VALUING TUITION WAIVERS FOR TAX PURPOSES

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Abstract

Some tuition waivers provided by universities to employees or family members of employees are taxable benefits; that is often the case for waivers in graduate and professional programs. This article argues that the method used by many universities to value the benefit for tax purposes—treating the tuition sticker price as if it measured value—is an incorrect reading of tax law. Because sticker price generally exceeds fair market value, the result is more taxable income to employees who "benefit" from waivers than should be the case—to the obvious detriment of the employees but also to the detriment of the universities, which may lose good students and employees to other institutions.

Warning! The following is about a tax issue, but please keep reading. The issue is actually interesting—and important to American universities and their employees: what is the value, for tax purposes, of a taxable tuition waiver provided by a university to an employee or to an employee's spouse or dependent? I have written about this issue for tax publications,[1] but it deserves wider exposure in the academy. University administrations often get the answer wrong, to the detriment of both the institutions and the employees.

Under generally applicable principles of tax law, it is the *value* of a taxable benefit provided by employer to employee that should be included in the employee's income. Undergraduate tuition waivers are not taxed in most circumstances—and should never be taxable as long as a tuition reduction plan meets statutory requirements—so valuation of those waivers generally does not matter for tax purposes. Whatever their value, the undergraduate waivers are not taxable to the employees.[2] But many graduate and professional school tuition

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1 Erik M. Jensen, *Graduate Education and the Taxation of Tuition Reductions*, 158 TAX NOTES 1187 (2018) [hereinafter Jensen I]; Erik M. Jensen, *If a Tuition Reduction Is Taxable, What's the Measure of Income?*, J. TAX'N INVESTMENTS, Summer 2018, at 63.

2 The controlling provision is generally I.R.C. section 117(d), which excludes from gross income any "qualified tuition reduction," I.R.C. section 117(d)(1), defined as "the amount of any reduction in tuition provided to an employee of an organization described in section 170(b)(1)(A)(ii) [which refers to "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on"] for the education (*below the graduate level*) at such organization (or another organization described in section 170(b)(1)(A)(ii)) 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).

I.R.C. § 117(d)(2) (emphasis added). Section 132(h) extends the potential exclusion to undergraduate tuition waivers for, among others, spouses and children of a school's employees. *See* I.R.C. § 132(h)(2).

waivers provided by universities to their employees or employees' family members are taxable to the employees, and determining the value of those waivers is therefore critical.[3] (Whether the distinction between undergraduate and graduate tuition waivers makes sense as a matter of tax policy, it is the law.[4])

It is my understanding that most, if not all, universities take the position that the value of a taxable tuition waiver is determined by using the stated tuition figure (the sticker price). My school, Case Western Reserve University, does things that way. For example, if the annual sticker price for a graduate or professional program is $50,000 and the purported tuition waiver is $30,000, the university reports that the employee has income of $30,000 and withholds tax from the employee's paycheck accordingly.

In many situations, however, using sticker price to measure value for tax purposes leads to nonsensical results. At one time, sticker price may have been a good proxy for value, but that stopped being the case more than thirty years ago, when increases in university sticker prices began to significantly outpace

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(Given the statutory language, tax-free tuition waivers can also be available for elementary and secondary education.) For an otherwise eligible waiver to be tax free to a highly compensated employee, however, the tuition reduction plan must not discriminate in favor of such employees. I.R.C. § 117(d)(3). If the no-discrimination rule is violated—if, for example, the waiver plan is available only to the families of faculty members—an undergraduate tuition waiver would be taxable to any highly compensated employee.

[3] The exclusion of section 117(d)(1) generally would not apply to a graduate-level waiver. *See supra* note 2 (quoting language of section 117(d)(2), referring to "below the graduate level"). But section 117(d)(5) provides special treatment for tuition waivers provided to graduate teaching and research assistants—applying the statutory language quoted *supra* note 2 "as if it did not contain the phrase "(below the graduate level)."

Legislation proposed in the 115th Congress would have repealed section 117(d), including the special treatment for graduate teaching and research assistants receiving tuition waivers. *See* H.R. 1, 115th Cong., 1st Sess., § 1204(a)(3) (2017), https://waysandmeansforms.house.gov/uploadedfiles/bill_text.pdf. That legislation attracted enormous negative reaction from universities worried about the effects on graduate assistants and the institutions' ability to attract such assistants cheaply. The Tax Cuts and Jobs Act of 2017 (as it is generally but not officially known), Pub. L. No. 115-97, 131 Stat. 2054, did not include the repeal. I have questioned whether the repeal of section 117(d) would have been catastrophic for most teaching and research assistants, who ought to be treated as employees for tax purposes. Jensen I, *supra* note 1. Although the general rules applicable to graduate-level tuition waivers are in section 117(d), a particular graduate-level waiver may be excluded from an employee's gross income if, for that employee, the benefit is a "working condition fringe" (i.e., the tuition, if paid by the employee, would be deductible to him or her as an ordinary and necessary business expense), *see* I.R.C. § 132(a)(3), (d), or if it is part of an educational assistance plan. *See* I.R.C. § 127 (generally permitting educational benefits provided by employer to employee to be excluded from the employee's gross income up to $5250 per year, assuming the statutory requirements are satisfied—including a requirement that the plan not discriminate in favor of highly compensated employees). One or both of those provisions would help many, if not most, graduate assistants if section 117(d)(5) were to disappear.

[4] These rules date from the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 532, 98 Stat. 494, 887 (adding section 117(d)(1)–(3) to the Internal Revenue Code), and the Technical [*sic*] and Miscellaneous Revenue Act of 1987, Pub. L. No. 100-647, § 4001(b)(2), 102 Stat. 3342, 3643 (adding section 117(d)(5) to the Code). The justification for treating graduate-level waivers differently from other waivers was to put employees of colleges without graduate programs on an equal footing (or as close as possible to an equal footing) with employees of universities that have both undergraduate and graduate programs. Whether that goal is achieved—or is even desirable—is another matter.

inflation.[5] University officials talk a lot about "discount rates" these days—the percentage of sticker price not paid by the average student—as if their classrooms could be filled with qualified students who would pay full sticker price.[6] In some programs at some universities (dental and medical schools, for example), that may be true. But for most graduate and professional programs, few students—other perhaps than foreign students supported by their governments—pay the sticker price.[7] Indeed, many of the programs would disappear if they were dependent on full-paying customers. In law schools at many universities, for example, the average student pays less than fifty percent of the published tuition figure.[8]

Because sticker price bears no necessary relationship to what potential students would be willing to pay, it does not reflect value in any meaningful sense. The general understanding among tax professionals is that the fair market value

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[5] It is not surprising that discount rates have risen to unprecedented levels when sticker prices have skyrocketed. The $5000 in Cornell Law School tuition that my parents paid on my behalf in 1978-79 is the equivalent of slightly less than $19,000 today, but the sticker price at Cornell is now almost $68,000.

[6] Significant "discounting" is pervasive in undergraduate institutions, particularly private ones. *See* Marjorie Valbrun, *Discount Rates Hit Record Highs*, INSIDE HIGHER EDUC. (May 10, 2019, https://www.insidehighered.com/news/2019/05/10/nacubo-report-shows-tuition-discounting-trend-continuing-unabated) (noting that, for the first time, discount rates for freshmen at private colleges exceeded fifty percent); Emma Petit, *A Fifth of Private Colleges Report First-Year Discount Rate of 60 Percent, Moody's Says*, CHRON. HIGHER EDUC. (Nov. 30, 2018), https://www.chronicle.com/article/A-Fifth-of-Private-Colleges/245092.

[7] One anonymous referee for *Journal of College & University Law* challenged my statement that discounts are the norm in graduate schools, pointing in particular to master's programs. It is true that discounting in master's programs has historically been less than in doctoral and professional programs. *See* Sandy Baum & Patricia Steel, *The Price of Graduate and Professional School: How Much Students Pay* 7 (Urban Institute, June 2017), https://www.urban.org/research/publication/price-graduate-and-professional-school-how-much-students-pay. It is also true that some universities have been able to create money-making master's programs, often in professional schools. But many of the would-be cash cows have turned out to be disappointments. *See* Lindsay McKenzie, *Has the Master's Degree Bubble Burst?*, INSIDE HIGHER EDUC. (Dec. 20, 2019), https://www.insidehighered.com/digital-learning/article/2019/12/20/probing-slowdown-masters-degree-growth?utm_source=Inside+Higher+Ed&utm_campaign=889b82e0a4-DNU_2019_COPY_03&utm_medium=email&utm_term=0_1fcbc04421-889b82e0a4-198609537&mc_cid=889b82e0a4&mc_eid=65b4834ff0. In any event, it is hardly the norm in traditional programs in the arts and sciences for students to pay full sticker price. (If it were the norm, why wouldn't schools raise their sticker prices?) And even if it is the case that students in a particular graduate program are generally paying full sticker price, that would mean only that sticker price would be a good measure of the value of a taxable tuition waiver *in that program*. It would not mean that sticker price is necessarily a good measure in other graduate programs at the same institution.

[8] *See* Paul Caron, *Median Private Law School Tuition Discount: 28% (Average Scholarship: $20,129)* TAXPROF BLOG (Feb. 28, 2018),, https://taxprof.typepad.com/taxprof_blog/2018/02/median-private-law-school-tuition-discount-28-average-scholarship-20129.html) (listing twenty schools with discount rates above forty percent, eight of which—one being my institution—exceeded fifty percent); *see also* Benjamin H. Barton, *The Law School Crash*, CHRON. HIGHER EDUC., Jan. 3, , https://www.chronicle.com/interactives/20200103-LawSchoolCrash?cid=wsinglestory_hp_1 2020 (noting that in 1999–2000, about fifty-eight percent of law students paid full sticker price, but in 2018–19 only twenty-nine percent did); Mike Spivey, *An In-Depth Analysis of the 2019 Law School Admissions & Entering Class Data* (Dec. 15, 2019), https://blog.spiveyconsulting.com/aba-2019-data/ (noting that 73.3% of law students in 2019 were receiving scholarship aid; at forty-eight schools at least 90% of the students receive scholarships; and at five schools *all* students receive scholarship aid). It has been estimated that "aggregate annual tuition revenue for all accredited American law schools fell over $1.5 billion from its inflation-adjusted peak in 2011–12." Bernard A. Burk et al., *Competitive Coping Strategies in the American Legal Academy: An Empirical Study*, 19 NEV. L.J. 583, 583 (2018).

of property is what a willing buyer and a willing seller of property, negotiating at arm's length, would agree on as the price. Similarly, the fair market value of services is the price that a willing provider and a willing consumer of services would negotiate. Such a definition is inevitably fuzzy in its application, unless the property being transferred is publicly traded,[9] but it obviously cannot mean sticker price if only a few are paying that price.[10]

If you are not already convinced that sticker price is a misleading measure of value, imagine that (for some reason) a university raised its sticker price in all programs by $50,000, but each student continued to pay exactly the same amount in tuition.[11] If that were to happen, would anyone seriously think that an employee receiving a taxable full-tuition waiver would have an annual increase of $50,000 in income? That would be absurd; the increase in sticker price would have changed nothing of substance. The net revenue figure, which is what institutions should care about, would be the same.[12] There would be no additional value from the preposterously overstated waiver.

Using sticker price as the measure of value makes taxable tuition waiver programs much less attractive than they should be. That is obviously harmful to employees, but it also harms the institutions, which lose good students and perhaps good employees as well. A taxable tuition waiver leaves the "beneficiary" in a worse position—because of the tax imposed on the amount of the purported "waiver" (the tax on $30,000 in my example above)—than a person with equivalent credentials but no family connections to the university who receives a tax-free scholarship in the same amount. In that situation, the employee "benefit" might even be considered to have *negative* value. All other things being equal, well-informed students eligible for such waivers should probably go elsewhere for

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[9] I am aware of no publicly traded services.

[10] It is like the tag price when you can "Buy one suit and get two free." The tag may say $600 for one suit, but, regardless of what it says, you are in effect being offered three $200 suits for that price. If that is the case, the "discount rate" in the haberdashery context is zero.

[11] Many are puzzled why colleges and universities have sticker prices that substantially exceed what the average customer is going to pay and that, if folks take the numbers seriously, can deter good students from applying. What is the point of pretending to charge more than most potential students with acceptable credentials (or the parents of such students) will be willing to pay? (After all, an easy way to decrease the discount rate, if that really were a figure more important than net revenue, would be to reduce the sticker price, which a few schools have reluctantly done.) Several explanations have been advanced. To begin with, a high sticker price may bring in *some* additional revenue if a few students, including foreign students, actually pay that price. University finances might also be improved because it is presumably easier to convince a potential donor to create an endowment fund for student aid than to convince the donor to create a fund to pay for janitorial services (even though the annual income from both sorts of funds will be used for operating costs). In addition, apparently there is prestige value in having a high sticker price. (If a school says it charges as much as Harvard does, maybe—I guess—some folks think it must be as good as Harvard.) Besides, a student likes to be able to tell Mom and Dad (and potential employers) about receiving a big "scholarship." (One assumes, however, that parents are starting to figure out that most tuition reductions in the form of scholarships are a product of market forces and not their kids' inherited genius. Employers must also have become aware that many scholarships listed on job applicants' CVs do not mean much.)

[12] Even if the effect of doing so would be to increase the discount rate, it is generally better for an institution's bottom line to take an additional student who will pay $20,000 when the sticker price is $50,000, rather than to have the student go elsewhere. (That is true so long as the additional student will not create substantial additional costs.)

graduate school, where a tuition reduction can be characterized as a tax-free scholarship.[13] Well-informed potential employees also should go elsewhere if they are making their employment decisions on the assumption that graduate waivers will be wonderful for them and their families.

And not everyone is well informed, of course. Many disgruntled university employees around the country thought they were going to get terrific benefits from their universities' graduate tuition waiver programs—indeed, universities typically characterize the waivers as major benefits—until the employees saw how much additional tax was being withheld from their paychecks.[14]

In a world with differential pricing (that is, when the same service is provided to different customers at different prices, the norm at universities), there is no clearly right answer to the valuation question. I am inclined to think the average amount paid in tuition in a particular program would be a defensible figure to use as the value of a full-tuition waiver. If, despite a $50,000 sticker price, the average graduate student is paying $20,000 in tuition in the college of engineering, say, it makes more than a little sense to value a full waiver in that college at $20,000 (or a partial waiver up to $30,000 as zero). But I could be convinced that, in some cases, a different number would be better.[15] We can argue about what the "right" answer is in any particular situation, but some answers are clearly wrong. And mindlessly using sticker price—the $50,000 figure—to determine value is one of them.[16]

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[13] Tuition reductions provided to employees or family members of employees are generally not treated as tax-free scholarships under section 117(a) because, even though in form tuition waivers may look like scholarships, they are provided as compensation for the employees' services. *See* Treas. Reg. § 1.117-4(c) (excluding from the definition of "scholarship" a tuition benefit that is part of a quid pro quo arrangement). As a result, a university ought not to be able to circumvent the rules governing the taxability of graduate-level tuition waivers by recharacterizing tuition reductions to employees or their family members as "scholarships." Some universities do take the position that tuition reductions of that sort can be tax-free scholarships in at least some circumstances, and that might be right—but only if the awards are made with the schools' having no knowledge of the students' connection with university employees. In most cases, such an assumption seems unrealistic.

[14] I have spoken to such people. They are irritated at the result, of course, and also because their employers gave them no hint about the unhappy tax consequences. Those consequences might well have affected the decision about where to go to graduate or professional school.

[15] One critical question is who gets included in computing the average tuition actually paid—that is, the benchmark against which the value of any particular waiver might be measured. For example, should the comparison group include only American students, American students and foreign students not subsidized by their governments, some other subset of students, or all students without regard to subsidies from other sources?

[16] A referee commented, "The fact that universities are able to offer financial aid in the form of scholarships or institutional grants to supplement tuition payments—thereby creating a discount rate—does not mean that the value of the education being received is not reflected in the full sticker price. There are schools where aid is largely if not completely need-based. Why would donors to the university provide money for financial aid if they did not think the scholarships given to needy students reflected the value of the education those students received?" To begin with, not all tuition "aid" is funded, and unfunded aid is a financial-statement entry, nothing more. Moreover, the income from endowments for scholarships—funded scholarships—is used for the same purpose as tuition: to cover operating costs—paying for faculty, staff, heating, air conditioning, and so on. *See supra* note 11. Why do donors contribute for such purposes? To help the institution and to get a tax deduction, I suppose. Universities regularly claim, generally truthfully, that tuition does not cover all costs, but costs should have no bearing in determining the value of tuition waivers. For tax

I have been told by university officials that treating sticker price as value is the only way they can administer a waiver program. I disagree. Yes, they cannot be expected to make individualized determinations of value; that would be an administrative nightmare (and it is also not the way valuation is ordinarily done for tax purposes).[17] Yes, a $50,000 waiver is likely to have a different value than a $20,000 waiver in a particular program at a university,[18] but a $20,000 waiver in that program should have the same value, for tax purposes, to all students getting such a taxable tuition reduction.[19] In any event, any administrator knows the average discount rate for each constituent unit in his or her university. Using those data for valuation purposes would present no administrative problems whatsoever.

Besides, employers have to come up with valuation figures for all sorts of difficult-to-value taxable benefits—flying for personal reasons at no charge on the company plane or eating meals at no charge in the executive dining room, for example. A certain amount of arbitrariness may be necessary for such valuation "rules"—grand theorists might not be satisfied with the given answers in particular situations—but we have to do the best we can. And it is helpful when the Internal Revenue Service (IRS) provides guidance about acceptable valuation methodologies, either through regulations or subregulatory notices.[20]

I can see no reason why universities should not want to do better on the valuation issue. What is the downside of doing something that would make employees happier and make recruiting good students and employees easier?[21] Deans do get nervous when real dollars might be reallocated within a university

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purposes, value is what consumers are willing to pay, regardless of the costs incurred by the provider and regardless of how inherently valuable we might think education is.

[17] A system in which subjective value is controlling—so that taxpayers could always argue that property or services received are not worth much of anything *to them*—would clearly be unworkable.

[18] I use the word "likely" in that sentence because it could be that, in a particular situation, neither a $50,000 waiver nor a $20,000 one has any value at all.

[19] That is, administrators cannot possibly be expected to determine how much each waiver student would have been willing to pay in tuition had there been no waiver, and to value the waivers accordingly—student by student.

[20] *See, e.g.*, Treas. Reg. § 1.61-21(g) (setting out the "non-commercial flight valuation rule").

[21] Often the concern with valuing difficult-to-value, taxable fringe benefits is that some employers may try to undervalue the benefits, making employees happy but damaging the federal treasury. That is decidedly not the situation with taxable tuition waivers, however, and many universities seem to be totally unconcerned about the welfare of their employees. The federal treasury is the beneficiary of the overvaluation (except insofar as, because of the overvaluation, eligible employees decide to forgo the waivers offered by their home institutions).

A referee complained that I made no showing that "the need to pay taxes for the value of graduate courses (once they cost more than $5250 per year [*see supra* note 3]) is a deterrent to recruiting employees or having employees taking advantage of tuition remission programs." I have several responses to that claim. One is basic economics: you make something more expensive, and folks are, except in unusual circumstances, going to buy less of it. I know from personal experience that potential hires do sometimes ask about tuition waiver programs; such programs affect employment decisions. If the referee's point is that people generally do not take into account the taxability of waivers, I agree. But if that is so, it is because the employees or potential employees are clueless about tax consequences (and are not helped by the universities), and that is not a good thing. It is not unusual for employees to have buyer's remorse when a tuition "benefit" that seemed so wonderful results in an unexpectedly dramatic reduction in take-home pay. *See supra* note 14 and accompanying text.

system, but a change in valuation methods need not affect existing allocation schemes.[22] And I hope that no university is treating tuition waivers that result in little or no lost revenue as overhead costs for purposes of government grants. If that is not so—if Uncle Sam is "reimbursing" some universities for phony costs—that is a scandal in the making, not a reason to maintain an absurd valuation method.

Of course, the application of the rules should be as uniform as possible. No university wants to go it alone, in a publicly visible way, in challenging what has become a widespread practice. Any tax liability is ultimately the employees', but universities have withholding obligations, with penalties potentially applicable for underwithholding. University officials therefore want to be sure that the IRS will bless a more realistic valuation process. Popular perceptions to the contrary, the IRS can be reasonable, and it could be convinced by a concerted university effort on this issue. Or if the IRS has already been convinced by a few educational institutions that sticker price does not necessarily equal value, it should let everyone else know that—so the rest of the schools with graduate and professional programs can get on board.

[22] For example, if $30,000 attributable to a tuition waiver leads to real dollars' being shifted from the budget of one school in a university to another's or from the university's fringe benefits budget to that of the school in which the student beneficiary is enrolled, there is nothing in tax law that would prevent the university from continuing that policy—even if the real value of the waiver is little or nothing.