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Taxation of Prepaid Tuition Plans and the 1997 Tax Provisions--

Middle Class Panacea or Placebo? Continuing Problems and

Variations on a Theme

Eric A. Lustig[*]

> *Today, America faces growing uncertainty about its ability to compete. The world economy is more interdependent than ever before. If we are going to continue to compete we have to have a competitive education. There is no uncertainty in my mind that if you put American workers up against other workers of the world and they have a level playing field, they will come off very well. They remain hard, dedicated workers.*
>
> *But if we are going to continue to keep the standard of living up in this country and continue to improve it, then we have to improve our educational standards.*
>
> *Education remains the key to our nation's future economic prosperity. The educational opportunities available to future generations are going to determine the strength of our economy and ultimately whether our nation's standard of living will rise or fall. Education has always been a top priority for our country, but now it truly must be a top priority.*[1]

* * *

> *We must make the 13th and 14th years of education -- at least two years of college--just as universal in America by the 21st Century as a high school education is today, and we must open the doors of college to Americans. (Applause.) . . . Now, this [tax savings and deduction] plan will give most families the ability to pay no taxes on money they save for college tuition. I ask you to pass it--and give every American who works hard the ability to go to college.*[2]

I. Introduction

When initially drafted, the title of this article was "Taxation of Prepaid Tuition Plans--Middle Class Panacea or Placebo? Continuing *Uncertainty* and Variations on a Theme." In the interim between the original draft and the time of publication, a number of things occurred which necessitated significant changes to the article.[3] Although the new title merely substitutes the word "problems" for "uncertainty," the underlying message is perhaps deeper. What were at one time uncertain issues have become more permanent problems through administrative and legislative action. Another change in the title adds the education tax provisions proposed by President Clinton and enacted by Congress as part of the Taxpayer Relief Act of 1997. These proposals are driven by much of the same forces as those underlying prepaid tuition plans and are considered in that light. Accordingly, the subject matter presents something of a moving target.

As the American economy matures in the post-cold war era, various forces threaten one of the fundamental tenets of the "American Dream" -- affordable college education for America's children.[4] College tuition continues to "spiral"[5] while federal aid to colleges and universities decreases drastically as Congress attempts to narrow the once burgeoning budget deficit on the path toward a balanced budget. Moreover, state colleges and universities have been similarly affected by comparable budgetary problems at the state level. The rise in tuition has pressured students and their parents or other benefactors, as well as colleges and universities and state governments, to seek ways to alleviate the burden of rising tuition.[6] For some time, a number of savings programs have existed to address this problem at the state and federal levels such as college savings bond plans and educational savings bonds, respectively. Financing higher education continues to be a high profile issue as illustrated by the 1996 legislative changes, as well as President Clinton's education tax incentives which were subsequently enacted in the Taxpayer Relief Act of 1997 (the "1997 Act").[7]

This article addresses the continuing tax issues and policies attendant to one form of financing the costs of higher education -- prepaid tuition plans. These plans generally allow one to purchase tuition in advance for future use. One attraction of such a plan is that the purchaser can lock in tuition at present rates, thus protecting against inflation and other tuition hikes. Moreover, favorable tax treatment exists as the build up of benefits is generally tax-free to the purchaser, which provides a significant advantage over other savings programs. Although prepaid tuition plans have been in existence for a number of years,[8] they have become particularly noteworthy[9] in light of three recent developments, which will be addressed in this article. The first development involves the taxability of the plan's investment income in light of the recent case, *State of Mich. V. United States*[10] involving the Michigan Education Trust, and holding the trust exempt from tax on its annual investment income. Although the Sixth Circuit's divided opinion drew strong criticism, Congress essentially codified the result in new Internal Revenue Code Section 529, as enacted in the Small Business Tax Act of 1996.[11]

The second issue involves the question of whether the prepaid tuition contracts are contingent debt obligations, and as such, subject to the original issue discount rules. In recently promulgated regulations, the Treasury ruled that prepaid tuition plans are not debt subject to the original issue discount rules.

The final development very much reflects the prevailing political and policy winds flowing from the first two developments. This last development concerns President Clinton's recently-enacted education initiatives, which include a higher-education tax credit and an educational savings account.

This article begins with a background of higher education costs generally, as well as the tax issues relevant to educational expenses. It then focuses on the tax issues involved with prepaid tuition plans, particularly the taxability of the plans and the original issue discount question. The article examines the *State of Mich. V. United States* case and new Section 529 Qualified State Tuition Programs, as well as the 1997 Act education tax provisions.

From a policy view, the article considers the broader issues of aiming tax incentives at the middle class and what collateral effects may result. Issues include whether Congress and the President have succumbed to the politically expedient to the detriment of good tax policy.

The article concludes that providing tax advantages for prepaid tuition plans is misguided tax policy disguised as middle-class income relief, and the article proposes that tax incentives for higher education be made more equitable. In sum, the prepaid tuition plan tax provisions and other tax incentives are more a middle-class placebo than panacea.

II. Higher Education Costs in General

A. *Paying for College*

In considering prepaid tuition plans, it is instructive to begin by considering the forces that created them. As discussed below, the country, particularly the middle class, has been squeezed by increasing college costs and a poor history of savings. Added to that is the continuing debate over the use of the tax law to encourage education and savings. As a result of these pressures, a number of college savings plans and federal tax incentives have recently emerged.[12]

1. Spiraling Costs

College costs have spiraled in the last fifteen years or so.[13] Higher education costs are paid for in a limited number of ways. Expenses may be covered by student loans or financial aid. For example, Pell Grants are need-based financial awards which are limited in amount.[14] Another form of aid is through subsidized student loans under the Stafford loan program.[15] Under this program, the federal government guarantees payment of the loan and subsidizes the interest payments.[16] The guaranteed loan program is need-based as well.[17] Moreover, a student might receive assistance through a scholarship award. Another form of funding, and perhaps the primary source,[18] comes from the savings of the student's family.

Rising college costs potentially affect the financing of higher education expenses in several ways. Perhaps the most obvious is to increase family savings for college.[19] Other possibilities include increased financial aid, "income-contingent loan programs," and controlling costs.[20] Of course, a most unpalatable consequence would be that some students would be precluded from going to college as a result of the higher costs.[21] While these alternatives may all be quite plausible, this article focuses on increasing savings, particularly through tax incentives.

2. Saving for College

To what extent should the government, state or federal, encourage saving for college?

> That government has a legitimate role to play in improving the accessibility of higher education is not a claim that needs extended defense. Even in the narrowest economic terms, an argument can be made that educational investments generally pay returns more than equal to their costs, and that without government intervention difficulties in paying for education would certainly lead to underinvestment by potential students.[22]

As a starting point, it seems a laudable goal that students and families should save for college expenses. Yet, lurking beneath this concept are several layers of policy issues that make it far more problematic. For example, there are "inter-generational" attitudes as to whether parents or children should bear the responsibility of paying for college. Moreover, socioeconomic class warfare issues arise with any role to be played by the government, whether direct or indirect:

On the one hand, parents expect students to be more responsible for their own education; and taxpayers are increasingly reluctant to finance government efforts to subsidize less privileged members of society, fearing that the poor may be getting something for nothing. On the other hand, knowing that subsidies do exist, everyone wants the opportunity to partake of them. Members of the middle- and upper-middle-class expect public assistance and feel cheated if it is limited to the "truly needy."[23]

In addition to the policy issues raised by the question of whether the government should encourage savings for college are issues of whether such encouragement is at all effective. This is more complicated by further questions of how families save for college. The data suggest that little is known as to how much families save for college, although what information there is suggests that any saving is a modest amount.[24] Another issue is the measurement of savings. For example, should the increase in value of a family's residence be counted as savings?[25] Understanding these savings patterns, to the extent possible, is necessary for analyzing college savings plans and how much government should encourage them.

In examining family saving patterns, two problems emerge.[26] The first problem, which generally applies to the middle class, is that families do save, but the assets that represent savings are not easily converted to pay college expenses.[27] For example, a family might have significant equity in the family house, but is unwilling to sell the house to pay for college. Of course, the family might be able to borrow against the equity.[28] The second problem, which is more applicable to lower income groups, is simply that many families are unable to save for any reason.[29] Moreover, there is a significant disparity cutting across racial lines, with African-American and Hispanic households saving substantially less relative to white families.[30]

While the data is far from conclusive as to how families save for college, two things seem abundantly clear and need to be considered in examining the government's role in sponsoring savings. First, family saving differs markedly among different socioeconomic and ethnic groups. In addition, middle-class families' savings are often invested in non-convertible assets.

B. *Tax Issues in Paying for Higher Education*

Saving for and paying college expenses raise several tax issues. The first is whether such expenditures are deductible, or in other words, subsidized in part by the government through the reduced tax liability resulting therefrom.[31] Historically, such expenditures were not deductible.[32] Another issue concerns the taxability of financial aid and scholarship awards. To the extent that financial aid represents a student loan, such loan is tax neutral. A scholarship is generally includible, unless it meets certain statutory criteria. The final issue involves the tax consequences related to various college savings plans. The tax incentives associated with savings plans are particularly important given the general non-deductibility of educational expenses.

1. Deductibility of Higher Education Expenses

Historically, the cost of tuition and other expenses of higher education have generally not been deductible under the tax law.[33] This non-deductibility was based on treatment as personal expenses,[34] as opposed to business-related expenses. [35] Alternatively, education expenses were viewed as non-deductible capital expenditures.[36]

In limited circumstances, however, deductions for educational expenses were allowed. Under Treasury Regulations, deductions are allowed for educational expenditures that either maintain or improve skills required in the taxpayer's employment or meet the express requirements of the individual’s employer or applicable law.[37] Deductible expenditures may not, however, fall within either of two negative provisions. Thus, even if an expenditure maintains or improves skills, a deduction is not allowed if the expenditure "meets the minimum educational requirements for qualification in the [taxpayer's] employment or other trade or business."[38] Neither is a deduction allowed to the extent an expenditure qualifies the taxpayer for a new trade or business.[39] Accordingly, college expenses leading to a bachelor's degree were generally not deductible because they either meet the student's minimum job requirements or qualify her for a new trade or business.

The non-deductibility of educational expenditures has attracted substantial criticism by those who argue that higher education expenditures should be capitalized and recovered through amortization deductions.[40] As discussed in Part II of this article, limited credit is now provided under the Taxpayer Relief Act of 1997.[41]

2. Taxation of Scholarship Awards

The Code excludes certain scholarships from income.[42] Prior to 1986, the rules were far more liberal.[43] As a result of the base broadening provisions of the Tax Reform Act of 1986, the rules were tightened so that only payment for tuition, fees, and required books paid to qualified candidates are excluded.[44]

3. Taxation of Student Loans

The recipient of a loan does not realize income for tax purposes because there has been no accession to wealth as there is a corresponding obligation to repay the loan.[45] Thus, when a student receives a student loan there are no tax consequences upon receipt. Upon repayment of the principal amount of the loan, there are also no tax consequences to the student.[46] Prior to the Tax Reform Act of 1986, however, the interest portion was generally deductible under Section 163(a). Currently, no deduction for personal or consumer interest is allowed.[47]

One exception to the general non-deductibility of personal interest survived the 1986 changes. Where a taxpayer refinances his or her principal residence, interest on such debt is deductible.[48] Thus, a taxpayer who refinances his or her house to pay for college costs, is able to deduct interest on the repayment of the debt.[49] As discussed in Part IV of this article, Congress restored a limited deduction for interest on student loans.[50]

4. Tax Incentives to Promote Saving for College

When prepaid tuition plans were created, tax incentives already existed for financing higher education expenses. At the federal level, for example, income from redemption of certain savings bonds is exempt if used for "qualified higher education expenses."[51]

The rising cost of a college education has pressured many Americans, particularly those in the middle class. Escalating tuition has been exacerbated by the fact that Americans have historically had problems saving for college. The growing pressure has resulted in the creation of state prepaid tuition plans as well as limited tax incentives for college savings.

III. Prepaid Tuition Plans--Operation and Taxation

A. *Prepaid Plans in General*

1. Background and Types of Plans

State prepaid tuition plans allow one party, generally the beneficiary's parent, relative or friend, to purchase tuition benefits for the beneficiary.[52] Although the various plans differ somewhat, they generally follow one of three models.[53] The first model follows the Michigan plan.[54] Under this model, the purchaser contracts to buy a "predetermined amount and type of tuition benefits,"[55] such as a number of years tuition at a state community college or university. For example, one might purchase a prepaid tuition contract for four years at state university. The purchase price would depend on the age of the beneficiary at the time of the transaction. The older the beneficiary, the higher the cost, and the younger the beneficiary, the lower the cost.[56]

Another model follows the Ohio plan.[57] The Ohio model allows a purchaser to open a prepaid tuition account with an initial minimum purchase.[58] Additional tuition benefits may be purchased incrementally in units of credit hours or smaller.[59] Unlike the Florida model, in which the price of the plan varies with the beneficiary's age, the price of the Ohio model does not.[60]

2. The Massachusetts Twist--The U.Plan

The third, and newest, form of prepaid tuition plan is the Massachusetts "U. Plan." The U. Plan differs from the Florida and Ohio models in several ways. The first difference concerns its form. Purchasers buy a "tuition certificate" which is based on general state obligation bonds. The tuition certificates are redeemable against tuition at any of the participating institutions. The tuition certificate represents a percentage of a year's tuition at one of the participating institutions fixed at the date of purchase. Another difference is that the Massachusetts plan is applicable at a wide variety of institutions, public and private alike.[61]

The Massachusetts U.Plan represents a relatively new twist on the standard prepaid tuition plan. The U.Plan began operations in 1995 under the auspices of the Massachusetts Educational Financing Authority ("MEFA") as a way to assist working-class and middle-class families save for college.[62]

Under the plan, participants purchase tuition certificates, the proceeds from which are invested in state bonds.[63] The tuition certificate is purchased in a denomination of at least $300. The purchaser must also designate a maturity date. Under the plan, the holder of a certificate may redeem it for a predetermined percentage of tuition and mandatory fees at a participating institution.[64]

Thus, for example, purchaser buys a $1,000 tuition certificate today for a maturity date of 2016. If the $1,000 represents 5 percent of the present tuition of $20,000 at college *A* and 10 percent of the present tuition of $10,000 at college *B*, then the holder of the certificate may use the certificate in 2016 to pay 5 percent of the tuition at college *A* and 10 percent at college *B*, even if tuition at that point is $50,000 at each institution. In the unlikely event that the tuition has not increased in that time period, or if the holder does not go to college, the certificate may be redeemed for the principal amount plus a return based on the compounded annual increase in the Consumer Price Index ("CPI").[65] When the certificate is redeemed for tuition, the participating institution receives the underlying state bond plus a return of the CPI plus two points.[66] Thus, the risk of investment, as to the CPI plus two points, is borne by the Commonwealth and backed by its full faith and credit.[67] The risk of tuition increases beyond the CPI plus two points, however, is borne by the institution.

Participants sign up during the annual enrollment period, which is March 1 through April 30. There is a one-time processing fee of $25, and a processing fee of 1 percent of the purchase price of the tuition certificate. Participation in the plan is sold through the branches of Fleet Bank, a large New England bank.[68] The plan boasts and impressive number and variety of participating institutions.[69] Moreover, the plan is financially accessible, with a minimum investment of $300, lump sum or in monthly payments of $25.[70]

To date, the U.Plan has been quite popular. In 1995, its first year of operation, over 28,700 participants enrolled and $26 million of bonds were purchased.[71] The average purchase was for $1,600.[72]

The tuition certificates, underlying bonds and income derived therefrom is exempt from state taxation imposed in Massachusetts.[73] The federal tax treatment was somewhat less certain as the offering materials state: "The Program is unique in its structure and therefore there is a lesser degree of certainty about its federal income tax consequences than is ordinarily the case in Commonwealth bonds."[74]

B. *Taxation of Prepaid Tuition Plans*

Apart from the tuition guarantee, prepaid tuition plans originally relied on favorable tax treatment in order to be competitive with other forms of college savings. The expected favorable tax treatment allowed the prepaid tuition plans to have lower investment returns in order to result in a competitive after-tax return.[75] This section of the article examines these tax issues. First, the article discusses how the investment income of the plan is taxed. This issue is first addressed under the law prior to Section 529 and then addressed under that section. Also considered is the taxation to the beneficiary of the plan. The article then addresses whether the prepaid tuition investment is a contingent debt obligation subject to the original issue discount rules.

1. Pre-Section 529 Treatment --*State of Mich. v. United States*

Although the taxation of prepaid tuition plans is now largely controlled by the provisions of Code Section 529 Qualified State Tuition Programs, it is helpful to first examine the developments leading up to the enactment of Section 529. That section essentially codified the holding in *State of Mich. v. United States*.[76]

Initially there were thought to be three potential sources for exempting or excluding from tax the income earned by prepaid tuition plans. First, the Internal Revenue Code does not apply to states *qua* states.[77] In addition, income from any state or political subdivision is excluded from federal income tax.[78] Also potentially applicable is the exemption from income tax for tax exempt educational organizations.[79]

The only prepaid tuition tax case to date was decided by the United States Court of Appeals for the Sixth Circuit.[80] Because the Michigan plan was the prototype program and, more importantly, because of its status as the only decided case, it provides a good vehicle through which to examine the tax issues relevant to prepaid tuition plans.

In *State of Mich. v. United States*, the Sixth Circuit held that the state-sponsored prepaid tuition plan, the Michigan Education Trust ("M.E.T.") was not taxable on the income earned by the trust.[81] Accordingly, the yearly investment build-up in the plan is not taxable.

The M.E.T. resulted from pressure placed on the state government to provide assistance to help parents pay for their children's educations.[82] Michigan has long made education a fundamental principle of state government.[83] The Michigan legislature created the M.E.T. in 1986 as a "public body corporate and politic."[84] In the enacting legislation, the legislature proclaimed the following purposes for the act:

> (a) To encourage education and the means of education.
>
> (b) To maintain state institutions of higher education by helping to provide a stable financial base to these institutions.
>
> (c) To provide wide and affordable access to state institutions of higher education for the residents of this state.
>
> (d) To encourage attendance at state institutions of higher education.
>
> (e) To provide students and their parents economic protection against rising tuition costs.
>
> (f) To provide students and their parents financing assistance for postsecondary education at a Michigan institution of higher education of their choice.
>
> (g) To help provide the benefits of higher education to the people of this state.
>
> (h) To encourage elementary and secondary students in this state to achieve high standards of performance.[85]

Under the plan, the M.E.T. and party paying on behalf of the beneficiary entered into an "advance tuition payment" contract.[86] The contract provided that the purchaser pay a sum based on "various actuarial assumptions and forecasts," in return for which the M.E.T. is obligated "to pay the beneficiary's full tuition cost, whatever that cost turns out to be."[87] The plan also provided for refunds in the event that the beneficiary decides either to attend a private college or not attend college at all.[88]

The Michigan Educational Trust Act also required that certain regulatory steps be taken prior to the sale of any contracts. Accordingly, the M.E.T.'s status under the federal securities law was required to be determined.[89] Moreover, the act required that the M.E.T. receive a ruling from the Internal Revenue Service that the trust's income be tax-free to the purchaser:

> An advance tuition payment contract shall not be entered into by the trust until the internal revenue service has issued a favorable ruling or opinion that the purchaser of the advance payment contract will not be considered actually or constructively to be in receipt of income.[90]

The M.E.T. received a "no action" letter from the Securities Exchange Commission ruling that the M.E.T.'s contracts, if securities, would be exempt from registration under federal securities law.[91] The tax ruling, however, proved to be far more problematic. The Michigan State Treasurer requested a ruling from the Internal Revenue Service ("IRS") as to whether the M.E.T.'s annual income was excluded from tax under Section 115 of the Internal Revenue Code, as well as the tax treatment to the beneficiary upon receipt of the benefits.[92] The IRS ruled that the M.E.T. was not an integral part of the State of Michigan[93] because it operated independently of the state and the M.E.T.'s funds were not subject to the claims of Michigan's creditors, nor were the funds considered cash of the state.[94] In addition, the IRS ruled that M.E.T.'s income was not excluded under Section 115(1) because it benefitted the private interests of its beneficiaries.

Changing its course, the M.E.T. applied to the IRS for tax exempt status under Section 501(c)(3).[95] The IRS subsequently denied the M.E.T.'s application,[96] at which time the M.E.T. paid income tax for 1989 and claimed a refund from the IRS. After the IRS allowed the claim to lapse, the M.E.T. followed the prescribed procedures and filed a suit for refund of income taxes in United States District Court for the Western District of Michigan.[97] The M.E.T. argued the same issues that it did in its ruling request; namely, that the Internal Revenue Code did not apply to it because the trust was part of the State of Michigan, and in the alternative, that Section 115(1) excluded M.E.T.'s income from tax.[98] In addition, the M.E.T. raised a number of constitutional arguments.[99]

The district court held against the M.E.T. concluding the trust was taxable.[100] The court rejected the M.E.T.'s argument that it was not subject to the Code because the trust was not an "integral part of the State of Michigan."[101] Specifically, the court held this because Michigan could not use the M.E.T.'s funds to pay the state's creditors, nor were the M.E.T.'s contracts backed with Michigan's full faith and credit.[102] The court similarly dismissed the trust's claim that Section 115(1) excluded the M.E.T.'s income from tax because the income did not accrue to the State of Michigan:[103]

> Income "accrues" to a state for purposes of Section 115 when some kind of actual or bookkeeping transfer of funds occurs. That is, a state or political subdivision of a state must have a "vested right" or an "enforceable claim" to the income.[104]

Because Michigan had no claim to the trust's assets or investment income, the income did not accrue to the state within the scope of Section 115(1).[105]

The M.E.T.'s argument that it was a tax-exempt organization under either Section 501(c)(3) or 501(c)(4)[106] was also dismissed by the district court. An organization's tax-exempt status will be lost if there is any "substantial non-exempt purpose."[107] The court rejected the trust's position that the benefits to the purchasers of the M.E.T. contracts were "incidental to the broader benefits gained by society at large in the form of a well-educated populace."[108] Rather, the court held that the tuition guarantee was a "substantial private purpose," which destroyed the trust's tax exemption.[109]

On appeal, the Sixth Circuit reversed the district court's decision.[110] The Sixth Circuit held that the M.E.T. was an integral part of the State of Michigan and accordingly, not subject to the Internal Revenue Code.[111] Accordingly, the court did not reach the trust's alternative arguments as to Sections 115(1), 501(c)(3), and 501(c)(4).[112] The Sixth Circuit found error in the district court's finding that the M.E.T. was not an integral part of the State of Michigan or political subdivision thereof.[113] The court liberally applied a broad construction of the term "political subdivision" from Section 103, [114] which generally excludes from income interest from state and local obligations:

> The term "political subdivision" is broad and comprehensive and denotes any division of the State made by the proper authorities thereof, acting within their constitutional powers, for the purpose of carrying out a portion of those functions of the State which by long usage and inherent necessities of government have always been regarded as public.[115]

The Sixth Circuit loosely interpreted this test as requiring that the "'activities of the subdivision were for a public purpose.'"[116] The court reasoned that encouraging higher education clearly was a public function.[117] In sum, the court viewed the issue as one better left to Congress, "[w]e conclude that while Congress could, if it wished, tax the investment income of state agencies such as the education trust, it has not chosen to do so."[118]

In a strong dissent, Judge Guy agreed with the district court. Judge Guy began his dissent noting the extremely political tone of both the M.E.T. and the case:

> I also would place more of a political overlay on the analysis of these issues than does the [majority]. However well intentioned it may sound to put into a place a program guaranteeing parents affordable college tuition in the future for their children, the engine driving this program was in no small degree plain old partisan politics. Fifty-five thousand persons signed up for this program, and I assume that most of them were registered voters.[119]

Moreover, Judge Guy acknowledged the fiscal problems of the M.E.T. and the importance of a victory for the trust, which had stopped accepting applications two years after its start:

> Parents who signed a contract with MET essentially were buying an annuity. They would put "X" dollars up front, and over time the interest earned would allow the fund to grow and keep pace with projected increases in college tuition. If it was this simple, why didn't parents just buy an annuity on the open market to accomplish the same result? The answer is that no private company could offer an annuity at the attractive price at which it was being offered by MET. MET was able to undercut the market for two reasons. First, in my view, MET proceeded imprudently on the assumption that its earnings would continue at the abnormally high rate that State investments had been earning. Second, unlike a private company, MET had the luxury of underestimating the rate of future tuition increases.

. . . .

> Although the [MET's] shortfall was primarily the result of less return on investment than anticipated and greater increases in tuition than contemplated, nothing could be done about these two factors. *The only adjustment that hopefully could be made was to secure tax-exempt status, notwithstanding that MET had been told from the start by the IRS that it would not qualify for tax-exempt status, a ruling MET accepted. MET was forced by financial pressure to revisit this issue, however, and instituted this lawsuit.*[120]

As to substantive issues, Judge Guy pointed out that determining whether an entity is an "integral part" of a state depended on a six-part test:

> (1) whether it is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses.[121]

While the M.E.T. had an undeniable connection with the state because it was created by Michigan and its board members were selected by the governor, in Judge Guy's opinion, it was not an integral function of the state.[122] The M.E.T. at a minimum failed to meet requirements (3), (4) and (6) because the purchasers' substantial private interests were involved as a result of the beneficiaries' receiving the benefit of prepaid guaranteed tuition.[123] Moreover, as an independent entity, the M.E.T. was not controlled or supervised by the state.[124] In addition, the M.E.T. was financially "autonomous" from the state because the trust's funds were not commingled with the state's other funds and thus not subject to being "raided" for state shortfalls.[125]

Judge Guy also rejected the M.E.T.'s assertion that its income was excluded from tax under Section 115(1).[126] The distinction, in Judge Guy's opinion, was between essential governmental function and those of a private character.[127] Although in agreement with the district court's holding that the Section 115(1) was not applicable because the trust's income did not accrue to the state, Judge Guy also challenged whether the M.E.T. performed an essential government function. While not disputing that higher education was an essential government function to the state of Michigan, Judge Guy noted that providing tuition prepayment programs to those able to afford it was not necessarily an essential government function.[128] To the contrary, Judge Guy argued, the M.E.T. engaged in the function of investing money, a "quintessentially private function."[129] Judge Guy rejected the trust's argument, in part, because the state did not put its full faith and credit behind the program:

> I might take this argument more seriously if the State pledged its full faith and credit to the MET program, because then the State would suffer direct and measurable harm if the program failed. The state provides no such guarantee, however. Instead, the legislature at its discretion can decide to bail out the Trust if it becomes actuarially unsound. Thus, MET's pledge to purchasers is chimerical. It is not bottomed on any state guarantee, but rather on wise investment strategies and the correctness of its financial assumptions to ensure the continued soundness of its guarantee.[130]

2. *State of Mich. v. United States* Aftermath--Section 529 Qualified State Tuition Programs

a. Congressional Action--The End of Uncertainty

Notwithstanding the Sixth Circuit's decision in *State of Mich. v. United States*, a great degree of uncertainty existed as to the taxation of prepaid tuition plans. The reasoning of the divided Sixth Circuit Court drew criticism,[131] although the Solicitor General's office declined to appeal the case to the Supreme Court.[132] Moreover, the IRS refused to issue rulings in a number of requests submitted by various plans,[133] and eventually announced a no-ruling policy while it further studied prepaid tuition plans.[134]

Administrative uncertainty yielded to legislative action as the Small Business Job Protection Act of 1996 was amended to exempt state tuition plans from tax:

> The [Senate Finance] Committee believes that it is appropriate to clarify the tax treatment of State-sponsored prepaid tuition and educational savings programs in order to encourage persons to save to meet post-secondary educational expenses.[135]

President Clinton subsequently signed the bill into law.[136]

b. New Section 529

Code Section 529 establishes a new type of entity exempt from taxation--the Qualified State Tuition Program. In addition, Section 529 creates a complex statutory scheme implementing the exemption.

A Qualified State Tuition Program is exempt from income taxes, although it is subject to the unrelated business income tax.[137] Section 529(b) defines Qualified State Tuition Program as follows:

> Qualified State tuition program. For purposes of this section--
>
> (1) In general. The term "qualified State tuition program" means a program established and maintained by a State or agency or instrumentality thereof--
>
> > (A) under which a person--
> >
> > > (i) may purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary, or
> > >
> > > (ii) may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account, and
> >
> > (B) which meets the other requirements of this subsection.[138]

Qualified higher education expenses are defined as follows:

> (3) Qualified higher education expenses. The term "qualified higher education expenses" means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution.[139]

In addition to the general definitions, the new section provides a number of operating rules which must also be met. First, contributions to the program may be made only in cash.[140] Moreover, neither the contributor nor the beneficiary may direct the investment decision of the trust.[141] Additionally, an interest in a Qualified State Tuition Program may not be pledged as security for a loan.[142] Furthermore, the program must set forth a separate accounting for each beneficiary.[143]

Because of the obvious temptation for abuse of the tax exemption, Section 529 also provides measures to guard against overfunding the program. Thus, a Qualified State Tuition Program must provide "adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary."[144] Furthermore, a Qualified State Tuition Program must provide a "more than de minimis penalty" on refunds of benefits not used.[145]

Section 529 also imposes a reporting responsibility on Qualified State Tuition Programs by requiring them to report distributions.[146]

c. Tax Consequences to the Beneficiaries of Prepaid Tuition Plans

Section 529 essentially codifies the holding of *State of Mich. v. United States* by providing that neither the contributor nor the beneficiary is taxed on the annual earnings of the plan.[147] Moreover, a contribution to the plan is not considered to be a taxable gift to the beneficiary.[148]

Upon distribution, the beneficiary is taxed in the same manner as an annuitant receiving a benefit under Section 72:

> Distributions. (A) In general. Any distribution under a State qualified State tuition program shall be includible in the gross income of the distributee in the manner as provided under section 72 to the extent not included from gross income under any other provision of this chapter.
>
> > (B) In-kind distributions. Any benefit furnished to a designated beneficiary under a qualified State tuition program shall be treated as a distribution to the beneficiary.

. . . .

> > (D) Operating rules. For purposes of applying section 72--
> >
> > > (i) to the extent provided by the Secretary, all qualified State tuition programs of which an individual is a designated beneficiary shall be treated as one program.
> > >
> > > (ii) all distributions during a taxable year shall be treated as one distribution, and

> (iii) the value of the contract, income on the contract, and investment in the contract shall be computed as of the close of the calendar year in which the taxable year begins.[149]

The annuity rules generally require that an annuitant allocate annuity payments between income and recovery of basis or investment.[150] This is generally done based on a pro-rata allocation of the investment over the amount expected to be recovered, according to mortality tables published in the regulations. Accordingly, the beneficiary of a prepaid tuition plan is taxed on the difference between the value of the benefits received and the allocable cost of the plan to the purchaser.

C. *Applicability of Original Issue Discount Rules*

Another tax issue that was unresolved until recently was whether prepaid tuition plans are subject to the original issue discount rules of the Code.

1. Time Value of Money Rules in General

The Code recognizes conceptually that the use of money has value.[151] These rules fall within the umbrella of the original issue discount ("OID") rules. The OID rules essentially seek to recast the transaction by imputing interest when none is expressly provided. For example, assume that corporation *A* issues for $1,000 a ten-year bond with a face value of $1,000 bearing a 9 percent interest rate, payable semi-annually. Accordingly, corporation *A* pays $450 to the bondholders twice a year. The bondholders must include these payments as interest income.[152] Assume further that instead of bearing interest, the bond is issued with no explicit interest rate. This type of bond is often referred to as a "zero-coupon bond."[153] Obviously, no rational purchaser would pay $1,000 for the bond. Rather, the purchaser would demand to be compensated in some form for the use of her money over the ten-year term of the note. Assuming that the prevailing market rate for a bond such as corporation *A*'s is 9 percent (compounded semi-annually), a willing buyer would purchase the bond for $415, which is the present value of $1,000 payable in ten years, with a 9 percent discount rate compounded semi-annually.[154] Thus, if the purchaser deposited the $415 in a bank account paying 9 percent interest (compounded semi-annually), the purchaser would receive an interest payment of $18.67 ($415.00 x 4.5%) after six months. Assuming that the purchaser adds the interest payment to the savings deposit, the next interest payment would be $19.51 (($415.00 + $18.67) x 4.5%). The account would grow to $1,000 after ten years.[155] Economically, the difference between the $1,000 face value and the $415 present value represents interest. The OID rules aim to recast transactions to adequately reflect the impact of the time value of money.

The OID rules require, *inter alia*, that the holder of a "debt instrument" having original issue discount include an amount allocated for each day of the taxable year, thereby allocating the OID over the term of the instrument.[156] The Code defines "original issue discount" as "the excess (if any) of the stated redemption price at maturity, over the issue price."[157] The issue price is generally the amount paid for the instrument.[158] The "stated redemption price at maturity" basically is the amount to be paid at the end of the instrument's term.[159]

2. Are Prepaid Tuition Plans Debt Instruments Subject to the OID Rules?

Until recently, it was unclear whether prepaid tuition plans were subject to the OID rules. Notwithstanding the outcome of *State of Mich. v. United States* if the plans were subject to the OID rules, the annual difference between the face value of the interests in the plan (presumably the amount that would be available for tuition) and the present value of the payments would be potentially subject to tax. This issue turns on whether a prepaid tuition plan interest is a debt instrument for purposes of the OID rules.

The Code very generally defines a debt instrument for purposes of the OID rules as "a bond, debenture, note, or certificate or other evidence of indebtedness."[160] The regulations further expand on this by defining a debt instrument as "any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or loan)."[161] The proposed regulations provided for OID treatment with respect to "contingent" payments.[162] Under the proposed regulations, interest income, including OID, on contingent payment debt instruments, must be determined by the "noncontingent bond method," which generally requires that a projected schedule be developed, which includes all payments, contingent and noncontingent. The excess of the payments over the issue price is OID.[163]

Early comments by the Treasury Department indicated that it was considering including prepaid tuition plans within the scope of the contingent debt proposed regulations. The issue evolved into a lobbying battle between the state prepaid tuition plans and the College Savings Bank of Princeton, New Jersey, the sellers of the "College Sure CD" college savings plan, which is a private plan subject to the OID rules and accordingly does not provide any tax advantages to its holders.

The state prepaid plans argued that they should not subject to the contingent debt proposed regulations because they are providing an educational service contract rather than a debt instrument.[164] The College Savings Bank, on the other hand, asserted that the prepaid plans are simple investment devices, which are similar to other debt instruments and as such, are subject to the contingent debt proposed regulations.[165]

In June of 1996, the final regulations on contingent debt obligations were promulgated. The final regulations resolved any past uncertainty in favor of the state tuition plans. The regulations expressly excepted prepaid tuition plans from OID treatment. Indeed, even if prepaid tuition plans are considered to be debt contracts, the regulations specifically do not apply.[166]

With the enactment of Section 529 Qualified State Tuition Program and the Treasury's promulgation of the final contingent debt obligation regulations, much of the uncertainty previously surrounding prepaid tuition plans has disappeared. The annual build-up of investment income to the plan is generally exempt from tax, and the beneficiary will include income in the year tuition benefits are received measured as the difference between the value of those benefits and their cost. In addition, the OID rules are generally not applicable to prepaid tuition plans, so that the ultimate difference between the value and cost is deferred until that point when the benefits are used.

Perhaps not unexpectedly, given the lowering of the various hurdles, states have responded positively to the end of the tax uncertainty--thirty-two states are at some stage of planning, developing or considering prepaid tuition plans.[167]

IV. The 1997 Act Education Tax Provisions

Close on the heels of the enactment of Section 529 Qualified State Tuition Programs, President Clinton renewed his education tax proposals, specifically targeting the middle class:

> Well educated workers are essential to an economy experiencing technological change and facing global competition. The Administration believes that reducing the after-tax cost of education for tax credits and deductions will encourage investment in education and training while lowering tax burdens on middle-income taxpayers.
>
> The expenses of higher education place a significant burden on many middle-class families. Grants and subsidized loans are available to students for low- and moderate-income families; high-income families can afford the cost of higher education. The combination of Federal grants and a tax credit reduces the after-tax cost of higher education expenses by reducing the after-tax cost of higher education. This guarantee will help make 14 years of education the norm in America.[168]

To the extent that the President's proposals continued the theme of middle class tax relief for education incentives, they are similar to prepaid tuition plans. Moreover, prepaid tuition plans and the President's proposals share much of the same underlying policy.

The President's proposals included a non-refundable tax credit and a deduction for qualified higher education expenses. Moreover, the President proposed a number of other educational initiatives that affect the financing of higher education including: tax incentives for expansion of student loan forgiveness;[169] an extended exclusion for employer-provided educational tax credit; and expanded individual retirement accounts.[170]

Republican support for President Clinton's proposals was warm, as reflected in the following comment: "The principle of using the tax code to help provide for affordable educational opportunity represents common ground, but I await [the President's] reply in order to evaluate the merits of this particular tax proposal."[171]

It was further suggested that the President would be willing to give the Republican Congressional leadership preferential capital gains treatment in exchange for educational tax incentives:

> So a capital gains-cut-for-tuition-tax-breaks deal would be great politics. The Republicans get the relief for capital gains that they have so passionately longed for and were so close to getting in 1989, 1992, and 1995. Clinton gets to be the "Education President." And lobbyists and the rank-and-file members of Congress get a big tax bill to serve as the vehicle for dozens of small vehicles.[172]

Ultimately, that is exactly what happened. While the President's proposals were politically attractive, as will be discussed in the next part of the article, it remains to be seen whether they are sound from a policy perspective.

A. *The Hope and Lifetime Learning Credits*

The Taxpayer Relief Act of 1997 created new Code Section 25A, which provides a tax credit consisting of the Hope Scholarship Credit and the Lifetime Learning Credit.[173] Both of these credits are subject to limitations as to amount and other qualifications. The Hope Scholarship Credit is based on a program organized by the State of Georgia.[174] The Hope Scholarship Credit consists of the sum of: (a) all of the "qualified tuition and related expenses" paid during the taxable year up to $1,000; plus (b) fifty percent of expenses over $1,000 but less than the "applicable limit."[175] Qualified tuition and related expenses include all those required for attendance or enrollment at an educational institution except for education relating to sports, games or hobbies.[176] The applicable limit is one-hundred percent of the qualified tuition and related expenses paid up to $1,000.[177] Thus, in effect, the Hope Scholarship Credit is limited to $1,500 per year.

In addition to the above limits on amounts, the Hope Scholarship Credit is only applicable for two years.[178] Moreover, Section 25A(b)(2) limits the Hope Scholarship Credit to students in their first two years of postsecondary education.[179] Furthermore, the credit is only available to at least half-time students.[180] Finally, the credit is not available to students who have been "convicted of a Federal or State felony offense consisting of the possession or distribution of a controlled substance."[181]

In addition to the Hope Scholarship Credit, the 1997 Act provided for a Lifetime Learning Credit.[182] The Lifetime Learning Credit reflects President Clinton's proposed tax relief for education and job training expenses.[183] That credit is an amount equal to twenty percent of the qualified tuition and related expenses paid by the taxpayer and not in excess of $10,000.[184] Eligible qualified tuition and related expenses include those "with respect to any course of instruction at an eligible educational institution *to acquire or improve job skills of the individual*."[185]

Coordination between the Lifetime Learning Credit and the Hope Scholarship Credit is provided by reducing the eligible qualified tuition and related expenses by that amount taken. The Lifetime Learning Credit is otherwise subject to the same limitations as applicable to the Hope Scholarship Credit. For purposes of determining both the Hope Scholarship and Lifetime Learning Credit, qualified tuition and related expenses are further reduced by scholarships received (which are excludable under Section 117) as well as other financial aid received.[186] The Hope Scholarship Credit and Lifetime Learning Credit are phased out for higher income taxpayers as the credit starts to be reduced for those taxpayers whose modified adjusted gross incomes exceed $40,000 ($80,000 for taxpayers filing married filing jointly).[187]

B. *Other Education Tax Provisions*

In addition to the tuition credit and education and job training deduction discussed above, President Clinton also proposed several other education tax incentives, including the expansion of the exclusion for forgiveness of certain student loans. At the time of the proposal, Section 108(f) generally excluded from tax[188] forgiveness of student loans by the federal, state or local government, or public benefit corporation with control over a government hospital provided that the loan forgiveness is "contingent" upon the student's working certain jobs for a certain period.[189] The proposal expanded the exclusion beyond loans by governmental or quasi-governmental agencies to loans extended by "nonprofit tax-exempt charitable or educational institutions to their students or graduates when the proceeds are to be used to repay outstanding student loans, provided the loan forgiveness is contingent on the student's working for a certain period of time in certain professions for any broad class of employers."[190]

The President has also proposed expanding the eligibility for deductible individual retirement accounts ("IRAs"). IRAs are tax favored investment vehicles for two reasons. First, contributions to the account may be deductible.[191] Second, the IRA is exempt from tax on its annual investment income.[192] The income earned is taxed upon withdrawal, which generally must begin by age 70 1/2.[193] Moreover, withdrawals before age 59 1/2 are generally penalized by a ten-percent excise tax (in addition to the tax on the income).[194] The President first proposed expanding the income thresholds and phaseouts for IRA deductions, thus making more taxpayers eligible for deduction.[195] In addition, the proposals called for establishing a "Special IRA," to which contributions would be non-deductible, but the earnings would be accumulate tax-free.[196] Most significantly, withdrawals from the "special IRA" would be allowed, without imposition of the ten-percent excise tax, as long as the proceeds are used for certain purposes, which are defined to include education expenses.[197]

The 1997 Act established a new "Education Individual Retirement Account,"[198] which provides yet another incentive for middle-class taxpayers to save for college. Under Section 530, an educational retirement account is generally exempt from income tax.[199] Such an account is a "trust created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the designated beneficiary of the trust," provided certain other requirements are met.[200] In order to qualify as an educational retirement account, the annual contributions may not exceed $500. The exemption from tax effectively allows the account to grow more rapidly than investments subject to annual income tax. In addition, withdrawals are not taxed to the extent that they are used to pay the qualified higher education expenses of the designated beneficiary.[201] The 1997 Act also generally provided for penalty-free withdrawal from IRAs for qualified higher education expenses.[202]

The 1997 Act also brought back a limited above the line deduction for interest on any qualified education loan.[203] The deductible amount is capped at $2,500 after a four year phase-in.[204] The deduction begins to phase out as a taypayer's adjusted gross income exceeds $40,000 ($60,000 for joint returns).[205] Another limitation restricts the deduction to interest paid "during the first 60 months . . . in which interest payments are required."[206] Moreover, the 1997 Act provided for expanded tax-free forgiveness of student loans under certain circumstances.[207]

C. *Increased Financial Aid*

In addition to the foregoing tax incentives, President Clinton proposed the "largest increase in Pell Grant Scholarships in 20 years."[208]

V. Prepaid Tuition Plans, Qualified State Tuition Programs and the 1997 Education Tax Provisions--Middle-Class Panacea or Placebo?

Although the uncertainty surrounding the tax treatment of prepaid tuition plans has subsided, several broader issues emerge. To the extent that prepaid tuition plans and President Clinton's recently-enacted education tax provisions are intended to encourage the middle class to save for college they shall be considered as a whole. Moreover, they raise a number of policy concerns. First and foremost, the plans raise equity concerns.

A. *Tax Policy Issues*

For tax policy purposes, taxes are evaluated on the basis of three goals: equity, efficiency and simplicity.[209] The goal of equity relates to fairness and is critical to our voluntary tax system.[210] Equity is further divided into components of horizontal equity and vertical equity. "The traditional test of fairness in the distribution of tax burdens consists of two principles: Persons who are similarly situated should be treated equally ('horizontal equity'), and there should be appropriate differentiations between persons on each income level and those on the levels above and below ('vertical equity')."[211] Accordingly, tax laws should be equitable to taxpayers who are similarly situated as well as equitable between taxpayers at different economic levels.

Efficiency, or neutrality, goes to the effect of the tax on the economy or market:

> The efficiency criterion requires that the tax interfere as a little as possible with people's economic behavior. The benchmark for this analysis is typically the allocation of goods and services that would occur in a market economy in the absence of taxes and that would presumably produce the greater consumer satisfaction. The ability of the economy to satisfy

> consumer demands is therefore reduced where taxes change the incentives to engage in various activities (such as work, investment or consumption) relative to what they would be in an economy without taxes. The efficiency criterion, like the equity criterion, generally implies uniform treatment of all sources and uses of income.[212]

Clearly, all forms of taxation will necessarily have some effect on economic efficiency. Indeed, the more the Code is used to further non-revenue based policy concerns, the less efficient it is.[213]

Finally, the third goal of simplicity is not so much a separate and distinct goal as a product of achieving the first two goals of equity and efficiency.

> Simplicity is often viewed not as a separate norm but as a feature of any tax system that is both equitable and efficient. For example, complex tax rules are inefficient because taxpayers must divert time from other activities in order to calculate their taxes (or earn the money to pay for professional tax assistance) and because the government must maintain a large agency to interpret these complex rules and to insure that taxes are calculated correctly.
>
> Moreover, complexity is inequitable because taxpayers with equal abilities to pay may have different tax burdens because of their unequal abilities to understand the tax rules; taxpayers with greater abilities to pay may not bear an appropriately greater tax burden because of their greater understanding of the rules. Finally, any tax which requires extensive recordkeeping and perhaps professional tax assistance for ordinary citizens cannot be described as simple.[214]

Prepaid tuition plans and many of the recently enacted Clinton education tax provisions present a number of tax policy problems from a vertical equity standpoint. First, to the extent that prepaid tuition plans operate under Section 529 to exempt from the purchaser's income the annual build up of income, the benefit of the exemption increases with the purchaser's marginal tax bracket. Thus, the benefit increases with the income of the taxpayer. This is particularly problematic, given that the data tend to suggest that it is the lower income and certain minority groups who are less to be able to save for college.

An additional vertical equity problem is presented by the President's education tax provisions. The various incentives such as the Hope Scholarship Credit and Lifetime Learning Credit are offset dollar for dollar by Federal education grants, such as Pell Grants.[215] Thus, to the extent that a student is receiving financial aid, he or she will be entitled to less of a credit or deduction, or none at all. Because Pell Grants and other federal financial aid are generally need-based,[216] this will likely not assist lower-income families and some middle-class families, leaving higher-income families as the more likely beneficiaries of the tax benefits (at least those whose ability to utilize the credits are not phased out).

In addition to vertical equity issues, prepaid tuition plans also raise efficiency concerns. Under Section 529, Qualified State Tuition Programs create an tax incentive for purchasers to invest in the plans rather than in other non-tax favored investment vehicles. Accordingly, taxpayers seem likely to make the investment, in part, because of the tax advantage. Thus, the tax policy goal of efficiency appears to be violated. This seeming violation of the efficiency criterion is perhaps justified by the governmental interest in encouraging families to save for education. It is unclear, however, whether prepaid tuition plans and the President's education tax provisions provide the best, most efficient, source of governmental assistance.

Finally, the President's provisions present enormous simplicity concerns as well. Educational institutions will be forced to undertake numerous administrative responsibilities. For example, as originally proposed, eligibility of students for the tuition tax credit requires that an eligible student maintain a B- average and be at least a half-time student.[217]

B. *Education Policy Concerns*

The Section 529 Qualified State Tuition Program provisions and the President's education tax provisions raise numerous educational policy issues as well. One argument is that much of the problem in paying for college education is the rising costs of the educational institutions themselves and that increasing the amount of money available for tuition simply will increase college tuitions. Neither Section 529 nor the President's proposals address this problem.[218]

Another problem is reflected from using a specific level of grade, B-, to qualify for the President's tuition tax credit. This raised the unappealing prospect of having the Treasury promulgate regulations defining a B-.[219] Moreover, such grade requirement might lead to grade inflation as sympathetic (and perhaps self-interested) professors give the grade necessary for students to receive the tuition tax credit as initially proposed.[220] While the requirement was ultimately dropped, it provides a meaningful illustration of a potentially unwelcome intrusion of the tax law into educational policy. Similarly, those convicted of drug felonies are precluded from using the credit.[221]

C. *Targeting the Middle Class*

Both Section 529 Qualified State Tuition Programs and the President's education tax provisions clearly focus on providing benefits to the middle class. Prepaid tuition plans tend to be unattractive to lower-income families because those families may be unlikely to even save ahead for college. Moreover, those households are more likely to receive need-based scholarships and financial aid to provide for educational expenses.[222] High-income taxpayers, on the other hand, are typically sophisticated investors, who will likely find that they are able to get far superior investment performance from other investment vehicles.[223]

The President's tax provisions similarly focus on the middle class. As previously discussed, the tuition tax credit and training deduction are reduced by financial aid, such as Pell Grants, which tend to be need-based.[224] The President's provisions also generally phase out the deductions and credits at certain levels of adjusted gross income, therefore eliminating high-income taxpayers.[225] Thus, the voter-rich middle class are left as the target of these provisions.

D. *Risk and Return*

By offering prepaid tuition plans, states are arguably entering into the investment business. Guaranteeing a return on income in order to meet the tuition guarantee places the state sponsors in a position to make risky investments in order to increase returns. To the extent that the state stands behind the plan with its full faith and credit, paying off the burden becomes the obligation of the population in general, causing further inequities as lower income taxpayers pay off obligations of a plan that benefited higher income taxpayers.

In addition, as previously discussed, prepaid tuition plans are generally not outstanding investments, because they are designed to protect only against tuition increases and inflation. Sophisticated taxpayers are likely to invest on their own and beat the return of the prepaid plans.

In summary, prepaid tuition plans, and the President's education tax provisions are more middle-class placebo than panacea. The provisions target the middle class with promised tax benefits and investment returns. In so doing, the provisions do damage from a tax and educational policy perspective.

VI. Conclusion

Paying for a college education is a serious problem for many Americans, not just those in the middle class. Aid for higher education through the use of tax incentives has become a political snowball.[226] State prepaid tuition plans and the President's recently-enacted education tax provisions are an example of such a snowball, and result in tax-policy problems. For some time he momentum of state prepaid tuition plans was tempered by uncertainty resulting from the questionable ruling by the Sixth Circuit in *State of Mich. v. United States* and the indecisiveness by Treasury and the Internal Revenue Service as to whether such plans are covered by the original issue discount rules. Unfortunately, the President, IRS and Congress appear willing to trade additional policy problems in exchange for certainty and political expediency.

1 Tax Incentives for Education: Hearings before the Senate Comm. on Finance, 100th Cong. 1 (1988) (statement of Committee Chairman Lloyd Bentsen). While these comments were made eight years ago, their import is as great today as they were then.

2 President's State of the Union Address, 33 WEEKLY COMP. PRES. DOC. 136 (Feb. 10, 1997). The State of the Union Address is also available on the Internet at <http://www.whitehouse.gov/WH/SOU97/>.

3 The most significant changes were the enactment of Section 529 Qualified State Tuition Programs, see infra notes 131-149 and accompanying text, and President Clinton's education tax proposals, as well as the changes as a result of the Taxpayer Relief Act of 1997, see infra notes 168-200 and accompanying text.

4 The "American Dream" would certainly include affordable and accessible higher education, a house, and children who are better off financially than their parents.

The prosperity that characterized the country until the middle 1970s resulted in a rising economic tide that affected all boats. Regardless of where they stood in the statistical income distribution, more and more people felt themselves able to purchase what we think of as the elements of a middle class lifestyle. These included houses, cars, and many other consumer goods, as well as college education for their children. JANET S. HANSEN, Introduction and Overview, COLLEGE SAVINGS PLANS: PUBLIC POLICY CHOICES 2 (Janet S. Hansen ed. 1990) [hereinafter COLLEGE SAVINGS PLANS].

Moreover, many aspects of the American dream in addition to higher education are at risk. The "American dream" may sound vague and grandiose, but it means something concrete and important to many Americans. It means an economy in which people who work hard can get ahead and each generation lives better than the last one. . . .

In recent years, the dream has been fading. Americans are worried about their economic future--and they should be . . . . Young people look at their job prospects and wonder whether they will do as well as their parents or will be able to own a house. Parents worry about their children's future. Many children face bleak futures: one in five now lives in poverty. ALICE M. RIVLIN, REVIVING THE AMERICAN DREAM: THE ECONOMY, THE STATES & THE FEDERAL GOVERNMENT 1-2 (1992).

5 See GENERAL ACCT. OFF., HIGHER EDUCATION: TUITION INCREASING FASTER THAN HOUSEHOLD INCOME AND PUBLIC COLLEGE COSTS 18 (1996) (noting that during the school years from 1980-81 through 1994-95 public college tuition has increased almost three times as much as increases in household income and inflation) [hereinafter GAO Higher Education Report]. ARTHUR M. HAUPTMAN & JAMIE P. MERISOTIS, THE COLLEGE TUITION SPIRAL: AN EXAMINATION OF WHY CHARGES ARE INCREASING, A REPORT TO THE COLLEGE BOARD AND THE AMERICAN COUNCIL ON EDUCATION (1990).

6 See generally ARTHUR M. HAUPTMAN, THE TUITION DILEMMA: ASSESSING NEW WAYS TO PAY FOR COLLEGE (1990).

7 The proposal initially provided for a $3,000 refundable tax credit-- $1,500 in tax credits during the first two years of post-secondary education as long as the student maintains a B average. John Godfrey, Clinton Adds Tuition Tax Credit to Budget, TAX NOTES TODAY (June 5, 1996), available in LEXIS 96 TNT 110-5. The President again repeated his proposal in his 1997 State of the Union Address. See State of the Union Address, supra note 2 and accompanying text. The proposals were then included in the budget negotiations in Congress and subsequently enacted. See infra notes 168-200 and accompanying text.

8 There is substantial scholarship on prepaid tuition plans. See, e.g., PREPAID COLLEGE TUITION PLANS: PROMISE AND PROBLEMS (Michael A. Olivas ed. 1993); Alan Gunn, Economic and Tax Aspects of Prepaid Tuition Plans, 17 J.C. & U.L. 243 (1990); Jeffrey S. Lehman, Social Irresponsibility, Actuarial Assumptions, and Wealth Redistribution: Lessons about Public Policy from a Prepaid Tuition Program, 88 MICH. L. REV. 1035 (1990); J. Timothy Philipps, Federal Taxation of Prepaid College Tuition Plans, 47 WASH. & LEE L. REV. 291 (1990); J. Timothy Philipps & Ed R. Haden, It's Not Love, But It's Not Bad: A Response to Critics of a Prepaid Tuition Plans, 26 U. RICH. L. REV. 281 (1992); Lee A. Sheppard, State Tax Immunity and Middle Class Entitlements, TAX NOTES TODAY (Dec. 13, 1994), available in LEXIS 94 TNT 243-15; David Williams, II, Financing a College Education: A Taxing Dilemma, 50 OHIO ST. L.J. 561 (1989).

9 Several members of Congress expressed a keen interest in prepaid tuition plans and requested that the Government Accounting Office ("GAO") study the issue. See GAO PREPAID TUITION REPORT, infra note 52 and accompanying text.

10 State of Mich. v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992).

11 See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996). Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986 (the "Code"), as amended.

12 The use of tax incentives for education is not a new idea. See e.g., Joe Thorndike, Tax History: Treasury's Case Against Education Tax Breaks, TAX NOTES TODAY (Dec. 17, 1996), available in LEXIS 96 TNT 244-4 (detailing the history of proposed education tax breaks and the Treasury's opposition thereto); John K. McNulty, Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowance for Personal Costs of Higher Education, 61 CAL. L. REV. 1 (1972).

13 A relatively recent report reflected the congressional concern over the rising costs of college:

During the 1980s, the cost of attending colleges of all kinds -- public and private, 2-year as well as 4-year schools --has been going up faster than inflation. In the 1989-90 academic year, average full-time costs of attendance including room and board [was] $6,671 at public 4-year schools and $14,326 at private 4-year schools. Some private 4-year schools cost considerable more. While costs might not climb as rapidly in [the 1990s] as they did in the [1980s] some increases are expected. CONGRESSIONAL RESEARCH SERVICE, CRS ISSUE BRIEF SAVING FOR COLLEGE 2 (1990) [hereinafter CRS REPORT ON SAVING FOR COLLEGE]. See also GAO HIGHER EDUCATION REPORT, supra note 5.

14 Michael S. McPherson & Morton Owen Schapiro, KEEPING COLLEGE AFFORDABLE--GOVERNMENT AND EDUCATIONAL OPPORTUNITY 5 (1991).

15 Id.

16 Id.

17 Id.

18 CONGRESSIONAL RESEARCH SERVICE, CRS REPORT FOR CONGRESS--COLLEGE COSTS: AN ANALYSIS OF TRENDS IN COSTS AND SOURCES OF SUPPORT 19 (1988) ("In the American higher education system, the family has always been the payor of first resort.")

19 CRS REPORT ON SAVING FOR COLLEGE, supra note 13, at 2.

20 Id.

21 Id.

22 McPherson & Shapiro, supra note 14, at 2.

23 SANDY BAUM, The Need for College Savings, in COLLEGE SAVINGS PLANS, supra note 4, at 8.

24 CRS REPORT ON SAVING FOR COLLEGE, supra note 13, at 3. Nevertheless, there is some information concerning parent's savings from a 1983 survey:

-- nearly all were saving for some reason, but only half were currently saving for college;

-- the median annual amount saved for college by parents who were saving was $517;

-- saving for college began when children were young, though typically more was saved as children approached college age; and

-- savings were greater the higher the parents' income: those with household incomes under $10,000 saved a median of $120 a year; those with incomes of $30,000 or more saved a median of $904 a year.

Id. (citing a nationally-representative survey commissioned by the National Institute of Independent Colleges and Universities ("NIICU")).

25 Id. at 4.

26 Id.

27 Id.

28 Id. See notes 48-49, infra, and accompanying text for a discussion of tax issues relat-ing to home refinancing.

29 CRS REPORT ON SAVINGS FOR COLLEGE, supra note 13, at 4-5.

30 Id. at 5. "[O]f all households (regardless of age) with monthly incomes under $900, the median net worth for whites was $8,443, for Spanish origin people it was $453, and for blacks it was $88." Id. (citing the 1984 Survey of Income and Program Participation ("SIPP") conducted by the U.S. Bureau of Census).

31 Assume a taxpayer has $100,000 of taxable income with $20,000 in deductions and is in a 30% marginal tax bracket. The $20,000 deduction saves the taxpayer $6,000 in taxes, which is, in effect, a partial subsidy to the taxpayer.

32 The 1997 Act tax provisions make a limited credit for educational expenses available. See infra notes 173-87 and accompanying text.

33 MARCUS SCHOENFELD, EDUCATIONAL AND PROFESSIONAL EXPENSES--SECTION 162, 267-3d TAX. MGMT. (BNA) A-1 (1990).

34 I.R.C. § 262(a) (1997) ("[E]xcept as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.").

35 I.R.C.§162(a) (1997) (generally allowing a deduction for ordinary and necessary expenses incurred in carrying on a trade or business).

36 I.R.C. § 263 (1997).

37 Treas. Reg. § 1.162-5(a)(1) - (2) (as amended in 1967).

38 Treas. Reg. § 1.162-5(a)(2) (as amended in 1967).

39 Treas. Reg. § 1.162-5(b)(3) (as amended in 1967).

40 Loretta Collins Argrett, Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive, 41 SYRACUSE L. REV. 621 (1990); David S. Davenport, Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy, 42 CASE W. RES. L. REV. 793 (1992); David S. Davenport, The 'Proper' Taxation of Human Capital, TAX NOTES TODAY MAG. (Sept. 16, 1991), available in LEXIS 52 Tax Notes 1401; Clifford Gross, Tax Treatment of Education Expenses: Perspectives from Normative Theory, 55 U. CHI. L. REV. 916 (1988). But, cf., Joseph M. Dodge, Taxing Human Capital Acquisition Costs--Or Why Costs of Higher Education Should Not Be Deducted or Amortized , 54 OHIO ST. L. J. 927 (1993).

41 See infra notes 173-87 and accompanying text.

42 I.R.C. § 117(a) (1997).

43 Charlotte Crane, Scholarships and the Federal Income Tax Base, 28 HARV. J. ON LEGIS. 63 (1991); CONGRESSIONAL RESEARCH SERVICE, CRS REPORT FOR CONGRESS - FEDERAL TAXATION OF STUDENT AID 2 (1994).

44 Id.

45 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS ¶6.1, at 6-2 (2d ed. 1989).

46 Marci Kelly, Financing Higher Education: Federal Income Tax Consequences, 17 J.C. & U.L. 307, 319 n. 67 (1991); CRS REPORT FOR CONGRESS, supra note 43.

47 I.R.C. § 163(a) (1997). See also Kelly, supra note 46, at 319.

48 I.R.C. § 163(h) (1997).

49 Kelly, supra note 46, at 319-20 (noting that Congress apparently contemplated that refinancing proceeds would be used for financing higher education).

50 See infra notes 202-06 and accompanying text.

51 I.R.C. § 135 states:

INCOME FROM UNITED STATES SAVINGS BONDS USED TO PAY HIGHER EDUCATION TUITION AND FEES

(a) GENERAL RULE.--In the case of an individual who pays qualified higher education expenses during the taxable year, no amount shall be includible in gross income by reason of the redemption during such year of any qualified United States savings bond.

(b) LIMITATIONS.--

(1) LIMITATION WHERE REDEMPTION PROCEEDS EXCEED HIGHER EDUCATION EXPENSES.--

(A) IN GENERAL.--IF--

(i) the aggregate proceeds of qualified United States savings bonds redeemed by the taxpayer during the taxable year exceed

(ii) the qualified higher education expenses paid by the taxpayer during such taxable year, the amount excludable from gross income under subsection (a) shall not exceed the applicable fraction of the amount excludable from gross income under subsection (a) without regard to this subsection.

I.R.C. §135 (1997).

52 GENERAL ACCT. OFF., COLLEGE SAVINGS: INFORMATION ON STATE TUITION PREPAYMENT PROGRAMS 20 (1995) [hereinafter GAO PREPAID TUITION REPORT].

53 Id. When the GAO Report was published in 1995 seven states had prepaid tuition plans. Id. at 22. As of April 1997, fourteen states have prepaid tuition plans (Alabama, Alaska, Colorado, Florida, Massachusetts, Michigan, Missouri, Ohio, Pennsylvania, Tennessee, Texas, Virginia, Wisconsin and Wyoming). Mark Kantrowitz, Financial Aid Info. Page, Prepaid Tuition Plans, (visited June 9, 1997) <http://www.finaid.org.finaid/ptp.html>. Moreover, thirty-two states are planning, developing, or at least considering prepaid tuition plans. Those states are: Arizona, California, Connecticut, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Mississippi, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Vermont, Washington, West Virginia and Wisconsin. Id. (visited Apr. 30, 1997).

54 GAO PREPAID TUITION REPORT, supra note 52, at 24. Wyoming, Florida and Alabama follow the Michigan model. Id.

Ohio provides a slight variation under which the purchaser opens an account with a minimum purchase and then purchases desired benefits by the credit hour (or smaller unit). Alaska and Pennsylvania have followed this approach. Id. at 25.

55 Id. at 24.

56 Id. at 25.

57 Id. Alaska and Pennsylvania follow this model. Id.

58 Id.

59 Id.

60 Id.

61 The U. Plan boasts a wide variety of participating institutions, public and private, rich and poor, rural and urban, large and small. As of February 1996, the following seventy-five institutions were participants in the plan: American International College, Amherst College, Anna Maria College, Art Institute of Boston, Assumption College, Babson College, Bay Path College, Bay State College, Berklee College of Music, Berkshire Community College, Boston University, Bradford College, Bridgewater State College, Bristol Community College, Bunker Hill Community College, Cape Cod Community College, Clark University, College of Our Lady of the Elms, College of the Holy Cross,

Curry College, Dean College, Eastern Nazarene College, Endicott College, Fitchburg State College, Framingham State College, Franklin Institute of Boston, Gordon College, Greenfield Community College, Hampshire College, Hebrew College, Hellenic College, Holyoke Community College, Laboure College, Lasell College, Lesley College, Marian Court College, Massachusetts Bay Community College, Massachusetts College of Art, Massachusetts Maritime Academy, Massasoit Community College, Merrimack College, Middlesex Community College, Montserrat College of Art, Mount Holyoke College, Mount Wachusett Community College, Newbury College, Nichols College, North Adams State College, North Shore Community College, Northeastern University, Northern Essex Community College, Pine Manor College, Quinsigamond Community College, Regis College, Roxbury Community College, Salem State College, Simmons College, Smith College, Springfield College, Stonehill College, Suffolk University, University of Massachusetts at Amherst, University of Massachusetts at Boston, University of Massachusetts at Dartmouth, University of Massachusetts at Lowell, Wellesley College, Wentworth Institute of Technology, Western New England College, Westfield State College, Wheaton College, Wheelock College, Worcester Polytechnic Institute, and Worcester State College. EXECUTIVE DEPT., COMMONWEALTH OF MASS., U. PLAN: THE MASSACHUSETTS COLLEGE SAVINGS PROGRAM 10-12 (1996) [hereinafter U. PLAN OFFERING MATERIALS].

The U. Plan was the brainchild of Massachusetts' then Governor William F. Weld. Ironically, Governor Weld's alma mater, Harvard University, has chosen not to participate in the plan. Harvard's decision caused Governor Weld to chide his alma mater. "Harvard, I hope you're listening . . . . It's the least you could do. You cannot lose more money in a year on this program than I've already given to Harvard College. And if I took back all the Weld money retroactively to 1630, Harvard would be bankrupt." Alice Dembner, State Savings Plan for College Launched; Governor Urges Participation by State's Leading Universities, BOSTON GLOBE, Dec. 7, 1994, at 35.

62 Jo-Ann Johnston, Find Out if the U.Plan is for You, State's Saving Program One Way to Earmark Funds, BOSTON GLOBE, Apr. 22, 1996, at 19.

63 Id.

64 U. PLAN OFFERING MATERIALS, supra note 61, at 14. MEFA maintains a website at <http://www.mefa.org/index.html>.

65 U. PLAN OFFERING MATERIALS, supra note 61, at 14.

66 Johnston, supra note 62, at 20.

67 U. PLAN OFFERING MATERIALS, supra note 61, at 19.

68 Id. at 20.

69 See Johnston, supra note 62, at 20.

70 U. PLAN OFFERING MATERIALS, supra note 61, at 8.

71 Id.

72 Id.

73 Id. at 17.

74 U. PLAN OFFERING MATERIALS, supra note 61, at 16.

75 As discussed, infra, notes 78-130 and accompanying text, when the U.Plan was created, continuation of favorable tax treatment was far from certain:

The most serious issue facing state tuition prepayment programs is the potential applicability of federal tax provisions. Two potential taxes are particularly troubling to program officials: (1) a tax on program investment earnings, because that would make it more difficult for programs to meet their future liabilities, and (2) an annual tax on participants, because that would be unappealing to purchasers and an administrative burden, according to program officials.

GAO PREPAID TUITION REPORT, supra note 52, at 93.

76 State of Mich. v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F.Supp. 120 (W.D. Mich. 1992).

77 The Code is not explicit as to this issue. Rather, the Code only applies to individuals, corporations, trusts, estates, etc. Moreover, Congress has never intended that the Code apply to states. David M. Richardson, Federal Income Taxation of States, 19 STETSON L. REV. 411 (1990).

78 I.R.C. § 115 provides in relevant part:

Gross income does not include--

(1) income derived from . . . the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia . . . .

I.R.C. § 115(1) (1997).

79 I.R.C. § 501(c)(3) exempts from the income:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . .

I.R.C. § 501(c)(3) (1997).

80 State of Mich. v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992); see Phillip Marchesiello, Federal

Tax Immunity for State - Related Organizations: Michigan v. United States, 49 TAX LAW. 429 (1996).

81 Id. at 817.

82 One commentator has suggested that the plan resulted from the then-governor's attempt to "secure the votes of the always anxious middle class." Sheppard, supra note 8.

83 See, e.g., MICH. CONST. art. VIII, § 1 ("schools and the means of education shall forever be encouraged"). As part of its mission, Michigan maintains an "extensive system of public colleges and universities." State of Mich., 40 F.3d at 820.

84 MICH. COMP. LAWS. ANN. § 390.1425 § 5(1) (West 1997). The M.E.T. was within the treasury department and was governed by an "independent board" consisting of the state treasurer (ex officio) and eight other members appointed by the governor and confirmed by the senate. State of Mich., 40 F.3d at 818.

For a thorough discussion of the background behind the M.E.T. see Gunn, supra note 8; Lehman, supra note 8; Philipps, supra note 8; and Williams, supra note 8; Marchesiello, supra note 80.

85 MICH. COMP. LAWS ANN. § 390.1423 § 3 (West 1997).

86 State of Mich. v. United States, 40 F.3d 817, 820 (6th Cir. 1994), rev'g 802 F.Supp. 120 (W.D. Mich. 1992).

87 Id. at 820-21.

88 Id. at 821.

89 MICH. COMP. LAWS ANN. § 390.1433 § 13(4) (West 1997).

90 Id. at § 13(3).

91 State of Mich., 40 F.3d at 821.

92 Priv. Ltr. Rul. 88-25-027 (June 24, 1988). The ruling also addressed the federal estate and gift tax ramifications to the purchaser of the contract. Id.

93 Priv. Ltr. Rul. 88-25-027 (June 24, 1988) (citing Rev. Rul. 87-2, 1987-2 C.B. 18 which ruled that a lawyer's trust fund supervised and controlled by a state's supreme court was not subject to federal income tax because the fund was an integral part of a state or political subdivision).

94 Priv. Ltr. Rul. 88-25-027 (June 24, 1988).

95 State of Mich. v. United States, 40 F.3d 817, 821(6th Cir. 1994), rev'g 802 F.Supp. 120 (W.D. Mich. 1992).

96 Id. at 822.

97 State of Mich. v. United States, 802 F.Supp. 120 (W.D. Mich. 1992).

98 Id. at 121.

99 Id. at 126-27. These arguments were subsequently abandoned. State of Mich., 40 F.3d at 822.

100 Id. at 127.

101 Id. at 123.

102 Id.

103 Id. at 124. Although there is some authority that I.R.C. § 115(1) did not apply to the trust at all because it is neither a state or political subdivision, the court acknowledged that §115 has been held to have a broader scope. Id. (citing David Richardson, supra note 77, at 503; Maryland Savings-Share Insurance Corp. v. United States, 308 F. Supp. 761 (D. Md. 1970)).

104 Id. at 124 (citations omitted).

105 Id.

106 I.R.C. § 501(c)(4) exempts from income tax:

Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare . . . and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

I.R.C. § 501(c)(4) (1997).

107 State of Mich., 802 F.Supp. at 125 (citations omitted).

108 Id.

109 Id.

110 State of Mich. v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992).

111 Id. at 828-29.

112 Id. at 829.

113 Id. at 824.

114 I.R.C. § 103(a) (1997) ("gross income does not include interest on any State or local bond"). State or local bond is defined as "an

obligation of a state or political subdivision thereof." I.R.C. § 103(c)(1) (1997).

115 State of Mich., 40 F.3d at 825 (quoting 30 Op. Att'y. Gen. 252 (1914)).

116 Id. (quoting Commissioner v. Shamberg's Estate, 144 F.2d 998, 1004 (2d Cir. 1944)).

117 Id.

118 Id. at 818.

119 Id. at 830 (Guy, J., dissenting) (citing and quoting E.J. Dionne Jr., Democrats Seek the Key to the Middle Class, N.Y. TIMES, Apr. 30, 1989, § 4, at 5).

120 Id. at 830-31 (Guy, J., dissenting) (footnotes omitted) (emphasis added).

121 Id. at 833 (Guy, J. dissenting) (citing Rose v. Long Island R.R. Pension Plan, 828 F.2d 910, 918 (2d Cir. 1987)).

122 Id. (Guy, J., dissenting).

123 Id. (Guy, J., dissenting).

124 Id. (Guy, J., dissenting).

125 Id. (Guy, J., dissenting).

126 Id. at 834 (Guy, J., dissenting).

127 Id. (Guy, J., dissenting).

128 Id. (Guy, J., dissenting) (citing Allen v. Regents, 304 U.S.

439 (1938)).

129 Id. (Guy, J., dissenting).

130 Id. at 835 (Guy, J., dissenting).

131 Ellen P. Aprill, More Outrage at Michigan Education Trust Decision, TAX NOTES TODAY (Jan. 4, 1995), available in LEXIS 95 TNT 2-94; Sheppard, supra note 8; Marchesiello, supra note 80, at 439-41.

132 GAO PREPAID TUITION REPORT, supra note 52, at 98.

133 Id.

134 Rev. Proc. 96-34, 1996-26 I.R.B. 14.

135 S. REP. NO. 104-281, at 106 (1996), reprinted in 1996 U.S.C.C.A.N. 1474, 1580.

136 Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996).

137 Section 1806(a) of the Small Business Job Protection Act of 1996, adding I.R.C. § 529(a), which provides as follows:

General Rule. A qualified State tuition program shall be exempt from taxation under this subtitle. Notwithstanding the preceding sentence, such program shall be subject to the taxes imposed by section 511 (relating to imposition of tax on unrelated business income of charitable organizations).

Small Business Job Protection Act of 1996 § 1806(a), 26 U.S.C. § 529(a) (1997).

138 I.R.C. § 529(b)(1) (1997).

139 I.R.C. § 529(e)(3) (1997).

140 I.R.C. § 529(b)(2) (1997).

141 I.R.C. § 529(b)(5) (1997).

142 I.R.C. § 529(b)(6) (1997).

143 I.R.C. § 529(b)(4) (1997).

144 I.R.C. § 529(b)(7) (1997).

145 I.R.C. § 529(b)(3) (1997). The legislative history provides as follows:

Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses.

S. REP. NO. 104-281, at 107 (1996), reprinted in 1996 U.S.C.C.A.N. 1474, 1581.

146 I.R.C. § 529(d)(1) provides:

In General. If there is a distribution to any individual with respect to an interest in a qualified State tuition program during any calendar year, each officer or employee having control of the qualified State tuition program or their designee shall make such reports as the

Secretary may require regarding such distribution to the Secretary and to the designated beneficiary or the individual to whom the distribution was made. Any such report shall include such information as the Secretary may prescribe.

I.R.C. § 529(d)(1) (1997).

147 I.R.C. § 529(c)(1) provides as follows:

In general. Except as otherwise provided in this subsection, no amount shall be includible in gross income of--

(A) a designated beneficiary under a qualified State tuition program, or

(B) a contributor to such program on behalf of a designated beneficiary, with respect to any distribution or earnings under such program.

I.R.C. § 529(c)(1) (1997).

148 I.R.C. § 529(c)(2) (1997).

149 I.R.C. § 529(c)(3) (1997).

150 I.R.C. § 72(a)-(c) (1997).

151 The concept of time value of money is as follows:

The fundamental premise of the time value of money rules are: (1) Parties dealing knowingly and rationally at arm's length provide compensation for the use of money in every deferred payment transaction and compute the amount of this compensation by the techniques of interest compounding; (2) this compensation should be treated for tax purposes as interest, taxable as ordinary income to the creditor and deductible by the debtor, subject to the usual limitations on the interest; and (3) this interest should be allocated among taxable years by accruing interest at a rate that remains constant throughout an instrument's term.

BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 56.2, at S56-4 to S56-5 (1996 cum. supp. #1).

152 I.R.C. § 61(a)(4) (1997).

153 BITTKER & LOKKEN, supra note 151, ¶ 56.2, at S56-4.

154 Id. ¶ 56.2, at S56-5 n.3.

155 Id.

156 I.R.C. § 1272(a)(1) (1997).

157 I.R.C. § 1273(a)(1) (1997).

158 I.R.C. § 1273(b) (1997).

159 I.R.C. § 1273(a)(2) (1997).

160 See I.R.C. §1275(a)(1)(A) (1997).

161 Treas. Reg. § 1.1275-1(a) (as amended in 1997).

162 Debt Instruments with Original Issue Discount; Contingent Payments, 59 Fed. Reg. 64884 (Dec. 16, 1994). See generally, Gary A. Herrmann ET AL., New OID Proposed Regulations Control Debt Instruments with Contingent Payments, 82 J. TAX'N 206 (1995); Kleinbard, et al., Proposed Regulations Affecting Contingent Payment Debt Obligations, TAX NOTES TODAY MAG. (Jan. 30, 1995), available in LEXIS 6 Tax Notes 723.

163 Treas. Reg. § 1.1275-4 (as amended in 1996).

164 See generally, Michigan Education Trust Says Regs Should Not Apply to Prepaid Tuition Programs, TAX NOTES TODAY (Mar. 23, 1995), available in LEXIS 95 TNT 57-26; Edward A. Sair, Prepaid Tuition Plan Are Not Debt Instruments, Says Accountant, TAX NOTES TODAY (June 15, 1995), available in LEXIS 95 TNT 116-31.

165 George Schutzer, Schutzer Says State Prepaid Tuition Plans Should Be Subject to OID Rules, TAX NOTES TODAY (Apr. 20, 1995), available in LEXIS 95 TNT 77-22.

166 T.D. 8674, 1996-28 I.R.B. 9. The regulations do not apply if there is not a debt instrument. Id. Moreover, the regulations except debt instruments from OID treatment as follows:

A debt instrument issued pursuant to a plan or arrangement if --

(A) The plan or arrangement is created by state statute;

(B) A primary objective of the plan or arrangement is to enable the participant to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and

(C) Contingent payments on the debt instrument are related to such objective.

Treas. Reg. §1.1275-4(a)(2)(viii) (as amended in 1996).

167 See supra note 53.

168 DEPARTMENT OF TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S REVENUE PROPOSALS 2 (Feb. 6, 1997), available in LEXIS 97 TNT 26-5 [hereinafter PRESIDENT'S TAX PROPOSALS].

169 Id.

170 Id.

171 Heidi Glenn, Common Ground Possible on Education Tax Breaks, Archer Tells Rubin, TAX NOTES TODAY (Jan. 24, 1977), available in LEXIS 97 TNT 16-1 (quoting a letter from House Ways and Means Committee Chairman Bill Archer to Treasury Secretary Robert E. Rubin).

172 Martin A. Sullivan, Here's the Deal: Capital Gains for Tuition Breaks, TAX NOTES TODAY (Dec. 31, 1996), available in LEXIS 96 TNT 253-3.

173 Taxpayer Relief Act of 1997 § 201(a), Pub. L. No. 105-34, 111 Stat. 788, 799 (1997).

174 State of the Union Address, supra note 2.

175 Hope Scholarship Credit.

(1) Per Student Credit. In the case of any eligible student for whom an election is in effect under this section for any taxable year, the Hope Scholarship Credit is an amount equal to the sum of --

(A) 100 percent of so much of the qualified tuition and related expenses paid by the taxpayer during the taxable year (for education furnished to the eligible student during any academic period beginning in such taxable year) as does not exceed $1,000, plus

(B) 50 percent of such expenses so paid as exceeds $1,000 but does not exceed the applicable limit.

I.R.C. § 25A(b) (1997).

176 Qualified tuition and related expenses.

(A) In general. The term "qualified tuition and related expenses" means tuition and fees required for the enrollment or attendance of --

(i) the taxpayer,

(ii) the taxpayer's spouse, or

(iii) any dependent of the taxpayer with respect to whom the taxpayer is allowed a deduction under section 151,

at an eligible educational institution for courses of instruction of such individual at such institution.

(B) Exception for education involving sports, etc. Such term does not include expenses with respect to any course or other education involving sports, games, or hobbies, unless such course or other education is part of the individual's degree program.

(C) Exception for nonacademic fees. Such term does not include student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

I.R.C. § 25A(f)(1) (1997).

177 "Applicable Limit. For purposes of paragraph (1)(B), the applicable limit for any taxable year is an amount equal to two times the dollar amount in effect under paragraph (1)(A) for such taxable year." I.R.C. § 25A(b)(4) (1997).

178 I.R.C. § 25A(b)(2)(A) (1997).

179 I.R.C. § 25A(b)(2)(C) (1997).

180 I.R.C. § 25A(b)(2)(B) (1997).

181 I.R.C. § 25A(b)(2)(D) (1997).

182 Taxpayer Relief Act of 1997 § 201(f)(2), Pub. L. No. 105-34, 111 Stat. 788, 806 (1997) (adding I.R.C. §25A(a)(2)).

183 The proposal was initially for an "above the line deduction;" that is, allowed in determining Adjusted Gross Income (AGI). PRESIDENT'S TAX PROPOSALS, supra note 168.

184 I.R.C. § 25A(c)(1) (1997). The $10,000 limitation is phased in fully for years beginning January 1, 2003. Before that date, there is a $5,000 limit. Id.

185 I.R.C. § 25A(c)(2)(B) (1997) (emphasis added).

186 I.R.C. § 25A(g)(2) (1997).

187 Limitation Based on Modified Adjusted Gross Income.

(1) In general. The amount which would (but for this subsection) be taken into account under section (a) for the taxable year shall be reduced (but not below zero) by the amount determined under paragraph (2).

(2) Amount of reduction. The amount determined under this paragraph is the amount which bears the same ratio to the amount which would be so taken into account as --

(A) the excess of --

(i) the taxpayer's modified adjusted gross income for such taxable year, over

(ii) $40,000 ($80,000 in the case of a joint return), bears to

(B) $10,000 ($20,000 in the case of a joint return).

(3) Modified adjusted gross income. The term "modified adjusted gross income" means the adjusted gross income of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933.

I.R.C. § 25A(d) (1997).

The limitations set forth above are indexed for inflation. Id. § 25A(h) (1997).

188 I.R.C. § 61(a)(12) (1997) (generally including income from the discharge from indebtedness).

189 I.R.C. § 108(f)(1) (1997).

190 PRESIDENT'S TAX PROPOSALS, supra note168.

191 I.R.C. § 219 (1997).

192 See generally, I.R.C. §§ 219 and 408. Currently, individuals are allowed a deduction up to the lesser of $2,000 or their compensation. This deductibility, however, is limited. I.R.C. § 219(b)(1) (1997). If either the individual (or spouse) is a participant in a retirement plan, the $2,000 limit is phased out once taxpayers exceed a certain AGI (for those filing married filing joint between $40,000 and $50,000) and for unmarried (between $25,000 and $35,000). I.R.C. § 219(g)(1) (1997). Even if the deduction is limited, taxpayers may still make non-deductible contributions to the IRA. I.R.C. § 408(o)(1) (1997) (thus preserving the tax-free annual build-up in the account).

193 I.R.C. §408(a)(6) (1997) (incorporating by reference I.R.C. § 401(a)(9) (1997)).

194 I.R.C. § 72(t)(1) (1997).

195 PRESIDENT'S TAX PROPOSALS, supra note 168.

196 Id.

197 Id.

198 Taxpayer Relief Act of 1997 § 213(a), Pub. L. No. 105-34, 111 Stat. 788, 813-16 (1997) (adding I.R.C. § 530).

199 I.R.C. § 530(a) (1997).

200 I.R.C. § 530(b)(1) (1997).

201 I.R.C. § 530(d)(2) (1997).

202 Taxpayer Relief Act of 1997 § 203(a), (b), Pub. L. No. 105-34, 111 Stat. 788, 809 (1997) (adding I.R.C. § 72 (t)(2)(E), (7), respectively).

203 Taxpayer Relief Act of 1997 § 202, Pub. L. No. 105-34, 111 Stat. 788, 808-09 (1997) (adding I.R.C. § 62(a)(17), allowing for deduction in arriving at adjusted gross income and redesignating I.R.C. § 221 as I.R.C. § 222 and adding new I.R.C. § 221.

204 I.R.C. § 221(b)(1).

205 Id. at § 221(b)(2).

206 Id. at 221(d).

207 Taxpayer Relief Act of 1997 § 225(a)(1), (2), 111 Stat. 788, 820 (1997) (amending I.R.C. § 108(f)(2) and adding I.R.C. § 108(f)(3)).

208 State of the Union Address, supra note 2.

209 MICHAEL J. GRAETZ, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 17 (2d ed. 1988). A more expanded set of goals of a "good" tax system would include the following:(1) economic efficiency; (2) administrative simplicity; (3) flexibility; (4) political responsibility; and (5) fairness. JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 390 (2d ed. 1988).

210 "It is also important that a tax system be perceived to be fair by the populace. If it is not many observers expect that noncompliance will be widespread." GRAETZ, supra note 203, at 17.

211 BITTKER AND LOKKEN, supra note 151, ¶ 56.2, at S56-4.

212 GRAETZ, supra note 209, at 17.

213 The Tax Reform Act of 1986 identified a lack of efficiency as one of the primary problems in the then-existing tax law. 1 DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 4-5 (1984).

214 GRAETZ, supra note 209, at 18.

215 See supra notes 173-87 and accompanying text.

216 See supra notes 14-17 and accompanying text.

217 See PRESIDENT'S TAX PROPOSALS, supra note 168.

218 See generally, Martin A. Sullivan, Clinton's Proposed Tuition Breaks Raise Questions on Several Fronts, TAX NOTES TODAY, Dec. 17, 1996, available in LEXIS 96 TNT 244-2.

219 Id.

220 Robert D. Reischauer & Lawrence E. Gladieux, Higher Tuition, More Grade Inflation, WASH. POST, Sept. 4, 1996, at A15; see also, Sullivan, supra note 212.

221 I.R.C. § 25A.

222 Carolyn D. Wright, Newest Middle-Class Perk: Tax-Favored Qualified State Tuition Programs, 96 TAX NOTES TODAY, Oct. 9, 1996, available in LEXIS 96 TNT 198-4.

223 Id. (noting that "investing in a mutual fund over a 15-year period will almost certainly yield a higher return than the hedge against inflation that tuition plans provide").

224 See supra notes 14-17, 173-87 and accompanying text.

225 See PRESIDENT'S TAX PROPOSALS, supra note 168.

226 See Sheryl Stratton, Prepaid Tuition Programs Major in Political Science, TAX NOTES TODAY (July 3, 1996), available in LEXIS 96 TNT 130-1.