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The Current Tax Status of Employer Education Assistance

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The Current Tax Status of Employer Education Assistance

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Summary

Section 127 of the Internal Revenue Code allows up to \$5,250 in tuition reimbursements and other forms of employer education assistance (e.g., books, supplies, and equipment) to be exempt from income and employment taxes even if the education does not qualify as a deductible business expense. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) reinstated the exclusion for graduate-level courses that begin after December 31, 2001. As with many other provisions in that legislation, the exclusion is extended only through December 31, 2010.

Taxable Employer Education Assistance

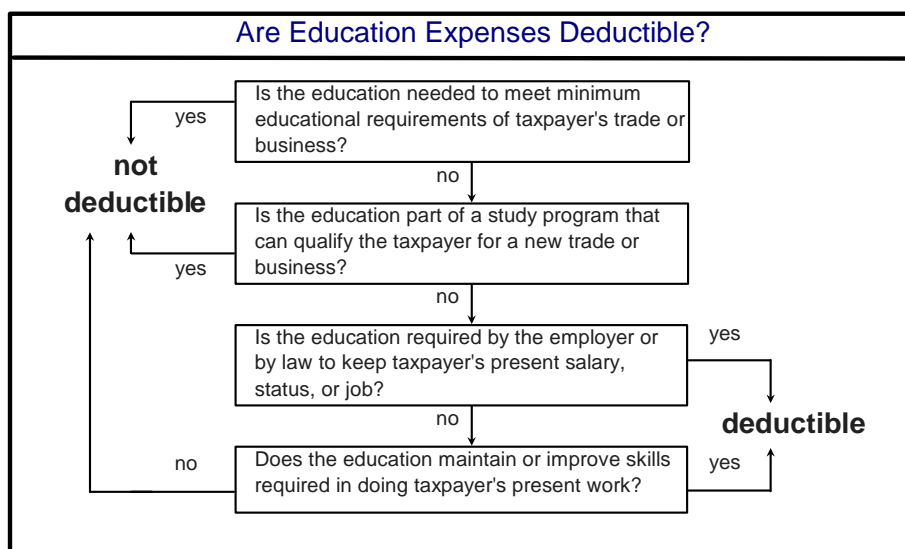
Except as discussed below, education assistance from employers generally must be included in employees' gross income for federal income tax purposes. The amount is reported on the W-2 statement that employees receive each January. Employers typically increase withholding for the additional income taxes employees owe. The assistance also is subject to Social Security and Medicare taxes, for which withholding is increased as well, and to unemployment taxes paid only by employers.

Deductible Business Expense

Education assistance from employers can be tax-exempt if the education meets Internal Revenue Service (IRS) tests for a deductible business expense. Essentially, these tests require that the education be job-related but *not* enable one to meet minimum requirements for current work or prepare for a new career. The tests consist of four questions displayed on the flow chart below.¹ Employer tuition reimbursements can be excluded from employees' gross income if the education meets the IRS tests and they are provided through an accountable plan (i.e., employees are required to substantiate reimbursements to their employer and return any excess payments). If an accountable plan does not exist, the assistance is included in employees' gross income; however,

¹ IRS regulations 1.162-5. For additional information, see *Your Federal Income Tax* (IRS publication 17) and *Tax Benefits for Education* (publication 970).

taxpayers who itemize their deductions may be able to deduct some portion, provided the education meets the four-question IRS tests. With some exceptions, such deductions are limited to the amount that the assistance plus other miscellaneous deductions exceeds 2% of adjusted gross income. Thus, they might not offset all or even any of the expense.



Employer Education Assistance Exclusion

Section 127 allows taxpayers to exclude from gross income up to \$5,250 a year in education assistance from their employer even if the education does not meet the above-described IRS tests. Courses do not have to be job-related; they can also help employees meet minimum requirements for current work or prepare for a new career. For the exclusion to apply, employer education assistance programs must have separate written plans, employee notification, and restrictions against favoring highly compensated employees. Education involving sports, games, or hobbies is not covered unless these activities are the business of the employer or the courses are part of a degree program.

Graduate-level courses were not covered between June 30, 1996 and December 31, 2001. P.L. 107-16 reinstated coverage for graduate-level courses beginning after December 31, 2001. It also extended the exclusion through December 31, 2010.

Taxpayers who receive employer education assistance not excluded or deducted as described above might be eligible for either the Hope Scholarship credit, the Lifetime Learning credit, or the tax deduction for higher education expenses.²

In January 2005, the Joint Committee on Taxation estimated that the tax expenditure (i.e., the aggregate difference in tax liability) attributable to the exclusion for employer education assistance will be approximately \$0.8 billion in FY2005.

² For more information, see CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by Adam Stoll and James B. Stedman.