

Underwriting employees' educational expenses tax-free

A debt-free education courtesy of your employer sounds nice, but it's not so straightforward. While many companies and HR teams may be well-intentioned, there's a difference between debt-free and tax-free. This nuance appears to be frequently missed in the continual contest to create more attractive benefits offerings. Many employers offer debt-free education as the latest in a long line of [probably taxable perks](#).

This can still be a great way to keep employees happy and up-to-date on skills. However, it's necessary to fully understand the distinctions, before those same employees you're trying to impress are hit with hefty taxes unexpectedly.

Time for some tax ed.

Tax-free education under Treas. Reg. § 1.162-5

You may underwrite all of the employees' educational expenses tax-free, even if the education leads to a degree, if one of these conditions applies:

- The education is required by you or the law so employees can keep their present salary, status, or job. The education must serve a *bona fide* business purpose.
- The education maintains or improves employees' skills needed in their present jobs.

Sounds like tax-free education is expensive, doesn't it? It's not. Even if the education meets one or both of these tests, it isn't qualifying work-related education you can underwrite tax-free if:

- Employees need the education to meet the minimum requirements of their present jobs.
- The education will qualify them for a new trade or business.

For example, you couldn't pick up an entry-level customer service employee's undergraduate expenses tax-free because, in all likelihood, they'll qualify for a new trade or business after graduation.

The same thing applies if, say, you want to underwrite flying lessons for an attorney who needs to travel long distances. If lawyering didn't pan out, this lawyer could become a full-time pilot.

You also couldn't hand employees who are recent graduates of a program you require them to complete, say, \$200 a month for 24 months to make up for the tuition and other expenses you didn't underwrite. The \$200 is a taxable bonus.

And finally, it doesn't matter whether you pay the educational institution directly.

So what is tax-free education under Treas. Reg. § 1.162-5? Refresher courses, seminars, continuing education courses. For example, computer techs could go to school to learn a new software program. Not exactly the debt-free education HR had in mind.

Read more about this [here](#).

Tax-free education under IRC § 127

It's much easier to underwrite employees' expenses under an IRC § 127 [educational assistance plan](#) because you don't have those pesky § 1.162-5 requirements to comply with. Nevertheless, it's not a blank check:

- You're limited to \$5,250 a year in tax-free benefits per employee. At this rate, it would take employees a long time to get their degrees.
- Plans must be written, they can't discriminate in favor of highly compensated employees and employees must substantiate their expenses to you.

Private foundations

You can set up an employer-sponsored [private foundation](#) through which employees and their families may receive tax-free scholarships. But this approach has many steps and pitfalls, so it's advisable to get some legal and tax advice.

And now the taxes

If you don't want to saddle employees with their taxable educational expenses, your only option is to pay the taxes yourself by grossing up the payment. Grossing up is a fraction. For federal tax purposes, the basic fraction is:

$$\frac{\text{Amount of the taxable expense}}{1 - .22 - .0765 \text{ (or } 0.7035\text{)}}$$

If you needed to gross up \$9,500 in taxable educational expenses, the formula is:

$$\frac{\$9,500}{0.7035}$$

A \$9,500 gross-up will cost the company \$13,503.91.