $20,000 to $25,000, and maybe even less, when the tuition is supposedly $50,000, isn’t that average price a better measure of FMV than the sticker price?

To illustrate the absurdity of using sticker price as a measure of income, consider the following: Suppose Big College doubles its stated tuition figure from $50,000 to $100,000, and nothing else changes. Every student pays exactly the same amount after the “hike” in tuition as before. Surely no one would think that each student is getting an additional benefit of $50,000 and that, if the benefit were taxable to the student or his parents, someone should have $50,000 more in gross income. Big College might — indeed, it probably would — trumpet the increase in its financial aid budget (“We guarantee every student a scholarship of at least $50,000!”), but nothing of substance has happened.

If a typical graduate student at a university is paying little or no tuition — and that’s the case for graduate students in the arts, humanities, and social sciences — why in the world would the value of a tuition reduction be treated as $50,000 (or whatever figure constitutes the sticker price)? The right number may not be zero — and there is, of course, no clearly “right” figure here — but it’s hard to see how $50,000 is even arguably right.

Of course, a few people might be paying the full sticker price (foreign students being supported by their governments, for example),

What, you might ask, would a university with a rational administration (they do exist) have an unrealistically high sticker price, when a preposterously high figure will inevitably scare away a few high-quality applicants? Several reasons are generally given: Many foreign students do in fact pay (or their governments pay) the full sticker price, so it’s necessary for a college to pretend that its real price is that higher figure. (Foreign governments are catching on, however.) There is also apparently some prestige value associated with having a high sticker price. (“We’re as good as Harvard, and of course we charge as much as Harvard does.”) Also, with higher and higher tuition figures, university administrators can, with a straight face, ask alums for “student support,” to cover the “cost” of those scholarships.

And students don’t necessarily suffer from the bloated sticker prices. Kids who get a scholarship for $30,000, say — even if almost everyone in the student body gets a “scholarship” at that or a higher level — can put something like “Recipient, C. Hubert Throckmorton Scholarship, 2016-2017” on their curricula vitae. The students can also tell Mom and Dad, “Look, I got this extraordinary scholarship. Aren’t you proud of me? Oh, and given what I’ve saved you, what about that new car?”

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70 Once mentioned to the CFO of a university that I saw no reason why the value of a taxable tuition benefit should be measured by sticker price, and his response was that that was the only way he could administer a program that provides some taxable educational benefits (e.g., tuition waivers for nonadministrative employees in the university’s MBA program, when the tuition reduction exceeds the $5,250 figure excludable under section 127). I’m not convinced. In many situations there’s no way to come up with an income figure that is unquestionably right — if, for example, a company official flies on a company jet for personal purposes. Rules must be developed to deal with these situations, and they have been. Yes, the rules are necessarily somewhat arbitrary, but they make the unadministrable administrable. If an undergraduate tuition waiver were taxable, I’d say the average price paid by an undergraduate student at a particular university would be a reasonable estimate of the value provided. Every college in the country could easily come up with that information. The same method of estimating FMV could be applied to graduate-level tuition reductions as well.

71 Charge graduate students in the English department $50,000 in annual tuition, and the institution will have no graduate program in English. If a school is going to have graduate programs in subjects for which potential earning power is limited, the institution can’t be expected to charge much in the way of tuition, whatever the official tuition price is. And there are prestige reasons — membership in the Association of American Universities, for example — for a university to have a significant number of PhD programs and to generate lots of PhDs. See Association of American Universities, “Membership Policy.” Even prestigious business schools are cutting the “real” tuition for MBA programs. See Gee, supra note 21.
just as a few buyers of used cars may pay the dealer’s initial asking price. But that shouldn’t mean that the sticker price is automatically the value of the service or property for federal tax purposes.

IV. Conclusion

The taxability (or nontaxability) of tuition benefits is much more complicated than it should be, and I’m sure you can come up with more hypothetical situations worth discussion. But my conclusion from all of this is that the outrage about the effect of a section 117(d) repeal on graduate students was overdone.

That’s not to say that a repeal of section 117(d) would have been meaningless. It would have affected some graduate students, but even more important, it would have had a devastating impact on the undergraduate tuition waiver programs at many colleges and on similar programs at private elementary and secondary schools. That would have mattered a lot, and it’s too bad that the discussion of the repeal of section 117(d) didn’t focus on those effects.

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