

**INTERNAL REVENUE SERVICE**

Number: **200403050**  
Release Date: 1/16.2004  
UIL Index No.: 0117.06-00  
0117.06-05

CC:ITA:Br05//PLR-102164-03

September 30, 2003

Attention:

Legend:

X (Taxpayer) =

Dates:

l =  
m =  
n =

Dear Taxpayer:

This is in response to your authorized representative's letter and submissions of October 16, 2002, and other, previous correspondence and submissions, in which he 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, X, (sometimes referred to herein as the Taxpayer or the College) under the College's tuition reduction program (the "Program"). We are pleased to address your concerns.

The information submitted indicates that X is an educational organization described in section 170(b)(1)(A)(ii) of the Code. As of date l, the College (including controlled affiliates) employed approximately 1,244 employees, excluding those employees who regularly work less than 50% time and certain temporary employees who had failed to complete a year of service with 1,000 or more hours of service. Of these 1,244 employees, 230 are union members, of whom 0 are highly compensated

within the meaning of section 414(q), and 1,014 are non-union employees, of whom 163 are highly compensated. The College's union employees are covered by a collective bargaining agreement. Of the College's non-union workforce, 1,014 are nonexcludable employees, 163 of whom are highly compensated employees, and 851 are non-highly compensated employees. Of the highly compensated employee group, 154 are eligible for Plan One, and 159 are eligible for Plan Two. 360 non-highly compensated employees are eligible for Plan One, and 204 non-highly compensated employees are eligible for Plan Two.

The purpose of the tuition reduction Program is to assist faculty and staff, union and non-union, with the cost of providing undergraduate college education for their spouses and children. The Program is composed of two different plans, "Plan One" and "Plan Two." Plan One provides tuition reduction for studies at the College, and is available with respect to the dependent daughters and wives of all full-time College employees, including faculty, administrative staff and union employees with three years (or one year, in the case of employees hired before date m) of continuous full-time service, provided the dependent daughters and wives are selected for admission through the normal admissions process and maintain diploma-grade standing. Plan One provides 100% of the College's tuition in the case of employees hired prior to date m, and 50% of the College's tuition in the case of employees hired on or after date m.

Plan Two provides tuition reduction benefits with respect to studies (full-time undergraduate only, limited to eight semesters) of dependent children outside of the College, at another educational institution providing post-secondary education. Prior to date n, Plan Two was available only to full-time faculty and full-time administrative staff at or above a particular grade, provided that the faculty or administrative staff member had five years of continuous full-time service. As of date n, Plan Two was no longer available to administrative staff hired on or after that date, although prior eligible staff remain eligible. The benefit is currently equal to 50% of the College's current tuition, or 100% of the tuition of the other educational institution, whichever is less.

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 an educational organization, 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 body of pupils or students in attendance at the place where its education activities are regularly carried on. An entity described in sections 170(c)(1) or (2) of the Code, 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 purposes of section 117(d).

Except for the case of certain graduate teaching and research assistants, 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 a 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 Code section 410(b) and may be incorporated into Code 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 tests 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 of 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 classifications include specified 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.

In the instant case, Plan One satisfies the "reasonable classification" of employees test of section 117(d)(3). Pending the adoption of Temporary or Final Regulations providing differently, Plan Two will also be treated as satisfying the "reasonable classification" of employees test of that section. Plan One satisfies the "safe harbor" test, and does not discriminate in favor of highly compensated employees. Plan Two falls between the safe harbor and unsafe harbor percentages; thus, whether that plan is discriminatory for purposes of section 117(d)(3) is determined based on all relevant facts and circumstances. Based on the significant number of non-highly compensated employees benefitting under Plan Two, and the fact that the College maintains as well, as a part of its tuition reduction benefits Program, Plan One, which is available to a much larger cross-section of its workforce, we conclude that Plan Two will be treated as not discriminating in favor of highly compensated employees. Thus, X's tuition reduction Program consisting of Plans One and Two satisfies the prohibition against discrimination in favor of highly compensated employees as described in section 117(d)(3) of the Code.

Based on the information provided and representations furnished, we have determined that the described tuition reduction benefits provided under the Taxpayer's tuition reduction Program, consisting of both Plan One and Plan Two, 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 persons at X or at any educational institution described in section 170(b)(1)(A)(ii), are excludable from the gross incomes 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 X's tuition reduction 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 the Federal Insurance Contribution Act (FICA)), or section 3301 (relating to the Federal Unemployment Tax Act (FUTA)). X is not required to file Forms W-2, or any returns of information under section 6041, with respect to such payments or remissions.

This letter ruling is based on the facts and representations provided by the Taxpayer, and is 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 12.04 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, at 46. However, when the criteria in section 12.05 of Rev. Proc. 2003-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

Because it could help resolve federal tax issues, a copy of this letter ruling should be maintained with X's permanent records.

Pursuant to a power of attorney currently on file with this office, copies of this letter are being sent to X's designated authorized representatives.

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 yours,

Associate Chief Counsel  
(Income Tax & Accounting)

/s/ William A. Jackson

By \_\_\_\_\_  
William A. Jackson  
Chief, Branch 5

Enclosures:

Copy of this letter

Copy for section 6110 purposes