Dear:

This is in response to your authorized representatives' letter and submissions of June 10, 2014 in which they requested on your behalf rulings under section 117(d) of the Internal Revenue Code of 1986 (Code) regarding the proper federal income tax treatment of certain tuition reduction benefits provided by you, Taxpayer, under Taxpayer’s tuition assistance program (the Program), more fully describes below. We are pleased to address your concerns.

FACTS

The information submitted indicates that Taxpayer is an educational organization described in section 170(b)(1)(A)(ii) of the Code. It is a corporation affiliated with and under the control of University.

University is a nonprofit corporation that is a tax exempt organization described in section 501(c)(3) of the Code and an educational organization described in section 170(b)(1)(A)(ii) of the Code which provides undergraduate and graduate education. University is the sole member of Taxpayer.
Corporation is a nonprofit corporation that is a tax-exempt organization described in section 501(c)(3) of the Code. University and Member are the sole members of Corporation, and each is a 50% member.

The Program is designed to assist the faculty and staff of Taxpayer with the cost of providing education for their dependent children. The Program applies to all full time faculty and staff who have completed at least three continuous years of full-time service. The Program is made up of two plans: “Plan A,” a tuition exemption program, and “Plan B,” a tuition scholarship program. Under Plan A, eligible children enrolled at and attending University pay 12% of the annual tuition in lieu of the normal tuition. Under Plan B, eligible children actively enrolled in associate or baccalaureate degree programs at other universities, qualified technical schools, or community colleges may receive the lesser of a specific dollar amount or the cost of tuition and academic fees the student is required to pay. All must be accredited institutions. There is an eight semester or twelve quarter maximum per student and a lifetime maximum benefit per employee for all dependent children receiving benefits under the Program.

For purposes of the Program, and “accredited institution” is an institution listed in “Accredited Institutions of Higher Education” published by the American Council of Education for the Federation of Regional Accrediting Associations or a foreign institution determined by University’s Provost to have standards equivalent to an American Accredited institution.

The term “eligible children” for purposes of the Program includes legally adopted children, step-children, and dependent children of an employee’s same-sex spouse. Eligible children must be younger than age 26 and substantially dependent upon the employee. A child is eligible only if he or she does not yet hold an undergraduate degree (baccalaureate or equivalent). A child’s eligibility continues for a maximum period of one year if an employee takes an approved leave of absence. Eligible children of employees who cease work due to disability remain covered for six months following the employee’s cessation of work. The benefit also remains available for the eligible children of employees who retired prior to January 1, 2012 at age 62 or older and whose age plus years worked equaled at least 75, even if such employee has since died.

Taxpayer intends to amend the Program effectively Date 2 to limit “eligible children” to children younger than age 24, with certain exceptions. Children who are at least 24 years of age but younger than age 26 will be eligible if they were, prior to the amendment date, enrolled in a program meeting the requirements of the Program upon turning age 24 and have remained continuously enrolled since reaching age 24. Further, children at least 24 years of age but younger than age 26 will also remain eligible if their failure to enroll or remain continuously enrolled is a result of illness or family emergency.

As of Date 1, Taxpayer (including controlled affiliates) employed approximately 3,663 employees. Of these 3,663 employees, 919 are highly compensated employees
(within the meaning of section 414(q)), of which 741 are eligible to participate in the Program, and 2,744 are not highly compensated, of which 2,332 are eligible to participate in the Program.

As of Date 2, Taxpayer plans to transfer 1,921 of its current employees to Corporation. The transfer will not affect the services the transferred employees provide. It is intended that faculty and certain “grandfathered” non-faculty employees will not be transferred from Taxpayer to Corporation and will continue to be eligible to benefit under the Program. A non-faculty employee will be grandfathered and remain with Taxpayer if on Date 2, (i) the employee had three or more years of service and (ii) the employee had at least one child who is age 14 or older but younger than age 24, or who is age 24 or 25 and meets one of the exceptions described above (and in either case has not already received the maximum amount of tuition concession benefit permitted under the Program). Each January 1 after the initial Date 2 transfer of employees from Taxpayer to Corporation, any grandfathered non-faculty employee who no longer has a child who is age 14 or older but younger than age 24, or who is age 24 or 25 and meets one of the exceptions described above (and in either case has not already received the maximum amount of tuition concession benefit permitted under the Program) will be transferred to Corporation.

REQUESTS

The taxpayer requests the following rulings:

1. That the tuition benefits and educational assistance provided under the Program to eligible employees of Taxpayer with respect to the undergraduate education of their dependent children covered by section 132(h) of the Code currently satisfies the requirements of section 117(d), including the prohibition against discrimination in favor of highly compensated employees, and, therefore, are excluded from the employees’ gross income.

2. That the tuition benefits and educational assistance provided under the Program to eligible employees of Taxpayer with respect to the undergraduate education of their dependent children covered by section 132(h) will, immediately after the proposed transfer of employees and amendment of the Program, satisfy the requirements of section 117(d), including the prohibition against discrimination in favor of highly compensated employees, and, therefore, will be excludable from the employees’ gross income.

3. That, assuming the Program remains unchanged after Date 2 and continues to pass the objective portions of the non-discrimination test of section 1.410(b)-4 of the Treasury Regulations, the tuition benefits and educational assistance provided under the Program to eligible employees of Taxpayer with respect to the undergraduate education of their dependent children covered by section 132(h) will, immediately after each subsequent proposed annual transfer of employees, satisfy the requirements of section 117(d),
including the prohibition against discrimination in favor of highly compensated employees, and, therefore, will be excludable from the employees’ gross income.

LAW AND ANALYSIS

Generally, amounts paid to or for the benefit of employees are presumptively compensatory in nature, and ordinarily includible in gross income as wages. Section 117(d)(1) of the Internal Revenue Code, however, provides a special rule in the case of a “qualified tuition reduction:” section 117(d)(1) provides that gross income shall not include any “qualified tuition reduction.”

Section 117(d)(2) defines a “qualified tuition reduction” as the amount of any reduction in tuition provided to any employee of a section 170(b)(1)(A)(ii) educational organization for the education (below the graduate level) at such organization (or another organization described in section 170(b)(1)(A)(ii)), of (A) such employee, or (B) any person treated as an employee (or whose use is treated as an employee use) under the rules of section 132(h). Section 132(h) refers, generally, to spouses and dependent children of employees.

Section 170(b)(1)(A)(ii) describes an educational organization as one which normally maintains a regular faculty and curriculum and normally has a regular enrolled body of pupils or students in attendance at the place where its education activities are regularly carried on. An entity described in section 170(c)(1) or (2), or an institution that is operated as an activity or function of such an entity, may qualify as an “educational organization” described in section 170(b)(1)(A)(ii) for the purposes of section 117(d).

Except for the case of certain graduate teaching and research assistance, the exclusion from income provided by section 117(d) is limited to education “below the graduate level.” Section 117(d)(5)[4] provides an exception for individuals who are graduate students at the employing institution and who are engaged in providing teaching or research activities for that educational institution.

Section 117(d)(3) of the Code provides that the exclusion from income of a qualified tuition reduction will apply to highly compensated employees only if such reduction is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees (within the meaning of section 414(q)).

Section 1.410(b)-4 of the Income Tax Regulations generally provides the test for determining whether a classification is reasonable and nondiscriminatory. That test has two parts: (1) section 1.410(b)-4(b), requiring that the classification established by an employer for its employees be reasonable; and (2) section 1.410(b)-4(c), requiring that a plan pass an objective test to assure that the reasonable classification is nondiscriminatory. The objective test has a safe harbor, an unsafe harbor, and a “facts
and circumstances” test for situations falling between the safe and unsafe harbors. The test applies with respect to the minimum coverage rules of section 410(b) and may be incorporated into section 117(d), taking into account the differences between a qualified retirement plan and a qualified tuition reduction plan. Nonetheless, although section 117(d)(3) prohibits discrimination in favor of highly compensated employees described in section 414(q), there is no specific language in section 117(d) mandating that the same coverage test applicable under section 410 are also applicable under section 117(d). Thus, the determination of whether a tuition reduction plan in fact discriminates in favor of highly compensated employees for purposes of section 117(d)(3), is made based upon an analysis of all relevant facts and circumstances.

Section 1.410(b)-4(b) of the Regulations provides that a classification will be reasonable if, based on all the facts and circumstances, the classification is reasonable and established under objective business criteria that identify the category of employees who benefit under the plan. Reasonable classification include specific job categories, nature of compensation (i.e., salaried or hourly), geographic location, and other similar bona fide business criteria. The House Ways and Means Committee Report on the Deficit Reduction Act of 1984, H.R. Rep. No. 98-432, Part 2, 98th Cong., 2d Sess. 1606 (1984), provides additional examples of reasonable classifications. The report explains that an employer could establish a classification based on such factors as seniority, full-time vs. part-time employment, or job description, provided that the classification is nondiscriminatory.

Taxpayer is an educational organization described in section 170(b)(1)(A)(ii). The tuition benefits and educational assistance provided under the Program are a tuition reduction for the education (below the graduate level) at such organization or another organization described in section 170(b)(1)A)(ii), of dependent children of employees of Taxpayer covered by section 132(h). Accordingly, the tuition benefits and educational assistance provided under the Program to eligible employees of Taxpayer with respect to the undergraduate education of their dependent children covered by section 132(h) meets the definition of qualified tuition reductions under section 117(d)(2).

We have determined that, currently, the tuition benefits and educational assistance provided under the Program to eligible employees of Taxpayer with respect to the undergraduate education of their dependent children covered by section 132(h) satisfies the “reasonable classification” of employees test of section 117(d)(3). Additionally, these tuition benefits and educational assistance provided under the Program, currently, satisfies the “safe harbor” test, and therefore, does not discriminate in favor of highly compensated employees. Thus, the tuition benefits and educational assistance provided under the Program to eligible employees of Taxpayer with respect to the undergraduate education of their dependent children covered by section 132(h) currently satisfies the requirements of section 117(d), including the prohibition against discrimination in favor of highly compensated employees. Thus, these benefits are excluded from the employees’ gross income under section 117(d)(1) as qualified tuition reductions.
We have determined that, on Date 2, after the initial transfer of employees, the tuition benefits and educational assistance provided under the Program will satisfy the “reasonable classification” of employees test of section 117(d)(3). Additionally, on Date 2, after the initial transfer of employees, these tuition benefits and educational assistance provided under the Program will satisfy the “safe harbor” test, and therefore, will not discriminate in favor of highly compensated employees. Thus, the tuition benefits and educational assistance provided under the Program to eligible employees of Taxpayer with respect to the undergraduate education of their dependent children covered by section 132(h) will, immediately after the proposed transfer of employees and amendment of the Program, satisfy the requirements of section 117(d), including the prohibition against discrimination in favor of highly compensated employees. Thus, these benefits will be excludable from the employees’ gross income under section 117(d)(1) as qualified tuition reductions.

Section 4.02(4) of Rev. Proc. 2014-3 provides that the Service will not rule on the tax effect of any transaction to be consummated at some indefinite future time. Based on section 4.02(4) of Rev. Proc. 2014-3, we are declining to make a determination on the effect on the Program of future annual transfers of staff. Accordingly, we express or imply no opinion regarding the satisfaction of section 117(d)(3) by the Program after one of these future annual transfers.

CONCLUSION

Based on the information provided and the representations furnished, we have determined that the described tuition reduction benefits provided to employees (within the meaning of section 117(d)(2) of the Code) of the Taxpayer for the education below the graduate level of dependent children at any educational institution described in section 170(b)(1)(A)(ii), are excludable from gross income of such employees under section 117(d)(1) of the Internal Revenue Code as “qualified tuition reductions.”

Also, based on the information provided and the representations furnished, we have determined that, after the initial transfer of employees, the described tuition reduction benefits provided to employees (within the meaning of section 117(d)(2) of the Code) of the Taxpayer for the education below the graduate level of dependent children at any educational institution described in section 170(b)(1)(A)(ii), are excludable from gross income of such employees under section 117(d)(1) of the Internal Revenue Code as “qualified tuition reductions.”

Accordingly, the value of the described tuition reduction benefits granted under Taxpayer’s Program to employees (within the meaning of section 117(d)(2) of the Code) of the Taxpayer for the education below the graduate level of such individuals does not constitute “wages” for purposes of section 3401(a). Additionally, such amounts are not subject to section 3402 (relating to withholding for income taxes at source), section 3102 (relating to withholding under Federal Insurance Contribution Act (FICA)), or section 3301 (relating to the Federal Unemployment Tax Act (FUTA)). Taxpayer is not
required to file Form W-2, or any returns of information under section 6041, with respect to such payment or remissions.

However, we express or imply no opinion regarding the satisfaction of section 117(d) of the Code, or any other section of the Code, after any future annual transfer of employees.

This letter ruling is based on the facts and representations provided by the Taxpayer and limited to the matters specifically addressed. No opinion is expressed as to the tax treatment of the transactions considered herein under the provisions of any other sections of the Code or regulations which may be applicable thereto, or the tax treatment of any conditions existing at the time of, or effects resulting from, such transactions which are not specifically addressed herein.

Temporary or Final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by adoption of final regulations, to the extent the regulations are inconsistent with any conclusions in this ruling. See section 11.04 of Rev. Proc. 2014-1, 2004-1 I.R.B. 1 at 50. However, when the criteria in section 11.06 of Rev. Proc. 2014-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare and unusual circumstances.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Because it could help resolve federal tax issues, a copy of this letter should be maintained with the Taxpayer’s permanent records.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
Office of Associate Chief Counsel
(Income Tax & Accounting)