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IT'S NOT LOVE, BUT IT'S NOT BAD: A RESPONSE TO CRITICS OF PREPAID COLLEGE TUITION PLANS

*J. Timothy Philipps**
*Ed R. Haden***

I. INTRODUCTION

Two years ago one of the authors published an article surveying the tax ramifications of prepaid college tuition plans, with a focus on the Michigan plan — the Michigan Education Trust ("MET").[1] That article took a generally positive view of such plans in general and of MET in particular. It discussed three basic themes: 1) the uncertainty of existing tax law with respect to prepaid tuition plans requires clarifying congressional legislation; 2) the position of the Internal Revenue Service ("Service") with respect to prepaid tuition plans, as enunciated in a private letter ruling addressed to MET,[2] is flawed; and 3) the position that prepaid tuition plans are basically a good idea, that deserve tax-favored treatment in any clarifying congressional legislation in order to be successful.[3] Commentary by other authors undoubtedly bears out the first theme.[4] The novelty of prepaid tuition plans and their sheer lack of fit with

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1. J. Timothy Philipps, *Federal Taxation of Prepaid College Tuition Plans*, 47 WASH. & LEE L. REV. 291 (1990).

2. Priv. Ltr. Rul. 88-25-027 (May 5, 1988), *reprinted in* 11 Fed Taxes (P-H) ¶54,969 (May 5, 1988) [hereinafter Priv. Ltr. Rul. 88-25-027, with Prentice-Hall page number). A second ruling followed Priv. Ltr. Rul. 88-25-027 in January 1989, essentially restating the position of the prior ruling. Priv. Ltr. Rul. 89-01-027 (Jan. 6, 1989). This was apparently a response to a request from the state of Indiana on its proposed tuition prepayment plan. At the time of this writing there have been no subsequent letter rulings on state plans, although Florida has requested a ruling for its plan. *See* Letter from Robert L. Maige to Assistant Commissioner of Internal Revenue (EP/EO) (Mar. 21, 1990) (on file with author). At this writing, the Service has not issued a ruling in response to Florida's request. Telephone Interview with William Nichols, Florida Prepaid Education Expense Board (Aug. 1, 1991).

3. *See* Philipps, *supra* note 1, *passim*.

4. *See* Alan Gunn, *Economic and Tax Aspects of Prepaid Tuition Plans*, 17 J.C. & U.L. 243 (1990); Jeffrey S. Lehman, *Social Irresponsibility, Actuarial Assumptions, Wealth Redistribution: Lessons About Public Policy from a Prepaid Tuition Program*, 88 MICH. L. REV. 1035 (1990).

existing Internal Revenue Code provisions make predicting the tax consequences of such plans more an exercise in speculation than in legal analysis. Perhaps one could do as well by casting lots or throwing darts as with the Code and regulations. Moreover, the commentators have generally agreed that the Service's position is flawed, although for widely varying reasons.[5]

Some commentators, however, have taken a much dimmer view of prepaid tuition plans, particularly MET. The desirability of prepayment plans and their claim to tax-favored treatment are disputed.[6] This article responds to the critics of prepaid tuition plans. Although many of the criticisms of existing plans are well taken, the authors believe that the prepaid tuition concept meets a genuine need for a middle class college savings vehicle. Plans enacted subsequent to MET, such as the Alabama and Florida plans,[7] have made improvements from both the technical tax law standpoint and the broader social policy standpoint.

Despite the criticisms, policymakers should not abandon the prepaid college tuition concept as an unworkable pipe dream, or a cynical ploy to garner middle class votes. Rather, the idea is an evolving one that demands further consideration to iron out the flaws that have appeared in its early implementation. Current plans do have flaws. But those flaws may be remediable, and even if all the flaws cannot be remedied, the virtues of tuition prepayment plans outweigh their vices. Prepayment plans may not be a panacea but they are worthwhile. In the words of an old country music tune, "It's not love, but it's not bad."[8]

This article 1) reviews problems of the MET plan raised by other commentators, 2) suggests some possible resolutions for these problems, 3) argues for tax-favored treatment of prepaid tuition plans, and 4) offers an illustrative plan that could be used by the private sector as well as by state-sponsored prepaid tuition plans.

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5. *Compare* Gunn, *supra* note 4, at 254-59 *with* David Williams II, *Financing a College Education: A Taxing Dilemma*, 50 OHIO ST. L.J. 561, 589 (1989).

6. *See* Gunn, *supra* note 4, *passim*; Lehman, *supra* note 4, at 1107-1133. Another article took a more favorable view of prepaid tuition plans. *See* Williams, *supra* note 5, at 561. The new administration in Michigan is reportedly rethinking its commitment to MET in the wake of criticisms of the program. *See* Goldie Blumenstyk, *2 States Rethink Prepaid-Tuition Plans; Elsewhere the Programs Run Smoothly*, CHRON. HIGHER EDUC., Mar. 27, 1991, at A22.

7. *See* ALA. CODE §§ 16-33C-1 to 16-33C-7 (1990); FLA. STAT. ANN. § 240.551 (1990).

8. A real-life country song title whose author and publisher have thus far eluded us.

II. Criticisms of Prepaid Tuition Plans

Commentators have leveled several criticisms at prepaid tuition plans, particularly the MET plan. These criticisms are directed at both the technical tax law aspects of prepaid tuition plans and at their policy aspects.

A. *Tax Law Criticisms*

There are two technical tax law criticisms of prepaid tuition plans. The first involves the exposure under section 7872 of the Internal Revenue Code ("IRC")[9] of the purchaser of a prepaid tuition plan contract (usually a parent or grandparent) to being taxed on account of accrual of the plan beneficiary's right to receive educational services. Section 7872 deals with the tax treatment of loans with below-market interest rates. The second criticism concerns the exposure of the prepaid tuition plan itself to being taxed on its investment income.

1. Tax Exposure of Contract Purchaser

In a recent article, Professor Alan Gunn argues for the possible applicability of IRC section 7872 to prepaid tuition plans.[10] While Professor Gunn's arguments are persuasive, we believe that there are equally persuasive arguments against applicability of section 7872. A prior article sets these arguments out in detail.[11] We address here only Professor Gunn's specific criticisms.

a. Legislative History

Professor Gunn states that the legislative history of section 7872 does not mention prepaid tuition payments.[12] That is correct if one limits the term "legislative history" to committee reports. However, if one includes congressional hearings as part of the legislative history, there is an indication that Congress did not intend section 7872 to apply to prepaid tuition plans.

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9. I.R.C. § 7872 (1988) (entitled, "Treatment of Loans with Below-Market Interest Rates").
10. Gunn, *supra* note 4, at 251-53.
11. Philipps, *supra* note 1, at 303-08.
12. Gunn, *supra* note 4, at 251.

In 1983 the Subcommittee on Internal Revenue Service Oversight of the Senate Finance Committee conducted hearings in preparation for enacting the comprehensive time-value of money provisions that were the heart of the Deficit Reduction Act of 1984.[13] During these hearings the Treasury presented testimony concerning various perceived abuses proposed to be remedied by the Act. Included in that testimony was the following example:

> Rather than charging parent tuition of $5,000 in 1985, College will accept $4,000 in 1983. Because College can earn $1,000 on the $4,000 over the two years without incurring any income tax liability, it is indifferent between $4,000 today and $5,000 in 1985. Parent is not indifferent, however. If he invested the $4,000 for two years, he would owe tax on the $1,000 earned. . . . In effect, the arrangement allows College to invest Parent's $4,000 and apply the tax-free earnings to Parent's tuition obligation, without subjecting Parent to tax on those earnings.[14]

Hence, the Treasury had specifically called prepaid tuition transactions to Congress' attention prior to the enactment of the comprehensive 1984 time-value of money legislation. Congress, in enacting the time-value of money provisions of the Code, easily could have enacted provisions dealing explicitly with prepaid tuition programs. Congress was certainly aware of the idea. Congress did not choose to enact such a provision. Congress did enact comprehensive and detailed legislation covering a myriad of tax planning devices. Despite the explicit reference to prepaid tuition arrangements by the Treasury in the hearings, no specific provision taxing prepaid tuition plans was contained in the comprehensive and extremely detailed legislation that became the Deficit Reduction Act of 1984.[15] The fact that the Treasury explicitly called prepaid tuition transactions to Congress' attention and that Congress failed to enact any specific provision to govern these transactions indicates that Congress intended the existing law to continue to govern.

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13. *See* I.R.C. §§ 461, 467, 483, 1271-78, 7872, *enacted* or *amended by* Tax Reform Act of 1984, Pub. L. No. 98-369, 98th. Cong., 2d Sess., 98 Stat. 494 (1984).

14. *Abusive Tax Shelters: Hearings Before the Subcommittee on Oversight of the Internal Revenue Service of the Senate Finance Committee*, 98th Cong., 1st Sess. 106 (1983) (statement of Robert G. Woodward, Acting Tax Legislative Counsel, United States Treasury Department).

15. Pub. L. No. 98-369, 98 Stat. 494 (1984).

Prior to the 1984 Act, interest-free and below-market interest loans were held not to result in taxable income to the borrower or the lender.[16] The detailed provisions of the 1984 Act changed this result in certain cases. For transactions to which the detailed provisions of the 1984 Act do not apply explicitly, the inference is that the 1984 Act provisions are not applicable. Hence, the case law result of non-taxability should continue to apply.

b. Tax Avoidance Loans

Section 7872 lists several categories of loans to which it applies: 1) gift loans (for example, loans from a parent to a child); 2) employment related loans (for example, loans from an employer to an employee); 3) corporation-shareholder loans (for example, loans from a corporation to a shareholder); 4) loans of which one of the principal purposes is the avoidance of any federal tax; and 5) to the extent provided in regulations, any below-market loan not included in one of the first four categories to the extent that the interest arrangements have a significant effect on the federal tax liability of the lender or borrower.[17] Professor Gunn emphasizes the possibility that prepaid tuition plans could be characterized as category four tax avoidance loans.[18] It is also conceivable that prepaid tuition loans could come within category five.

Section 7872 applies to "[a]ny below-market loan 1 of the principal purposes of the interest arrangements of which is the avoidance of any federal tax."[19] We agree that prepaid tuition plans could conceivably come within the tax avoidance loan category. Application of this provision raises a "purpose" issue which is generally treated as a question of fact, and, hence, involves a high degree of uncertainty.[20] Nevertheless, we believe that there are strong

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16. *See, e.g.* Greenspun v. Commissioner, 72 T.C. 931 (1979), *aff'd*, 670 F.2d 123 (9th Cir. 1982); Suttle v. Commissioner, 1978-393 T.C.M. (CCH), *aff'd*, 625 F.2d 1127 (4th Cir. 1980); Marsh v. Commissioner, 73 T.C. 317 (1979); Dean v. Commissioner, 35 T.C. 1083 (1961); P. Kieth Bilter, *Interest-Free Loans — Boon or Bust*, 37 MAJOR TAX PLANNING 23-1 (1985); Michael D. Hartigan, *From Dean and Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans*, 60 NOTRE DAME L. REV. 31 (1984); Daniel E. Riley, Note, *Recent Developments Affecting the Income and Gift Tax Consequences of Interest-Free Loans*, 40 WASH. & LEE L. REV. 1685 (1983).

17. I.R.C. §§ 7872(c)(1)(A),(B),(C),(D),(E) (1988). A sixth category, irrelevant to this discussion, includes certain loans to continuing care facilities. *Id.* § 7872(c)(1)(F).

18. Gunn, *supra* note 4, at 251-53.

19. I.R.C. § 7872(c)(1)(D) (1988).

20. *See* Commissioner v. Duberstein, 363 U.S. 278 (1960); 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, GIFTS AND ESTATES ¶ 4.3 (2d ed. 1989); Walter J.

arguments that prepaid tuition plans should not come within this provision.

This "purpose" test looks to the purpose for structuring the transaction as it is constituted rather than structuring it in some other way.[21] Whether it is the state's or the plan purchaser's purpose that the test looks to is not entirely clear. Since the state has control over the structure of the plan, it is reasonable to look to the state's purposes.

The statute requires that the tax avoidance be a *principal* purpose. There can be more than one principal purpose. The dictionary definition of principal is, "[b]elonging to the first or highest group in rank or importance; of the first order; main, prominent, leading."[22] While dictionary definitions are obviously not controlling, they can afford guidance. The basic idea is that a principal purpose is a main purpose. Not every purpose is a main purpose. A purpose can be incidental or subsidiary to a main or principal purpose. For example, the principal purposes of a lawyer arguing a case may be to win for the client and earn a fee. An incidental purpose may be to attract other clients with the lawyer's good work.

There is no doubt that the purpose of minimizing taxes played a part in the creation of tuition prepayment plans.[23] The question is whether that was a main purpose or simply an incidental purpose. In other words, the issue is whether the tax savings result was the

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Blum, *How the Courts, Congress and the IRS Try to Limit Legal Tax Avoidance*, 10 J. TAX'N 300 (1959); Ned Fischer, *Intent and Taxes*, 32 TAXES 303 (1954).

21. The proposed regulations under § 7872 state that:

> For purposes of this rule, tax avoidance is a principal purpose of the interest arrangements if a principal factor in the decision to structure the transaction as a below-market loan (rather than, for example, as a market interest rate loan and a payment by the lender to the borrower) is to reduce the federal tax liability of the borrower or the lender or both. The purpose for entering the transaction (for example, to make a gift or to pay compensation) is irrelevant in determining whether a principal purpose of the interest arrangements of the loan is the avoidance of federal tax.

Prop. Treas. Reg. § 1.7872-4(e)(1), 50 Fed. Reg. 161 (1985).

22. OXFORD ENGLISH DICTIONARY 1373 (2d ed. 1978). This is a secondary definition. The Oxford English Dictionary gives the first definition of "principal" as "First or highest in rank or importance. . . ." *Id.* This would preclude there being more than one principal purpose. However, the wording of the statute ("1 of the principal purposes") makes clear that Congress contemplated that there could be more than one principal purpose. Consequently, the secondary definitions appear more appropriate in this context.

23. For example, the MET legislation was conditional on a favorable IRS ruling with respect to income tax consequences to the purchaser of the plan (usually a parent or grandparent). *See* MICH. COMP. LAWS § 390.1433.3 (1990).

impetus for structuring the prepaid tuition arrangement as it was structured, as opposed to some other reason. In addressing this issue, one could compare MET's structure with an arrangement under which a university accepts advance payments for tuition. Alternatively, one could compare MET with the option of the state's issuing tax-exempt bonds. The comparison with issuance of tax-exempt bonds is more apt, inasmuch as the state of Michigan, not the colleges and universities, established MET to sell prepaid tuition contracts. Since the state easily could have issued tax-exempt bonds that would certainly exonerate the parent of any tax liability for interest income, no tax was avoided by the state's establishment of MET to perform a similar function.[24]

The Michigan Legislature stated its purposes in creating MET as promoting state institutions of higher education and advancing the education of the state's citizenry.[25] Perhaps the cynic can dismiss a state legislature's statement of purpose, but that does, in effect, presume that the state legislature is promulgating lies on its own statute books.

Given all the tax uncertainties involved in prepaid tuition plans, it is difficult to believe that rational persons would devise such plans with a main purpose to avoid federal taxes on interest income. If avoidance of tax on interest income were more than a subsidiary purpose, the state could easily achieve that purpose by issuing tax-exempt bonds to parents for the purpose of college saving. In fact, several states have done precisely that by issuing so-called baccalaureate bonds the interest on which is tax-free to the purchasers.[26]

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24. Even if the proper comparison is to a university prepayment arrangement, there is an argument that the state has accomplished no tax avoidance for the parent by structuring MET as it is. The Service held in 1988 that MET is taxable on its earnings. Priv. Ltr. Rul. 88-25-027, *supra* note 2, ¶ 54,987. Those earnings will be used to pay the tuition of the contract beneficiaries. This imposes a quasi-withholding tax on earnings that are earmarked for tuition payments. To use Professor Gunn's own words, "[T]he parents will in fact pay the MET's taxes, even though they are not, nominally, liable." Gunn, *supra* note 4 at 258. Professor Gunn also states, "One does not enhance one's after-tax welfare by paying someone else's 34% tax instead of paying one's own 28% tax." *Id.* This amounts to construing I.R.C. § 7872 to find tax avoidance on a transaction, while simultaneously asserting that the very same transaction does not avoid tax.

25. MICH. COMP. LAWS § 390.1423.

26. As of September 1990, 28 states had adopted tax-exempt baccalaureate bond plans: Arkansas, California, Colorado, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Missouri, New Hampshire, North Carolina, North Dakota, Ohio, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Vermont, Virginia, Washington, West Virginia, and Wisconsin. AIMS C. MCGUINNESS & CHRISTINE PAULSON, ED-

The states that created prepaid tuition plans obviously have contemplated much more than tax exemption. They want to establish plans that will provide an accessible college savings plan with protection against tuition inflation. The fact that Michigan chose to go ahead with MET in spite of an adverse Private Letter Ruling speaks for itself on the purpose issue. If tax avoidance was more than an incidental purpose, Michigan would have abandoned or materially altered its plan. Officials of the MET plan went ahead, because, as stated by a MET spokesman, "[t]he key is the tuition guarantee. Forget the tax implications."[27]

Is avoidance of tax on interest income a main purpose of setting up MET and other tuition prepayment plans the way they are structured? Or is tax avoidance an incidental, albeit hoped-for, goal? The applicable proposed Treasury regulation does not negate the distinction between a main and an incidental purpose.[28] A state could choose to help middle class taxpayers provide college education for their children in a variety of ways: by educational grants, issuance of baccalaureate bonds, or by a prepaid tuition plan. The first two alternatives would most certainly be tax free. Most state aid to education is tax exempt. A state interested mainly in the tax results probably would not choose the alternative with the greatest tax risk.

A reading of the regulation that rejects a distinction between main and incidental purposes would mean that any arrangement that avoids some taxes would automatically come within section 7872. The tax-saving result would automatically imply the requisite purpose. Any tax-saving purpose, however remote or indirect, would be sufficient to bring section 7872 into play. We question whether Congress intended such a broad sweep for section 7872.

Another hurdle to the application of section 7872 is the classification of the prepaid tuition transaction as a loan. Professor Gunn argues that *Commissioner v. Indianapolis Power & Light Co.*[29] in-

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UCATION COMMISSION OF THE STATES 1990 SURVEY OF COLLEGE SAVINGS AND GUARANTEED TUITION PROGRAMS Section I, at 4-5. Of these, all but Arkansas, Colorado, Ohio, and West Virginia had at least one baccalaureate bond sale by the end of 1990. *Id.*

27. Statement of Michigan Treasury spokesman Robert Kolt, *quoted in* Ellin Rosenthal, *Tax Implications of Michigan Tuition Prepayment Program Remain Unsettled*, 39 TAX NOTES 676, 678 (1988). At another point Michigan Treasury Secretary Robert A. Bowman stated that the program should not be scrapped because of tax issues. Lehman, *supra* note 4, at 1129 n.278.

28. Prop. Treas. Reg. § 1.7872-4(e)(1), 50 Fed. Reg. 161 (1985).

29. 493 U.S. 203 (1990).

dicates that prepaid tuition plans may be classified as loans.[30] *Indianapolis Power* distinguishes between a loan and a prepayment on the basis of whether the payment, "protects [the seller] against the risk that the purchaser will back out of the deal before the seller performs."[31] If the payment so protects the seller then it is a prepayment, not a loan. A payment with a commitment to purchase would be a prepayment, while a payment with no such commitment would be a loan.[32]

The argument is that prepaid tuition contracts are loans, not prepayments, because the purchaser gets a refund if the child does not go to college. There is, therefore, no commitment to go through with the deal. Aside from the fact that the *Indianapolis Power* situation differs from that of tuition prepayment plans, there is a strong practical incentive (if not a strictly legal commitment) to use the educational services rather than seek a refund. This is true because the refund allowed is likely to be worth much less than the educational services available.[33] Nevertheless, *Indianapolis Power* indicates that it is the legal rights of the parties, not the practical ramifications of the transaction that control loan classification.[34] Moreover, the definition of a loan in the proposed regulations is quite broad.[35] Therefore, *Indianapolis Power*, in conjunction with the proposed regulation, may well cause the prepaid tuition transaction to be classified as a loan.

However, classification of the prepaid tuition contract as a loan arrangement is by no means a certainty. The proposed regulations do provide an exception to loan classification for certain prepayment transactions. Prepayment for services is not classified as a loan if made in a manner consistent with normal commercial practices. Again, whether prepaid tuition programs conform to normal

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30. Gunn, *supra* note 4, at 252.

31. *Id.* (quoting Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 212 (1990)).

32. *Id.*

33. *See* Lehman, *supra* note 4, at 1066-69. Professor Gunn recognizes this in his article. Gunn, *supra* note 4, at 252 n.19.

34. *Indianapolis Power & Light Co.*, 493 U.S. at 213-14.

35. The term "loan" is to be interpreted broadly to implement the anti-abuse intent of the statute. Prop. Treas. Reg. § 1.7872-2(a)(1), 50 Fed. Reg. 33553 (1985). The proposed regulation defines loan as "any extension of credit and any transaction under which the owner of money permits another person to use the money for a period of time after which the money is to be transferred to the owner or applied according to an express or implied agreement with the owner." *Id.* However, a bona fide prepayment made in a manner consistent with normal commercial practices for services is generally not a loan.

commercial practices appears to be a factual question. These programs are new and innovative. To that extent they do not conform to normal commercial practices. By the same token, they are marketed in a commercial context and advertised as prepayments for future services, and not advertised as loans.[36]

Finally, a practical argument for not applying section 7872 to prepaid tuition plans is a sheer lack of fit between these plans and the section itself. Assume the section is applicable to prepaid tuition plans. How would it apply? The proposed regulations cannot readily apply to prepaid tuition plans because of the uncertain interest rate and total payouts associated with them.[37] Furthermore, under the regulations is a prepaid tuition plan a demand loan or a term loan?[38] While these problems are certainly not insurmountable, they do indicate that the drafters of the section did not have prepaid tuition plans in mind when they wrote the section.

In summary, we do not quarrel with the plausibility of Professor Gunn's arguments. We do believe, nevertheless, that the accumulation of counter-arguments presents a persuasive case for not applying section 7872 to prepaid tuition plans. The Internal Revenue Service has not attempted to apply section 7872 in the letter rulings it has issued so far. We do not believe this is because the writ-

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36. Professor Lehman argues that a MET contract is a hybrid equity-insurance product. However, he acknowledges the possibility that the IRS could classify the contract as a variable rate loan. Lehman, *supra* note 4, at 1098.

37. In determining whether an obligation is a below market loan, the interest rate of a variable rate loan will be the rate fixed by the index (e.g., LIBOR, AFR, or Treasury Bill rate) on the date the loan is made. Prop. Treas. Reg. § 1.7872-3(e)(1), 50 Fed. Reg. 33553 (1985). A prepaid tuition contract's interest rate will be determined by the cost of tuition upon maturity and the earnings of the tuition fund, rather than a general market index. Further, in determining the amount of original issue discount to impute on certain below-market loans, the present value of "all payments which are required to be made under the terms of the loan" must be determined. Prop. Treas. Reg. § 1.7872-7(a)(1)(B), 50 Fed. Reg. 33558 (1985). A prepaid tuition contract "requires" tuition to be paid, and the amount of tuition cannot be determined with the accuracy of principal and interest payments due on an average loan.

38. Section 7872 defines a demand loan as "any loan which is payable in full at any time on demand of the lender." I.R.C. § 7872(f)(5) (1988). A prepaid tuition contract is not payable upon demand of the purchaser or beneficiary, but rather upon matriculation, death, or some other event. Thus, it appears that a prepaid tuition contract would not be a demand loan. Section 7872 defines a term loan as "any loan which is not a demand loan." I.R.C. § 7872(f)(6) (1988). Also, any loan that is outstanding for an ascertainable time is a term loan. Prop. Treas. Reg. § 1.7872-10(a)(2), 50 Fed. Reg. 33553 (1985). Since a prepaid tuition contract beneficiary may not matriculate directly upon high school graduation, but within some limited time thereafter, the term of the prepaid tuition contract is not definitely ascertainable. However, given the broad Internal Revenue Code definition, a prepaid tuition contract seems to be closer to a term loan than a demand loan.

ers of these rulings had not kept up to date past *Eisner v. Macomber*,[39] as Professor Gunn facetiously suggests.[40] Prepaid tuition plans might logically be dealt with under any number of theories applying existing law, many of which are inconsistent with one another.[41] It is precisely for this reason that we believe Congress should enact legislation governing the tax consequences of prepaid tuition plans. The tax consequences of such a significant and innovative approach to college finance should not be left to logic chopping and argument by analogy.

c. Applicability of Section 103

To the extent that a prepaid tuition contract constitutes a "loan," the commentators have indicated that the interest from such a loan potentially could be tax-exempt under section 103.[42] Section 103 provides, in general, that "gross income does not include interest on any State or local bond."[43] Professor Gunn accurately points out that an obligation must be issued by a state or political subdivision pursuant to its borrowing power in order to gain tax-exempt treatment under section 103.[44] In addition to the borrowing power requirement, a prepaid tuition contract must also avoid classification as an arbitrage bond under section 148 in order provide its holder with tax-free interest income.[45]

(i) Borrowing Power

Professor Gunn states that "[b]ecause money paid under the Michigan plan is kept separate from other state funds, an argument that the state has not exercised its 'borrowing power' has some plausibility."[46] However, the exercise of borrowing power is not evidenced by the intermingling of the bond retirement funds

39. 252 U.S. 189 (1920).

40. Gunn, *supra* note 4, at 259.

41. *See* Philipps, *supra* note 1, at 302-33; Gunn, *supra* note 4, at 251-59; Lehman, *supra* note 4, at 1081-99.

42. *See* Philipps, *supra* note 1, at 308-09; Gunn, *supra* note 4, at 253.

43. I.R.C. § 103(a) (1988). Section 103 then defines a "State or local bond" as "any obligation of a state or political subdivision thereof." *Id.* § 103(c)(1). The courts have long ruled that such an obligation does not have to be evidenced by a formal bond. Commissioner v. Meyer, 104 F.2d 155 (2d Cir. 1939). Thus, a prepaid tuition contract could fall into the broad definition of obligation under § 103.

44. *See* Gunn, *supra* note 4, at 253.

45. I.R.C. § 103(b)(2) (1988).

46. *See* Gunn, *supra* note 4, at 253.

with state funds. Rather, exercise of the borrowing power requires 1) a binding obligation of the state to repay, and 2) a voluntary transaction generating the repayment obligation.

Several cases illustrate the binding obligation requirement for exercise of the borrowing power. These cases hold that the issuance of bonds secured only by special assessments, rather than the general funds, is an exercise of the borrowing power of a state or political subdivision.[47] Professor Gunn cites *King v. Commissioner*[48] in support of the proposition that the separation of MET funds from other state funds could give rise to an argument that the bargaining power has not been exercised.[49] While the Service raised this argument in *King*, the opinion indicates that the Tax Court believed that the separation of funds was not a relevant factor.[50] Thus, as long as MET is legally obligated to repay the principal and any earnings thereon to the beneficiary or the college the beneficiary attends, the binding obligation prong of the borrowing

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47. In Commissioner v. Pontarelli, 97 F.2d 793 (7th Cir. 1938), the court stated in reference to special assessment sewer bonds:

> Although such obligations do not constitute a debt payable from the general funds, yet bonds which are issued in the name of the municipality to be paid only from a special fund created by an enabling act and so limited on the face of the obligation are the bonds of the municipality . . . The municipality as the obligor [of] the bond, must fulfill the obligations imposed upon it and is subject to appropriate action in respect thereof, notwithstanding the fact that it is not under any general liability . . . for the debt.

Id. at 795 (quoting 2 JOHN FORREST DILLON, DILLON ON MUNICIPAL CORPORATIONS, ¶ 827, at 1388 (5th ed. 1911)).

In Fairbanks, Morse & Co. v. Harrison, 63 F. Supp. 495 (E.D. Ill. 1945), revenue bonds issued by several municipalities and to be repaid from the funds generated by the water and power machinery purchased with the proceeds thereof were tax-exempt. The court held that the revenue funds were as much the property of the municipalities as their general tax funds. Thus, the transactions involved the borrowing power of the municipalities. Further, in Commissioner v. Estate of Shamberg, 144 F.2d 998 (2d Cir. 1944), the court stated, "[i]t has many times been held that bonds issued by municipalities are within the exemption . . . even though payment is to be made only out of special funds and the credit of the municipalities was not pledged." *Id.* at 1006.

48. 77 T.C. 1113 (1981).

49. *See* Gunn, *supra* note 4, at 253 n.26.

50. The Tax Court in *King* stated:

> Although we think that [the political subdivision] remained liable to [the seller] for payment of the warrants regardless of what happened to the [separate retirement] account, we note that the bonds issued by municipalities have been held within sec. 103(a)(1) or its predecessors even though payment was to be made out of special funds and the general credit of the municipalities was not pledged.

King, 77 T.C. at 1123 n.7.

power test could be satisfied even though the MET funds were kept separate from other Michigan state funds.[51]

The voluntary transaction requirement reflects the purpose behind the congressional policy[52] of not taxing the interest on state and local obligations: to aid state and local governments in raising debt-financed capital to be used in the furtherance of the public interest.[53] State bonds, if tax-exempt, will command a better price in the market than if they are subject to taxation "because the purchaser is not compelled to buy them and, being a free agent, may be induced by the tax-exemption feature to prefer them to private bonds for investment."[54] When a state issues a tax-exempt bond, a voluntary investor will be attracted to the bond by its tax exemption.

By contrast, where a state condemns property, the owner is forced to sell the property to the government for just compensation. Accordingly, whether the state's payment to the owner is tax-exempt or not will not influence the owner's decision to enter the transaction. Hence, if the state pays for the condemned property with an interest bearing note instead of cash, the interest will not fall within the scope of section 103's exemption.[55] Professor Gunn calls the distinction between applying the section 103 exemption to

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51. There is an argument that MET is, in fact, an integral part of the state, and that MET funds are state funds. *See* Philipps, *supra* note 1, at 321-25. However, an issue that still would have to be decided is whether MET is actually bound to repay "principal and interest." If MET were not so obligated, the binding obligation requirement would not be met. Michigan law authorizes MET to issue contracts that provide for payment to the specified college or university of all of the funds allocable to the beneficiary up to the amount of tuition. MICH. COMP. LAWS § 390.1426 (1987). The funds allocable to a beneficiary could be divided into the initial purchase price (i.e., principal) and the earnings thereon (i.e., interest). However, if MET's investment experience is very poor and the funds on hand no longer exceed the initial purchase price of the contract, MET is only liable for the amount of funds on hand. Thus, MET is not liable for a fixed amount of principal or interest. This may not satisfy the requirement.

52. The Supreme Court has held that the federal government is not constitutionally prohibited from taxing the interest on state and local obligations. South Carolina v. Baker, 485 U.S. 505 (1988). Congress has continued to refrain from taxing the interest on state and local obligations, however, as a matter of policy.

53. Holley v. United States, 124 F.2d 909, 911 (6th Cir. 1942).

54. *King*, 77 T.C. at 1119 (quoting United States Trust Co. v. Anderson, 65 F.2d 575, 578 (2d Cir. 1933)).

55. *See id.* ("It disregards the whole purpose of the exemption to apply it to interest upon obligations of a state which it can compel a citizen to take in exchange for the fair value of his property."). In condemnation proceedings, a state or municipality is deemed to be exercising its power of eminent domain rather than its borrowing power. Holley v. United States, 124 F.2d 909 (6th Cir. 1942); Williams Land Co. v. United States, 90 Ct. Cl. 499 (1940).

voluntary and involuntary obligations "absurdly formal."[56] Nevertheless, we agree with the federal judiciary[57] that it would be inconsistent with the purpose of assisting states to raise debt-financed capital to apply the exemption also to transactions where the creditor would enter into the transaction even without the exemption feature.

Since the purchase of a prepaid tuition contract is completely voluntary on the part of the purchaser, the exemption of any interest income attributable to the holder of the contract would no doubt serve as a market inducement for the purchase of the contract. Accordingly, if MET is deemed to be part of a state or political subdivision,[58] the sales of prepaid tuition contracts could be viewed as an exercise of the state's borrowing power.

(ii) Arbitrage

Once the borrowing power requirement has been satisfied, an obligation must avoid classification as an arbitrage bond in order to obtain tax-exempt status.[59] Section 148 defines an arbitrage bond as "any bond . . . any portion of the proceeds of which are reasonably expected [at the time of issuance of the bond] to be used directly or indirectly to acquire higher yielding investments . . . ."[60] "Higher yielding investments" are defined as "any investment property which produces a yield over the term of the issue which is materially higher than the yield on issue."[61] Thus, if the actual return on investment exceeds the "yield on issue", the obligation will be classified as an arbitrage bond.[62]

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56. *See* Gunn, *supra* note 4, at 253 n.26 ("The Tax Court held in *King* that interest on negotiable notes given as part of the purchase price of property bought (but not condemned) by the agency was exempt. The distinction drawn in these and other cases strikes me as absurdly formal, but it does exist.").

57. *See supra* notes 54 & 55.

58. I.R.C. § 103(c)(1) (1988) requires a state or political subdivision thereof to issue an obligation in order for the interest to be tax-exempt. An IRS ruling stated that because MET was a separate entity from the state, was not subject to state control, and was protected from state use of its funds, etc., it was neither a part of the state government nor a political subdivision thereof. Priv. Ltr. Rul. 88-25-027, *supra* note 2. Hence, a key issue is whether a state sponsored prepaid tuition plan is a "state or political subdivision thereof" instead of whether the borrowing power is exercised by the sale of the prepaid tuition contracts. For a discussion of this issue, see Philipps, *supra* note 1, at 321-27.

59. I.R.C. § 103(b)(2) (1988).

60. *Id.* § 148(a)(1).

61. *Id.* § 148(b)(1).

62. In general, an investment yield which exceeds the yield on issue by more than .125% will be deemed "materially higher" than the yield on issue. Treas. Reg. § 1.103-13(b)(5)

While the actual return on the investments is self-explanatory, the yield on issue is substantially more difficult to determine. Professor Gunn assumes that the yield on issue is the "zero explicit interest paid by [the prepaid tuition plan]."[63] However, the yield on the bond issue is defined as the discount rate that will equate the present value of all future unconditional payments of principal and interest with the issue price of the obligation.[64] The issue price of a prepaid tuition contract will generally be its purchase price.[65] Thus, the yield on issue is the discount rate necessary to equate the present value of the total payments a beneficiary receives on a prepaid tuition contract (i.e., the cost of four years of college tuition starting on the date of matriculation) with the original purchase price his parents paid for the contract.[66]

The regulations pose difficulties in their application to the prepaid tuition contract obligation. The regulations calculate yield based on the unconditional principal and interest payments due under the bond provisions.[67] For a prepaid tuition contract, the ultimate amount of tuition payable (which will be comprised of a return of the original investment and investment earnings) is dependent on tuition levels and investment earnings that can only be

(1979). In certain instances, however, the de minimis percentage is increased to 1.5%. *Id.* § 1.103-13(b)(5)(vii). Thus, if the actual return on investment exceeds the "yield on issue" by the applicable de minimis percentage, the obligation will be classified as an arbitrage bond under I.R.C. § 148.

63. Gunn, *supra* note 4, at 254.

64. *See* Treas. Reg. § 1.148-3T(b)(5)(i) (1989).

65. I.R.C. § 148(h) provides that for purposes of determining the yield on issue, the issue price of a bond will be determined under §§ 1273 and 1274. Section 1273(b)(1) provides that for debt instruments which are publicly offered and not issued for property, the issue price is the initial offering price to the public. Prepaid tuition contracts are issued to the public and are issued in exchange for money, not property. Section 1273(b)(5) defines property as including services and the right to use property, but not money. While prepaid tuition contracts may be redeemed by the provision of educational services, they are issued in exchange for a cash payment by the purchaser. Section 1273 focuses on the issuance exchange rather than the redemption exchange. Hence, the issue price is the cash price of the contract.

66. For example, assume Mr. Smith purchases a prepaid tuition contract for his son for $10,000 when the son is thirteen years old. The son matriculates at State University five years later, and eventually graduates after four years of study. The total cost of four years of tuition was $15,000 (i.e., 2,000, 3,000, 4,000 and 6,000). Accordingly, the yield of the prepaid tuition contract is approximately 6.05% (rate necessary to produce the total payments on the contract). If the tuition plan invested the initial contract price in a taxable mutual fund that yielded 8.5% over the term of the contract, the contract will be classified as an arbitrage bond under I.R.C. § 148 (8.5% - 6.05% = 2.45% which exceeds the de minimis percentage).

67. Temp. Treas. Reg. § 1.148-3T(b)(5)(i) (1989).

predicted, not unconditionally guaranteed.[68] Accordingly, the application of these regulations to a prepaid tuition contract epitomizes the attempt to fit a square contract into a round regulation.

The concept of arbitrage measurement and classification could possibly apply to prepaid tuition contracts. If the yield on investment that a prepaid tuition plan earns over the term of a contract exceeds the implicit discount rate on that contract by a material amount,[69] arbitrage classification could deny tax-exempt status. However, the current regulations promulgated under section 148 do not explicitly provide for the type of debt obligation presented by a prepaid tuition contract. This may be one of the reasons the IRS avoided the issue by not imputing any interest income to the contract holder over the term of the contract.[70]

2. Tax Exposure of the Plan

The IRS took the position in a private letter ruling that MET is taxable on its investment income.[71] Commentators have pointed out that taxability of the investment income of a prepaid tuition plan could have a disastrous effect on its financial soundness.[72] If a plan is taxable on its investment income, its net rate of return on investment would be diminished as compared to a tax-exempt situation. The plan either would have to increase its rate of return by making riskier investments or increase the price charged for its prepaid tuition contracts.

If a plan is already trying to maximize its rate of return, it will probably be unable to increase its investment return by any sizeable amount. Hence, the only alternative would be to increase the price of the plan's prepaid tuition contracts. It is not certain just

68. Further, even for variable yield bonds, the amount of arbitrage is calculated via a five-year recapture window vehicle. *Id.* §§ 1.148-3T(b)(2)(i), 1.148-8T(b)(1)(i) (1989). This methodology looks at the previous five years a bond was outstanding, computes the yield on issue, and compares this to the investment yield to determine the amount of arbitrage. *Id.* § 1.148-2T. This process is repeated until the bond is retired. The amount of arbitrage can be paid over to the IRS at the end of each five-year period in order to prevent the loss of tax-exempt status of the bonds. I.R.C. § 148(f) (1988). The five-year look-back period is sufficient for a regular bond issue because the municipality will be redeeming investments and spending the proceeds for governmental purposes each year. Prepaid tuition plans may not have to redeem investments and pay college tuition for periods of well over five years. Again, the regulations were not designed to apply to prepaid tuition contracts.

69. *See supra* note 62.

70. Priv. Ltr. Rul. 88-25-027, *supra* note 2, at (P-H) ¶ 54,987.

71. *Id.*

72. Lehman, *supra* note 4, at 1127-32; Gunn, *supra* note 4, at 256-58.

how much higher the price of a contract would have to be if the plan chose that course of action, but the increase would probably be substantial.[73] The higher priced contracts would be less attractive and less affordable. Consequently, a prepaid tuition plan with taxable investment income faces a major problem that threatens the viability of the whole plan. This threat appears to have deterred some states from going ahead with prepaid tuition plans.[74]

A state may be able to avoid taxability of its prepaid tuition plan if the plan is properly structured. The Service held that MET is taxable because 1) it is not an integral part of state government, and 2) it is not exempt from tax under section 115 because it primarily benefits private, as opposed to public, interests.[75]

The Service held that MET is not an integral part of state government, because 1) decisions by MET's board of directors cannot be overridden by any state agency, 2) MET's funds are not derived from the state or any state agency, 3) MET's funds are not subject to claims of the state's creditors and "are not considered state money or common cash of the state," 4) the state may not loan, transfer or use MET's funds for any purpose, and 5) MET's funds may only be used for the provision of educational services or refunds authorized in the trust's enabling legislation.[76] The Service concluded that since MET is not an integral part of state government, it cannot be exempt from taxation on that ground.[77]

The IRS has long taken the position that an integral part of state government is not subject to income tax. For example, in Revenue Rulings 71-131 and 71-132, the Service held that profits from state-owned liquor stores are not subject to the income tax,

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73. *See* Lehman, *supra* note 4, at 1065-1108.

74. Several states held up implementation of prepaid tuition plans following issuance of Private Letter Ruling 88-25-027, presumably because the Service ruled that MET was a taxable entity. *See* Elin Rosenthal, *Tax Implications of Michigan Tuition Prepayment Program Remain Unsettled*, 39 TAX NOTES 676, 678-79 (1988). As of September 1990, six states had adopted tuition prepayment plans but had not put them into operation. Indiana, Maine, Oklahoma, Missouri, and West Virginia still have the legislation on their statute books. The sixth state, Tennessee, repealed its legislation altogether. *See* MCGUINNESS & PAULSON, *supra* note 26, Section I, at 2.

75. Priv. Ltr. Rul. 88-25-027, *supra* note 2, at (P-H) ¶ 54,987. Both of these conclusions are subject to dispute. For a discussion of arguments against the Service's conclusions, see Philipps, *supra* note 1, at 321-27.

76. Priv. Ltr. Rul. 88-25-027, *supra* note 2, at (P-H) ¶ 54,987.

77. *Id.*

because the stores are operated as an integral part of the state.[78] The IRS bases its position on the notion that a state or subdivision of a state is not taxable in the absence of a specific statutory provision imposing tax. Since the income tax statute imposes a tax generally on individuals, estates, trusts, and corporations, but not on states, it follows that states are not generally subject to income tax.[79] Except for imposition of tax on the unrelated business income of state colleges and universities,[80] neither Congress nor the Service has ever attempted to tax the direct income of a state.[81]

It appears that a state could easily get around the Service's reasoning in the MET situation by structuring its plan as an integral part of state government. Thus, if the plan is established as a division of a state department (such as the Treasury), is operated by state officials and employees, is made part of the state's funds, subject to general creditors, and is protected by the state obligation to make good any shortfalls in investment income, the plan would seem to qualify as an integral part of state government. Hence, its investment income would be exempt from federal income tax.

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78. *See* Rev. Rul. 71-131, 1971-1 C.B. 29; Rev. Rul. 71-132, 1971-1 C.B. 29. Rev. Rul. 71-131 superseded and adopted the reasoning of Gen. Couns. Mem. 14,407, *reprinted in* XIV-1 C.B. 103 (1935), which likewise exempted state-run liquor stores from income tax.

79. *See* Rev. Rul. 87-2, 1987-1 C.B. 18 (holding that a Lawyer Trust Account fund created and controlled by State Supreme Court not subject to income tax because an integral part of state government). The Service position is based on the income tax statute itself, and not on any constitutional limitation on the power of the federal government to tax the states under the doctrine of intergovernmental immunity.

The precise constitutional limits on the power of the federal government to tax the state remain unclear. *See* Philipps, *supra* note 1, at 322; Michael Wells and Walter Hellerstein, *The Governmental-Proprietary Distinction in Constitutional Law*, 66 U. VA. L. REV. 1073, 1080-85 (1980); Stefan F. Tucker and Robert A. Rombro, *State Immunity from Federal Taxation: The Need for Reexamination*, 43 GEO. WASH. L. REV. 501, 503-512 (1975).

80. *See* I.R.C. § 511(a)(2)(B) (1988) (imposing an income tax on the unrelated business income of state colleges and universities).

81. In General Counsel Memorandum 14,407 the Service stated:

> Not only has the Bureau failed to tax the direct income of any state or municipality but it has throughout this period of 22 years made no effort to obtain income returns from states or municipalities, or to determine by any other means whether any State or municipality has had income of this nature. This persistent non-enforcement of the tax against States may be reasonably explained only as indicating a tacit construction by the Bureau in accordance with the interpretation that has just been suggested.

Gen. Couns. Mem. 14,407, *reprinted in* XIV-1 C.B. 103 (1935).

The state of Florida has structured its plan along these lines.[82] The Prepaid Postsecondary Expense Board, which is administratively a part of the Division of Benefits of the Department of Insurance, administers Florida's plan.[83] The Board consists of state officials, university officials, and appointees of the Governor.[84] The Board is subject to state administrative procedures and other laws governing state agencies and the program's annual budget must be approved by the state.[85] The Expense Board, acting with approval of the State Board of Administration, is responsible for investing the program's funds, which can be transferred to a commercial investment manager.[86] Perhaps, most importantly, the Prepaid Postsecondary Education Trust Fund is maintained within the State Treasury,[87] and the program's Master Covenant provides that future tuition payments are *guaranteed by the state.*[88] Florida officials are hopeful that this structure will avoid the taxability problems of the MET plan and have requested a letter ruling that Florida's prepaid tuition plan is an integral part of the state whose income is exempt from federal income tax.[89]

B. *Policy Criticisms*

Many of the policy criticisms made by commentators point out real weaknesses in existing plans. For example, Professor Lehman criticizes MET's actuarial assumptions as too optimistic[90] and Pro-

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82. *See* FLA. STAT. ANN. § 240.551 (West 1989). Also, the state of Alabama's plan has been structured as an integral part of state government. ALA. CODE § 16-33C-1 (1990).

83. FLA. STAT. ANN. § 240.551(5) (West 1989).

84. *Id.*

85. *See generally* FLA. STAT. ANN. § 240.551 (West 1989) and FLA. ADMIN. CODE ANN. 4G-1.001 to 1.010; *see* FLA. STAT. ANN. § 216.181.

86. *See* FLA. STAT. ANN. §§ 240.551(5)(e), (f) (West 1989).

87. *Id.* § 240.551(4).

88. The Florida Prepaid Postsecondary Education Expense Program Master Covenant provides:

> [a]ll legal and beneficial interests in the assets held by the trust fund are vested in the State for its exclusive benefit and the exclusive benefit of the colleges and universities; therefore, payments are guaranteed to be made on the beneficiary's behalf to the State college or university.

THE FLORIDA PREPAID POSTSECONDARY EDUCATION EXPENSE PROGRAM MASTER COVENANT 1989-1990, § 5.08. Also, the Florida legislature will appropriate the amount of funds necessary to meet any shortfall the trust fund experiences in meeting its obligations. FLA. STAT. ANN. § 240.551(9) (West 1989).

89. *See* Letter from Robert L. Maige to Assistant Commissioner of Internal Revenue, *supra* note 2. As of August 1, 1991, the Service has not responded to Florida's ruling request. Telephone interview with William Nichols, *supra* note 2.

90. *See* Lehman, *supra* note 4, at 1106-08.

fessor Gunn laments the lack of a true tuition guarantee in the MET plan.[91] These are valid criticisms. Professor Lehman's analysis of problems associated with MET's implementation is particularly acute, as is Professor Gunn's critique of MET's failure to provide a true tuition guarantee. Nevertheless, the idea should not be discarded. Some of the commentators' general objections about prepaid tuition plans appear to be basically ideological in nature.[92] Such objections obviously are matters about which reasonable people can differ; the subject may be approached from a different ideological perspective. Many of the specific problems raised can be remedied in subsequent programs. Moreover, it may be possible to devise a tuition program that would involve not only state-sponsored institutions, but the private sector as well.

The arguments in favor of prepaid tuition plans have been discussed in a previous article.[93] This article will discuss objections that have been raised to prepaid tuition plans, restating the arguments in favor of prepaid tuition plans where necessary, while attempting to avoid unnecessary repetition of the prior article.

1. Actual Legal Tuition Insurance Not Provided

Professor Gunn aptly points out that MET does not provide an actual tuition guarantee.[94] In order to provide actual insurance protection against future increases in the cost of college tuition, a prepaid tuition plan sponsored by the state would need financial backing other than the plan's own funds which could pay any shortfall between funds on hand and the actual cost of tuition. One way to obtain this financial backing is to have the state guarantee that it will make up any shortfall between the plan fund balance and the actual cost of tuition.[95] In exchange for this guarantee by the state, a prepaid tuition plan would have to be structured so that the state's general fund is not drained by continual subsidies to the tuition plan.[96] Two measures could accomplish this result: 1) tie actual tuition increases to actuarial cost assumptions; and 2)

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91. *See* Gunn, *supra* note 4, at 255-59.

92. *See infra* notes 108-138 and accompanying text.

93. *See* Philipps, *supra* note 1, at 336-40.

94. Gunn, *supra* note 4, at 255-59.

95. The State of Florida guarantees that the full tuition payments will be made to the college or university to which the beneficiary matriculates. *See supra* note 85 and accompanying text.

96. Further, from a political perspective, citizens of the state who either do not have young children or do not plan to send their children to college may not welcome the idea of

place the tuition plan under direct control of state government, thereby eliminating the plan-level tax burden with a resultant increase in plan after-tax revenue.

a. Tie Tuition Increases to Actuarial Expense Assumptions

Professor Lehman maintains that the inflation factor for future tuition increases used by MET's actuaries was too low.[97] Accordingly, if Michigan public colleges raised their tuition charges at a rate in excess of the actuarial assumed rate, MET would be underfunded. Since MET is an independent entity, there are no legal restraints on the public colleges to keep them from outstripping the MET fund balance by raising their tuition levels "too fast."[98] Professor Lehman projects that when cost underestimations are combined with revenue overestimations, MET should have charged approximately fifty percent more for its prepaid tuition contracts in order to assure a sufficient fund balance to cover actual future tuition costs.[99]

After MET began operations, Michigan public colleges announced tuition increases that exceeded MET's inflation assumptions.[100] Instead of increasing prices for MET contracts, Michigan's governor launched a lobbying campaign to pressure the colleges into lowering their tuition increases.[101] The colleges yielded and lowered their projected tuition increases.[102]

Dependence on informal political pressure to force actual tuition increases that approximate the actuarial assumptions of a prepaid tuition program is obviously a poor way to proceed. A more direct and legally binding control over both tuition increases and actuarial assumptions is preferable. Under this approach, one state

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having their state taxes support the college expenses of the children of other citizens beyond the current tuition subsidies for residents at state-sponsored institutions.

97. *See* Lehman, *supra* note 4, at 1072-76. MET's actuaries assumed a tuition inflation rate of only 7.3%, while actual tuition inflation for Michigan public colleges for two successive ten-year periods beginning with the 1968-1969 school year equalled 8.7%. *Id.*

98. Conversely, there is no ultimate statutory requirement for MET to tie its tuition inflation assumptions directly to actual tuition increases charged by state colleges and universities. If the fund is insufficient, MET merely dissolves and distributes the fund balance to the beneficiaries. MICH. COMP. LAWS § 390.1433(2) (1990).

99. *See* Lehman, *supra* note 4, at 1107.

100. *See id.* at 1114. Michigan public schools announced a weighted average tuition increase of 12.4% in June of 1988, instead of the 7.3% assumed by MET. *Id.*

101. *See id.* Governor Blanchard threatened to veto state appropriations for any university that did not roll back its tuition increase to less than 10%. *Id.*

102. *See id.*

agency would control the amount of tuition increases allowed for public colleges and the actuarial assumptions used by the prepaid tuition plan in arriving at the purchase price for a contract.

Such an agency could be administered by members of the tuition plan as well as representatives from the state colleges.[103] Thus, both groups would have input into deciding long range increases in tuition levels. This would yield some degree of cost control over tuition increases which would benefit all the families within the state that had children attending college, not just those who participate in the prepaid tuition plan.[104] Further, this approach would make a major contribution to the actuarial soundness of the plan fund.

Colleges, like many state governments, would be required to be more fiscally responsible and the tuition plan would be required to charge a more realistic price for a prepaid tuition contract. The state's general fund would have some degree of certainty that the cost assumptions underlying the prepaid tuition plan fund balance would not be so understated as to require a massive subsidy from the state general fund.

It would be naive to believe that state college authorities would not resist strenuously a proposal such as this one. It would, after all, result in a diminution of their independence. Even so, it appears to be preferable to the Michigan situation where all parties seemed to go their merry ways until the governor stepped in.

b. Make the Tuition Plan an Integral Part of State Government

In addition to minimizing cost underestimation, a tuition plan could increase its after-tax revenue by being structured as an integral part of the state government and thereby avoiding a plan-level

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103. Alabama's plan provides that the Chancellor of the Alabama Department of Post-Secondary Education will serve as a member of the board administering the plan. ALA. CODE § 16-33C-4(a) (Cum. Supp. 1990). Florida's plan provides that the Chancellor of the Board of Regents and the Executive Director of the State Board of Community Colleges serve on the plan's board. FLA. STAT. ANN. § 240.551(5) (West Supp. 1991).

104. Professor Lehman points out that colleges faced with tuition limits would cut spending and/or turn to other sources of revenue such as out-of-state students. *See* Lehman, *supra* note 4, at 1116. However, in the Michigan scenario the actuarial assumptions were set independently of and prior to the actual tuition increases. Both colleges and plan actuaries should have significant input into setting one increase factor which will be used for both purposes. This would generally result in a factor somewhat lower than the colleges prefer and somewhat higher than the plan actuaries prefer.

income tax.[105] The state agency described above would have final authority over all plan decisions. All plan funds would be subject to the general creditors of the state, and the state would have the legal authority to use plan funds for non-educational purposes.[106]

This type of structure will 1) allow the state to control the fund that it is guaranteeing will be sufficient to meet future tuition costs, and 2) avoid the maze of uncertainties that face programs like MET in determining the plan's potential tax liability.[107] A tax-exempt plan would provide a higher after-tax return to investors, allowing lower prices for prepaid tuition contracts.

2. Disproportionate Benefit to Middle Income Groups

The most persistent objection to prepaid tuition programs seems to boil down to the assertion that they provide too much benefit to the middle class.[108] We agree that the programs mostly benefit middle and upper-middle income citizens. However, we do not believe this to be a fatal flaw. A program to help middle class citizens to provide higher education for their children is a real need at this time. The proof lies in the public response to the programs that have been put into operation. The number of contract purchases has been at or above expectations, despite the criticisms and problems with the plans.[109] Perhaps the purchasers are all misguided or defrauded, but the members of the general public appar-

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105. For a more complete discussion of the tax law treatment of integral parts of state government, see *supra* notes 71-89 and accompanying text.

106. Priv. Ltr. Rul. 88-25-027, *supra* note 2, at (P-H) ¶ 54,987:

> [MET] was created as a corporation to operate independently from [the State of Michigan] under an appointed board of directors. Decisions by [MET's] board of directors, including those involving investment discretion, may not be overridden by any state agency. [MET's] funds are not derived from [the State of Michigan] or one of its political subdivisions, and by statute are not subject to the claims of [the State of Michigan's] creditors and are not considered state money or common cash of the state. [The State of Michigan] may not loan, transfer, or use [MET's] funds for any purpose. [MET's] funds may only be used by [MET] for the tuition payment or refund purposes expressly provided in the enabling legislation. These factors indicate that [MET] is not an integral part of [the State of Michigan] or one of its political subdivisions. Therefore, [MET's] income, unless otherwise excluded by statute, is subject to federal income tax.

107. *See* Philipps, *supra* note 1, at 321-33; Lehman, *supra* note 4, at 1081-1106.

108. *See* ARTHUR M. HAUPTMAN, THE TUITION DILEMMA 82-85 (1990) (stating that government programs should benefit the neediest students); Lehman, *supra* note 4, at 1038-41, 1053-55, 1110-13, 1134-41.

109. As of September 1990, Michigan had sold at least 90,000 contracts, Alabama had sold at least 14,000 contracts and Florida had sold at least 101,000 contracts. MCGUINNESS & PAULSON, *supra* note 26, Section III.

ently believe they need these programs, regardless of what the professors tell them.

There is nothing wrong with a program that benefits the middle income group. Professor Lehman asserts that the central function of civil society is to create institutions "that will lead people to think about others."[110] This seems connected to the egalitarian notion that equality of condition (rather than equality of opportunity) is the preeminent value to be accomplished by government. However, liberty is at least co-equal to equality as a value to be pursued. The government ought to maximize liberty within the constraints of a civil society. The opportunity to obtain an education of one's choice is a valued liberty. Moreover, an educated citizenry is vital to the preservation of liberty.

Middle income citizens need help in educating their children. College costs have historically risen at a rate about two percent greater than the general inflation rate.[111] The middle income groups are finding themselves with fewer educational choices. They are increasingly unable to consider private schools, or even the more expensive state institutions, as financially feasible choices.[112]

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110. Lehman, *supra* note 4, at 1038.

111. Derek Bok, *What's Wrong with Our Universities?*, 14 HARV. J. L. & PUB. POL'Y 305, 325 (1991) (citing KENT HALSTEAD, HIGHER EDUCATION TUITION 20-21 (1989)). The cost of higher education tuition went up faster in the decade of the 1980s than the cost of any other good or service, including medical care. Statement of Arthur Hauptman, Educational Consultant, American Council on Education, *in Proceedings, Invitational Conference on College Prepayment and Savings Plans* 21 (1987). For the 1990-91 school year, the average tuition increase for private colleges was about eight percent for private four year colleges and seven percent for public four year colleges, with the general inflation rate remaining at about five percent. Gary Putka, *Private Colleges Tempering their Increases in Tuition*, WALL ST. J., Sept. 27, 1990, at B1 (citing the COLLEGE BOARD ANNUAL SURVEY OF COLLEGES (1990)).

Another way to view the situation is to compare the rise in college costs to the rise in disposable income. Between 1980 and 1987, disposable income grew at an average annual rate of 6.5 percent. MINNESOTA HIGHER EDUCATION COORDINATING BOARD, STATE SAVING INCENTIVE AND PREPAID TUITION PLANS 4 (1988). For the same period tuition and fees increased at a rate of 9.8 percent. *Id.* This contrasts with the trend prior to the 1980s, when disposable income increased more rapidly than the cost of attending college. *Id.* Professor Lehman points out that all this is not as bad as it sounds at first, especially when one uses the geometric difference between tuition inflation and general inflation. Lehman, *supra* note 4, at 1044-53. Nevertheless, Professor Lehman does acknowledge a middle class tuition squeeze. *Id.* at 1051. His response is that middle class families should be willing to spend a greater portion of their income on education if they value education so highly. *Id.* at 1049-51.

112. Between 1980 and 1989, the cost of tuition, room, and board increased by 118% at private universities and 106% at private four-year colleges. Similar costs rose 82% at public universities and 77% at public colleges. These increases amounted to a range of 18% to 56%

According to statistics provided by MET, sixty-four percent of families purchasing MET contracts are in the $20,000 to $80,000 adjusted gross income range.[113] Professor Lehman points out that MET's statistics are subject to varying interpretations.[114] However, it seems safe to say that the bulk of MET contract purchasers could be classified as middle income. Consider a family of four with two small children in the mid-part of this range. Assume this family has an adjusted gross income of $50,000 all consisting of wage income. After federal income, FICA, and state income taxes are considered, the average monthly take-home pay for this family would be about $3,133.[115] This makes the unlikely assumption that there are no other deductions from the paychecks, such as for the employee's share of medical insurance. So the take-home pay might be even lower. While this is not an insubstantial income it would not leave much left over after mortgage and car payments, utility bills, groceries, school costs, commuting costs, insurance premiums, medical bills, etc. Do these people need help with sending their children to college? Is a private college in easy reach?[116]

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in real terms. Sandy Baum, *The Need for College Savings, in* COLLEGE SAVINGS PLANS 9 (Janet S. Hansen ed., 1990). *See* Thomas Toch & Ted Slafsky, *The Great College Tumble — Education is Becoming More Stratified by Class,* U.S. NEWS & WORLD REPORT, June 3, 1991, at 50. Even at the 7.3% rate of college cost inflation for 1990, four years of tuition, fees, room, and board at an average private institution will cost around $225,000 for a child born in 1991. *The Savings and Investment Act of 1991: Hearings on S. 612 Before the Senate Committee on Finance,* 102d Cong., 1st Sess. (1991) (statement of Peter A. Roberts, Chairman and Chief Executive Officer, College Savings Bank), *reprinted in College Savings Bank of Princeton Chairman Testifies on Bentsen-Roth IRA Bill,* TAX NOTES TODAY, Aug. 1, 1991, *available in* LEXIS, Fedtax library, TNT File, 91 TNT 161-37. Half of all college students attended private schools in 1950. In 1990, 22% attended private institutions. Marj Charlier, *Ailing College Treats Student as Customer, and Soon is Thriving,* WALL ST. J., July 17, 1991, at A1. The private institutions are there for those who can attend. Although only 22% of students currently attend private institutions, almost half the existing institutions of higher education are private. A. Kenneth Pye, *What's Wrong with Our Universities? - An Additional View,* 14 HARV. J. L. & PUB. POL'Y 335, 337 (1991) (citing Arthur M. Hauptman & Charles J. Andersen, *Background Paper on American Higher Education, in* COMM'N ON NAT'L CHALLENGES IN HIGHER EDUC., MEMORANDUM TO THE 41ST PRESIDENT OF THE UNITED STATES 16, 17 (1988)).

113. *See* Lehman, *supra* note 4, at 1134. Of the remaining 36%, 19% had adjusted gross income in excess of $80,000 and 17% had adjusted gross income below $20,000.

114. *Id.* at 1134-41.

115. The 1991 payroll deductions would approximate $465 of federal wage withholding, $319 of FICA, and $250 of state wage withholding (assuming the state tax at an average rate of 6% of adjusted gross income). The total of these deductions is $1,034, which subtracted from a gross monthly pay of $4,167 ($50,000 ÷ 12 months) leaves a net paycheck of $3,133.

116. Under government guidelines for financial aid assistance this family sending one of their children to college would have an "Expected Parental Contribution" of around $7,000 ($583 per month), even if the family has no net assets. CONGRESSIONAL BUDGET OFFICE, STUDENT AID AND THE COST OF POSTSECONDARY EDUCATION 16, Tbl. 2 (1991).

Are they likely to save enough out of each paycheck to finance two college educations? They are likely to be ineligible for low income aid such as Pell grants.[117] The likelihood is that they will be faced with taking on substantial debt when it comes time for their children to attend college, especially if they attend a private college.[118]

How would a tuition prepayment plan help? The key would be a regularized savings plan that could be marketed by either the state or private organizations. This can be accomplished by permitting prepayment contracts to be purchased on an installment basis.[119] Most people simply do not save enough in advance to make large lump-sum expenditures. But they do manage to make installment payments on a month-to-month basis, because they can budget the installments into their periodic income. The paradox is that many people save by borrowing, and then paying back on the installment plan. At the end of the payment period they have an asset they would not have had without borrowing. Not many houses or automobiles would be sold if they had to be paid for in a lump sum. The same principle can apply to prepaid tuition plans.

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117. *See* Kenneth J. Cooper, *Election-Year Issue Looms: Aiding Poor or Middle-Class College Student*, WASH. POST, June 12, 1991, at A21.

118. A recent survey by the American College Testing Service concluded that families need an income of about $50,000 to cover costs of a two year community college out of current income and about $95,000 for a private college. *The Savings and Investment Incentive Act of 1991: Hearings on S. 612 Before the Senate Comm. on Finance*, 102d Cong., 1st Sess. (1991) (statement of William J. Byron, S.J., President, The Catholic University of America), *reprinted in Association of Independent Colleges and Universities Official Testifies on Bentsen-Roth IRA Bill*, TAX NOTES TODAY, Aug. 2, 1991, *available in* LEXIS, Fedtax Library, TNT file, 91 TNT 162-31. Loans have replaced grants as the major source of federal student assistance. Margaret A. Schenet, *Higher Education: Reauthorization of the Higher Education Act* CRS-3 (CONGRESSIONAL RESEARCH SERVICE: ISSUE BRIEF 1991). A report in the *Washington Post* is illustrative:

> Linda A. Martinelli of Cranston, Rhode Island complained in an interview that her family, whose annual income is about $35,000, has been ineligible for Pell Grants. It took $25,000 in commercial loans, as well as $17,500 in guaranteed student loans to educate her daughter, Lisa, at Salve Regina College, a small Catholic school.

Cooper, *supra* note 117, at A21. Rising educational debt loads are now recognized as a serious problem for the middle class. *See* Pye, *supra* note 112, at 351-52; J. Timothy Philipps & Timothy G. Hatfield, *Uncle Sam Gets the Goldmine — Students Get the Shaft: Federal Tax Treatment of Student Loan Indebtedness*, 15 SETON HALL LEGIS. J. 249 (1991); Wm. J. Kenny, *Establishing a Program to Provide for College Cost Requires Careful Planning after TAMRA*, TAX'N FOR LAW. 56 (July/Aug. 1989); Roy A. Knight & Lee G. Knight, *New Ways to Manage Soaring Tuition Costs*, 167 J. ACCT. 46 (March 1989); Michael S. McPherson and Mary Skinner, *Paying for College: A Lifetime Proposition*, 4 BROOKINGS REV. 29 (1986).

119. MET, and the Alabama and Florida plans all permit some form of installment payment for prepaid tuition contracts. *See* MICH. COMP. LAWS § 390.1426(1)(b) (1988); ALA. CODE § 16-33C-5(11) (Cum. Supp. 1990); FLA. STAT. § 240.551(5)(c)(17) (Cum. Supp. 1991).

If the opportunity to purchase these plans on an installment basis is made widely available and if the plans are adequately marketed, prepaid tuition plans could become as commonly used as IRAs were in their heyday.[120] This would be especially effective if the installment plan could be combined with payment by voluntary payroll deduction. Each month our hypothetical family would simply have an additional amount deducted from its paychecks for the purchase of prepaid tuition. The availability of prepaid installment tuition plans would aid lower-middle income families who find it difficult to save voluntarily.[121]

The education of all citizens has long been recognized as a proper function of government.[122] Chief Justice Warren recognized this in *Brown v. Board of Education*[123] when he wrote:

> Today, education is perhaps the most important function of state and local governments. Compulsory school attendance laws and the great expenditures for education both demonstrate our recognition of the importance of education to our democratic society. It is required in the performance of our most basic public responsibilities, even service in the armed forces. It is the very foundation of good citizenship.[124]

Every government program does not have to result in redistribution of wealth from the rich to the poor. Egalitarianism is not the only proper standard for measuring the worth of a government program. Education is such a fundamental value that we, as a society, have chosen to make it available on a non-need basis in many

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120. *See* Janet S. Hansen, *Introduction and Overview, in* COLLEGE SAVINGS PLANS 4 (Janet S. Hansen ed., 1990).

121. Series EE bonds are currently available on a payroll deduction plan. The interest on these bonds can be tax-free when the bond redemption proceeds are used for qualified educational purposes, and the taxpayer meets other requirements of the statute. *See* I.R.C. § 135 (1988). The exclusion is phased out between modified adjusted gross income levels of $60,000 and $90,000 for married couples filing joint returns. For single taxpayers and heads of household the phaseout range is between $40,000 and $55,000. *Id.* § 135(b)(2)(A). The threshold phaseout amounts are indexed for inflation beginning in 1991. *Id.* § 135(b)(2)(B). Bond purchasers who were under age 24 on the date of the bond's issuance and married taxpayers filing separate returns are not eligible for the exclusion. *Id.* § 135(c)(1)(B),(d)(2). The government has taken some steps to market these bonds for educational purposes. The adequacy of that effort has not been established. *See Bank Sues Treasury Over "Deceptive" Advertising,* WALL ST. J., June 26, 1991, at C15.

122. *See* New York v. United States, 326 U.S. 572, 587-88 (1946) (Stone, C.J., concurring); Allen v. Regents, 304 U.S. 439, 449, 452 (1938).

123. 347 U.S. 483 (1954).

124. *Id.* at 493.

contexts. The wealthiest citizens are free to send their children to public school and to state supported institutions of higher education.

Up to now, higher education has been more accessible in the United States than in any other country.[125] However, the growth in access to higher education has slipped in the past decade.[126] It is safe to assume that the increasing difficulty of financing a college education is at least partly responsible for that.

Families have three sources of funds available for college finance: savings, current income, and loans. Many families are likely to use a combination of the three,[127] with loans becoming increasingly prominent.[128] Families appear not to be saving enough for college costs. A widely quoted 1984 study found that only about half the families who plan to have a child attend college were currently sav-

125. Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), 56-57, May 30, 1991, *reprinted in* BNA Special Supplement, Report No. 107, June 4, 1991. [hereinafter *International Competitiveness*]. Only Canada comes close in terms of percentage of college age students enrolled at institutions of higher education as the following table illustrates:

Enrollment Rates for Postsecondary Education in
Selected Countries, 1985

Country	Postsecondary enrollment rates (percent) inhabitants	Postsecondary students per 100,000
Australia	29	2,464
Canada	55	5,090
China	2	168
West Germany	30	2,546
France	30	2,362
Italy	26	2,065
Japan	30	2,006
Mexico	16	1,529
Soviet Union	21	1,847
Sweden	37	2,650
United Kingdom	21	1,795
United States	57	5,145

Id. at 56.

126. The median years of school completed by persons aged 25-29 reached a peak of 12.9 in 1976. That figure remained stable until 1987, when it declined to 12.8 years. The proportion of 25-29 year-olds who completed four or more years of college increased from 11.1% in 1960 to 16.3% in 1970. During the 1980s this percentage stayed virtually unchanged at 22%. *International Competitiveness*, *supra* note 125, at 57.

127. MINNESOTA HIGHER EDUCATION COORDINATING BOARD, STATE SAVING INCENTIVE AND PREPAID TUITION PLANS 11 (1988).

128. *See* Cooper, *supra* note 117.

ing anything for that purpose. Moreover, for those who did save, the level of saving was glaringly inadequate.[129]

One reason families undersave for college costs may be that the available savings options appear inadequate in light of anticipated college costs.[130] For a small saver the common alternatives for cash saving are savings accounts, series EE bonds, municipal bonds, life insurance policies, common stocks, and annuities. Except for common stocks, the rate of return on these alternatives has historically been below the rate of college cost inflation.[131] Many middle income persons have neither the time, temperament, nor talent to engage in a sophisticated investment program. They do not have adequate information to make investment choices. Appropriate investment vehicles are not readily available. Prepaid tuition plans can meet both these needs when advertised and made available on an installment payment basis. Prepaid tuition contracts are sold in large numbers in states where they are widely publicized and readily available.[132] Prepaid tuition programs offer the middle class saver an opportunity to take advantage of the expertise and mar-

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129. *Tax Incentives for Education: Hearing Before the Senate Finance Committee*, 100th Cong., 2d Sess. 194, 203 nn.1-2 (1988) (statement of John D. Finnerty, Executive Vice-President and Chief Financial Officer, College Savings Bank) (citing ROPER ORGANIZATION, A NATIONAL STUDY ON PARENTAL SAVINGS FOR CHILDREN'S HIGHER EDUCATION EXPENSES 5 (National Institute of Independent Colleges and Universities Aug. 1984)). The overall median level of saving was only $517 (about $650-700 in current dollars) per year, and families tended to wait until the child was within five or six years of college to begin saving. The study also indicated that 70% of families with 1984 incomes in excess of $30,000 did some saving for college. Their median savings level was $904 in 1984. Adjusted for subsequent inflation, the current median yearly saving amount for these families would be about $1,300-1400. *Id.* Another study was more optimistic. Of all households with children under 18, only 6% indicated that they did not save for any reason. The rest of the families had savings, but only 34% indicated they were saving specifically for college expenses. A. Charlene Sullivan, *Saving for College: The Investment Challenge, in* COLLEGE SAVINGS PLANS 18, 21 (Janet S. Hansen ed., 1990). However, these same families had debt payments amounting to about 30% of their pre-tax income, and most of their savings was in the form of checking and savings accounts, certificates of deposit, and money market funds. *Id.* at 23.

130. Most people, when asked, overestimate rather than underestimate the cost of attending college. MINNESOTA HIGHER EDUCATION, *supra* note 127, at 11. One authority has blamed college cost sticker shock for causing a college saving paralysis. *The Savings and Investment Act of 1991: Hearings on S. 612 Before the Senate Committee on Finance*, 102d Cong., 1st Sess. (1991) (statement of Peter A. Roberts, Chairman and Chief Executive Officer, College Savings Bank), *reprinted in College Savings Bank of Princeton Chairman Testifies on Bentsen-Roth IRA Bill*, TAX NOTES TODAY, Aug. 1, 1991, *available in* LEXIS, Fedtax Library, TNT File, 91 TNT 161-37.

131. *See* Richard Anderson, Prepaying for Higher Education: Why it Works 4-7 (paper presented to the American Economics Association Dec. 29, 1988, and to the Brookings Institution Dec. 6, 1988).

132. *See supra* note 109.

ket power that a large sophisticated investor can exercise.[133] The poor and the middle class are two distinct groups that find financing a college education difficult. Different policies are needed for each.[134] To the extent that middle income parents save for their children's education, financial resources are available for tuition aid to poorer students.[135] More emphasis on saving will ultimately ameliorate the financial burden government now bears with subsidization of loan programs.[136] Finally, middle class voters are less likely to support educational policies that they perceive as being modern day versions of Robin Hood, taking resources from the middle class to benefit only the poor.[137]

Prepaid tuition plans offer an attractive policy choice for meeting the college finance needs of the middle class. They provide an educational savings vehicle for those citizens who have proven themselves to be most ambitious and productive in the marketplace, who practice the value of thrift, and who take seriously the obligation to provide for the education of their children. What is wrong with that? These citizens do have a special moral claim, as Professor Lehman would require,[138] to assistance from the government in providing their children with an education. That claim lies in the contributions these citizens make to the commonwealth.

III. PROPOSALS

The current situation with respect to prepaid tuition plans can be improved in two ways. First, prepaid tuition plans should be granted tax favored treatment by Congress. Second, prepaid tuition plans can be improved by involving the private sector, widening college choice, and making them more accessible to the average citizen.

A. *Tax Favored Status for Prepaid Tuition Plans*

The tax status of prepaid tuition plans currently is uncertain. If the IRS is correct in its holding that state plans are taxable, the

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133. For a fuller discussion of the investment advantages that prepaid tuition plans offer to the small investor, see Philipps, *supra* note 1, at 338-40.

134. Janet S. Hansen, *Introduction and Overview, in* COLLEGE SAVINGS PLANS 4 (Janet S. Hansen ed., 1990).

135. *See* Pye, *supra* note 112, at 339.

136. *See* statement of Peter A. Roberts, *supra* note 130.

137. *See id.*; Cooper, *supra* note 117, at A21.

138. *See* Lehman, *supra* note 4, at 1053.

results for those plans will be detrimental to say the least.[139] The same would be true if the purchasers of prepaid tuition plans are ultimately taxed as Professor Gunn suggests they might.[140] Taxation of the student receiving educational services, while probably not as harmful, is still a disincentive to purchase the plans.[141]

The tax system should encourage, not discourage, the idea of prepaid tuition plans. As long as the current situation exists, states will be reluctant to experiment with plans in the face of possible adverse tax consequences,[142] and the private sector will be even more disinclined to do so.[143] It is a simple maxim that if government wants to discourage something the government should tax it; if the government wants to encourage something the government should grant a tax break. Prepaid tuition plans should be encouraged and be given a tax break.

Congress should enact legislation that 1) exempts the plan itself from income tax, and 2) exempts parent and child from tax on the difference between the price of the plan contract and the value of the educational services received. This proposal exempts from tax any investment income that results from saving for college. It is similar to the super IRA recently proposed by Senators Bentsen and Roth.[144] The initial payment (or payments) for the contract would not be deductible.

The tax benefits would be backloaded. The disadvantage of backloading the plan is that it probably provides less psychological incentive than front-loading the tax benefit by making the initial payment deductible, but taxing the payout. Nevertheless, the eco-

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139. *See* Gunn, *supra* note 4, at 257-59; Lehman, *supra* note 4, at 1106-08.

140. *See* Gunn, *supra* note 4, at 254.

141. The student presumably would be in the lowest marginal tax bracket. Nevertheless, payment of a tax would present a cash-flow problem for the student who would be taxed on the receipt of services in kind with no accompanying cash to pay the tax.

142. *See supra* note 74.

143. The College Savings Bank in Princeton, New Jersey offers certificates of deposit with interest rates indexed to rising college costs as a form of prepaid tuition plan. The bank issues the CollegeSure CD, a certificate of deposit that the thrift guarantees will pay at least the average one-year tuition at a four-year private college upon maturity. Bob Webster, *Lifestyle*, UPI, Feb. 5, 1990, *available in* LEXIS, Nexis library, UPI file (Feb. 12, 1990). A St. Paul-based company, Hemar Education Corp. of America, reportedly was working on a plan but awaiting IRS rulings. Charles Child, *Private Tuition Fund Ceases Operations*, CRAIN'S DETROIT BUS., Aug. 27, 1990. A company in Ann Arbor, Michigan, National TMO, attempted to start a private plan but reportedly has ceased operations. *Id.*

144. *See* Joint Committee on Taxation, *Description and Analysis of S. 612 (Savings and Investment Act of 1991)*, (JCS-5-91), 1, May 14, 1991, *reprinted in* Daily Tax Rep. (BNA), May 16, 1991, at L-1 (No. 95).

nomic incentive of a backloaded plan is exactly the same as for a front-loaded plan, assuming the taxpayer's marginal rates do not change from year to year.[145]

1. Encouragement to College Saving

The proposed legislation would provide tax neutrality between the decision to consume or to save for college, unlike the current law, which is biased in favor of the decision to consume.[146] This bias results from the fact that both saved income and the investment return that the saved income generates are each taxed.[147] For example, assume first that there is no income tax, and taxpayer can earn a ten percent return on saved income. If taxpayer earns $1,000, taxpayer has the choice of spending the $1,000 on current consumption or saving it and earning an additional $100 income. The price of each dollar of additional income is ten percent in foregone current consumption.[148]

Suppose there is a twenty-five percent income tax in the same situation. After taxes there is $750 left of the original $1,000 earned. If taxpayer invests this $750 at ten percent, taxpayer receives $75 additional income. This $75 income is subject to the twenty-five percent tax, leaving an after-tax return of $56.25. The twenty-five percent tax raises the cost in foregone current consumption of each additional dollar of income from $10 to $13.33

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145. A simple example will illustrate this point. Assume taxpayer has a 28% marginal tax rate, earns a 10% return on investment, and has $1,000 income to invest in a prepaid tuition plan. Taxpayer contributes the earnings to a frontloaded plan in which contributions are deductible and the payout is taxable. The $1,000 will grow to $1,100 at the end of a year, and the total tax due is $308, leaving taxpayer with $792 net at the end of a year under a frontloaded plan. Now assume a backloaded plan in which the initial contribution is not deductible, but for which there is no tax on the payout. Taxpayer would have $720 to contribute after taxes on the $1,000 income. At the end of a year with a 10% return taxpayer would be left with $792 after taxes, exactly the same as under the frontloaded plan. *See id.* at 26-33; Daily Tax Rep. (BNA), at L-8 to L-10. This analysis is independent of the number of years the investment is held. The economic effects of the backloaded plan will be the same as the frontloaded plan assuming the marginal tax rates remain the same. *Id.* at 27, *reprinted in* Daily Tax Rep. (BNA), at L-8.

146. The arguments here concerning tax neutrality and tax expenditures have been made in prior articles. *See* Philipps, *supra* note 1, at 342-45; Philipps & Hatfield, *supra* note 118, at 285-87. We restate them in this article for the convenience of the reader.

147. *See* NORMAN B. TURE & STEPHEN J. ENTIN, SAVE, AMERICA: A PRIMER ON U.S. SAVING AND ITS EFFECT ON ECONOMIC HEALTH 15-18 (Institute for Research and Taxation 1989).

148. *Id.* This discussion assumes that investment is a substitute good for current consumption, because investment is equivalent to deferred consumption. *See* JOSEPH M. DODGE, THE LOGIC OF TAX 326 (1989).

($750 foregone current consumption ÷ $56.25 additional income). Hence, the twenty-five percent tax raises the foregone current consumption cost of saving by thirty-three percent.[149]

If the situation is exactly the same, except that the investment income is exempt from income tax, the $750 after-tax income when saved produces $75 additional income on which no tax is paid. Consequently, the cost of one dollar additional income is $10, the same as in the no-tax situation. Hence, there is no bias in favor of consumption, and tax neutrality exists between the consumption and saving decisions.[150]

Would tax favored status such as the one proposed actually result in increased saving for college? Or would it merely shift savings from currently existing investments to prepaid tuition plans? There seems to be no agreement on the similar question of whether IRAs cause new savings or merely cause savings to be shifted from other investments to IRAs.[151] Nevertheless, there is no denying that taxpayers did use IRAs heavily when they were widely available and intensively marketed.[152] If the private sector could offer a tax favored prepaid tuition plan such as suggested below, the IRA experience indicates that marketing efforts would result in a widespread public response. As one economist has said, referring to the IRA boom in the 1980s, "It may well be that saving, like life insurance, is sold, not bought."[153] This suggests that tax favored status can at least exercise influence over an important incentive to saving: encouragement of saving by third parties.[154]

2. Cost

The most basic objection to tax favored status for prepaid tuition plans is that it costs too much. This is bolstered with the argument that such plans disproportionately benefit middle and upper income taxpayers. Critics argue why grant a "tax expenditure" to a program that benefits the middle and upper income groups rather than the lowest income groups? The argument ultimately

149. TURE & ENTIN, *supra*, note 147, at 16.

150. *Id.* at 17.

151. *See* Joint Comm. on Taxation, *supra* note 144, at 36-43, *reprinted in* Daily Tax Rep. (BNA), May 16, 1991, at p. L-11 to L-13 (No. 95).

152. *Id.*

153. Janet S. Hansen, *Introduction and Overview*, *in* COLLEGE SAVINGS PLANS 4 (Janet S. Hansen ed., 1990) (quoting economist Lawrence Summers).

154. *Id.*

relies on tax expenditure theory to establish that tax favored status would "cost" the government too much in the form of lost revenues, and hence should not be undertaken in an era of budget deficits. Any new initiatives in the area of higher education they argue should be reserved for the poor.[155]

This argument is appealing. No one wants to be against the poor. Nevertheless, the middle class needs help too.[156] This proposal would benefit the middle class without necessarily harming lower income groups. Middle class tax relief is an idea being espoused across the political spectrum,[157] and so is aid to middle class taxpayers in providing their children with a higher education.[158]

Tax favored status for prepaid tuition plans is a vehicle for providing tax relief in a way that targets one of the most worrisome financial burdens of middle class taxpayers: providing an education for their children. There are two large components in the American dream: owning one's own home and providing one's children with a college education. The tax system has many features that encourage the first of these, home ownership.[159] In contrast, powerful governmental incentives to save for higher education do not exist. The initiatives of states with baccalaureate bonds[160] and the fed-

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155. *See* HAUPTMAN, *supra* note 108, at 84; Lehman, *supra* note 4, at 1054-55.

156. *See supra* notes 108-138 and accompanying text.

157. *Tax Report, Middle-Class Tax Relief Tops the Agenda for Congressional Democrats*, WALL ST. J., Sept. 4, 1991, at A1; A letter signed by 156 Democrats in the House of Representatives recently urged the Democratic leadership initiate a plan to cut taxes for the middle class. *See House Democrats Urge Leadership to Act on Tax Relief for Middle-Income Families*, Daily Tax Rep. (BNA), July 24, 1991, at G-5 (No. 142). A study by the Center on Budget and Policy Priorities indicates an economic squeeze on the middle class over the past decade. *See Study Says Tax Changes Exacerbated Growing Trend Toward Income Inequality*, Daily Tax Rep. (BNA), July 24, 1991, at G-1 to G-2 (No. 142).

158. For example, Senator Bill Bradley has recently proposed a government sponsored loan program aimed at helping the middle class pay for college. *See* Congressional News Release, *Bradley Announces New Student Aid Plan*, TAX NOTES TODAY, Aug. 2, 1991, *available in* LEXIS, Fedtax Library, TNT File, 91 TNT 162-21. Senator Bradley stated that he was introducing his initiative because, "[T]he middle class is finding itself 'too wealthy' to afford college." *Id.*

159. *See* I.R.C. § 163(h)(3),(4) (1988) (home mortgage interest deduction); *id.* § 1034 (the tax-free rollover of gain on sale of a principal residence); *id.* § 121 (the exclusion of gain on sale of a principal residence by a person age 55 or older); *id.* § 1014 (the step-up in basis of an asset at death). BORIS F. BITTKER AND LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS 5-15 to 5-21 (2d ed. 1989) (the exclusion from gross income of unrealized asset appreciation). All afford powerful incentives for home ownership.

160. *See* Philipps, *supra* note 1, at 294-95.

eral government with tax exempt Series EE bonds [161] have thus far been fairly limited.[162]

Moreover, one should question the slavish adherence to the tax expenditure concept that is the order of the day in current tax policy analysis.[163] The idea is based on the notion that in an ideal income tax all economic income — defined as personal consumption plus wealth accumulation[164] — should be taxed. The next step is to assert that deviations from this ideal income tax base represent indirect subsidies or tax expenditures for those who pay less tax because of the deviation.[165]

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161. *See supra* note 121.

162. The federal government has actually removed several incentives for college saving that previously existed. The 1986 Tax Act removed the Clifford Trust. *See* I.R.C. § 671 (1988). Also, it imposed a tax rate equal to the parent's rate on the unearned income of children under age 14. *See id.* § 1(g). This removed income splitting possibilities available under prior law.

163. This apparently is related to the vogue for analyzing social problems in economic terms. While economic analysis is a useful tool, it is often overdone. The fact is "we live in a society not an economy." Jerry Avorn, *Benefit and Cost Analysis in Geriatric Care*, 310 NEW ENG. J. MED. 644 (1984) (quoting R. Fein, *On Measuring Economic Benefits of Health Programs*, *in* MEDICAL HISTORY AND MEDICAL CARE: A SYMPOSIUM OF PERSPECTIVES 179-220 (1971)).

164. This is a version of the familiar Haig-Simons definition of income:

> the algebraic sum of 1) the market value of rights exercised in consumption and 2) the change in the value of the store of property rights between the beginning and end of the term in question.

See Robert Murray Haig, *The Concept of Income — Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 7 (Robert Murray Haig ed., 1921) ("income is money value of the net accretion to one's economic power"); HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938) (consumption plus net change in wealth); William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 320-25 (1972). *See generally*, ANTHONY B. ATKINSON, THE ECONOMICS OF INEQUALITY 35-60 (1975).

165. For a classic exposition of the tax expenditure concept, see Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). This article was amplified in Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept: Current Developments and Emerging Issues*, 20 B.C.L. REV. 225 (1979). *See generally*, STANLEY SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973). Congress has enacted the tax expenditure concept into law. The statute requires Congress to examine tax expenditures as part of budgetary policy. *See* Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, §§ 3(a)(3), 101(c), 102(a), 88 Stat. 297, 299, 300, 300-01 (codified at 2 U.S.C. § 622 (1988)). The statute also requires the President to include tax expenditures as an item in his recommended budget. *See id.* § 601, 88 Stat. 297, 323-24 (codified at 31 U.S.C. § 1105(a)(16) (1988)). For a brief history of the tax expenditure concept, see Allaire Urban Karzon & Charles H. Coffin, *Extension of the At-Risk Concept to the Investment Tax Credit: A Shotgun Approach to the Tax Shelter Problem*, 1982 DUKE L.J. 847, 850 n.13.

The tax expenditure is measured by the revenue foregone by the government on account of deviation from the ideal. For example, the tax expenditure from granting tax favored status to prepaid tuition plans would be measured by the amount of excluded income multiplied by the applicable tax rate. However, as presently formulated, the measurement of foregone revenue is inaccurate, because it fails to take into account changes in taxpayer behavior that will occur if a deviation from the ideal income tax base is eliminated. Consequently, it is incorrect to assert that excluding an item of income will decrease government revenue by an amount equivalent to the product of the excluded income times the applicable tax rate.[166] The existence or not of the exclusion will, in itself, affect the amount of foregone revenue.[167]

The tax expenditure concept also fails to take a long view. Perhaps granting a tax favored status to prepaid tuition plans may result in short-term revenue loss. Nevertheless, it will also result in long-term revenue gain, if the exclusion fosters a better educated and, hence, higher earning work-force. Moreover, there are indications that even the short-term revenue loss measured in tax expenditure terms might not be too great. A recent study for the Ohio Tuition Trust Authority by the Coopers & Lybrand accounting firm indicated that the direct revenue loss of exempting all investment income of state prepaid tuition plans would be about $450 million over a five year period.[168] If Congress needs a revenue offset for this "expenditure," it should repeal the current interest deduction on second home mortgages.[169] The tax expenditure concept assumes that income, broadly defined, is the proper tax base. This assumption assumes the very issue to be decided: the proper defi-

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166. *See* Joseph E. Stiglitz & Michael J. Boskin, *Impact of Recent Developments in Public Finance Theory on Policy Decisions*, 67 AM. ECON. REV. 295 (1977).

167. A good example of the failure to take changes in taxpayer behavior into account is the revenue estimates made in the 1990 budget agreement. Revenues are now expected to fall far short of the original predictions. *See* Matthew B. Kibbe, *The Laffer Curve in Reverse*, WALL ST. J., July 22, 1991, at A8.

168. John G. Wilkins, *Estimated Impact on Federal Revenues Resulting from Providing Tax-Exempt Treatment to Income Accrued By State-Created Trusts Administering Tuition Prepayment Programs* at Table 1 (Sept. 1, 1990) (Coopers & Lybrand study entitled *Estimate of Federal Tax Revenues Resulting from Providing Tax-Exempt Treatment to Income Accrued by State-Created Trusts Administering Tuition Prepayment Programs), reprinted in Wilkins Proposed Exemption of Tuition Trust Income from Federal Income Tax*, TAX NOTES TODAY, Oct. 9, 1990, *available in* LEXIS, Fedtax Library, TNT File, 90 TNT 206-21).

169. *See* I.R.C. § 163(h)(4)(A) (1988) (granting an interest deduction for mortgage interest paid on loans secured by a taxpayer's principal residence plus one other residence).

nition of the tax base. The appropriate measure of income to include in the tax base is the essential question of tax policy. Simply because we call the tax an income tax does not mean that everything an economist might call income presumptively should be included in the tax base. Viewed from the perspective of saving/consumption neutrality, a tax that exempts some income derived from saving may be more appropriate.[170] Moreover, there are cogent arguments that educational expenses are more akin to income earning expenditures than to consumption expenditures, and, hence, should receive more favorable tax treatment.[171] Slavish devotion to the tax expenditure analysis hinders the analysis of proposals for tax relief via deductions or exclusions with intellectual blinders.

B. *An Illustrative Plan*

The following plan is an illustration of how a prepaid college tuition plan might be structured to answer some of the critics' objections, and also provide an opportunity for private sector involvement. The plan is admittedly sketchy and is not a finished product. Nevertheless, it is useful as a vehicle for further discussion.

The proposed College Savings Trust[172] (CST) has several goals as a tuition funding vehicle. First, a CST would be a privately funded and operated entity that would allow parents to pre-fund the tuition costs of their children. Second, a CST would provide real insurance against tuition inflation (i.e., a tuition guarantee). Third, a CST would allow children a wide choice of colleges to attend. Fourth, a CST would provide parents with the opportunity to earn a higher after-tax rate of return than a regular savings account or government bonds. Finally, a CST should be easily accessible to middle and lower income families. Instead of direct government aid to the financially less fortunate, federal legislation for CSTs would operate as a catalyst to extend the benefits of private enterprise to middle and lower income families.

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170. *See supra* notes 146-54 and accompanying text.

171. *See* Brian E. Lebowitz, *On the Mistaxation of Investment in Human Capital*, 52 TAX NOTES 825 (1991).

172. The authors acknowledge the similarity of the proposed CST plan with the National Education Savings Trust bills. S. 1572, H.R. 3252 & H.R. 2509, 100th Cong., 1st Sess. (1987).

1. Tax Treatment

Under the legislation we propose,[173] payments to a CST would not be deductible, but neither the child nor the parent would realize any tax liability upon the purchase of CST credits.[174] A CST, however, would not pay taxes on the investment income it earned. Further, payments of tuition to a qualified college[175] would not be taxable to the student.[176] In order to provide a broad range of college choices, federal legislation could require a minimum number of colleges to participate in a CST before it became qualified for a tax-exemption.

2. Basic Operation

A CST could operate like a defined contribution pension plan with a four year payout.[177] Colleges could become members of a CST if they agreed to be legally bound to accept CST tuition cred-

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173. *See supra* notes 139-71 and accompanying text.

174. Priv. Ltr. Rul. 88-25-027, *supra* note 2, at (P-H) ¶ 54,986-87 held that the plan purchaser made a taxable gift to the beneficiary by purchasing a prepaid tuition contract. Philipps, *supra* note 1, at 300. We address only the income tax results in our legislative proposal. However, it would be possible to extend the $10,000 annual exclusion to purchase of prepaid tuition contracts by making an exception to the present interest requirement for the annual exclusion.

175. Presumably, qualifications similar to those set forth in I.R.C. § 135(c)(3) (1988) could be used to determine which institutions could be CST members. The relevant portions of § 135(c)(3) provide as follows:

> [t]he term "eligible educational institution" means an institution described in section 1201(a) or subparagraph (C) or (D) of sections 481(a)(1) of the Higher Education Act of 1965 (as in effect on October 21, 1988), and area vocational education school (as defined in subparagraph (C) or (D) of section 521(3) of the Carl D. Perkins Vocational Education Act) which is in any State (as defined in section 527(27) of such Act), as such sections are in effect on October 21, 1988.

I.R.C. § 135(c)(3) (1988).

176. *Id.* If it were thought necessary to prevent this tax benefit from accruing to more wealthy taxpayers, the exemption for the earnings portion of the payments made on behalf of the student could be phased-out for parents with adjusted gross incomes in certain ranges. This phase-out level could be increased by a specified amount per child under 18 and should be indexed for inflation. I.R.C. § 135(b)(2) provides a somewhat similar type of phase-out for the exemption for interest income on U.S. savings bond used to finance higher education. However, any phase-out should be set at a realistic level. Senator Bradley, in his proposed student loan legislation, eschews a needs test altogether. *See* Congressional News Release, *Bradley Announces New Student Aid Plan,* TAX NOTES TODAY, Aug. 2, 1991, *available in* LEXIS, Fedtax Library, TNT File, 91 TNT 162-21.

177. The actual payouts could be determined by when the selected college charges tuition to its students (e.g., on a quarterly or semester basis).

its as payment upon the matriculation of a CST participant.[178] Member colleges (public or private) would have to set the number of tuition credits each college would charge for four years of tuition. The price per credit would be determined by the plan actuaries, taking into account expected tuition inflation and investment return. For example:

Example CST Tuition Credit Schedule

College	Tuition Credits Required for 4 Years of Tuition
A-(Public, Resident)	40
B-(Public, Non-Resident)	65
X-(Private)	95
Y-(Private)	100
Z-(Private)	120

Price Per Credit = $400

A parent in our example could purchase ninety tuition credits from the CST. Eighteen years later, if his child is accepted and decides to attend College Y, the parent would instruct the CST to pay College Y the CST fund balance equivalent to ninety credits over a four year period.[179] The parent or child would have to finance the balance of the cost at College Y with cash, loans, etc.

If the child in the example attends College A, the full four years of tuition would be paid for by the CST. The fifty extra credits (ninety credits purchased minus forty credit cost) would be refunded to the parent or child. The portion of this refund that represented earnings on the original purchase price would be taxable to the recipient. In addition, a ten percent surcharge on the entire refund could be charged by the CST to discourage parents from

178. A college would be allowed to terminate its membership in a CST at its discretion. However, the termination would be effective for prospective student classes only. The terminating college would still have to accept tuition credits from the CST for students that purchased the credits prior to the withdrawal of the college. Thus, the student would be guaranteed tuition credit at any of the colleges which were members of the CST when his parents purchased the credits. Of course, the student would have to meet the requisite academic entrance requirements of a college prior to being eligible to offset tuition with CST credits.

179. The fund balance in this case would equal the original purchase price of $36,000 (90 credits at $400 per credit) plus any earnings up to 90% (90 credits purchased divided by 100 credits cost) of current tuition costs at College Y.

purposely over-funding CST balances in order to take advantage of the tax deferred investment income.

a. Access

Allowing parents to purchase tuition credits through payroll deductions could provide easy access to a CST.[180] The CST could provide for five, ten, and fifteen year payment plans. This type of payment plan would bring the high after-tax return, tuition guarantee, and educational benefits formerly available only to upper income taxpayers to middle and lower income taxpayers. In our example, if a middle income parent wanted to purchase ninety tuition credits, the lump sum price would be $36,000 (ninety credits at $400). However, if the parent could spread payments to the CST over fifteen years, the parent could purchase ninety credits for approximately $314 per month. Likewise, a lower income taxpayer probably could not afford to pay $16,000 for forty tuition credits. However, the same taxpayer could more easily afford a monthly payment of approximately $140 for fifteen years.[181]

b. Disposition of Earnings

If a CST's earnings outpaced tuition inflation, the excess would inure to the member colleges. For example, assume a member college has a CST tuition charge of 100 CST units and that its dollar tuition charges are $80,000 for four years of tuition when a student matriculates. If the CST fund balance at that time exceeds $800 per credit, the college would receive the entire fund balance up to 100 credits worth.[182] If a CST's earnings lagged behind actual tui-

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180. The Michigan, Alabama, and Florida plans all allow payroll deduction funding already. 1990 MICHIGAN EDUCATION TRUST MONTHLY PURCHASE FULL BENEFITS CONTRACT; PREPAID AFFORDABLE COLLEGE TUITION: THE WALLACE-FOLSOM PREPAID COLLEGE TUITION TRUST FUND 3 (1991) (brochure); *Florida Prepaid College Program*, 7-10 (1989) (brochure). While the mechanics of payroll deduction funding are simple when there is one state plan, they would become more complex if there were several alternative CSTs. Accordingly, the CSTs would have to make arrangements with banks to collect payments on their behalf. Alternatively, participants could be allowed to mail in their payments.

181. The monthly payments amounts used here assume an interest rate of 6.5% which a tax-exempt CST could afford to charge (as opposed to the 8.5% rate a taxable bank might charge).

182. Any excess over 100 credits would be returned to the parent as a refund. For example, if a parent purchased 110 credits and his child attended a 100 credit college, the parent would receive a refund of cash equivalent to approximately 9% (ten excess credits divided by 110 total credits purchased) of his child's CST fund balance. The IRS could impose a 10% penalty on the amount refunded.

tion inflation at the selected college, that college would bear the cost differential.[183] To the extent earnings equaled tuition inflation expectations, they would be paid to the member colleges as CST tuition credits.

c. Investment Restrictions

In order to avoid speculative investing, federal legislation could restrict the types of investments that a CST could purchase and still retain tax-exempt status. For example, legislation could limit CST investments to the purchase of only highly rated debt securities and common stocks with proven earnings per share records. In addition, there could be limits on the amount of the total CST portfolio that could be invested in one type of security (e.g., corporate bonds) or the securities of one issuer (e.g., X Company annuities). These types of broad guidelines should help give colleges the confidence that the investment they are counting on to meet future tuition costs will not be squandered.[184]

d. Refund Options

If a child fails to attend a CST member college, the CST could make a variety of refund options available. If the child attended a non-CST college that was still a qualified educational institution, payment to this college should not be taxable. However, the CST could impose a surcharge, perhaps ten percent, to compensate its members for bearing the investment risk for the participant. If a child dies or decides not to attend college, the child's CST fund balance would be payable to the parent. The parent would pay tax on the investment earnings and a ten percent penalty on the earnings as well. This penalty would help compensate the federal government for the time value of money lost on the tax deferral of CST earnings attributable to the early withdrawal.

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183. Alternatively, a cost sharing arrangement could be established in which any excess earnings are divided between all CST member colleges or reinvested to cover future investment shortfalls.

184. Colleges are no strangers to the management of large financial portfolios. Many colleges have substantial endowments that are professionally managed and provide a substantial source of operating revenue.

e. Benefits to All Parties

Under the proposed CST arrangement, middle and lower income families, colleges, investment managers and the federal government would all benefit.[185] The economic catalyst provided by the federal tax exemption of plan earnings to a prepaid tuition plan that is not an integral part of a state government would immediately attract substantial investment capital from the private sector. This capital would, in turn, attract investment managers who would probably compete for the opportunity to manage the CST funds. Middle and lower income families would benefit by having an incentive to start saving for tuition expenses early,[186] obtaining a higher after-tax return on their investments and securing a guarantee against future tuition inflation. Colleges would benefit by making themselves available to more tuition paying students and sharing in the higher after-tax investment yield. Investment managers would benefit by earning a fee for applying their expertise to substantial portfolios. Finally, the federal government would benefit by having to pay less student aid to CST participants.[187]

A simple example can illustrate how the tax benefits of the proposed CST vehicle would provide incentives to colleges, parents, and investment managers to create, fund and operate a CST. Our CST is funded with contributions of one million dollars for its first class year. The CST invests the entire portfolio in government backed securities (e.g., GNMAs and FNMAs) that have a weighted average yield of ten percent. The parents that purchase CST cred-

185. The CST plan outlined above is merely an offering and does not purport to contain the best of all possible features. Varying the service charges, withdrawal penalties, and phase-out ranges could affect investor behavior and serve as a control on the allowance of benefits to high income taxpayers. Moreover, legislators may find other more appropriate investment guidelines and reporting requirements in any CST legislation. Finally, provision of insurance to assure the stability of the fund, increased government oversight, and limits on the types of colleges that could be members, are all issues that deserve further consideration. We merely present the idea and do not claim to have the investment expertise necessary to provide a detailed model.

The key, however, is providing an incentive and a methodology for middle and lower income families to save for college tuition costs. For instance, instead of only exempting the interest on the relatively low yielding Series EE Savings Bonds, why not shift the § 135 exemptions to trusts that invest in government backed mortgages that generally earn a higher rate of return. The proceeds are still invested in federal securities, the interest is still exempt and the parents and colleges have an opportunity to earn more.

186. *See supra* notes 146-54 and accompanying text.

187. *See* HAUPTMAN & ANDERSON, *supra* note 112, at 41 ("On a long-term basis the federal cost for interest subsidies and guarantees against defaults range from 30 to 50 cents per dollar lent depending on the interest rate.").

its have a marginal federal tax rate of twenty-eight percent and state tax rate of five percent.[188] Assume a weighted average tuition inflation for all member colleges equal to nine and seven-tenths percent.[189] The tax savings on CST investments when compared to taxable investments would total thirty-three percent of the ten percent pre-tax yield, or three-and-three-tenths percent. This three-and-three-tenths percent could be shared as follows: three percent to parents and three- tenths percent to investment managers.[190] Colleges would obtain part of the parents' portion of the savings if the total investment yield outpaced tuition inflation. Thus, parents could obtain a tuition guarantee and earn an after-tax return of nine and seven-tenths percent rather than six-and-seven-tenths percent. Investment managers could earn a three-tenths percent fee on CST assets. Thus, parents would have a yield incentive to invest their private capital in a CST, the investment managers would have a fee incentive to manage the CST, and colleges would have a marketability incentive to participate in the CST. Thus, market forces would provide the funding vehicle if the heavy hand of taxation removed its presence from the prepaid tuition area.

IV. CONCLUSION

The criticisms made of current prepaid tuition plans are serious. However, policy makers should not abandon the idea. It is possible to ameliorate many of the problems through restructuring the plans. Moreover, Congress can and ought to remedy the tax problems of prepaid tuition plans by enacting legislation that would grant tax favored status to prepaid tuition plans and encourage the private sector to participate. Widespread marketing of prepaid tuition plans, along with their availability on an installment payment basis, would promote a shift in college finance from borrowing to saving. The concept and implementation of these plans may never become perfect, but having them available better

188. We assume the states would pass parallel tax legislation that exempts from tax CST earnings and students who received such earnings in the form of tuition credits.

189. This approximates the 10% investment yield less the 3% management fee (3% management fee as a percent of earnings multiplied by a 10% yield = .3% fee as a percent of principal and 10% yield less .3% fee = 9.7%).

190. A .3% fee on average net assets is similar to some fees charged in the private market place. *See, e.g.*, THE SOLOMON BROTHERS FUND, INC., SEMI-ANNUAL REPORT 8-9 (June 30, 1991) (where a stepped percentage fee system was used). This example uses only one fee percentage for the purposes of simplicity.

serves the public interest than not having them at all. In summary, when it comes to prepaid tuition plans, "It's not love, but it's not bad."