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THE ILL EFFECTS OF MID-1980s TAX POLICY ON HIGHER EDUCATION

by

J. TIMOTHY PHILIPPS*
ROBERT A. BULLIVANT**

INTRODUCTION

Since 1980 there have been at least fourteen major pieces of federal tax legislation¹ along with the inevitable technical corrections acts.² One aspect of this frenetic legislative activity is that those interest groups most effective in putting their cases forward to Treasury policymakers and the Congressional tax writing committees have come out of the process much better than those whose efforts have not been so effective. A review of federal tax legislation in this decade indicates that one interest group has been relatively ineffective in putting its case forward -- higher education.

Tax law changes in the 1980s have been predominantly unfavorable to higher

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¹ Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980); Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (1980); Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 95 Stat. 172 (1981); Subchapter S Revision Act, Pub. L. No. 97-354, 96 Stat. 1669 (1982); Highway Revenue Act of 1982, Pub. L. No. 97-424, 96 Stat. 2169 (1982); Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324 (1982); Railroad Retirement Solvency Act of 1983, Pub. L. No. 98-76, 97 Stat. 411 (1983); Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (1983); Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984); Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), Pub. L. No. 99-272, 100 Stat. 83 (1986); Superfund Amendments and Reauthorization Act of 1986, Pub. L. No. 99-499, 100 Stat. 1613 (1986); Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (1986); Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986); and most recently, the Revenue Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330-382 (1987). For a brief history of tax legislation in the 1980s, see Leonard, *Perspectives on the Legislative Process*, 38 TAX NOTES 69 (1988).

² Technical Corrections to the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 98-369, tit. VII, §§ 711-15, 98 Stat. 942 (1984);

Technical Corrections to the Highway Revenue Act of 1982, Pub. L. No. 98-369, tit. VII, §§ 721-22, 98 Stat. 942 (1984);

Technical Corrections to the Tax Reform Act of 1984, Pub. L. No. 99-514, tit. XVIII, §§ 1801-81, 100 Stat. 2785 (1986);

Technical Corrections to the Deficit Reduction Act of 1984, Pub. L. No. 99-514, tit. XVIII, §§ 1882-93, 100 Stat. 2914 (1986);

Technical Corrections to the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-514, tit. XVIII, §§ 1895-97, 100 Stat. 2931 (1986).

education, especially private higher education. The Tax Acts of 1984 and 1986 were particularly adverse to higher education. Although many of the changes taken singly have merit, their cumulative effect appears to be an unstated, and perhaps unintended, educational policy that discourages rather than encourages higher education activity.

This article will focus on the provisions of the 1984 and 1986 Acts that most directly affect higher education in an adverse way. While tax legislation in the early 1980s left higher education relatively unscathed, these two acts of the mid-1980s had major detrimental effects on higher education.

This article will catalog and assess the impact on higher education of several tax law provisions enacted in the mid-1980s. It is the thesis of this article that the individual pieces of legislation are a de facto (and probably unwitting) educational policy that adversely affects higher education. This article will not rehash all of the arguments for or against providing tax incentives for higher education. These have been amply analyzed in prior literature.³ There appears to be a general social consensus that higher education should be encouraged and that the tax system should not discourage it. Tax incentives for higher education have a long and venerable history.⁴ It is an abrupt change from prior practice, therefore, for tax policy to take a turn in precisely the opposite direction.

THE 1984 AND 1986 LEGISLATION

Several provisions in the 1984 and 1986 Acts are likely to have adverse effects on higher education. These include changes dealing with charitable giving, scholarships, prizes and awards, interest deductions, restrictions on miscellaneous itemized and travel deductions, personal exemptions, standard deduction and kiddie tax, the exclusion for employee educational expenses, tax deferred annuities, section

³ See, e.g., Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?* 28 TAX L. REV. 37 (1972); Surrey, *Federal Income Tax Reforms: The Varied Approaches Necessary to Replace Tax Expenditures With Direct Governmental Assistance*, 84 HARV. L. REV. 352, 381-94 (1970); Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 344-75 (1972); McDaniel, *Federal Matching Grants for Charitable Contributions A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377 (1972). Yang, *Collaboration Between Nonprofit Universities and Commercial Enterprises: The Rationale for Exempting Non-Profit Universities From Federal Income Taxation*, 95 YALE L.J. 1857 (1986); Hansmann, *The Rationale for Exempting Nonprofit Organizations From Corporate Income Taxation*, 91 YALE L.J. 54 (1981); Bittker & Rahdert, *The Exemption of Nonprofit Organizations From Federal Income Taxation*, 85 YALE L.J. 299 (1976).

⁴ For example, the tax deduction for contributions to educational institutions was enacted in 1917 as part of the general charitable contribution deduction. War Revenue Act of 1917, ch. 63, tit. XIII, § 1201(2), 40 Stat. 30. The exemption of educational institutions from income tax dates as far back as the Revenue Act of 1894. Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 556. There was also an earlier recognition by the Internal Revenue Service of an exemption for literary, scientific or other charitable institutions. Bittker & Rahdert, *The Exemption of Nonprofit Organizations From Federal Income Taxation*, 85 YALE L.J. 299, 301 n.2, citing G. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 275 (1863). Moreover, since the Statute of Uses (1601), the statutory term, charitable, has been interpreted to include educational institutions. Bittker & Rahdert, *supra* at 333.

501(c)(3) bonds, and the research and development credit. Each of these changes represents individual aspects of Congressional tax policy. All or almost all of these changes arguably have some merit taken individually. However, their cumulative effect is to constitute a substantial tax disincentive to higher education activity.

Charitable Giving

Changes in the alternative minimum tax, lower tax rates, increases in the amount by which the amount of a charitable gift of property must be reduced in certain circumstances, expiration of the charitable deduction for non-itemizers, and stricter appraisal requirements for large gifts of property combine to make it less attractive to contribute charitable gifts to educational institutions. This is especially true with respect to gifts of appreciated property, which are an important source of charitable contributions to higher education.

1. Alternative Minimum Tax

Tax law has historically permitted a taxpayer to take into account the full fair market value of appreciated capital gain property given to certain charities and to deduct that amount within certain percentage limits.⁵ This remains the law for purposes of the regular income tax. However, the 1986 Act requires that any appreciation in gifts of property to charity be included in the alternative minimum tax base.⁶ The appreciation element will, therefore, be taxed at the alternative minimum tax rate of 21 percent.⁷ This is likely to have an adverse effect on charitable gifts of property, although the extent of that effect is uncertain.⁸

Studies by some economists indicate that charitable contributions to educational institutions are highly sensitive to the cost of making the charitable gift.⁹

⁵ Essentially, gifts of long-term capital gain property made to public and operating charities as defined in Internal Revenue Code of 1986 § 170(b)(1)(A) qualify for this benefit. See Internal Revenue Code of 1986 § 170(e). [Hereafter, references to the Internal Revenue Codes of 1954 and 1986 will be to 1986 IRC or 1954 IRC and section number.] A taxpayer can deduct the full fair market value of such gifts up to a maximum of 30% of the taxpayer's contribution base for the tax year. § 170(b)(1)(C). The contribution base is the taxpayer's adjusted gross income for the year computed without regard to any net operating loss carryback. § 170(b)(1)(F). Some tax theorists have attacked this benefit as a loophole. See, e.g., Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 371-72 (1972) (criticizing full fair market value deduction although generally approving the charitable deduction). However, to date no serious legislative attack has been made on it under the regular income tax.

⁶ I.R.C. § 57(a)(6) (1986).

⁷ I.R.C. § 55 (1986)

⁸ See Auten & Rudney, *Tax Reform and Individual Giving to Higher Education*, 31 TAX NOTES 935, 940 (June 2, 1986).

⁹ See Feldstein, *The Income Tax and Charitable Contributions: Part II - The Impact on Religious, Educational and Other Organizations*, 28 NAT'L TAX J. 209 (1975); Fisher, *The Combined State and Federal Income Tax Treatment of Charitable Contributions*, 1977 Proceedings of the Nat'l Tax Ass'n 397. The price elasticity of giving measures the response of giving to a change in the cost of giving. Feldstein found that giving to educational institutions had a price elasticity of -2.23. This indicates that a rise of 10 percent in the price of giving would decrease the amount of giving by 22.3 percent. Fisher's study reached similar results. See Auten & Rudney, *supra* note 8, at 940.

Inclusion of the appreciation component of a charitable gift in the alternative minimum tax base will raise the after-tax cost of making a contribution of appreciated property for at least some taxpayers, those subject to the alternative minimum tax.¹⁰

Gifts of appreciated property constitute a high proportion of all gifts to educational institutions.¹¹ Historically, more than 40 percent of their contributions have been in the form of appreciated property, and more than 60 percent of those gifts are for capital purposes.¹² Moreover, gifts to educational institutions are relatively more likely to come from the higher income taxpayers who are more sensitive to the after-tax cost of giving.¹³ Higher education institutions receive 70 percent of their gifts in amounts of \$5,000 or more from high income taxpayers.¹⁴ Finally, gifts to educational institutions are more likely to be considered "discretionary" than gifts to religious organizations and organizations such as the Boy Scouts which are more likely to be considered "commitments", and, therefore, less sensitive to tax effects.¹⁵ All of these factors, combined with the fact that Congress has substantially lowered marginal income tax rates to only 28 percent for the highest income taxpayers, indicate that charitable giving to educational institutions will be adversely affected.¹⁶

This conclusion seems to be borne out in a recent study by the American Association of Fundraising Counsel. The Association's report indicated that for 1987 the rate of growth of charitable contributions was below the increase for 1986.¹⁷ More significantly for higher education, a survey of 125 art museums commissioned by the Association of Art Museum Directors found that the number of art works donated fell from 45,000 in 1986 to 23,000 in 1987, a drop of nearly 50 percent.¹⁸ A major cause of this drop was almost surely the inclusion of appreciation in the alternative minimum tax base. One taxpayer was quoted as saying that "I now have

¹⁰ The after-tax cost of a charitable contribution is the amount of the contribution less the amount of tax saved by making the contribution. For example, the after-tax cost of making a \$100 cash contribution for a taxpayer in the 28 percent marginal tax bracket is \$72. This consists of the \$100 amount of the gift minus the \$28 tax savings engendered by the charitable deduction. Inclusion of appreciation in the alternative minimum tax base reduces the tax saving caused by the contribution, and, thereby, raises the after-tax cost of the gift.

¹¹ Auten & Rudney, *supra* note 8, at 938.

¹² Hoyt, *How to Avoid the AMT When Making Gifts of Appreciated Property*, 37 TAX NOTES 638, 640 (1987).

¹³ Auten & Rudney, *supra* note 8, at 939.

¹⁴ Hoyt, *supra* note 12, at 40.

¹⁵ Auten & Rudney, *supra* note 8, at 940.

¹⁶ See Abbin, *Tax Reform Will Affect Charitable Giving of Appreciated Property*, 33 TAX NOTES 675 (1986); Lindsey, *Gifts of Appreciated Property; More to Consider*, 34 TAX NOTES 67 (1987). The lower the marginal rate, the lower the tax savings and, hence, the higher the after-tax cost of the gift. See note 8.

¹⁷ Cox, *New Figures Show Growth in Donations Has Slackened*, Wall St. J., June 13, 1988 at 19. Another recent study using the National Bureau of Economic Research TAXSIM model estimated that charitable giving would decline by about one-sixth as a result of the 1986 Act, with gifts of appreciated property being especially hard hit. Lindsey, *NBER Reports*, 39 TAX NOTES 1340, 1341 (1988).

¹⁸ Cox, *supra* note 17, at 19.

to figure each year how much I can give before I get pushed over into the alternative minimum tax."¹⁹ Although it is still too early to determine the exact effects of this change in the tax laws it is doubtful that anyone would argue that it was beneficial to higher education.

2. Reductions in Basis

Another change in the charitable giving rules that is likely to have some effect on donations to higher education, although most likely not a great one, is the reduction in basis rule. A taxpayer has the election to apply a 50 percent of contribution base limitation rather than the normal 30 percent limitation for a gift of capital gain property to an operating or public charity. Formerly the cost of this election was that the taxpayer had to reduce the amount of the contribution taken into account by 40 percent of the appreciation element in the property.²⁰

The election could be advantageous when the taxpayer made a large gift in relation to the taxpayer's adjusted gross income. This would allow the taxpayer to deduct up to 50 percent of adjusted gross income in the current year at a cost in total deduction over the five year carryover period²¹ of 40 percent of the appreciation element.

Under current law, the entire amount of the appreciation, not merely 40 percent, must be subtracted from the amount of the contribution. Therefore, if the election is made now, the amount of the contribution will be limited to basis only rather than basis plus 60 percent of the appreciation as was true under the old law.²² Granted, this is a relatively minor change, but it is still likely to affect charitable giving adversely.

3. Non-Itemizer Charitable Deduction

Under prior law, taxpayers who did not itemize their deductions were entitled to take a charitable contribution above-the-line in addition to using the old zero rate bracket.²³ The amount of the deduction allowed was phased in over the period from 1982 to 1986, so that the full amount of contributions made in 1986 was deductible by non-itemizers.²⁴ However, the deduction was subject to a sunset provision that

¹⁹ *Id.* It has been reported that John Whitney Payson sold the Van Gogh masterpiece "Irises" rather than donate it to his alma mater. This was likely prompted at least partly by the 1986 Tax Act changes. *Art For Money's Sake*, FORTUNE, Oct. 12, 1987, p. 9.

²⁰ I.R.C. § 170(b)(1)(C); § 170(e)(1) (1954).

²¹ Taxpayers whose gifts exceed the percentage of adjusted gross income limitations are entitled to carry over the excess contribution for a period of up to 5 years. See I.R.C. § 170(d) (1986).

²² See Slaughter, *1986 Act Squeezes Some Charitable Contributions of Appreciated Property*, 33 TAX NOTES 505 (1986).

²³ I.R.C. § 170(i) (1954). The zero rate bracket has been replaced in the 1986 Act by a standard deduction. 1986 Act § 63(c).

²⁴ I.R.C. § 170(a), (i) (1954).

caused it to expire at the end of 1986.²⁵

When Congress enacted the 1986 Tax Act it did not extend the non-itemizer deduction. Therefore, taxpayers who do not itemize deductions can no longer take a charitable contribution deduction. Prior to the 1986 Act approximately 60 percent of taxpayers did not itemize deductions.²⁶ Because the 1986 act raised the standard deduction substantially, the number of itemizers is expected to decline by approximately one quarter under the 1986 Act.²⁷ This means that approximately 70 percent of all taxpayers will not itemize under post 1986 law. For these taxpayers, the cost of making a charitable contribution will rise to 100 percent of the gift. This change is likely to affect giving to educational institutions by recent alumni, whose income is relatively low and who, therefore, are less likely to itemize their deductions. Although this may not have any immediate substantial effect on the amount of contributions, it is likely to deter some of these younger alumni from making the smaller contributions which they would otherwise make, and thereby, prevent them from getting into the habit of giving to their alma mater.

4. Appraisal Requirements

The 1984 Act specifically delegated authority to the Treasury to issue regulations providing that certain contributions of property will not be allowed as deductions unless the donor complies with substantiation requirements set out in those regulations.²⁸ In response to this delegation of authority the Treasury has issued regulation section 1.170(a)-13²⁹ setting out requirements for substantiation of the value of property where the value of the gift exceeds \$5,000.³⁰

In general, for contributions to which the requirements apply, the donor must obtain a qualified appraisal and attach an appraisal summary to the tax return on which a deduction with respect to the appraised property is claimed.³¹ The regulations set out detailed requirements for a qualified appraisal including the time that the appraisal must be made, the qualifications of the appraiser and the

²⁵ I.R.C. § 170(i)(4) (1954).

²⁶ Internal Revenue Service Statistics of Income Bulletin, p. 87, Table 7 (Winter 1987-88). In 1986, out of approximately 103 million individual income tax returns, nearly 41 million itemized deductions. *Id.*

²⁷ Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (Blue Book) 11 (99th Cong., 2d Sess. 1986) [hereinafter referred to as 1986 Bluebook]. The standard deduction for 1988 is \$5,000 for a married couple filing a joint return, and \$3,000 for an unmarried individual. I.R.C. § 63(c)(2) (1986). The zero rate bracket for 1986 was \$3,540 for a married couple filing a joint return and \$2,390 for an unmarried individual. I.R.C. § 1 (1954).

²⁸ Deficit Reduction Act of 1984 (DEFRA) § 155, Pub. L. No. 98-369, 98 Stat. 494 (1984).

²⁹ Treas. Reg. § 1.170A-13(c) (1988).

³⁰ The requirements do not apply to contributions of money or publicly traded securities for which market quotations are regularly available. Treas. Reg. § 1.170A-13(c)(1)(i). Contributions of non-publicly traded securities for which a value of between \$5,000 and \$10,000 is claimed are subject to less stringent requirements than other contributions. *Id.* at (c)(2)(ii).

³¹ *Id.* at (c)(2)(i).

information that must be contained in the appraisal.³² In addition, an appraisal summary containing information similar to that in the appraisal must be attached to the tax return.³³ If these requirements are not met the deduction is disallowed.³⁴ Moreover, the 1984 Act also substantially broadened the penalty for overvaluation of a charitable gift of property.³⁵

These requirements apply to precisely the kind of large appreciated property gift upon which institutions of higher education so heavily rely. The Senate Committee report accompanying the authorizing legislation specifically mentioned tax shelter promotions with books, gems, and the like, and the donation of gems to museums as abuses which required a tightening of the law.³⁶ Undoubtedly, egregious abuses with respect to tax shelters dealing in overvalued property needed to be remedied. One wonders, though, whether the broad appraisal requirements and overvaluation penalties finally enacted were not a case of overkill. In any event, the economic and transactional costs of the appraisal requirement and the possibility of overvaluation penalties are likely to have at least some deterrent effect on giving of appreciated property to institutions of higher education.

Scholarships and Prizes

Both the 1984 and 1986 Acts contained provisions affecting the scholarship exclusion in section 117, and the 1986 Act virtually eliminated the exclusion of prizes and awards under section 74. These provisions directly affect the individual recipients of the scholarship or award. However, they will also affect institutions of higher education indirectly by making scholarships worth less to the recipients on an after-tax basis, and making awards to individuals for activities traditionally carried on by higher education personnel, such as literary and scientific activity, less valuable to those recipients. Moreover, they are likely to burden institutions of higher education with higher administrative costs of compliance with these changes.

³² Basically, the appraisal must be made not earlier than 60 days prior to the date of the gift, *Id.* at (c)(3)(i)(a), and must be made by a qualified appraiser. *Id.* at (c)(3)(i)(B). A qualified appraiser is a person who includes on the appraisal summary a declaration that the person: 1) holds oneself out to the public as an appraiser; 2) is qualified to make appraisals because of qualifications set out in the appraisal; 3) is not the donor, donee, a party to the transaction in which the donor acquired the property, or a party related to any of the above within the definition of related party of I.R.C. § 267(b) (1986). *Id.* at (c)(5). The appraisal must also contain: 1) a detailed description of the property. *Id.* at (c)(3)(ii); 2) the date or expected date of the gift, *Id.*; 3) the basis for the valuation, *Id.*; and information concerning the appraiser. Finally, the valuation may not involve a prohibited appraisal fee, such as one based on a percentage of the deduction allowed. *Id.* at (c)(3)(i); (6)(i).

³³ *Id.* at (c)(2)(B),(4).

³⁴ *Id.* at (c)(1)(i).

³⁵ I.R.C. § 6659(f) (1986) imposes a new penalty of 30 percent of the understatement of tax attributable to overvaluation of a charitable gift of property other than publicly traded securities. Hence, the penalty applies to gifts of closely held stock, works of art, and real estate. The penalty becomes applicable where the overvaluation is more than 150 percent of the amount determined to be the correct value. *Id.* at § 6659(c).

³⁶ S. REP. -98-169, 98th Cong., 2d Sess. 444 (1984). The reference to "gems donated to museums" presumably referred to a scandal involving overvaluation of gifts to the Smithsonian Institution. See Gup, *IRS is Challenging Smithsonian Donors on Tax Shelter Gifts*, Washington Post, March 29, 1983, at A1, col. 1.

1. Scholarships

The 1986 Act substantially narrowed the exclusion for scholarships that had been codified since the enactment of the 1954 Code.³⁷ Under prior law scholarship and fellowship grants awarded to degree candidates were tax free, regardless of the use to which the grant was put. Therefore, amounts spent for items such as room and board, travel, and incidental expenses were fully excludable.³⁸ For nondegree candidates, the exclusion was limited to \$300 per month.³⁹ In addition, there was an exclusion for federal grants that were conditioned upon the performance of services for the federal government.⁴⁰

The 1986 Act completely eliminates the scholarship exclusion for items such as room and board and incidental expenses. The exclusion is now limited to amounts incurred by the student for tuition, fees, books, supplies, and equipment.⁴¹ The terms of the grant need not expressly require that the amounts received be used for tuition and related expenses.⁴² However, to the extent that terms of the grant earmark any portion for expenses such as room and board, such amounts are not excludable.⁴³ Incidental expenses are not considered related expenses.⁴⁴ For example, if a student is enrolled in a course in which a word processor is recommended but not required, any amount expended for the word processor would not qualify for the exclusion.⁴⁵

The 1986 Act also repealed the former exclusions for 1) amounts received in exchange for services required of all candidates for a particular degree as a condition to receiving such a degree, and 2) grants conditioned upon performance of services for the federal government.⁴⁶ The new law requires that students must include in gross income all amounts received that represent payment for teaching, research, or

³⁷ Prior to 1954 there was no express provision in the Internal Revenue Code dealing with scholarships. However, scholarships determined to be gifts were excludable under the gift exclusion. This required a case by case analysis of whether the scholarship possessed the requisite characteristics of a gift. In 1954 Congress enacted § 117 in an attempt to remove the case by case uncertainty from the area. See Judge, *Student Athletes as Employees: Income Tax Consequences*, 13 J. COLL. & UNIV. LAW 285, 289-93 (1986); Lee, *The Taxation of Athletic Scholarships: An Uneasy Tension Between Benevolence and Consistency*, 37 FLA. L. REV. 591, 592-93 (1985).

³⁸ I.R.C. § 117(a) (1954); Treas. Reg. § 1.117-1(a).

³⁹ I.R.C. § 117(b)(2)(B) (1954).

⁴⁰ I.R.C. § 117(c) (1954).

⁴¹ I.R.C. § 117(a), (b) (1986). Section 117(a) limits the exclusion to amounts received as a "qualified scholarship." Section 117(b) defines a "qualified scholarship" as amounts used by the student for:

(A) tuition and fees required for the enrollment or attendance of a student at an educational organization described in section 170(b)(1)(A)(ii), and

(B) fees, books, supplies, and equipment required for courses of instruction at such an educational organization.

I.R.C. § 117(b)(2)(A), (B) (1986). For a summary of the new law see Madoff, *Back to School After the Tax Reform Act of 1986: Effect of the New Law on Educational Funding*, 66 TAXES 570 (1987).

⁴² Proposed Treas. Reg. § 1.117-6(c)(1), 53 Fed. Reg. 21688 (1988).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.* at (c)(6), e.g. 1.

⁴⁶ I.R.C. § 117(b)(1) (1954).

other services by the student required as a condition of receiving the scholarship.⁴⁷

This requirement encompasses both cash amounts received in return for services, and also amounts by which tuition or related expenses of the person who performs services are reduced.⁴⁸ For example, a student who receives a tuition remission on account of being editor-in-chief of the law review at the student's law school would, presumably, come under this section, since the amount represents payment for services (research, writing, and editing) performed on behalf of the grantor of the tuition reduction. Moreover, this provision applies regardless of whether the services are required of all candidates for a particular degree or not.⁴⁹ For example, if a law school requires all J.D. candidates to fulfill a writing requirement and law review writing counts toward that requirement, the tuition reduction for the editor-in-chief would still be taxable under the new law.

Finally, the 1986 Act repealed the former \$300 per month exclusion for non-degree candidates.⁵⁰ Henceforth, any amount received as a scholarship or fellowship by a person who is not a candidate for a degree will be fully includable in gross income.⁵¹ This will affect professors and other nondegree candidates who receive grants to perform research or receive scholarships to attend conferences and other educational activities. It will not, however, affect whether unreimbursed educational expenses may be deducted as trade or business expenses.⁵² So in appropriate circumstances professors may be able to deduct these amounts. The deduction will, however, be subject to the two percent of adjusted gross income floor under section 67, and will be available only to taxpayers who itemize deductions.⁵³ These restrictions will severely limit the actual value of the potential deduction.

Amounts taxable under section 117 that do not represent payment for services are not subject to income tax withholding. However, amounts received which represent payments for services are considered wages for purposes of sections 3401 and 3402 relating to withholding for income taxes and to section 6041 and 6051

⁴⁷ I.R.C. § 117(c) (1986).

⁴⁸ Prop. Treas. Reg. § 1.117-6(d), 53 Fed. Reg. 21692 (1988).

⁴⁹ *Id.*

⁵⁰ I.R.C. § 117(b)(2) (1954).

⁵¹ See I.R.C. § 117(a) (1986). The proposed regulations define a degree candidate as:

- (i) A primary or secondary school student;
- (ii) An undergraduate or graduate student at a college or university who is pursuing studies or conducting research to meet the requirement for an academic or professional degree; or
- (iii) A full-time or part-time student at an educational organization described in section 170(b)(1)(A)(ii) that--

(A) Provides an educational program that is acceptable for full credit towards a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation, and

(B) Is authorized under Federal or State law to provide such a program and is accredited by a nationally recognized accreditation agency.

Prop. Treas. Reg. § 1.117-6(c)(4), 53 Fed. Reg. 21691 (1988).

⁵² See *Id.* H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-16 (1986) [hereinafter 1986 Conference Report].

⁵³ See text accompanying notes 87 to 98A *infra*.

relating to reporting amounts paid for services.⁵⁴ Whether these amounts are also subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) withholding depends upon the nature of the employment.⁵⁵ Generally services performed in the employ of a college or university are exempt from FICA and FUTA if such service is performed by a student who is enrolled and regularly attending classes.⁵⁶ If part of the grant is in return for services and part of it is a pure excludable scholarship, the college or university must for withholding purposes make an allocation between the amount for excludable scholarship and the includable amount for services.⁵⁷

Under the new rules, therefore, institutions of higher education will have to meet new withholding and reporting requirements with respect to many additional students. Compliance will impose additional administrative costs on these institutions. In addition, many students will find that they face income tax liability on account of receipt of pure scholarships. This will occur when grants are used for expenditures that do not come within the definition of tuition and related expenses.

For example, assume that an undergraduate student receives a tuition, room and board scholarship amounting to a total of \$14,000, of which \$8,000 is attributable to tuition and \$6,000 to room and board. Assume further that the student is eligible to be claimed as a dependent on his parents' own tax return.⁵⁸ In such a circumstance, the student is not entitled to take a personal exemption for himself on his own tax return under the 1986 Act rules.⁵⁹ The student would, however, be eligible to take the full \$3,000 standard deduction because the includable scholarship is characterized as earned income under the proposed Treasury Regulations.⁶⁰ The student would have a gross income inclusion of \$6,000, representing the value of the room and board component of the scholarship. This inclusion would be partially offset by the \$3,000 standard deduction, leaving a taxable income of

⁵⁴ Prop. Treas. Reg. § 117-6(d)(4), 53 Fed. Reg. 21692 (1988).

⁵⁵ *Id.*

⁵⁶ I.R.C. § 3121(b)(10) (1986).

⁵⁷ Prop. Treas. Regs. § 1.117-6(d)(3). Factors to be taken into account in making this allocation include but are not limited to compensation paid by:

- (i) The grantor for similar services performed by students with qualifications comparable to those of the scholarship recipient, but who do not receive scholarship or fellowship grants;
- (ii) The grantor for similar services performed by full-time or part-time employees of the grantor who are not students; and
- (iii) Educational organizations, other than the grantor of the scholarship or fellowship, for similar services performed either by students or other employees.

Id.

⁵⁸ Amounts received as a scholarship by a student who is a child of the taxpayer do not count toward support provided by the child in determining whether the parent provided over one-half the child's support. I.R.C. § 151(d) (1986). This provision presumably applies regardless of whether the scholarship is partially includable in gross income under § 117.

⁵⁹ I.R.C. § 152(d)(2) (1986). See text accompanying notes 99 to 105 *infra*.

⁶⁰ Prop. Treas. Reg. § 1.117-6(h), 53 Fed. Reg. 21694 (1988). The 1986 Act limits the standard deduction of an unmarried individual who can be claimed as a dependent to the greater of \$500 or earned income up to a maximum of \$3,000. I.R.C. § 63(c)(5) (1986).

\$3,000. The student would then owe a tax of \$450 at the 15 percent tax rate.

Unless the \$6,000 room and board amount were in return for services no amount of this \$450 tax liability would be withheld from the student.⁶¹ The student would, therefore, be faced with a lump sum tax liability of \$450 on April 15, or in the alternative, could make estimated tax payments throughout the year. While the \$450 liability is not astounding, it is a sizeable amount for a student who has few other resources, especially in view of the fact that the income is in-kind income that generates no cash flow.⁶²

Many scholarships are awarded based on the need of the student. It does not make sense to award a scholarship to a student based on need, and then have the federal government take part of it away because it is partially taxable. The Bluebook indicates that the lawmakers believed the increased standard deduction under the 1986 Act would cause many students who receive nonexcludable scholarship income to be absolved of any potential tax liability.⁶³ However, this fails to take into account the denial of the personal exemption in many cases. There are, in fact, likely to be many students who do incur tax liability on account of the receipt of a scholarship. The irony of this is that most of those students will be those who have the largest scholarships and who are awarded such large scholarships, presumably, at least in part, because they are in greatest need. Thus, the tax is likely to hit the neediest students the hardest.

⁶¹ See text accompanying notes 53 to 56, *supra*.

⁶² For graduate students the situation may be even more critical. A special exclusion for tuition remissions of graduate student teaching and research assistants, I.R.C. § 127(c)(8) (1986), was allowed to expire for tax years ending after December 31, 1987. An article in the Chronicle of Higher Education traced the three year tax history of a typical graduate student:

Bea is an unmarried, full-time student pursuing an advanced degree. All students in her program are required by the university to learn and perform certain tasks in the laboratory. Bea earns \$10,000 for her lab work, and course fees amounting to \$5,000 are remitted. She does not itemize deductions and lives in a state that imposes a flat-rate tax of 2 percent on federal adjusted income.

Bea's taxes for 1986 were zero. Under the old law, her stipend was tax-free because the work was required for her degree. The remission of tuition came under a provision in the tax law that allowed employers to provide employees up to \$5,250 in tax-free education assistance.

If Bea's work had not been required for her degree, she would have been taxed on the portion of her stipend that would be "reasonable" compensation for her services. Assuming that 60 percent or \$6,000 was considered compensation, she would have paid \$284 in federal taxes,... and \$120 in state taxes.

Under the revised law, the whole stipend for 1987 was taxable, whether her work was required for her degree or not, but the remission of tuition was still tax-free. Last April she paid \$762 for federal income tax,... and \$200 for state income tax....

This year, the employer-assistance provision expired, and Bea's tax picture became even darker. Because the \$5,000 in remitted tuition is now considered income, her tax obligations next April will be \$1,508 for federal income tax,... and \$300 for the state. An additional twist is that she will have to pay the... tax on \$15,000 out of her actual income of \$10,000....

Enis, *Colleges Face An Uphill Battle in Their Efforts to Undo The Adverse Effects of the New Tax Law*, Chronicle of Higher Education, August 10, 1988, at 2.

⁶³ 1986 Bluebook at 40.

2. Prizes and Awards

Prior to 1986, the law provided an exclusion in certain circumstances for prizes and awards received in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement.⁶⁴ The 1986 Act virtually eliminated this exclusion.⁶⁵ Prizes and awards are now excludable only if the award is transferred by the payor to a governmental unit or charitable organization pursuant to a designation made by the recipient prior to any use of the award by the recipient.⁶⁶ This change is not likely to affect colleges and universities directly. However, it does reduce the value of prizes and awards given in recognition of activities which colleges and universities promote. It, therefore, makes such prizes as the Nobel Prize less valuable. This has been criticized as being at least a symbolic detriment to higher education.⁶⁷

3. Tuition Reduction Plans

Finally, the 1984 Act tightened the exclusion requirements of college sponsored tuition reduction plans provided as a benefit to employees' children. Under prior law the regulations provided that tuition remissions provided by a college for children of its faculty were excludable as scholarships.⁶⁸

⁶⁴ § 74(b) (1954) provided:

(b) Exception.--Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if--

- (1) the recipient was selected without any action on his part to enter the contest or proceeding; and
- (2) the recipient is not required to render substantial future services as a condition to receiving the prize or award.

⁶⁵ I.R.C. § 74(b) (1986) provides:

(b) Exception for Certain Prizes and Awards Transferred to Charities.--Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if--

- (1) the recipient was selected without any action on his part to enter the contest or proceeding;
- (2) the recipient is not required to render substantial future services as a condition to receiving the prize or award; and
- (3) the prize or award is transferred by the payor to a governmental unit or organization described in paragraph (1) or (2) of section 170(c) pursuant to a designation made by the recipient.

(Emphasis added.)

⁶⁶ *Id.* § 74(b)(3). This exception would apply to a person such as Mother Theresa who received a Nobel Prize and whose vow of poverty required her to turn the prize over to her religious order. If Mother Theresa were otherwise subject to U.S. income tax, this provision would relieve her of liability. A charitable deduction would not result in a tax wash because of the percentage of adjusted gross income charitable deduction limitations. See I.R.C. § 170(b) (1986). For a detailed discussion criticizing the 1986 changes in treatment of prizes and awards, see Kogan, *The Taxation of Prizes and Awards--Tax Policy Winners and Losers*, 63 WASH. L. REV. 257 (1988).

⁶⁷ See Kogan, *supra* note 64, at 311-12.

⁶⁸ Treas. Reg. § 1.117-3(a).

When Congress addressed the problem of fringe benefits in 1984 it basically decided to codify the rule in the regulations. The House Bill included a provision providing for exclusion of tuition reductions, including cash grants, under section 117(d) of the Code.⁶⁹ The bill also provided that a tuition reduction plan would be subject to the nondiscrimination requirements included in the bill for other fringe benefits. Specifically, the bill provided that the plan must be made available on substantially the same terms to each member of a group of employees defined under a classification which does not discriminate in favor of highly compensated employees.⁷⁰ If the plan discriminated, then tuition reductions received by highly compensated employees would be taxable.⁷¹ However, the House bill specifically excepted from the anti-discrimination requirement plans that were restricted to faculty members only. That is, a plan which was restricted only to faculty members of an institution of higher education would not be discriminatory on that account alone.⁷² This faculty-only exception, however, was unexplainedly dropped in the Conference Committee.⁷³

This change had a severe impact on colleges and universities sponsoring tuition reduction plans. Many of these plans were restricted to faculty members. Accordingly, these institutions were faced with a choice of opening up the plans to of their employees on a nondiscriminatory basis, or having tuition reductions taxed to those employees defined as highly compensated. At the time, the definition of a highly compensated employee was not clear and it was speculated that any faculty member would be deemed highly compensated in relation to clerical and other staff personnel.⁷⁴ Making these benefits taxable at 1984 rates would have resulted in a drastic reduction in the value of the benefit.⁷⁵

⁶⁹ H.R. 4170, Tax Reform Act of 1984 § 503(a); H.R. REP. 98-432, 98th Cong., 2d Sess. 1605-06 (1987).

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² Proposed section 117(d)(3) provided:

(3) REDUCTION MUST NOT DISCRIMINATE IN FAVOR OF HIGHLY COMPENSATED, ETC.--Paragraph (1) shall apply with respect to any qualified tuition reduction provided with respect to any officer, owner, or highly compensated employee only if such reduction is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners, or highly compensated employees. *For purposes of the preceding sentence, a classification which includes all employees of the organization who are members of its faculty shall be treated as a reasonable classification.* (Emphasis added.)

⁷³ Deficit Reduction Act of 1984 § 532; H. Rep. 98-861, 98th Cong., 2d Sess. 1173 (1984). In addition, a provision that would have extended the exclusion to graduate level tuition reductions provided to teaching and research assistants, as well as undergraduate tuition was also dropped in Conference. *Id.* However the exclusion for graduate tuition was retained temporarily in I.R.C. § 127(c)(8) (1954). See *supra*, note 60A.

⁷⁴ National Association of College and University Business Officers, *NACUBO Report: Tuition Remission, The Business Officer* 22-23 (Dec. 1984).

⁷⁵ The cost of the taxable option would have been considerable under 1984 rates. For example, assume a married resident of Virginia whose child received a tuition benefit from his university of \$6800 in 1985. If the faculty member filed a joint return and had a joint taxable income (husband and wife combined) of \$30,000 (exclusive of the grant) they would be taxed at a marginal rate of 28 percent on the federal tax return and 5.75 percent on the state tax return, for a combined marginal rate of about 34 percent (rounded). In addition, the grant would be subject to FICA taxes of about 7 percent (rounded) payable to both the faculty member (employee) and the University (employer). The faculty member would pay total additional taxes

Colleges and universities, especially private institutions, have traditionally used such plans as a means of attracting qualified faculty members. For most faculty members, obtaining a quality higher education for their children is a very high priority. Accordingly, the tuition reduction plans offered by many private colleges and universities had a personal value to these faculty, probably far in excess of what the cost was to the college or university providing them.

The exclusion for such plans had been in the regulations since at least 1954, and, apparently, the Service had never mounted a serious challenge to the exclusion prior to 1954. Therefore, it came as quite a shock to institutions sponsoring tuition reduction plans when the faculty-only exception was eliminated. The options facing these institutions were all unpalatable in one way or another. They could simply drop their plans. Or they could reduce the amount of benefit, while opening up the plan to all employees. Alternatively, they could retain their discrimination in favor of faculty and thereby make at least some of the benefits taxable.⁷⁶ The cost of the latter option to faculty members receiving tuition reduction could be considerable, thus reducing the net value of the benefit.⁷⁷ Finally, institutions could choose to broaden the eligibility for their plans to all employees, and thereby comply with the nondiscrimination rules. This option, of course, would cost the institutions choosing it considerable amounts, especially those institutions having a program of cash grants for tuition.

There is no recorded legislative history that details the reasons for elimination of the exception for faculty-only tuition reduction plans. Little revenue will be gained from its elimination and any gains in equity to non-faculty employees may well be offset by losses to faculty whose institutions limit or drop the plans entirely on account of the non-discrimination requirement. Whatever benefits there may be from elimination of the faculty-only exception are likely to be offset many times by the costs that higher education institutions have and will incur as a result of it.

Interest Deduction

Under prior law, taxpayers were entitled to deduct almost all of their interest paid without regard to the use to which the loan proceeds were put.⁷⁸ A deduction for interest had been in the tax law as early as the Civil War Income Tax Act.⁷⁹ The

of \$2788 ($\$6800 \times [34\% + 7\%]$), leaving a net benefit of \$4012. In addition, the university would be subject to FICA taxes of about \$475 ($\$6800 \times 7\%$ rounded). Total federal, state and FICA taxes paid by both the faculty member and employer would be \$3263 ($\$2788 + \475) on a \$6800 grant.

⁷⁶ *Tuition Remission and Tuition Grants -- Analysis of Survey Concerning Eligibility and Scholarship Values*, Tuition Exchange, Sept. 1984, at 6, 7.

⁷⁷ See *supra* note 71.

⁷⁸ There were limitations with regard to certain investment interest, see I.R.C. § 163(d) (1954), and interest on indebtedness incurred to purchase or carry tax exempt bonds. See I.R.C. § 265(2) (1954). These provisions affected only a limited number of taxpayers.

⁷⁹ Act of March 3, 1865, ch.78, 13 Stat. 479. The 1894 Income Tax Act also contained a provision allowing a deduction for personal interest. See Act of August 27, 1894, ch. 349, § 28, 28 Stat. 553.

interest deduction was among the original itemized deductions allowed by the 1913 Revenue Act.⁸⁰

The 1986 Act, however, eliminated the interest deduction for interest on indebtedness, the proceeds of which are used for personal consumption purposes.⁸¹ The only exception to this disallowance of personal consumption interest is that certain indebtedness secured by a taxpayer's principal residence and one other secondary residence is still deductible.⁸² Basically, a taxpayer can deduct (1) interest on up to \$1,000,000 of indebtedness secured by and used to acquire, construct, or substantially improve the residences (acquisition indebtedness), plus (2) up to \$100,000 additional indebtedness secured by the residences (home equity indebtedness).⁸³ Home equity indebtedness is deductible regardless of the use to which the proceeds of the indebtedness are put.⁸⁴ Hence, a person can take out a home equity loan and use it for a vacation, or to buy a car, or to purchase other consumer items, and the interest will still be deductible.

Moreover, the deduction applies not only to a taxpayer's principal residence but also to a secondary residence such as a vacation home.⁸⁵ In fact, under temporary regulations, the deduction can extend to a mobile home or boat that is used as a residence by the taxpayer.⁸⁶ The regulations require only that the mobile home or boat contain sleeping space and toilet and cooking facilities.⁸⁷ Obviously this gives the taxpayer fairly wide berth in designating a secondary residence.

While interest secured by a secondary residence is deductible regardless of the use to which it is put, interest on a student loan is no longer deductible. This is probably one of the most egregious results of the 1986 legislation. Students who incurred large amounts of debt in the expectation that interest on it would be deductible now find that this legitimate expectation will not be fulfilled. This is because the disallowance applies to interest on debts incurred prior to the 1986 Act, as well as debt incurred subsequent to the Act. This will be especially difficult for graduate and professional students, many of whom face as much as \$50,000 or \$60,000 of student loan indebtedness upon graduation. A questioner asked a top Treasury official at the 1986 Virginia Tax Conference what the rationale was for disallowing interest on student loans and allowing it on second residences. The

⁸⁰ Act of October 3, 1913, ch. 16, § 2(B), 38 Stat. 167 (1913).

⁸¹ I.R.C. § 163(h) (1986). The Act does phase in the disallowance. In 1987, 35% of personal interest was disallowed, in 1988, 60% is disallowed, in 1989, 80% will be disallowed, and in 1990, 90% will be disallowed. In 1991, all personal consumption interest will be disallowed. *Id.* §163(d)(6).

⁸² I.R.C. § 163(h)(3) (1986).

⁸³ *Id.* § 163(h)(3). The amount of home equity indebtedness is further limited to the fair market value of the residence reduced by any acquisition indebtedness. *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.* § 163(h)(4).

⁸⁶ Temp. Treas. Reg. § 1.163-10T(p)(3)(ii), (iii).

⁸⁷ *Id.*

answer the official gave was that it was simply politics.⁸⁸

There seems to be no good reason why an interest deduction should be allowed for indebtedness incurred in connection with a second home while at the same time a deduction is denied for student loan indebtedness. The basic rationale for the mortgage interest deduction is that it provides a tax incentive for persons to own their own homes. One tax-incentive-home for a person should be enough. Higher education provides a much more beneficial long-range investment in the economy than do second homes. By increasing the cost of student loans, Congress discourages students from taking these loans to further their education.

Students who take loans are those who most need help in financing their education. To tax the interest on these loans while persons able to afford second homes can still deduct their mortgage interest makes no sense. Legislation has been introduced to reinstate deductibility of student loan interest.⁸⁹ Passage of this legislation should be a high priority for any Congressman interested in furthering higher education.

The nondeductibility of student loan interest affects a substantial number of taxpayers. According to one study, 43 percent of graduates of four-year institutions of higher education in 1984 had borrowed money for educational expenses.⁹⁰ Student loans provide a substantial portion of the income of higher education institutions.⁹¹ The denial of the interest deduction for these loans simply means that the cost of attending an institution of higher education, already rising more rapidly than the cost of living generally,⁹² will be even higher.

Restriction of Employee Business Deduction

The 1986 Act severely restricted employee business expense deductions. Indeed, for most taxpayers the Act effectively eliminated these deductions. This is because newly enacted section 67 puts a two percent floor under "miscellaneous itemized deductions," including employee business expenses.⁹³ Prior law permit-

⁸⁸ Response to question from audience of Roger P. Mentz, Assistant Secy. of Treas. for Tax Policy, at 1986 Virginia Tax Conference, Charlottesville, Virginia, June 5, 1986. A Congressional staffer remarked to one of the authors on another occasion that this result came about because most Congressmen have two residences.

⁸⁹ S. 628, 100th Cong., 2d Sess. (1988).

⁹⁰ Joint Comm. on Taxation Staff pamphlet (JCS-5-88) on Tax Incentives for Education, 100th Cong., 2nd Sess. 29 (1988), reprinted in BNA Daily Tax Report, March 15, 1988, at L-26, L-34.

⁹¹ See *Id.* at 37, Table 2, reprinted in BNA Daily Tax Report, March 15, 1988 at L-36.

⁹² See *Id.* at 34, Table 1, reprinted in BNA Daily Tax Report, March 15, 1988 at L-35:

⁹³ I.R.C. § 67 (1986) provides as follows:

(a) General Rule.--In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of the adjusted gross income.

(b) Miscellaneous Itemized Deductions.--For purposes of this section, the term "miscellaneous deductions" means the itemized deductions other than--

ted the deduction of most employee business expenses in full as an itemized deduction. Moreover, expenses for employees who travel away from home, reimbursed expenses, and expenses of an outside salesman were all deductible from gross income above-the-line, even if a taxpayer did not itemize deductions.⁹⁴

Under the 1986 Act, all employee business expenses except reimbursed expenses, are deductible only as below-the-line itemized deductions.⁹⁵ In addition, these expenses are subject to the requirement that they, along with certain other deductions, such as investment expenses and expenses for preparation of a tax return, may be deducted only to the extent that they exceed 2 percent of a taxpayer's adjusted gross income. Most taxpayers do not expend more than two percent of adjusted gross income for employee business expenses. For these taxpayers the Act effectively eliminates the deduction.

Many professors incur expenses for professional association dues, and for periodicals, books, and supplies used in their teaching and research activities. These items have historically been allowed as employee business expense deductions.⁹⁶ Although these expenditures are still technically deductible, no deduction will in fact be allowed in most instances, because of the 2 percent floor on the deduction. Hence, even though such expenditures are directly and legitimately related to a professor's business of teaching, researching, and lecturing, they will, for the most part, no longer be deductible. A deduction will be allowed only in instances where there are very substantial expenditures. Even then, taxpayers may deduct these expenditures

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- (1) the deduction under section 163 (relating to interest),
 - (2) the deduction under section 164 (relating to taxes),
 - (3) the deduction under section 165(a) for losses described in subsection (c)(3) or (d) of section 165,
 - (4) the deduction under section 170 (relating to charitable, etc., contributions and gifts),
 - (5) the deduction under section 213 (relating to medical, dental, etc., expenses),
 - (6) the deduction under section 217 (relating to moving expenses),
 - (7) any deduction allowable for impairment-related work expenses,
 - (8) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),
 - (9) any deduction allowable in connection with personal property used in a short sale,
 - (10) the deduction under section 1341 (relating to computation for tax where taxpayer restores substantial amount held under claim of right),
 - (11) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),
 - (12) the deduction under section 171 (relating to deduction for amortizable bond premium), and
 - (13) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

⁹⁴ See I.R.C. §§ 62(a)(2) (1954); § 162(a).

⁹⁵ See I.R.C. § 62(a)(2) (1986). There is a very limited exception to the itemization requirement for certain expenses of performing artists. *Id.* § 62(a)(2)(B).

⁹⁶ See *Treas. Reg.* § 1.162-6; *Rev. Rul.* 63-275, 1963-2 C.B. 85; *Rev. Rul.* 54-565, 1954-2 C.B. 95.

only to the extent that they exceed 2 percent of the taxpayer's adjusted gross income.

The likely effect of this provision will be to put considerable pressure on colleges and universities to provide reimbursement for their faculty members who incur such expenditures. The reason is that if the expenditure is reimbursed by the employer, the deduction is an above-the-line deduction and also is not subject to the two percent floor. Therefore, if a university provides a professor with reimbursement for professional journals or association dues, the reimbursement will constitute gross income but the offsetting deduction will wash out that income.⁹⁷ The net effect will be that the amount of the expenditure, thereby, escapes the professor's income tax base.

Compare the case of a university professor who expends \$500 during the year for professional association dues and periodical subscriptions. If the professor's adjusted gross income is \$30,000, and the university does not reimburse the professor for these expenditures, no deduction will be allowed on account of them, because they do not exceed two percent of the professor's adjusted gross income.⁹⁸ However, if the university reimburses the \$500, the reimbursement income is offset by a corresponding above-the-line deduction. This change will, therefore, either cost faculty members additional taxes or cost universities additional fringe benefit expenditures in the form of employee expense reimbursements.

Universities that choose to bear the cost of employee business expenses by reimbursement may, over a period of time, compensate for these increased costs by reducing salary cash payments. However, they will not be able to do so immediately through voluntary salary reductions under a cafeteria plan.⁹⁹ Payment of employee business expenses on their behalf would qualify for exclusion from gross income as a working condition fringe benefit under section 132.¹⁰⁰ However, fringe benefits excludable by reason of section 132 are not eligible for cafeteria plan treatment.¹⁰¹ Therefore, it is not possible for a university to implement such a policy immediately by means of voluntary salary reduction under a cafeteria plan.

⁹⁷ I.R.C. § 62(a)(2)(A) (1986). If the university pays these amounts directly, the payment is excludible from the taxpayer's gross income as a working condition fringe benefit. I.R.C. § 132(d) (1986).

⁹⁸ I.R.C. § 67 (1986).

⁹⁹ A so-called cafeteria or flex-benefit plan is a plan under which an employee can choose between receiving cash and receiving one or more eligible non-taxable fringe benefits. If the employee chooses the fringe benefit, section 125 provides that the benefit does not become taxable merely because the employee had the option of choosing cash. I.R.C. § 125(a) (1986). For example, the employee may be given the option of having salary reduced by an amount, say \$500, to be used for dental work. If the employer then pays \$500 for the employee's dental work, the \$500 is excludible from the employee's gross income, even though the \$500 would have been includible if taken directly by the employee in cash. Prior to enactment of section 125, the taxpayer, by reason of the option to take cash, would have been considered to be in constructive receipt of the cash. See Treas. Reg. § 1.451-1(a).

¹⁰⁰ I.R.C. § 132(d) (1986) excludes from gross income of an employee, property or services provided to the employee that would be deductible as employee business expenses if the employee had incurred the expenditure himself.

¹⁰¹ I.R.C. § 125(e)(1) (1986).

The 1986 Act also changed the away from home travel deduction for employees from an above-the-line to a below-the-line deduction when the expenditures are not reimbursed by the employer.¹⁰² Faculty members frequently travel away from home in connection with their duties. Often expenditures connected with such travel are either only partially reimbursed or not reimbursed at all by the employer institution. This may be because the reimbursement is not adequate to meet the daily travel expenses or, for example, as in the case of a sabbatical leave, because no reimbursement at all is provided.

Formerly, the faculty member could take any expenditures in excess of reimbursement as above-the-line deductions with no limitation on the amount of the deduction other than that the expenditure not be lavish or extravagant. These deductions must now be taken below-the-line. This means a faculty member must itemize in order to take these deductions. Moreover, they are now subject to the two percent of adjusted gross income limitation for employee business expenses. Finally, any unreimbursed away-from-home expenditures for meals are further subject to the limitation that they can be deducted only to the extent of 80 percent of the expenditure.¹⁰³

¹⁰² I.R.C. § 62(2) (1954) allowed an above-the-line deduction for employee business expenses as follows:

(2) Trade and business deductions of employees.

(A) Reimbursed expenses.--The deductions allowed by part VI (sec. 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowed arrangement with his employer.

(B) Expenses for travel away from home.--The deductions allowed by part VI (sec. 161 and following) which consist of expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

(C) Transportation expenses.--The deductions allowed by part VI (sec. 161 and following) which consist of expenses of transportation paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

(D) Outside salesmen.--The deductions allowed by part VI (sec. 161 and following) which are attributable to a trade or business carried on by the taxpayer, if such trade or business consists of the performance of services by the taxpayer as an employee and if such trade or business is to solicit, away from the employer's place of business, business for the employer.

By contrast I.R.C. § 62(a)(2) (1986) limits above-the-line deduction of employee business expenses to two circumstances:

(2) Certain trade and business deductions of employees.--

(A) Reimbursed expenses of employees.--The deductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer.

(B) Certain expenses of performing artists.--The deductions allowed by section 162 which consist of expenses paid or incurred by qualified performing artist in connection with the performance by him of services in the performing arts as an employee.

¹⁰³ I.R.C. § 274(n) (1986) provides in relevant part:

(n) Only 80 Percent of Meal and Entertainment Expenses Allowed as Deduction.--

(1) In general.--The amount allowable as a deduction under this chapter for--

(A) any expense for food or beverages,...

shall not exceed 80 percent of the amount of such expense or item which would (but for this paragraph) be allowable as a deduction under this chapter.

For many faculty members the potential deduction will become worthless, either because they do not itemize, or even if they do itemize, their expenditures do not exceed the two percent floor. The net result of this will be to increase the after-tax cost of employment-related travel for faculty members. In the alternative, the cost of such travel to institutions of higher education will increase where these institutions choose to bear the additional cost by increasing the amount of reimbursement to its faculty members for employment-related travel.

Although the away from home travel deduction can be and has been abused by some taxpayers, that is certainly not the case for most faculty members. Most faculty members do not have the financial resources to abuse the deduction by engaging in lavish and extravagant travel disguised as business trips. Furthermore, employees are much less likely to be able to engage in such abuse than are self-employed professionals to whom the foregoing limitations (other than the 80 percent meal limitation) do not apply.

Finally, the 1986 Act completely disallowed a deduction for travel as a form of education.¹⁰⁴ Prior to the 1986 Act, a taxpayer could deduct travel expenses when the travel was in itself a form of education directly and centrally related to the taxpayer's trade or business.¹⁰⁵ This deduction was used most often by faculty members who travelled in order to enhance their knowledge in their particular field of teaching. For example, in one case, a married couple, both teachers, made a trip to France. The wife, who taught history and collected slides and other teaching aids on the trip, was allowed to deduct her share of the travel expenses. However, the husband, who taught Latin, was denied a deduction despite making visits to Roman ruins.¹⁰⁶

Undoubtedly, taxpayers have abused this deduction in some instances. However, it appears that the Service and courts were policing this deduction vigorously prior to the 1986 Act, and the question arises whether a flat-out denial of the deduction to all taxpayers was the proper way to deal with the abuse problem. This all or nothing approach will, without doubt, in some cases cause taxpayers who legitimately deserve to take a deduction on account of travel as a form of education to be denied that deduction. The taxable income of these taxpayers will be to that extent overstated.

The income tax is theoretically a tax on net income. Denial of legitimate employee business expense deductions on account of the two percent floor, or

¹⁰⁴ I.R.C. § 274(m)(2) (1986) provides:

(A) Travel as a form of education. No deduction shall be allowed under this chapter for expenses for travel as a form of education.

¹⁰⁵ See Treas. Reg. § 1.162-5(d).

¹⁰⁶ *Marlin v. Commissioner*, T.C. 560 (1970) (Acq. 1970-2 C.B. XX) (1970). See 1 Bittker, *Federal Income Taxation of Income, Estate and Gifts*, ¶122.1.4 (1981).

otherwise, transforms the tax pro tanto to a tax on gross income.¹⁰⁷

Personal Exemption, Standard Deduction, and the Kiddie Tax

Changes made in the rules governing personal exemptions and the standard deduction lead to some anomalous results that provide a disincentive to saving for higher education. In addition, the new provision requiring unearned income of children under 14 to be taxed at the parent's higher tax rates the -- so-called Kiddie Tax -- is also likely to be a tax disincentive for higher education.

1. Personal Exemptions and Standard Deduction

The interaction of the new rules governing personal exemptions and the standard deduction produces some truly bizarre results. Prior to the 1986 Act a taxpayer could always claim a personal exemption for himself on his own tax return, regardless of whether that taxpayer was also claimed as a dependent on the tax return of another.¹⁰⁸ For example, a parent who provided over one-half the support for a child who was a full-time student during at least five months of the year could claim a dependency exemption for that child, even though the child had gross income in excess of the exemption amount during the year.¹⁰⁹ In addition, the child could also claim a personal exemption for himself when he filed his own tax return.

In effect, there was a doubling up of the exemption in the case of that particular child. However, the law did limit utilization of the zero bracket amount (now replaced by the standard deduction) in this situation. The child whose dependency exemption was allowable to the parent could utilize the zero bracket amount only to the extent of the dependent child's income.¹¹⁰ The net result of these rules was that for a student claimed as a dependent on the parent's tax return, unearned gross income could be offset by the personal exemption, but could not be offset by the zero bracket amount. Nevertheless, to the extent that the dependent child's income was earned income, the full zero bracket amount and full personal exemption was available.

The 1986 Act produces a similar but not identical result. In the case of a taxpayer with respect to whom the dependency exemption is allowable on the return of another, the personal dependency exemption is no longer allowable on that taxpayer's own return. Hence, if a parent claims a student as a dependent on the parent's tax return, the student cannot claim his own personal exemption. This reverses the old rule. In addition, for such a taxpayer the standard deduction is

¹⁰⁷ Diss and Ruby, *Miscellaneous Itemized Deduction Floor is Bad Policy*, 34 TAX NOTES 689, 692 (Feb. 16, 1987).

¹⁰⁸ I.R.C. § 151(e) (1954).

¹⁰⁹ *Id.*; Treas. Reg. § 1.151-3(b).

¹¹⁰ I.R.C. § 151(e)(2) (1954).

limited to the greater of (1) \$500 or (2) earned income.¹¹¹ Therefore, if the dependent taxpayer has no earned income, the standard deduction can offset up to \$500 of unearned income, but if the taxpayer has more than \$500 of earned income, then even \$1 of unearned income will be subject to tax.¹¹²

For example, consider the case of Johnny B. Goode, a 15-year-old taxpayer whose parents have taught him that it is important to work hard and to save his money for his future education. Johnny follows his parents' advice and obtains a paper route which pays him \$1,000 in the first year he operates it. Again, following his parents' advice, he puts all of the \$1,000 into a savings account. In year two he earns another \$1,000 from his paper route and, in addition, is credited with \$50 interest from the \$1,000 that he put into the savings account the previous year. In both years, Johnny's parents provided over one-half his support and they claimed Johnny as a dependent on their joint income tax return for each year.

In year one Johnny is saved from income tax liability. He cannot claim his own personal exemption, but he is entitled to a standard deduction in the amount of his earned income for the year -- \$1,000.¹¹³ The standard deduction, therefore, will offset his entire gross income in year one. In year two, however, Johnny is not so fortunate. He will have gross income consisting of the \$1,000 earned income from the paper route and the \$50 interest on his savings account that is classified as unearned income. Again, he is not entitled to claim his own personal exemption on his tax return for year two. Moreover, his standard deduction is limited to \$1,000. Therefore, in year two Johnny will have gross income of \$1,050 offset by a standard deduction of \$1,000 leaving him with taxable income of \$50. This will be taxed at the 15 percent rate so that Johnny will have a tax liability for year two of \$7.50.¹¹⁴

What possible rationale can there be for imposing a tax in this situation? The amount, though de minimis, is at least a nuisance. It provides a disincentive to some of the important values that many people try to instill in their children -- hard work and thrift. If the dependent taxpayer has as little as \$500 of earned income, any unearned income automatically becomes taxable. Moreover, these rules are likely to result in substantial non-compliance. The result is so counter-intuitive that many

¹¹¹ I.R.C. § 63(d)(5) (1986) provides in relevant part:

(5) Limitation on standard deduction in the case of certain dependents.--In the case of an individual with respect to whom a deduction under section 151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the standard deduction applicable to such individual for such individual's taxable year shall not exceed the greater of--

(A) \$500, or

(B) such individual's earned income.

¹¹² See Thoronyi, *Simplification for the Average Taxpayer*, 40 TAX NOTES 183, 187 (1988).

¹¹³ This is the greater of \$500 or earned income -- \$1,000. See I.R.C. § 163(d)(5) (1986).

¹¹⁴ I.R.C. § 1(c) (1986). If Johnny is under 14 and has other unearned income of more than \$950, such as interest on a bank account given him by his grandmother, a portion of his income will be taxed at his parents' higher marginal tax rate. See text accompanying notes 106 to 109 *infra*.

are unlikely even to suspect that a tax may be due in this situation.

One commentator has suggested that the rule be changed so as to allow as the standard deduction the amount of earned income up to \$3,000, plus the amount of unearned income up to \$500, but in no event greater than \$3,000.¹¹⁵ In Johnny's case this would result in no tax liability at all. One can only wonder what was in the minds of the tax writers when they drafted the current law. Perhaps it is attributable to the haste with which the 1986 Act was enacted.

2. Kiddie Tax

In addition to the exemption and standard deduction changes, the 1986 Act also changed the taxation scheme for minors by enacting section l(i) the so-called Kiddie Tax.¹¹⁶ This provision, which can be very difficult in application, provides essentially that unearned income over \$1,000 of a child under 14 years of age shall be taxed to the child at the tax rates of the child's parents. This is regardless of the source of the unearned income and regardless of whether the parents claim the child as a dependent on their own return.¹¹⁷ Thus, the tax can apply even if the source of the income is a gift from someone other than the parents, such as a grandparent, and even if the child is financially independent of the parents.

This provision will virtually eliminate many traditional devices used by parents to fund their children's education, such as setting up trusts of 10 years or

¹¹⁵Thoronyi, *supra* note 103, at 181. Legislation similar to this proposal has been introduced. See H.R. 5063, 100th Cong., 2d Sess. (1988) (introduced by Rep. Kennelly).

¹¹⁶I.R.C. § 1(i) (1986) provides in part:

- (i) Certain Unearned Income of Minor Children Taxed as if Parent's Income.--
 - (1) In general.--In the case of any child to whom this subsection applies, the tax imposed by this section shall be equal to the greater of--
 - (A) the tax imposed by this section without regard to this subsection, or
 - (B) the sum of--
 - (i) the tax which would be imposed by this section if the taxable income of such child for the taxable year were reduced by the net unearned income of such child, plus
 - (ii) such child's share of the allocable parental tax.
 - (2) Child to whom subsection applies.--This subsection shall apply to any child for any taxable year if--
 - (A) such child has not attained age 14 before the close of the taxable year, and
 - (B) either parent of such child is alive at the close of the taxable year.
 - (3) Allocable parental tax.--For purposes of this subsection--
 - (A) In general.--The term 'allocable parental tax' means the excess of--
 - (i) the tax which would be imposed by this section on the parent's taxable income if such income included the net unearned income of all children of the parent to whom this subsection applies, over
 - (ii) the tax imposed by this section on the parent without regard to this subsection.

¹¹⁷*Id.* § 1(i)(2). See Baetz, *The Indefensible Kiddie Tax*, 126 TRUSTS AND ESTATES 27, 30 (1987).

more duration with income payable to the child (so-called Clifford Trust).¹¹⁸ Granted there were persuasive equitable arguments for not permitting such income splitting. However, the effect on higher education is likely to be that there will be fewer funds available to fund higher education under the new provisions.

Moreover, there is a substantial question as to whether the complexity and administrative difficulty accompanying the Kiddie Tax is worth the effort. The Clifford Trust rules that permitted a trust grantor to retain a reversion after 10 years, and still have trust income taxed to the trust beneficiary have been repealed. Furthermore, the tax rates under the new law have been substantially compressed. Hence, the opportunity and incentive for such income splitting as took place in the past is substantially diminished. Taxpayers are much less likely to place property in trust for income splitting purposes when they cannot get the property back. Additionally, the ride up the rate brackets by splitting income under the 1988 rates is worth only \$2,320.¹¹⁹ All in all, this provision may well cost more in terms of taxpayer compliance and administrative complexity than it is worth.

Exclusion for Employer Paid Educational Expenses

Under prior law an employee's income for both income and employment tax purposes did not include amounts paid by the employer for educational assistance provided to the employee if the amounts were paid under an educational assistance program that met certain requirements under section 127.¹²⁰ At the time of enactment of the 1986 Act section 127 contained a sunset provision that had caused it to expire as of December 31, 1985.¹²¹ The 1986 Tax Act extended the exclusion for a period of two years retroactive to January 1, 1986.¹²² In so doing, the Conference Committee rejected a Senate proposal to make the exclusion permanent.¹²³ The Act also raised the annual limit on excludable educational assistance benefits from \$5,000 to \$5,250, but rejected a Senate proposal to index this limit.¹²⁴ Finally, the Act made educational assistance plans subject to certain requirements in section 89(k) that employees be given reasonable notification of the plan, that the plan be legally enforceable, be for the exclusive benefit of employees, and be established with the intention of being maintained for an indefinite period of time.¹²⁵

¹¹⁸ The 10-year or Clifford Trust was also eliminated by the 1986 Act. I.R.C. § 673 (1986).

¹¹⁹ Baetz, *supra* note 107, at 28.

¹²⁰ I.R.C. § 127 (1954). Essentially, the program had to be in writing and could not: 1) discriminate between high and low paid employees, and 2) pay more than 5% of the benefits under the program to shareholders or related parties. *Id.* § 127(c).

¹²¹ I.R.C. § 127(d) (1954).

¹²² I.R.C. § 127(d) (1986).

¹²³ H.R. Rep. No. 481, 99th Cong., 2d Sess. II-541 (1986).

¹²⁴ *Id.*

¹²⁵ I.R.C. § 89k(l) (1986) requires in relevant part that:

- (A) such plan is in writing,
- (B) the employees' rights under such plan are legally enforceable,
- (C) employees are provided reasonable notification of benefits available in the plan,

Congress allowed the December 31, 1987 expiration date for section 127 to pass without renewing the exclusion. This left employers having such plans in a state of limbo, because it appeared that there was a good chance of the exclusion ultimately being renewed. The House Ways and Means Committee has proposed to renew the exclusion retroactive to January 1, 1988 in its version of the Technical Corrections Act for the 1986 Act.¹²⁶ However, as part of the renewal, the cap on the amount of excludable benefits was reduced from \$5,250 to \$1,500 per year.¹²⁷ Still worse, the Senate in its version of Technical Corrections failed to renew the exclusion at all.¹²⁸ Higher education officials expect this reduced limit or outright expiration of the exclusion will have a harsh effect on their institutions.¹²⁹ They fear that many students when faced with the prospect of having their educational assistance benefits taxed, may simply decide to forego their plans for college study.¹³⁰

The exclusion has been important for colleges in two ways. First, it has helped them attract students, and second, many universities acting as the employers of graduate students have used it to provide benefits to their teaching and research assistants.¹³¹ The extension of section 127 was the top priority for higher education representatives in the Technical Corrections Act.¹³² Unfortunately, for higher education, the adverse pattern toward higher education of the mid-1980s has continued with respect to this piece of legislation. The House basically took the estimated \$100,000,000 saved in revenue by reducing the exclusion limit and used it to provide tax reductions for other sectors of the economy.¹³³

Tax Deferred Annuities

One aspect of employment in higher education is the lower cash compensation often received as compared to that of similarly skilled professionals in the commercial sector. This burden is somewhat tempered, however, by the favorable

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- (D) such plan is maintained for the exclusive benefit of employees, and
 - (E) such plan was established with the intention of being maintained as an indefinite period of time.

¹²⁶ H.R. 4333, 100th Cong., 2d Sess. § 301 (1988).

¹²⁷ *Id.* at § 301(c). The House bill would also eliminate the exclusion for any graduate level course of a kind leading to a law, business, medical or similar advanced academic or professional degree. *Id.* at § 301(b)(1).

¹²⁸ S. 2238, 100th Cong., 2d Sess. (1988).

¹²⁹ See *House Panel Would Cut Tax-Free Tuition Limit From \$5250 to \$1500*, Chronicle of Higher Education, July 20, 1988, at A17.

¹³⁰ *Id.* Subsequent to submission of this article for publication, Congress enacted legislation which kept the exclusion limit at \$5,250. However, in the same legislation Congress entirely eliminated the exclusion for graduate education. Furthermore, Congress chose to extend the remaining exclusion only to December 31, 1988, thereby, leaving taxpayers in limbo again with respect to education provided in 1989. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 § 4001, 100th Cong., 2d Sess., 102 Stat. 3643 (1988).

¹³¹ *Id.* at A24. See example, *supra* note 60A.

¹³² *Id.* at A24.

¹³³ *Id.* at A17.

income tax treatment of annuity plans which satisfy section 403(b) of the Internal Revenue Code.¹³⁴ Two related organizations offering these tax-sheltered annuity plans are the Teachers' Insurance and Annuity Association (TIAA), and the College Retirement Equities Fund (CREF). Since 1918, TIAA has operated as a tax exempt organization offering an effective means by which those employed by higher education institutions could save for retirement.¹³⁵ CREF has been in existence since 1952, specializing in tax-deferred equities investments.¹³⁶ The Tax Reform Act of 1986 placed numerous restrictions upon the existing methods of formulating TIAA-CREF and similar section 403(b) annuity plans. Areas of particular note include annual contribution limitations, restrictions on early distributions, changes in non-discrimination rules, and the tax-exempt status of TIAA-CREF.

1. Excludable Contribution Limitations

Under both prior and present law, employees who participate in section 403(b) plans purchased by educational institutions are permitted to calculate the annual income exclusion amount by using section 415 rules covering defined contribution plans.¹³⁷ In general, section 415(c)(1) limits annual additions to a defined contribution plan such as TIAA-CREF to the lesser of 25 percent of the employee's annual compensation, or \$30,000.¹³⁸ Included in the annual additions amount are the full amount of both employer and employee contributions. Before the 1986 Act, only a portion of employee contributions was included in the calculation.¹³⁹

The House version of the 1986 Act proposed to set the annual limit on employee contributions at \$7,000 for all tax-sheltered annuity plans to which an employee contributes.¹⁴⁰ This figure was to include elective deferrals made pursuant to section 403(b) plans and section 401(k) plans as well as contributions made to IRA plans. The Ways and Means Committee felt that this measure would lessen the disparity between employees whose employers offered salary reduction agreements and employees without that option.¹⁴¹ In addition, the House added a special "catch-up" provision allowing up to an additional \$3,000 annual deferral under certain circumstances.¹⁴²

¹³⁴ Federal tax law allows special tax advantages to participants in annuity plans that are established pursuant to section 403(b) of the Internal Revenue Code. A participant may exclude from income, up to a specified limit, transfers made by his employer to a 403(b) plan. See I.R.C. § 403(b)(1) 1986; § 403(b)(1). Secondly, an employee may choose to contribute additional amounts to the plan which are also excludable from income, hence, the term, elective deferrals. Finally, the interest income earned on the plan is not taxable until the year that withdrawals are made. See I.R.C. § 403(b)(1)(C) (1986).

¹³⁵ *NACUBO Report: TIAA-CREF User Issues*, Business Officer, August 1986, at 15.

¹³⁶ *Id.* at 15.

¹³⁷ I.R.C. § 403(b)(2)(B) (1986).

¹³⁸ I.R.C. § 415(c)(1) (1986).

¹³⁹ I.R.C. § 415(c)(2)(B) (1954).

¹⁴⁰ 1986 Conference Report at II-404.

¹⁴¹ *Id.*

¹⁴² *Id.*

The Senate Finance Committee did not propose a provision pertaining to contribution limitations. The Conference Committee largely adopted the House bill, with the exception of increasing the annual limit on elective deferrals under section 403(b) plans to \$9,500.¹⁴³

In its present version, the 1986 Act places a \$9,500 limit on annual elective deferrals made after 1986 under TIAA-CREF and similar tax-sheltered annuity plans.¹⁴⁴ Included in the \$9,500 figure are employee contributions made pursuant to any salary reduction agreement, to the extent that the contributions are excludable from the employee's gross income. Therefore, contributions made by employees to TIAA-CREF must be combined with employee contributions to other plans such as TIAA-CREF's Supplemental Retirement Accounts, when determining whether the \$9,500 annual limit has been reached. The 1986 Act also amended the \$30,000 annual limit on contributions made to tax-sheltered annuities to include the full amount of all transfers made by an employee.¹⁴⁵

In all likelihood, the reduced income exclusion allowance will not interfere with the retirement arrangements of most of the employees in the higher education setting. This is so because of the improbability that the salaries of most employees in higher education are large enough to accommodate annual contributions of more than \$9,500. However, some higher paid employees and employees who are nearing retirement age may wish to contribute more than the \$9,500 limit will permit. For those individuals, the Act created a special rule allowing an additional \$3,000 in annual income exclusions provided the employee has served fifteen years with his current employer.¹⁴⁶ Nonetheless, these changes in the law demonstrate the willingness of Congress to restrict the favorable tax treatment of an important means by which higher education may offer employment incentives to highly marketable professionals.

2. Restrictions on Early Distributions

Before the 1986 Act, amounts invested in non-custodial tax-sheltered annuity plans were not subject to any withdrawal restrictions. Funds taken from these plans were taxed as ordinary income regardless of whether the employee had reached a certain age or had suffered financial hardship.¹⁴⁷ As a result, plans such as TIAA-CREF's Supplemental Retirement Annuities (SRAs) represented a desirable means of deferring additional income without the concomitant penalty for early withdrawals. SRAs permit an employee to make withdrawals at any time.

In addressing this aspect of tax-sheltered annuities, the House took the

¹⁴³ *Id.* at II-405.

¹⁴⁴ I.R.C. § 402(g)(4) (Section 402(i)(4) as amended).

¹⁴⁵ I.R.C. § 415(c)(2)(B).

¹⁴⁶ I.R.C. § 402(g)(8) (Section 402(i)(8) as amended).

¹⁴⁷ 1986 Bluebook 713.

position that by allowing an annuitant access to annuity funds before retirement, the tax incentives for retirement savings were being circumvented.¹⁴⁸ Under the House bill, the existing restrictions applicable to tax-sheltered custodial accounts were extended to all tax-sheltered annuities for taxable years after December 31, 1988.¹⁴⁹ These restrictions flatly prohibit certain unjustified early distributions and place an additional 10 percent tax on certain early distributions not otherwise prohibited.¹⁵⁰ Although the Senate bill did not extend these additional restrictions to section 403(b) non-custodial annuities, the Conference Committee adopted the position of the House on this issue.¹⁵¹

By placing all tax-sheltered annuity funds "beyond the reach" of most participants, the 1986 Act rendered SRAs much less attractive to employees in the higher education environment. Since SRA participants understandably do not wish to bear the severe withdrawal prohibitions and the substantial tax placed on early withdrawals that are still not completely prohibited, the incentive for these employees to invest in these types of retirement plans is gone.

3. Nondiscrimination Requirements

Another restrictive change in the law governing tax deferred annuities is the addition of nondiscrimination rules in the 1986 Act. For tax years beginning after 1988, section 403(b) plans will not qualify for favorable tax treatment unless they comply with these new requirements.¹⁵² First, the section 403(b) plans must meet the existing nondiscrimination tests applicable to section 401(a) plans as well as the coverage rules found in § 410(b).¹⁵³ In addition, if *any* employee may elect to have his employer make contributions pursuant to a salary reduction agreement, then *all* employees must have the right to such contributions.¹⁵⁴

There is nothing in the legislative history of this provision of the 1986 Act which points to evidence that general plan availability is a problem in the higher education environment. The application of the nondiscrimination rules seems misplaced in this setting. The rules are designed to curb inequities in the administration of fringe benefit plans found in the commercial sector.¹⁵⁵ Moreover, annuity

¹⁴⁸ *Id.* at 713.

¹⁴⁹ 1986 Conference Report at II-453.

¹⁵⁰ "Unjustified" early withdrawals are generally those which occur before the annuitant reaches the age of 59 1/2; is separated from service; is disabled; or dies. An additional justification is allowed in cases of hardship, but this term of art lacks IRS interpretation. See Act of October 22, 1986, Pub. L. No. 99-514, Title XI, §§ 1123(c)(1), (e)(2), 100 Stat. 2085 (1986). (Section 403(b)(11) as amended.)

¹⁵¹ 1986 Conference Report at II-455.

¹⁵² Act of October 22, 1986, *supra* note 139, § 1120 (Section 403(b)(1)(D) as amended).

¹⁵³ The main thrust of the § 401(a) nondiscrimination requirements is to prevent plans from favoring highly paid workers, officers or shareholders. See I.R.C. § 401(a)(4), (5), and (26) (1986). The coverage rules of § 410(b) generally are met if at least 70% of all non-highly paid employees are benefited under the plan.

¹⁵⁴ Act of October 22, 1986, *supra* note 139 (Section 403(b)(10)(A)(ii) as amended).

¹⁵⁵ Section 401 is specifically directed at controlling profit sharing and stock bonus arrangements, neither of which is appropriate in the not-for-profit world of higher education. See I.R.C. § 401 (1986).

plans traditionally have been available to most higher education employees. These new plan requirements interpose additional compliance and administrative costs to the section 403(b) plans currently being offered. These added costs will be passed on to the plan participants in the form of decreased benefits.

4. TIAA-CREF Tax Exemption

One of the areas given close scrutiny by the House Committee on Ways and Means was the tax exempt status of entities recognized as charitable organizations, such as TIAA-CREF.¹⁵⁶ The committee adopted as a premise that tax exempt status is inappropriate where the charitable organization engages in substantial business activity that is commercial in nature.¹⁵⁷ Specifically, the committee cited the example of charitable organizations engaging in the business of insurance as an activity that is inherently commercial in nature.¹⁵⁸ A footnote in the House Committee report referred to TIAA-CREF in this respect, although not by name. The committee reasoned that to allow tax exempt status to organizations engaging substantially in the insurance business would constitute an unfair competitive advantage over taxable organizations in the same line of business.¹⁵⁹ Therefore, the committee proposed in H.R. 3838 that tax exempt status would apply to charitable organizations under section 501(c)(3) only if no substantial part of its activities consists of providing insurance in a commercial-type manner.¹⁶⁰ Enactment of this provision would have resulted in loss of TIAA-CREF's tax exempt status. This is because the bill explicitly provided that issuance of annuity contracts (TIAA-CREF's principal activity) "shall be treated as providing insurance" and, hence, commercial-type activity.¹⁶¹

As noted in the next section, TIAA-CREF mounted an effort to prevent the proposals of the Ways and Means Committee from becoming a permanent part of the bill without modification. No provision was included in the Senate bill on this issue. In conference, the TIAA-CREF effort failed to effect a change in the language of the bill in its general application to section 501(c)(3) organizations that issue annuity contracts. However, the final bill did provide a "special rule" which specifically exempted TIAA-CREF's annuity activities from classification as commercial type activity.¹⁶² This "special rule" thus preserved TIAA-CREF's

¹⁵⁶ House Committee on Ways and Means, H.R. 3838, 99th Cong., 1st Sess., 663 (1985).

¹⁵⁷ *Id.* at 664.

¹⁵⁸ *Id.* at 663 n.3.

¹⁵⁹ *Id.*

¹⁶⁰ The House proposal included several exceptions to this general rule. If insurance is provided to a class of charitable recipients (i.e., sec. 501(c)(3) groups), at substantially below cost, then such insurance does not fall into the category of commercial-type insurance. *Id.* at 665. In addition, commercial-type insurance does not include health insurance provided by a health maintenance organization, or property and casualty insurance policies which are provided by a church organization. *Id.* at 665.

¹⁶¹ H.R. 3838, 99th Cong., 2d Sess. § 1012(a) proposing I.R.C. § 501(m)(4) (1986).

¹⁶² This special provision of the House bill appears in the effective date subsection. It explicitly provides that the portion of TIAA-CREF business attributable to pension activity is to remain exempt from federal income

status as a tax exempt section 501(c)(3) organization.

TIAA-CREF may have dodged a bullet regarding the tax-exempt status of its pension business, but it did not emerge completely unscathed. The exception carved out by Congress for TIAA-CREF's annuity contracts does not extend to its life insurance division.¹⁶³ TIAA-CREF income attributable to the sale of life insurance policies is now subject to federal income tax as unrelated business income.¹⁶⁴

5. Opposition to the New Legislation

The higher education community voiced its opposition to these new provisions while the legislation was moving through Congress. TIAA-CREF played a key role in organizing the lobbying effort. The organization circulated several newsletters to plan participants which both outlined the proposed plan restrictions and facilitated individual protest to the new legislation.¹⁶⁵ The common theme of many of these individual communications to Capitol Hill was that higher education had already been dramatically affected by federal reductions in direct aid. The letters pointed out that additional financial obstacles in the form of more restrictive federal income tax legislation would surely "add insult to injury" as well as cripple higher education's ability to attract skilled employees.¹⁶⁶ The effort seems to have had an impact on the Senate Finance Committee, where the House bill was either tempered or at least not exacerbated, and in conference, where TIAA-CREF's status as a tax exempt section 501(c)(3) organization was preserved.

Research and Development Tax Credits

Although the 1986 Act granted the research and development tax credit a new three-year lease on life, the new law is a trimmed-down model as compared to its predecessor.¹⁶⁷ This may cause a diminished flow of income for universities and colleges that rely on research contracts as an important source of revenue. The 1986 Act features a lower tax credit percentage as well as tighter restrictions on eligibility of research expenses for the credit.

Under prior law, taxpayers were permitted a tax credit of 25 percent of the

tax. *See Id.* at 666. This exception is not codified in the Internal Revenue Code. It is found only in the Federal Statutes at Large. *See* Tax Reform Act of 1986 § 1012(c)(4)(B) which provides in relevant part as follows:

(B) The amendments made by this section shall not apply to that portion of the business of the Teachers Insurance Annuity Association-College Retirement Equities Fund which is attributable to pension business.

¹⁶³ *See supra* note 151 and accompanying text.

¹⁶⁴ *See* I.R.C. § 501(m)(2) (1986).

¹⁶⁵ *See, e.g.*, Correspondence to members from TIAA-CREF, 1985-86, on file at the Washington and Lee University Law Library.

¹⁶⁶ *See, e.g.*, Letters to Senators from the faculty of Washington and Lee University, 1986, on file at the Washington and Lee University Law Library.

¹⁶⁷ I.R.C. § 41 (1986) (I.R.C. § 30 1954).

qualified research expenses that exceeded the average research expenses that occurred over a base period.¹⁶⁸ The 1986 Act reduced the maximum research tax credit percentage to 20 percent.¹⁶⁹ Moreover, the 1986 Act subjected research tax credits to the overall limitation applicable to general business tax credits.¹⁷⁰ Finally, the 1986 Act introduced a new and somewhat complex set of rules from which taxpayers must calculate tax credits for research contracts with universities.¹⁷¹

Congress has taken the position that it is desirable for corporate taxpayers to make resources available for university research.¹⁷² In fact, the 1986 Act includes a special provision drafted exclusively for permitting tax credits for “university basic research.”¹⁷³ However, it is quite possible that the 1986 Act has made corporate investment in university research a less attractive proposition. Corporations are now faced with choices as to how their research expenditures will qualify for the federal tax credit. A corporate taxpayer might invest solely in “qualified research expenses” under section 41(b). The law requires that these expenditures must consist of “in-house” research done to further a technological project, the ultimate purpose of which is to develop or improve a business product of the taxpayer.¹⁷⁴ Alternatively, the corporate taxpayer may “earn” the research tax credit by investing in general, “basic” research performed by or with the facilities of a university.¹⁷⁵ Keeping in mind the reduced overall research credit percentage, as well as the inclusion of research credits in the general business credit limitation, it is probable that many corporate taxpayers will limit their available research budgets to projects which benefit the corporation most directly. This is precisely what the 1986 Act has encouraged by enacting the “qualified research expenses” provision of section 41. Unfortunately, the ultimate losers are the universities who must now forego those resources which were formerly available to them. The result is that the 1986 Act has served, perhaps unintentionally, to impair an important flow of income to the higher education community.

Qualified 501(c)(3) Bonds

The ability of institutions of higher education to raise capital at a relatively low cost is crucial to their financial health. This is especially true in the case of private

¹⁶⁸ I.R.C. § 30(a) (1954).

¹⁶⁹ I.R.C. § 41(a) (1986).

¹⁷⁰ Taxpayers may use the aggregate of certain business tax credits to offset the first \$25,000 of annual income tax liability. Thereafter, only 75 percent of any remaining tax can be reduced by the credits. Before TRA 1986, this limitation did not apply to research and development tax credits. See I.R.C. § 38(b)(4) (1986).

¹⁷¹ Before the 1986 Act, corporate taxpayers were entitled to include as qualified research expenses 65% of any amount paid or incurred by the corporation to colleges and universities for contract research work. See I.R.C. § 30(e)(1) (1986). Under the new law, only actual *cash* payments are included. In addition, the credit is 20% of only those cash payments which exceed a special “floor.” See I.R.C. § 41(e)(1), (2), (3), and (4) (1986).

¹⁷² 1986 Bluebook at 131.

¹⁷³ I.R.C. § 41(e) (1986).

¹⁷⁴ I.R.C. § 41(b)(1), and (d)(1)(B) (1986).

¹⁷⁵ I.R.C. § 41(e)(7) (1986).

institutions due to their limited access to direct governmental aid. Thus, it is very important for many colleges and universities that federal tax law does not serve to impair the flow of capital through bond financing. Unfortunately, the 1986 Act has put in place several new provisions which in the aggregate could result in reducing the available funds needed by colleges and universities. These changes include tightened restrictions on the use of bond proceeds and a limit on the amount of outstanding bond issues.¹⁷⁶

1. Tightened Restrictions on the Use of Bond Proceeds

“Qualified 501(c)(3) bonds” generally are bonds from which the proceeds are used for the qualified activities of a section 501(c)(3) organization.¹⁷⁷ If the requirements for these types of bonds are met, then the interest on the bonds is tax-exempt.¹⁷⁸ One of the most important of these requirements is the restriction on the allowable use of the bond proceeds. Under prior law, a 501(c)(3) organization was permitted to use up to 25 percent of qualified bond proceeds for purposes unrelated to their exempt activity.¹⁷⁹

The House proposed a change in the law whereby tax-exemption is not permitted unless *all* proceeds of qualified 501(c)(3) bonds are used for activities which are directly related to the exempt purpose of the organization.¹⁸⁰ Moreover, the House bill provided that all property that is purchased with the proceeds from qualified 501(c)(3) bonds must be owned by either an exempt organization or a governmental unit.¹⁸¹ The Senate amendment was a little more lenient, requiring only ninety-five percent of the proceeds of qualified 501(c)(3) to be used for exempt activities.¹⁸² The ninety-five percent benchmark was adopted by the Conference Committee as was the ownership requirement for property financed with qualified 501(c)(3) bonds.¹⁸³

These changes in the law increase the risk of non-compliance in the case of financing certain university facilities with qualified 501(c)(3) bonds. One example is the construction of a private university medical school facility using the proceeds

¹⁷⁶ I.R.C. § 145 (1986) (I.R.C. § 103(b)(3)(B) (1954)).

¹⁷⁷ Specifically, the Code characterizes qualified 501(c)(3) bonds as private activity bonds with restrictions as to both usage of the proceeds and ownership of property purchased with the proceeds. See I.R.C. § 145(a) (1986).

¹⁷⁸ I.R.C. § 103(a) and (b)(3)(B) (1954).

¹⁷⁹ Treas. Reg. § 1.103-7(b)(3)(iii) (1987). For thorough analyses of the effect of the 1986 Act on qualified 501(c)(3) bonds, see Zimmerman, *Effect of Tax Reform Act of 1986 Upon Tax-Exempt Bond Financing for the Health Care Industry*, 18 Loy. U. L.J. 887 (1987); Bates, *Changes Made in the Tax-exempt Bond Area by 1986 Act Usher in New Era in Public Finance*, 66 J. TAX'N 72 (1987); Bates, *Bond Financing for Governments and 501(c)(3)s Newly Restricted*, 66 J. TAX'N 160 (1987).

¹⁸⁰ 1986 Conference Report at II-725.

¹⁸¹ *Id.*

¹⁸² *Id.* at II-726.

¹⁸³ *Id.*

of such bonds. If more than five percent of the proceeds are used to finance an office building for the use of physicians in conducting the private practice of medicine, then the entire bond issue loses its tax-exempt status.¹⁸⁴ This result holds true even where the ownership or operation of the office building is construed as a related trade or business of the university.¹⁸⁵

2. Limit on the Amount of Outstanding Bond Issues

A second limitation that the 1986 Act placed on qualified 501(c)(3) bond financing is a \$150 million ceiling on the amount of outstanding bond issues that an exempt organization can maintain.¹⁸⁶ This provision, which was initially proposed in the House bill, was omitted from the Senate bill.¹⁸⁷ The Conference Committee revived this provision while at the same time exempting hospital bonds from the limitation.¹⁸⁸ Once again though, higher education has taken a back seat, as medical school facilities are specifically excluded from the definition of hospital for the purposes of this special exemption.¹⁸⁹ This \$150 million limitation is a constraint on the larger universities, whose growth plans might include using tax-exempt bond financing for the purchase of new academic buildings, sports facilities, computer equipment or other kinds of improvements that are prohibitively expensive.

3. Other Restrictions on Qualified 501(c)(3) Bond Financing

Other new restrictions on qualified 501(c)(3) bond financing include public approval and rebate requirements, as well as expanded arbitrage restrictions that also serve to hinder the availability of this source of capital.¹⁹⁰ The details of these very complex and technical provisions, however, are beyond the scope of this article.

CONCLUSION

The preceding rather lengthy laundry list of tax provisions enacted in the mid-1980s presents a troubling situation. Many of these provisions taken singly have some merit. For example, the requirement that the appreciation element in gifts of property to charities be included in the alternative minimum tax base has considerable theoretical support.¹⁹¹

Viewed in their entirety, however, these separate pieces of legislation present a different story. A pattern emerges. And that pattern is one of legislation that

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ I.R.C. § 145(b) (1986).

¹⁸⁷ 1986 Conference Report at II-726.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ For a detailed treatment of these issues, see *Zimmerman, supra* note 168.

¹⁹¹ *Andrews, supra* note 3 at 371-72.

consistently affects higher education harshly and adversely. It appears there have been no total successes with respect to higher education's efforts before the tax writing committees in the mid-1980s. One of the most successful efforts was probably the tax deferred annuity legislation which ultimately emerged in the 1986 Tax Act. Although that legislation did have some adverse impact on higher education, its effect could have been considerably worse had not the colleges and universities acted effectively to protect their interests. For example, TIAA-CREF stood to lose its section 501(c)(3) tax exempt status under the bill as originally proposed by the House.

It seems that the tax writing committees in Congress have stumbled into a higher education policy that is essentially negative. They appear to view higher education as just another service industry that deserves no more consideration in the writing of tax laws than the fast food industry. While the education committees in Congress enact laws to promote higher education, the tax writing committees have worked in precisely the opposite direction. Does the right hand know what the left hand is doing?

Higher education must do a better job in the future of presenting its interests before the tax writing committees of Congress. Each individual piece of adverse tax legislation is like a piece of salami. When one slice is cut off the piece, the piece does not look very much smaller. But after several slices are cut, there is not much salami left. If higher education continues to be treated by the tax writing committees of Congress as it has been in the mid-1980s there may not be any salami left by the 21st Century.