

# College Tax Strategy



***IRS Section 127  
Education Assistance Program***



## **Basic Tax Strategy # 4**

### **– The Education Assistance Program**

Several thousand companies offer tuition assistance programs as a fringe benefit for employees who want to further their college studies. The tax treatment of these Employer Educational Assistance Programs (IRS Section 127) can be tax deductible to the employer and also tax-free, up to \$5,250 per year, to the employee. Beginning in 2002, the Tax Relief Act of 2001 extended this benefit to students who are enrolled in graduate-level studies.

Employers are not required to offer educational assistance to employees. However, with increased technology in the workplace, the continuing education of employees is necessary to ensure the employer will stay competitive in the market place. Many employers recognize this and choose to offer educational assistance benefits.

### **How To Qualify For The EAP Strategy**

There are some very specific IRS regulations that must be followed in order to qualify for this benefit. To be qualified, an Educational Assistance Plan must meet the following requirements [IRC Sec. 127(b)]:

- It must be a separate written plan of the employer. The terms of the program (i.e., eligibility, benefit requirements, and claims procedures) must be set forth in a separate document specifying the details of the tuition assistance that qualifies for the exclusion.
- It must be used for the exclusive benefit of employees. The term “employee” may include retired, disabled or laid-off employees, employees on leave (e.g., in the U.S. Armed Forces), and self-employed persons. However, the program can not benefit employees’ spouses or dependents, unless they are also employees of the employer.
- It must be nondiscriminatory. This means the plan must meet an eligibility test and a 5% concentration test.

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- Reasonable notice of the availability and terms of the educational assistance program must be provided to all eligible employees.

The self-employed business owner can also set up an Educational Assistance Program. The advantages of these programs can be substantial for both the self-employed businessperson and the employee. They are as follows:

- The employee does not have to report the amount (up to \$5,250 per year) of the educational assistance as income on his tax return.
- The employer and the employee are not responsible for any payroll taxes (up to \$5,250 per year) on this type of employee compensation.
- The employer receives a current tax deduction for the education assistance paid.
- The employer does not have to fund this program, as is the case in other types of employee benefits.

**The self-employed business owner can also provide this fringe benefit for their own children, if they employ them in their business. The courses the children take need not be job-related. In order to qualify for this fringe benefit, the following tests must be met:**

1. *The child must be a legitimate employee of the business,*
2. *The child must be age 21, or older, unless the business owner is a grandparent funding a grandchild's education, in which case there is no age limit,*
3. *The child must not own more than 5% of the business and, the child must not be a tax dependent of the parent owner.*

## **Benefits Of The EAP Strategy**

Under Section 127 of the Internal Revenue Code [IRC Sec. 127(a)(1)] any amount paid, or expense incurred, by employers for educational assistance for their employees can be deducted by the business owner and also excluded from the employee's gross income (up to \$5,250 per year).

If self-employed business owners employ their children and meet the stipulations under IRS Section 127, they may be able to deduct one or two years of undergraduate college costs when the child turns age 21, or up to \$5,250 to \$10,500. If the child decides to attend graduate school, the benefits are even greater. In this case, the money paid for tuition assistance for the

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employee/child can be deductible to the self-employed business owner, yet will not be treated as income to the employee/child.

### **Tax Savings Involving The EAP Strategy**

The basic tax benefit of Education Assistance Program strategy comes from the ability to deduct one or two years of undergraduate college costs when the child turns age 21, or up to \$5,250 to \$10,500. If the child decides to attend graduate school, the business owner can further deduct the graduate school tuition and expenses for the employee/child. This is another great way to further reduce your family's total tax liability.

### **Example Of The EAP Strategy**

Tom is a self-employed business owner whose son will be a 21 year old junior in college this year. Since Tom's son is employed in his business during the summer months, Tom can deduct tuition and fees incurred during the next two years of school. If Tom's son needs a fifth year to graduate, he can deduct tuition and fees for that year also. If his son decides to attend graduate school, Tom can deduct the graduate school tuition and fees also (up to \$5,250 per year).

Tom currently pays 25% in federal taxes, 6% in state taxes and 15.3% in self-employment taxes, for a total tax rate of 46.3%. Assuming Tom's son will graduate in two years (and incurs at least \$5,250 in tuition costs each year), Tom can now deduct \$5,250 each year for those two years, which will result in a tax savings of \$2,431 each year ( $\$5,250 \times 46.3\% = \$2,431$ ).

### **Implementing The EAP Strategy**

- Step 1: Prepare a corporate resolution – If you have a corporation, a partnership, or a Limited Liability Company (LLC) you should have an attorney draw up a resolution to incorporate the Education Assistance Plan (Section 127) as an employee benefit into your business.
- Step 2: Establish an employer identification number (FEIN) – If you operate as a sole proprietor (you file IRS form Schedule C or F) you should apply for a FEIN. You can apply for the FEIN by using IRS SS-4 Form.
- Step 3: Determine the eligible employees (children/grandchildren).
- Step 4: Execute an employment agreement with the children/grandchildren (employee) – When hiring your children you need a formal hiring process that should include the completion of a standard Employment Application, W-4 form, and an I-9 form.

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- Step 5: Determine the plan education benefits (Example: only pay for limit on tuition of 10,000, or for undergraduate studies only, not graduate studies).
- Step 6: Reimburse the employee/child or the education providers directly for the cost of the tuition and fees. Be sure to use a company check.
- Step 6: Deduct the cost of the education assistance plan benefits as “Employee Benefits” on your IRS tax return.

## **Documents Used To Implement The EAP**

These are the documents you will need to implement the Education Assistance Program:

- Employer identification number (IRS SS-4 Form)
- Employment Application, W-4 form, and an I-9 form
- Educational Assistance Plan Document
- Employee Tuition Expense Reimbursement Form

## **IRS Publications & Forms References**

### **IRS Publications**

#### **Employer's Tax Guide to Fringe Benefits**

Publication 15-B – Education Assistance Plan

<http://www.irs.gov/publications/p15b/ix01.html>

#### **Tax Benefits for Education**

Publication 970 (2008), Tax Benefits for Education

<http://www.irs.gov/pub/irs-pdf/p970.pdf>

### **IRS Forms SS-4, W-2, W-4, I-9, and 941**

<http://www.irs.gov/app/picklist/list/formsInstructions.html>

**EDUCATION ASSISTANCE PLAN  
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**Sample Documents  
Education Assistance Program**

The following documents are needed in order to implement the “Education Assistance Plan” strategy and follow the IRS procedures and guidelines.

**EDUCATION ASSISTANCE PLAN  
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**Educational Assistance Plan**

\_\_\_\_\_ ("Employer") hereby establishes this Educational Assistance Plan ("Plan") for the exclusive benefit of its Employees.

**1) Education Expense Reimbursement**

Effective \_\_\_\_/\_\_\_\_/\_\_\_\_ ("Effective Date"), Employer shall reimburse all eligible Employees for education expenses described in **Eligible Expenses** below.

**2) Eligible Employees**

All Employees age 18 and above shall be eligible to participate.

**3) Eligible Expenses**

"Qualified educational expenses" shall include expenses incurred by or on behalf of an employee for education of the employee (including, but not limited to, tuition, fees, insurance, books, supplies, and equipment). Education expenses are not limited to courses that are job-related or part of a degree program. Education assistance shall not include any payment for, or provision of: 1) tools or supplies which may be retained by the Employee after completion of the course of instruction; 2) room and board, or any transportation; 3) any course or other education involving sports, games, or hobbies.

**4) Manner of Payment**

The Employer may, in its discretion, make payments for eligible expenses to employees or directly to their education provider. If the Employer makes payments directly to a provider, the Employer shall be relieved of any further liability for that expense. Any Employees applying for reimbursement under this Plan shall submit all tuition notices and eligible bills not more than 30 days following the end of the calendar quarter for which they are submitted for verification before payment. Failure to comply with this requirement may terminate employees' right to reimbursement for expenses not timely submitted.

**5) Benefit Limits**

Reimbursement is limited to \$5,250 per employee per calendar year.

**6) Notice of Plan Document**

The Employer shall provide employees with a copy of this Plan within 60 days of hire.

**Amendment and Termination**

The Employer hereby reserves the right to amend or terminate this Plan at any time during any year.

**Exclusions**

The Employer intends that this Plan and all benefits payable under this Plan shall qualify for exclusion from eligible employees' gross income under Internal Revenue Code Section 127. The Employer reserves the right to amend or terminate this Plan in the event that plan benefits no longer qualify for such exclusion.

The Employer hereby adopts this Plan on \_\_\_\_/\_\_\_\_/\_\_\_\_

**Signed By Employer:** \_\_\_\_\_

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**Employment Agreement (Child)**

Employment Agreement, between \_\_\_\_\_ (the "Company") and  
\_\_\_\_\_ (the "Employee").

For good consideration, the Company employs the Employee on the following terms and conditions:

**1) Term of Employment**

Subject to the provisions for termination set forth below this agreement will begin on \_\_\_\_\_, 20\_\_\_\_, unless sooner terminated.

**2) Compensation**

The Company shall pay Employee a salary of \$\_\_\_\_\_ per year, for the services of the Employee, payable at regular payroll periods.

**3) Duties and Position**

The Company hires the Employee in the capacity of \_\_\_\_\_. the Employee's duties may be reasonably modified at the Company's discretion from time to time.

**4) Employee to Devote Time to Company**

The Employee will devote time, attention, and energies to the business of the Company, and, during this employment, will not engage in any other business activity, regardless of whether such activity is pursued for profit, gain, or other pecuniary advantage. Employee is not prohibited from making personal investments in any other businesses provided those investments do not require active involvement in the operation of said companies.

**5) Confidentiality of Proprietary Information**

Employee agrees, during or after the term of this employment, not to reveal confidential information, or trade secrets to any person, firm, corporation, or entity. Should Employee reveal or threaten to reveal this information, the Company shall be entitled to an injunction restraining the Employee from disclosing same, or from rendering any services to any entity to whom said information has been or is threatened to be disclosed, the right to secure an injunction is not exclusive, and the Company may pursue any other remedies it has against the Employee for a breach or threatened breach of this condition, including the recovery of damages from the Employee.

**6) Reimbursement of Expenses**

The Employee may incur reasonable expenses for furthering the Company's business, including expenses for entertainment, travel, and similar items. The Company shall reimburse Employee for all business expenses after the Employee presents an itemized account of expenditures, pursuant to Company policy.

**7) Vacation**

The Employee shall be entitled to a yearly vacation of \_\_\_\_\_ weeks at full pay.



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**8) Disability**

In the event that the Employee cannot perform the duties because of illness or incapacity for a period of more than \_\_\_\_ weeks, the compensation otherwise due during said illness or incapacity will be reduced by \_\_\_\_\_ ( \_\_\_\_ percent) . The Employee's full compensation will be reinstated upon return to work. However, if the Employee is absent from work for any reason for a continuous period of over \_\_\_\_ months, the Company may terminate the Employee's employment, and the Company's obligations under this agreement will cease on that date.

**9) Termination of Agreement**

Without cause, the Company may terminate this agreement at any time upon \_\_\_\_ days' written notice to the Employee. The Employee may terminate employment upon \_\_\_\_\_ days' written notice to the Company. Employee may be required to perform his or her duties and will be paid the regular salary to date of termination but shall not receive severance allowance. Notwithstanding anything to the contrary contained in this agreement, the Company may terminate the Employee's employment upon \_\_\_\_\_ days' notice.

**10) Effect of Prior Agreements**

This Agreement supersedes any prior agreement between the Company or any predecessor of the Company and the Employee, except that this agreement shall not affect or operate to reduce any benefit or compensation inuring to the Employee of a kind elsewhere provided and not expressly provided in this agreement.

**11) Oral Modifications Not Binding**

This instrument is the entire agreement of the Company and the Employee. Oral changes have no effect. It may be altered only by a written agreement signed by the party against whom enforcement of any waiver, change, modification, extension, or discharge is sought.

Signed this \_\_\_\_ day of \_\_\_\_\_ 20\_\_\_\_.

\_\_\_\_\_  
Company

\_\_\_\_\_  
Employee

