

Providing Tax-Free Educational Benefits to Employees

By Jason Quinn

For many companies, a large portion of the total compensation package they offer employees is made up of noncash benefits. Generally, when an employer provides noncash benefits to an employee, the employee is taxed on the fair market value of those benefits, unless an exception to taxation applies.

A common example is employer-provided or subsidized health insurance. Under general tax rules, an employee is required to pay taxes on the value of the health benefits he receives, but the tax law carves out an exception to taxability for employer-provided health benefits, allowing the employee to receive health insurance benefits without increasing his or her tax liability. An employer also gains from compensating its employees with the use of tax-free benefits instead of additional cash compensation. With the use of tax-free benefits, the employer can provide similar after-tax value to the employee with less out-of-pocket cost to the employer. There are exceptions to taxation similar to the exception for employer-provided benefits throughout the tax law, some of which may be underutilized or may be more relevant under current economic conditions.

Tax-free education benefits in particular may be more valuable to both employers and employees in a slowing economy. When business activity is slow, employees likely have more time to devote to acquiring new skills and have a greater need to enhance their value to their employer. As employees acquire new skills, an employer can use those skills to achieve the goals of the organization and retool as it adjusts to changing market conditions. An employer can provide tax-free education benefits by developing and maintaining an educational assistance program or by taking advantage of the tax exclusion for working condition fringe benefits. Both of these approaches have distinct advantages, disadvantages, and requirements for tax-free qualification.

Educational Assistance Program

Under an educational assistance program, an employer can provide tax-free payments for education expenses. These tax-free payments are limited to \$5,250, but they can be provided regardless of whether the program is designed to improve the skills needed by the employee in his or her employment.

To qualify for the exclusion, an educational assistance program must meet the following requirements:

- The program must be set forth in a written plan and must be designed to provide educational assistance for the employer's employees exclusively;
- The program must benefit qualified employees under a classification defined by the employer, provided that classification does not discriminate in favor of highly compensated employees or their dependents;
- No more than five percent of payments under the plan may be made to shareholders or owners who own more than five percent of the employer;
- The program may not offer eligible employees a choice between educational assistance and other benefits; and
- The employer must provide reasonable notification to the employees of the availability and terms of the program.

Education Benefits Provided as a Working Condition Fringe Benefit

An employer is not limited in the value of the educational benefits it can provide to an employee as a working condition fringe benefit. In addition, an employer does not need to meet the documentation, non-discrimination, and notice requirements of an educational assistance program. However, education expenses reimbursed to an employee as a working condition fringe benefit are non-taxable to the employee only if the education expenses incurred by the employee qualify as deductible trade or business expenses.

To qualify as trade or business expenses, education expenses must be paid for an education program that meets the following requirements:

- It maintains or improves skills required by the individual in his or her employment; or
- It meets the express requirements of the individual's employer, imposed as a condition of the employer to the retention of the employee in his or her established employment position.

Even if an education program meets one of the above requirements, reimbursed educational expenses do not qualify for tax-free treatment if the education program either:

- Is necessary for the employee to meet the minimum requirements for qualification in his or her employment; or
- Qualifies the employee for a new trade or business.

If your company is considering providing education benefits to its employees, carefully structuring the education benefits program as an educational assistance program or a working condition fringe benefit can provide value to your company and its employees.