

If a Tuition Reduction Is Taxable, What's the Measure of Income?

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For many families and individuals, the price of a college education is the largest investment they will make. This article considers what the measure of income should be if a tuition reduction is taxable, and it challenges the idea that an educational institution's stated tuition figure should control in that determination. It's the value of the reduction, not the dollar difference between sticker price and the tuition actually paid by a particular student, that is potentially income, and the article suggests one reasonable method that might be used to determine that value. Although the focus of the article is on tuition reductions, the argument applies just as well to other situations in which a price reduction (or what in form looks like a price reduction) is taxable.

Introduction

The Tax Cuts and Jobs Act of 2017,¹ signed by the president in December 2017, was controversial, as any major piece of tax legislation is. Although it didn't survive the legislative process, one of the most controversial proposals included in the bill originally passed in the House, to repeal Section 117(d) of the Internal Revenue Code,² attracted enormous attention among administrators and graduate students at American colleges and universities.³

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¹ P.L. 115-97, 131 Stat. 2054. As has been noted repeatedly in these pages, that's not the official name of the Act. It was supposed to be the official name, but that name had to be discarded as part of the reconciliation process. (That's an indication, I suppose, of the seriousness, or lack of seriousness, of reconciliation.) In any event, that title continues to be widely used, and I'm going to use a shortened version ("Tax Cuts Act") to refer to the Act.

² H.R. 1, 115th Cong., 1st Sess., § 1204(a)(3), available at https://waysandmeansforms.house.gov/uploadedfiles/bill_text.pdf.

³ I'm going to use the terms "college" and "university" interchangeably, although the tendency these days is for lower-level institutions to change their names from Swamp College, say, to the University of Swamp. Apparently "university" is thought to have a cachet that "college" doesn't. (Dartmouth, Swarthmore, Williams, Amherst, and quite a few other prestigious institutions disagree.)

Section 117(d) deals with the taxability of tuition reductions that aren't scholarships.⁴ Among other things, it makes tax-free many tuition benefits ("qualified tuition reductions") provided by educational institutions to employees and the dependents of employees.⁵ A college employee who is getting a break on the tuition for his kids to attend that college is unquestionably being compensated for services, but, if Section 117(d)(1) applies, the tuition break won't be taxable to the employee (or to the kids).

The exclusion of Section 117(d)(1) generally doesn't apply to graduate tuition waivers, however; such waivers are usually not "qualified tuition reductions."⁶ But, in the public discussions about what became the Tax Cuts Act, one point of contention was that Section 117(d) contains a subsection (117(d)(5)) making graduate students who are "engaged in teaching or research activities," unlike other graduate students receiving tuition reductions, potentially eligible for the exclusion of Section 117(d)(1).⁷ If all of Section 117(d) had been repealed, however, Subsection 117(d)(5) would obviously have disappeared. Because of that, horror stories were rampant in the popular press and on university campuses that the repeal of Section 117(d) (together with a proposed simultaneous repeal of Section 127, making tax-free some benefits associated with "educational assistance programs" established by employers for the benefit of employees⁸) would have had catastrophic effects on graduate education in the United States.

Those using end-of-the-world rhetoric assumed that, if the repeal had been successful, almost all graduate student tuition reductions would have

⁴ "Qualified scholarships" aren't taxable to the student (or to anyone else) because of IRC § 117(a). It's generally understood that a scholarship is an award to a student that contains no quid pro quo (except perhaps for the student's having to continue to do well academically). A scholarship isn't compensation for anyone's services, and the grantor isn't expected to receive any particular benefit (except perhaps a feeling of pride) from awarding the scholarship. See Treas. Reg. § 1.117-4(c). If a university employee's kid pays less than full tuition because of Mom's employment with the university, that's not a scholarship. It's compensation to Mom, and it's taxable, unless the requirements of IRC § 117(d) are satisfied. (Because of IRC § 102(c), a transfer from employer to employee (or a transfer for the benefit of the employee) can't be treated as a nontaxable gift.)

⁵ See IRC § 117(d)(1).

⁶ See IRC § 117(d)(2) (defining "qualified tuition reduction" as potentially including only tuition reductions "below the graduate level").

⁷ See IRC § 117(d)(5) (providing that, "[i]n the case of the education of an individual who is a graduate student at [a qualifying educational institution] and who is engaged in teaching or research activities for such organization, paragraph (2) [see supra note 6] shall be applied as if it did not contain the phrase '(below the graduate level)'").

⁸ Like the repeal of IRC § 117(d), the repeal of IRC § 127 was provided for in the House bill. See H.R. 1, supra note 2, § 1204(a)(2). If certain requirements are met, IRC § 127 provides an exclusion of up to \$5,250 per employee for amounts paid or incurred by an employer in providing educational assistance to employees. Section 127 also survived the Tax Cuts Act.

become taxable, and, even worse, it was assumed that the measure of income would have been determined by each university's sticker price for tuition. If the nominal tuition for a graduate student at a particular institution is \$50,000, but graduate TAs or RAs pay no tuition, it was assumed each would have \$50,000 of income.

With respect to the first assumption, I've argued elsewhere why I think the concerns about a repeal of Section 117(d) were grossly overstated.⁹ Most graduate TAs and RAs would have had alternative justifications for excluding the benefit of a tuition reduction from gross income, and many graduate tuition reductions for students who aren't TAs or RAs are simply scholarships, for which Section 117(d) is irrelevant.¹⁰

It's the second assumption—that a school's sticker price should be used to measure income if a tuition reduction is taxable—that is the focus of this article.¹¹ That assumption is also misguided; indeed, it's inconsistent with basic principles of taxation. And the measure of income is an issue that has relevance far beyond the educational context: If a price reduction of any sort is taxable, what has to be included in the beneficiary's gross income?

The Measure of Income

Some graduate-level tuition reductions would have become (or would have remained) taxable with the repeal of Subsection 117(d)(5), and, even more important, the repeal of Section 117(d) would have made *undergraduate* tuition waivers—a major benefit for employees with college-age kids and therefore an important recruiting tool for colleges¹²—taxable, unless the tuition reduction is a scholarship.

So, for those tuition reductions that are taxable, what's the amount of income for tax purposes? The assumption in much of the commentary about Section 117(d)'s possible repeal was that the *dollar amount* of any tuition

⁹ See Erik M. Jensen, "Graduate Education and the Taxation of Tuition Reductions," 158 Tax Notes 1187 (2018).

¹⁰ IRC §117(a) controls. See *supra* note 4.

¹¹ I did discuss this issue in my first article. See Jensen, *supra* note 9. But here I expand on what I wrote before.

¹² Except for the big bosses, college staff generally aren't well compensated. But the possibility of being able to send the kids to college at little or no out-of-pocket cost (assuming the kids meet the school's admissions requirements) obviously helps attract some talented employees who would otherwise have signed on elsewhere. (It can help attract faculty as well.) Taxing the benefit would take much of the fun out of the arrangement, however, particularly if, as the rest of this article explains, the measure of income is exaggerated. If a tuition waiver at a college with a sticker price of \$50,000 were to result in gross income of \$50,000 to an employee, it might make economic sense to forgo the waiver, send the kid to another school, and pay tuition.

reduction, the difference between the sticker price and tuition actually paid, would become taxable. That's why graduate-level TAs and RAs were scared stiff: they thought a tuition waiver of \$50,000, say, meant that they (or their parents, if the tuition reduction is attributable to a parent's employment with the university) were going to be taxed on \$50,000 of income.¹³ There's no way most graduate students could afford a significant tax bill,¹⁴ unless the college became responsible for the students' tax liabilities (something that no college administrator would have been enthusiastic about).¹⁵

How Problematic Would Repeal Really Be? But the horrors of a Section 117(d) repeal are (or should be) less substantial than has been generally assumed. The idea that the measure of income associated with a tuition reduction is automatically the stated amount of the reduction is inconsistent with the way we usually think about income taxation.

When Tuition Benefit Is Compensation to the Student. To be sure, TAs and RAs should be taxed on the value of any tuition benefit that is compensation for teaching or research services required as a condition for getting the tuition reduction. But that's true whether or not Section 117(d)(5) is on the books.¹⁶ That point, too, was ignored in much of the discussion about Section 117(d)'s possible repeal.¹⁷ Ever since Section 117(d) was added to the Code, it's been clear that TAs and RAs who get a tuition break associated with their services should have some tax liability.¹⁸ And the same principle applies to

¹³ The TAs and RAs generally didn't do the legal analysis themselves. They accepted what they were told by others.

¹⁴ Besides, a tuition reduction provides no cash to pay any tax liability.

¹⁵ In addition, a college's paying a student/employee's tax bill would itself be income to the student. See *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929). To make the student whole, the college would have to gross up the amount of income.

¹⁶ See IRC § 117(c)(1) (providing that, with some exceptions, "subsections (a) [dealing with scholarships] and (d) [dealing with "qualified tuition reductions"] shall not apply to that portion of any amount received which represents payments for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship or qualified tuition reduction"). "Amount received" for teaching or research would obviously include any salary, but it should also include the value of any tuition reduction attributable to performing the research or teaching services. A college may characterize a tuition waiver as a scholarship or a qualified tuition reduction, but that characterization doesn't control for tax purposes to the extent the tuition benefit is in fact compensation for services on which the award is conditioned.

¹⁷ If some colleges have been ignoring the compensation aspect of tuition reductions for students who perform services required as a condition of the reduction, those colleges haven't been following the law.

¹⁸ Assuming, that is, that the total of otherwise taxable income exceeds the student's standard deduction and, when it was in existence, the personal exemption deduction. (The Tax Cuts Act increased the former and eliminated the latter.)

undergraduates required to perform services to get the benefit of a tuition reduction: there's income to the extent the tuition reduction is compensation for the required services. Presumably the amount of income should equal the value of the services performed, and that figure may well be lower than the total reduction in tuition.

For Non-Compensation Benefit, Consider Fair Market Value.

But even if a tuition reduction is taxable above and beyond any amount treated as compensation for required services, the measure of income should be the fair market value of the benefit, not the sticker price. What is in form a tuition waiver of \$50,000 isn't necessarily worth \$50,000, a principle that is obvious in other contexts. For example, if a used car dealer transfers a car, at no cost, to an employee—pretty clearly there's compensation for services in that case¹⁹—the measure of income should be the value of the car, not the price marked on the windshield.²⁰ The value isn't \$5,000 just because that's the amount the dealer would like to sell the clunker for. We all know that the \$5,000 is, for most car dealers, nothing but a starting point for negotiation, not a hard and fast price. It certainly isn't an incontrovertible measure of value.

Impact of Inflated Sticker Prices. The same can be said for stated tuition figures at most colleges in the United States. Of course every college would like to be able to get \$50,000 (or more) per year from each student, but the actual amount paid will, on average, be far less than that. College administrators talk about the “discount rate” for their tuition;²¹ a discount rate of 60 percent means that the college receives only 40 percent of the revenue it would have had if all students had paid the full sticker price. But most colleges couldn't come close to filling their entering classes with students paying the stated price, and those that could fill the class with full-paying customers would probably be unhappy with the academic credentials of many students. It's always been true that colleges have admitted students who pay less than the stated tuition figure, but it's particularly true now since, in the last few decades, sticker prices have gone up much faster than inflation. No one really expects very many students to pay full tuition these days.

Why—you might reasonably ask—would a university have an unrealistically high sticker price, when such a figure will inevitably scare

¹⁹ It can't be a gift. See *supra* note 4.

²⁰ I'm ignoring the possibility that part of the benefit might qualify as a qualified employee discount. See IRC § 132(a)(2), (c).

²¹ “Discount rate” is a buzzword in the education industry.

away a few high-quality applicants?²² Several reasons are generally given. Many foreign students do pay (or their governments pay) full freight, so it's thought to be necessary for a college to pretend that its real price is that higher figure. (Foreign governments are increasingly aware of this deception, however, and we can anticipate more pushback from those governments.) In addition, some prestige value is apparently associated with having a high sticker price. (If you pretend to charge as much as Yale, people might think you're as good as—or at least as prestigious as—Yale.²³) Besides, with higher and higher tuition figures, university administrators can, with straight faces, ask alums for donations to cover the “cost” of those tuition reductions.

Students don't necessarily suffer from ridiculous sticker prices either. They certainly don't suffer if they don't pay anything like the sticker price, and most don't. For the most part students know that the sticker price or the tuition reduction offered in the admissions package is just the starting point for negotiations. Tell the Swamp College admissions office that you'd really like to attend Swamp but Siwash has made a better offer, and the Swamp officials are likely to sweeten their offer. And students who get a “scholarship” for \$25,000, say—even if almost everyone in the student body gets a “scholarship” at that or a higher level—can put “C. Rupert Dibble Scholarship, 2017–2018” or something similar on their CVs.²⁴ The kids can also tell Mom and Dad, “Look, I got this great scholarship. You should be proud of me! And—hey!—I've saved you so much that you can get me a new car.”²⁵

All of that is to say that sticker prices are suspect measures of value. The used car dealer who sells a car marked \$5,000 for \$1,500 may say he has a discount rate of 70 percent,²⁶ but by definition he got full value for the car. (You know, the willing buyer, willing seller bit.) If the average student at Siwash University is paying only \$20,000–25,000, and maybe even less, when the tuition is supposedly \$50,000, that average price is a much better measure of fair market value than the sticker price. You may be able to come

²² At a minimum, it will terrify the parents of many potential applicants. Those parents might well tell their kids not to apply to the apparently expensive college.

²³ I've never met anyone who thinks like that, but I'm told such people exist.

²⁴ At least they can do that if C. Rupert Dibble has no skeletons that, in this day of the Internet, are marching out of his closet.

²⁵ The moms and dads of the world are catching on too, however. Many now know that almost everyone gets some sort of financial aid.

²⁶ Actually he wouldn't talk like that, but he'd make the same point using earthier language.

up with a more appropriate figure to use for tax purposes—I'd be interested in your thoughts—but, whatever number we agree on, it should be clear that \$50,000 isn't the right one. Universities ought to be able to come up with reasonable figures that would convince the Internal Revenue Service of the value of the benefit associated with a tuition reduction.²⁷

The valuation issue is more difficult for tuition reductions than it is for used cars. By its nature college tuition is effectively a differential pricing scheme: different prices are by design charged to different persons for equivalent services provided.²⁸ (In some circumstances, differential pricing would be illegal. This isn't one of them.) What's the value of the services being provided when there isn't a generally applicable price? There's no clearly right answer to that question, but I've convinced myself that using the average-tuition-paid figure makes sense—certainly more sense than focusing on sticker price.

Sticker price should be irrelevant, or nearly so, but, if you're still skeptical, one more illustration should close the deal. Suppose Swamp College doubles its stated tuition figure from \$50,000 to \$100,000, and nothing else changes. Every student pays exactly the same amount after the tuition increase as before. Surely no reasonable person would think that each student is getting an additional benefit of \$50,000 and that, if the "benefit" were taxable to the student or his parents, someone should have \$50,000 more in gross income. I'm sure that Swamp College would trumpet the resulting increase in its financial aid budget ("We guarantee every student a scholarship of at least \$50,000!"), but that's just academic puffing. Nothing of substance would have happened with the tuition hike and the offsetting increase in financial aid. (Indeed, the hike isn't really a hike and the scholarship increase isn't really student aid.)

As I noted earlier, it was graduate students who mobilized in opposition to the repeal of Section 117(d), as if the proposed repeal were directed at them. But if a typical graduate student at a university is paying little or no tuition—and that's the case for many, if not most, graduate students in the

²⁷ University administrators might argue—indeed, they do argue—that it would be impossible to administer a program in which the measure of value (assuming a tuition benefit is taxable) is anything other than the difference between sticker price and amount actually paid by the student. That's the easy way, but it's also the wrong way. In any event, the average tuition paid is a figure easily calculated and therefore easy to administer. I suspect almost every college financial officer in the country already knows the average tuition paid.

²⁸ As a result of bargaining, a used car dealer also might wind up charging two customers different prices for equivalent vehicles, but the numbers are likely to be in the same ballpark (unless one of the customers is an idiot).

arts, humanities, and social sciences today²⁹—why in the world would the value of a “tuition reduction” be treated as \$50,000 (or whatever figure constitutes the sticker price)? The right number (if there is such a thing) may not be zero, but it’s hard to see how \$50,000 is even arguably right.

A few people might be paying full sticker price—foreign students being supported by their governments, for example³⁰—just as a few buyers of used cars may stupidly pay a dealer’s initial asking prices. But that shouldn’t mean that the sticker price is automatically the value of the service or property for federal income tax purposes.

Conclusion

The question dealt with in this article—valuing a tuition reduction—is, in its details, peculiar to education, but the principles are of more general application. The measure of income, if any, on a taxable transfer of property or services is the value of the property or services. And the value of a price reduction might well not be the difference between the price that the transferor says he, she, or it wants to charge and the amount actually paid by the customer. If we know that negotiations are likely to result in an agreed-on price much lower than the sticker price, we should have to take that into account in measuring income.

²⁹ Charge graduate students in English \$50,000 in annual tuition, and an institution will have no graduate program in English. If a school is going to have graduate programs in subjects where potential earning power is limited, the institution can’t be expected to charge much in the way of tuition, whatever the official tuition figure is. And there are prestige reasons—membership in the Association of American Universities, for example—for a university to have a significant number of Ph.D. programs and to generate lots of Ph.D.s. See Association of American Universities, “Membership Policy,” available at <https://www.aau.edu/who-we-are/membership-policy>. Even prestigious business schools are cutting the “real” tuition for M.B.A. programs. See Kelsey Gee, “Hey, Bargain-Hunters: An M.B.A. Is Cheaper Than You Think” (Wall St. J., Jan. 3, 2018) (noting that for the Harvard Business School’s class of 2019, the average annual tuition paid is \$35,000, when the sticker price is \$72,000), available at <https://www.wsj.com/articles/hey-bargain-hunters-an-m-b-a-is-cheaper-than-you-think-1514988000>.

³⁰ As I noted earlier, however, foreign governments are increasingly resistant to accepting stated tuition figures as givens.



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