

# Educational Assistance Exclusion

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*This fact sheet was designed to provide awareness of social security coverage and reporting responsibilities for Kentucky state agencies. This fact sheet should not be cited or used as authority with respect to federal employment taxes. The Internal Revenue Code and the Social Security Act, along with the associated regulations, rulings and case law, are the only valid citations of authority.*

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## **Tax Exclusion for Educational Assistance**

**The exclusion from income for educational assistance programs is generally available for expenses paid by state agencies for undergraduate courses. Graduate courses, beginning before January 1, 2002, are ineligible for this exclusion. (IRC Section 127)**

Employee benefits under an employer's nondiscriminatory educational assistance plan are generally excluded under IRC Section 127 from a state employee's gross income and wages. The excludable amount of tuition, fees, and related expenses is limited to \$5,250 per individual per year for undergraduate courses and also for graduate courses beginning after December 31, 2001. Expenses paid for graduate-level courses, beginning before January 1, 2002, are ineligible for this exclusion. To the extent that educational assistance is not excludable because it exceeds the \$5,250 limit it may be excludable under IRC section 132 as a working condition fringe benefit. (See Job Related Education Assistance below)

In order for the IRC Section 127 exclusion to apply, certain requirements must be satisfied. The education assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified education assistance plan can be provided for the class of individuals consisting of more than five-percent owners of the employer (and their spouses and dependents).

The term "education" includes any form of instruction that improves or develops the capabilities of an individual. The educational courses covered by the section 127 plan need not be job-related or part of a degree program. Courses in sports, games or hobbies (unless involved in the employer's business) cannot be covered. Education that instructs employees how to maintain and improve their health can, however, be covered as long as it is not recreational in nature.

A state agency can provide educational benefit payments either at the time the employee began a course or when the course is completed. The agency can furnish the education received by the employee, either alone or in conjunction with other employers or through a third party, such as an educational institution.

An educational assistance plan can, generally, cover tuition, fees, and the cost of books, supplies and tools. Payments for tools or supplies that the employee was permitted to retain after completion of the instruction course are not excludable, nor is the cost of meals, lodging, or transportation for this purpose.

### **Job Related Educational Assistance**

Educational assistance that exceeds the Section 127 threshold of \$5,250 may be excluded from wages if the assistance is "job related" or "job required". (IRC section 132 and section 162) Educational expenses are employee business expenses and excludible from income if the education:

1. maintains or improves skills required by the individual's current employment, trade or business, or

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2. meets the express requirements of the employer, or the requirements of applicable law or regulations, imposed as a condition to the individual's retention of salary, status or employment.

Even though the above tests are met, educational expenses are nondeductible if they are personal expenditures. The two categories of educational expenses that are not excluded from income are those that:

1. are required of the individual in order to meet the *minimum educational requirements* for qualification in the individual's present employment, trade or business, or
2. qualify the individual for a *new trade or business*.

## **Employees of educational institutions**

The amount of any qualified tuition reduction to employees of educational institutions is excluded from their gross income. (IRC section 117)

In order to qualify for this exclusion, the tuition reduction must be provided to an employee of a qualified educational organization. The tuition reduction can be for education provided by the employer educational organization or by another qualified educational organization where there is a reciprocal agreement between the institutions involved. Moreover, it can be for education provided to the employee's spouse, dependent child, or other person treated as an employee as well as the employee himself. The tuition reduction cannot be for education at the graduate level except for education of an employee who is a graduate student and who is engaged in teaching or research activities for his employer.

The tuition reduction should be made available to employees on a nondiscriminatory basis because the amount of tuition reduction provided to any officer or highly compensated employee is excludable only if the tuition reduction is available on substantially the same terms to other employees.