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Malcolm L. Morris

Northern Illinois College of Law

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Education Expense Epiphanies

MALCOLM L. MORRIS†

INTRODUCTION

Little Johnny can't read, nor can his sister Jane. Even worse, neither can integrate a differential equation. Consequently, they cannot find good jobs in a modern economy; or so the story goes. This is the perceived sad state of the higher education system in America today. A situation that the country's politicians would no longer tolerate. And what is their formula for making Americans better qualified for the "new" work force: additional or improved centers of learning, greater funding of college or vocational programs, mandatory minimum education requirements? No, the problem will be solved by the Internal Revenue Code ("tax code" or "Code").¹ Yes, the tax code, the panacea for all of America's woes is being called upon yet again² to remedy a national crisis. Give the American people some additional

† Professor of Law, Northern Illinois University College of Law. B.S., 1969, Cornell University; J.D., 1972, State University of New York at Buffalo; L.L.M., 1977, Northwestern University.

1. 26 U.S.C. §§ 1-7872 (1997).

2. It is not uncommon for Congress to use the tax code as a means to encourage certain activities or reduce the cost of necessary outlays by providing an offsetting tax benefit. The interplay of I.R.C. §105 and §106 (West 1998) is illustrative of the former. These provisions provide favorable tax treatment for costs attributable to and distributions from employer sponsored medical plans, provisions which are clearly responsive to taxpayer needs. Similarly, I.R.C. §219 (West 1998) originally provided a deduction for all workers willing to save for their own retirements. This provision directly responded to retirement needs of workers not provided such benefits to their employees. Also consider I.R.C. §21 (West 1998) which provides a credit for childcare costs incurred so that the otherwise custodial parent can go to work. This section and its precursor (I.R.C. § 214 *repealed* effective tax years following 1975 by Pub. L. No. 94-455, § 504(b) (1976)) was needed to combat the court rulings that denied parents a trade or business expense deduction for this type of expense and provide taxpayers the relief needed to make entering the workforce worthwhile. See, e.g., *Smith v. Comm'r.* 40 B.T.A. 1038 (1939), *aff'd per curiam*, 113 F.2d 114 (2d Cir. 1940); *O'Connor v. Comm'r.*, 6 T.C. 323 (1946))

tax benefits for higher education expenses, and the problem will disappear.

Although somewhat tongue-in-cheek, the above suggestion is rooted in an eerie reality. Conferring special tax benefits for higher education expenses is no longer trapped in the theoretical throes of determining the proper place human capital has in the tax system.³ This erstwhile significant policy concern was rendered academic by the rush of politicians promoting their plans designed to help citizens pay for college expenses.⁴ A more cynical view suggests there are other motivations afoot, those that equate a popular-sounding tax benefit with re-election votes. In any event, the pretense of sound tax policy may well have fallen prey to political concerns as our elected officials sallied forth with a variety of crisis-solving tax plans. Although the proposals came in different shapes and sizes, each was designed to provide tax relief for "qualifying" higher education expenses. After the requisite political haggling, the Taxpayer Relief Act of 1997 ("TRA '97")⁵ emerged with a number of new education-based initiatives. These now will work with the pre-existing rules that offered limited relief to form the basis for an education incentive tax policy. Whether this hodge-podge of tax provisions best meet the needs of the country, its students, and their financial sponsors remains to be seen. Given its significance from both a policy and practical perspective, the new rules deserve to be examined. When the testing is

3. The tax treatment of human capital as it relates to education expenses has been the subject of much debate over the years. Some pieces in the rich literature include: Loretta Collins Argrett, *Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive*, 41 SYRACUSE L. REV. 621 (1990); David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793 (1992); Joseph M. Dodge, *Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927 (1993); Marcus Schoenfeld, *The Educational Expense Deduction: The Need for a Rational Approach*, 27 VILL. L. REV. 237 (1982); David S. Davenport *The 'Proper' Taxation of Human Capital*, 52 TAX NOTES 1401 (Sept. 16, 1991); Brian E. Lebowitz, *On the Mistaxation of Investment in Human Capital*, 52 TAX NOTES 825 (Aug. 12, 1991).

4. For an analysis of these proposals, see *infra* Section III. It is worth noting that providing some type of tax benefit is not a novel idea. For a review of the legislative "ups and downs" of prior attempts in this area, see John K. McNulty, *Tax Policy and Tuition Credit Legislation: Federal Income Tax Allowances for Personal Costs of Higher Education*, 61 CAL. L. REV. 1, 4-14 (1973).

5. Pub. L. No. 105-34, 111 Stat. 788 (1997).

over, some thoughts on how to improve the benefits will be advanced. The primary emphasis will be on restructuring the system to promote meaningful self-help funding opportunities. The proposals are perhaps better suited to meet the projected financial goals, especially insofar as targeting the benefits to the students themselves is concerned.

II. PRE-1997 OPERATING RULES

It is well settled that an expense is not deductible unless the Code provides otherwise.⁶ The Code specifically disallows deductions for all personal, living or family expenses.⁷ As a general rule, college costs are considered personal, and therefore, non-deductible expenses.⁸ Nonethe-

6. See JACOB MERTENS, JR., *THE LAW OF FEDERAL INCOME TAXATION* § 3.50, at 77 (1991) (stating that deductions "will be allowed only when granted by clear language"); see also *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) (finding "[w]hether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed."); *First Nat'l Bank & Trust Co. v. United States*, 115 F.2d 194 (5th Cir. 1940) (holding that a taxpayer has no constitutional right to deductions, and must rely upon a statutory provision specifically allowing the claimed deduction).

7. I.R.C. § 262 (West 1998). The section provides that "[e]xcept as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses." *Id.* Even expenses that are arguably for business purposes may not be deductible if they are too personal in nature. See, e.g., *Smith v. Comm'r* 40 B.T.A. 1038 (1939), *aff'd per curiam*, 113 F.2d 114 (2d Cir. 1940). The court disallowed a deduction for a couples' expenses incurred in employing a nanny for their child. See *id.* The expense was deemed of a personal nature in spite of Mrs. Smith's argument that but for the expenses she would be unable to work and earn income. See *id.* Certain childcare expenses now qualify for a tax credit courtesy of congressional action. See I.R.C. § 24 (West 1998).

8. Treas. Reg. § 1.262-1(b)(9) (1997) expressly interprets § 262 to provide that "[e]xpenditures made by a taxpayer in obtaining an education or in furthering his education are not deductible unless they qualify under section 162 and § 1.162-5 (relating to trade or business expenses)." See *Carroll v. Comm'r*, 51 T.C. 213 (1968), *aff'd*, 418 F.2d 91 (7th Cir. 1969) (holding that a policeman could not deduct the costs of taking philosophy courses as these were personal expenses, and were not the ordinary and necessary expenses of carrying on a trade or business). In *Welch v. Helvering*, 290 U.S. 111 (1933), the Court in dictum suggested that education expenses could not meet the "ordinary" test of I.R.C. § 162 and therefore were not deductible. The Court stated that to allow the deduction at bar would be to "open the door to many bizarre analogies" including:

Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich

less, some educational expenses have long qualified for favorable tax treatment. In certain instances a deduction can be allowed;⁹ in others, exclusions from or deferrals of income are permitted.¹⁰ Notwithstanding the introduction of the new tax incentives, these older benefits continue to remain in effect. Stringent and strictly enforced limitations, however, make these "old-timers" neither universally available nor easily obtained.

The principal opportunity for education expense tax relief was the "trade or business" deduction permitted under Section 162 of the Code.¹¹ This provision permits a deduction for all reasonable "ordinary and necessary"

his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the good will of an old partnership . . . money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.

Id. at 115-16.

Denying education expenses deductibility is not of recent vintage. The government took this position as early as 1921 when it issued two rulings denying taxpayers a deduction for such expenses. In O.D. 892, 4.C.B. 209 (1921), a teacher's deduction for summer course expenses was disallowed, and in O.D. 984, 5 C.B. 171 (1921), a doctor was denied a deduction for post-graduate courses. For an historical review of the early history of the effort to deduct education expenses, see Jay Katz, "The Deductibility of Educational Costs: Why Does Congress Allow the IRS to Take Your Education So Personally?" 17 VA. TAX. REV. 1, 16-35 (1997).

9. See *infra* notes 11-27 and accompanying text. For a more complete history of the development of the deductibility of education expenses, see Daniel I. Halperin, *Business Deductions for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859, 899-905 (1974).

10. See *infra* notes 28-51 and accompanying text.

11. I.R.C. § 162 (West 1998) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . ." and then lists several types of expenses so deductible, but which are inapplicable here. Treas. Reg. § 1.162-5(a) (1997) has interpreted I.R.C. § 162(a) to provide that educational expenses which are incurred as "ordinary and necessary business expenses" are deductible if the education is for the improvement or maintenance of skills required by the taxpayer in his or her trade, business, or employment, or are deductible if the education sought is required by the individual's employer or law or regulations which again concern the individual's current, established employment. Treas. Reg. § 1.162-5(b)(3)(i) (1997) limits the deduction, stating that it is inapplicable in cases where the education is sought merely to satisfy minimum requirements to gain employment in the first instance, or where the education sought qualifies the taxpayer for a new trade or business.

business-related expenses.¹² Thus, a deduction for education expenses is available for the taxpayer who can show the proper nexus between the education expense and her trade or business. Unfortunately, the section has some significant, self-imposed barriers to deductibility.

First, and foremost, in order to obtain any benefit the taxpayer must be engaged in a trade or business.¹³ This effectively eliminates the deduction for many full-time students since being a student is neither a trade nor a business. Some students (either full-time or part-time) may work as employees or be conducting their own businesses. Nonetheless, students who work or workers who go to school may fare no better than their non-working fellows. To be deductible, the expenses must be connected to the trade or business.¹⁴ Students pursuing a general college education usually are hard pressed to demonstrate their coursework is specifically related to any of the myriad types of jobs that they may hold while in school. Even if a student can "connect" the education to the job, administrative rules further require the taxpayer to show that the education either (1) improves or maintains skills necessary for the job,¹⁵ or (2) is required by the employer.¹⁶ Whereas individual, isolated courses might satisfy one of these tests, normally an entire education cannot.

Satisfying the administrative test is not enough; an additional roadblock exists. The education must not qualify the taxpayer for his or her chosen trade, or a new trade or business.¹⁷ This effectively denies deductibility for much

12. See I.R.C. § 162 (West 1998).

13. See *Frank v. Comm'r*, 20 T.C. 511, 513 (1953) (finding where a husband and wife who were employed at a newspaper were not allowed to deduct expenses incurred in traveling and searching for a newspaper to purchase and run, since these expenses were not "in connection with" or "in the course of" the trade or business of the employment they had at the time the expenses were incurred); see also *McDonald v. Comm'r*, 323 U.S. 57, 60 (1944) (holding that a judge was not allowed to deduct re-election expenses as these were incurred not in carrying on the trade or business of judging, but "in trying to be a judge.") The question of whether or not a taxpayer is engaged in a trade or business is one of fact. See *Ford v. Comm'r*, 56 T.C. 1300, 1307 (1971), *aff'd*, 487 F.2d 1025 (9th Cir. 1973).

14. See *Kornhauser v. Comm'r*, 276 U.S. 145, 153 (1928); *Noland v. Comm'r*, 269 F.2d 108, 111 (4th Cir. 1959), *aff'g* T.C. Memo 1958-60; *Hynes v. Comm'r*, 74 T.C. 1266, 1289 (1980); *Schulz v. Comm'r*, 16 T.C. 401, 405 (1951).

15. See Treas. Reg. § 1.162-5(a)(1) (1998).

16. See Treas. Reg. § 1.162-5(a)(2) (1998).

17. See Treas. Reg. § 1.162-5(b)(2), (3)(i) (1998); see also *Sharon v. Comm'r*,

post-baccalaureate degree work and all professional degrees. Moreover, the restriction has been applied even if the taxpayer had no intention of ever entering into the new trade or business. Thus, for example, in *Wilmshurst v. Commissioner*,¹⁸ the court ruled that a business executive could not deduct the cost of his law school education pursued solely for the purposes of helping him operate his commercial businesses, despite the fact he never intended to practice law. The education qualified him to enter the new profession, and that was sufficient to deny the deduction.¹⁹

The Code also allows deductions for expenses incurred in a variety of income-related activities that do not rise to the level of a trade or business.²⁰ Education expenses can be deducted under the aegis of Section 212 of the Code.²¹ The same rules, however, that bar deductions under the Code's Section 162 apply equally to Section 212.²² Demonstrating that one's entire college education is directly related to the Section 212 activity will be most difficult, if not impossible. Education expenses that qualify for a deduction under Section 212 tend to be individual courses of a special nature that directly tie into a specific Section 212 activity. Consequently, Section 212 does not offer a serious oppor-

66 T.C. 515, 527 (1976), *aff'd per curiam*, 591 F.2d 1273 (9th Cir. 1978); *Vannier v. Comm'r*, 74 T.C.M. (CCH) 315 (1997).

18. 43 T.C.M. (CCH) 1307 (1982).

19. *See id.* at 1311; *see also* *Glenn v. Comm'r*, 62 T.C. 270 (1974) (finding that a public accountant was not allowed to deduct expenses incurred in taking refresher courses which went towards qualifying him to be a Certified Public Accountant); *Bodley v. Comm'r*, 56 T.C. 1357, 1360 (1971) (stating it is immaterial whether or not the taxpayer does in fact enter the new trade or business qualified for by the education).

20. *See* I.R.C. § 212(1), (2) (West 1998). I.R.C. § 212 specifically allows individuals to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year . . . for the production or collection of income; . . . for the management conservation or maintenance of property held for the production of income; or . . . in connection with the determination, collection, or refund of any tax." *See id.*

21. *Id.*

22. *See* Treas. Reg. § 1.212-1(o)-(p) (1998), which specifically applies I.R.C. § 162, providing that:

[t]he provisions of section 212 are not intended in any way to disallow expenses which would otherwise be allowable under section 162 and the regulations thereunder. . . . The deduction of a payment will be disallowed under section 212 if the payment is of a type for which a deduction would be disallowed under section 162(c), (f), or (g) and the regulations thereunder in the case of a business expense.

tunity for taxpayers to deduct college education expenses.

Even when the tests for deductibility are met, other rules can operate to curtail the benefit. For example, Section 274 of the tax code has the potential to limit the deductibility of certain otherwise qualifying educational expenses. The provision is designed to deny or limit a deduction for those expenses that have some business aspects to them but are deemed to be incurred mostly for personal entertainment purposes.²³ Additionally, some computational tax rules also serve to limit otherwise available benefits. First, all deductible education expenses for employees, and for any taxpayer, most of those deductible under Section 212, can only be taken if the taxpayer itemizes deductions.²⁴ Second, these expenses will be considered miscellaneous itemized deductions.²⁵ As such, only that portion of the expense(s) that, when aggregated with other miscellaneous itemized deductions, exceeds two percent of adjusted gross income can be deducted.²⁶ Finally, the deductible amount may be further limited by another rule which can reduce by three percent the amount of otherwise allowable itemized deductions for high-income taxpayers.²⁷

Although payments made for college education may be difficult to qualify as deductions under these sections, amounts received by taxpayers that are used for education costs have greater potential for generating tax benefits. Scholarships are a prime example. They are excluded from income²⁸ provided the payment is not merely disguised

23. See I.R.C. § 274(h) (West 1998) (prescribing additional rules for the deductibility of expenses for attending "a convention, seminar or similar meeting" held outside of North America). Thus, summer education programs in, for instance, Europe or Asia, must overcome additional obstacles to generate deductible expenses.

24. See I.R.C. § 63(e) (West 1998) (allowing taxpayers the opportunity to elect to take all of the deductions allowed by Chapter 1 in lieu of the standard deduction of I.R.C. § 63(c) (West 1998)).

25. See I.R.C. § 67(b) (West 1998).

26. See I.R.C. § 67(a) (West 1998).

27. See I.R.C. § 68 (West 1998). This section provides that individuals with income in excess of a certain amount (\$50,000 for married persons filing separately, \$100,000 for other individuals, both figures to be adjusted for inflation), shall have their itemized deductions reduced by either three percent of the amount of the individual's income earned in "excess of" the amount, but in no event shall the reduction exceed 80% of the total amount of otherwise allowable itemized deductions. See *id.*

28. See I.R.C. § 117(a) (West 1998).

salary for a student's rendition of services to the payer.²⁹ Other excludable items include qualified education assistance programs,³⁰ certain working condition fringe benefits,³¹ and interest paid on special U.S. Government EE Savings Bonds ("EE bonds") used to pay qualified education expenses.³² Each benefit has limited availability. The first two can only benefit taxpayers that have the good fortune to work for employers willing and able to provide and fund the programs. The EE bond interest exclusion, although facially applicable to all, in practice assists few taxpayers; and then, only on a limited basis. The exclusion only applies to the interest earned on the EE bonds. Given their relatively modest rate of return, the earnings will not be particularly large.³³ Even if the bonds are held for a decade or longer, absent substantial original investments, there will be relatively little excludable interest. Additionally, the benefit is pegged to the taxpayer's income level at the time the benefit is claimed, and phases-out entirely at surprisingly low

29. See I.R.C. § 117(c) (West 1998); see also *Godfrey v. Comm'r*, T.C.M. (CCH) 1738 (1998).

30. See I.R.C. § 127 (West 1998) (providing that an employee may exclude from gross income, up to a limit of \$5250, amounts paid or expenses incurred by his or her employer pursuant to a written plan providing such employee with educational assistance). Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 221(a), 11 Stat. 810 amended I.R.C. § 127(d) (West 1998) extends the termination date of the benefit from expenses incurred after tax years beginning after May 31, 1997 to May 31, 2000. The Education Savings and School Excellence Act of 1998, H.R. 2646, sought to extend the benefit through December 31, 2002, but the bill was vetoed by the President. See H.R. 2646, 105th Cong. (1998).

31. See I.R.C. § 132(a) (West 1998) (providing rules for excluding qualified fringe benefits from income). For a complete discussion of the "fringe benefit" rules, see generally MERTENS., *supra* note 6, at § 7:136-70.

32. See I.R.C. § 135 (West 1998) (allowing a taxpayer to exclude from income the interest portion of redeemed United States savings bonds which are used to pay for "qualified higher education expenses"). These expenses are defined as "tuition and fees required for the enrollment or attendance . . . at an eligible educational institution." I.R.C. § 135(c)(2)(A). These expenses include contributions to qualified state tuition programs. See I.R.C. § 135(c)(2)(C) (as amended by TRA '97 § 211(c)). If the proceeds from the redemption exceed the qualified expenses, then the exclusion is limited. See I.R.C. § 135(b)(1) (West 1998).

33. The interest rates and redemption values for series EE bonds are computed according to equations promulgated by the Secretary of the Treasury. See 31 C.F.R. § 351.2 (1998) (discussing offering of United States Savings Bonds, series EE, 31 C.F.R. § 351.2, at pt. 351 (1998), as authorized by 5 U.S.C. § 301; 12 U.S.C. § 391 (1988); 31 U.S.C. § 3105 (1994)).

thresholds.³⁴ A taxpayer in a qualifying tax bracket at the time of purchase will probably have to make sacrifices to buy the bonds. Ironically, she may discover that when the time comes to redeem them to pay for education expenses her financial position may have improved to the point she no longer qualifies for the exclusion. It is probably fair to say that none of these benefits provide meaningful assistance for the majority of deserving taxpayers.

In response to these barriers to tax assistance, taxpayers have pursued self-help remedies to fund college education costs. Most efforts involve investing in tax favored vehicles (tax free bonds,³⁵ annuities,³⁶ or growth securities³⁷), borrowing (tax favored³⁸ or otherwise), shifting income to the children to benefit from their lower marginal tax rates,³⁹

34. If the taxpayer's modified adjusted gross income exceeds \$40,000 (\$60,000 for a joint filer), then the exclusion is reduced "by the amount which bears the same ratio to the amount which would be so excludable as such excess bears to \$15,000 (\$30,000 in the case of a joint return)." I.R.C. § 135(b)(2) (West 1998). Note that I.R.C. § 135 was amended by the Small Business Job Protection Act, Pub. L. No. 104-188 (1996). See I.R.C. § 135 (West 1998); see also I.R.C. § 135(b)(2)(B)(ii) (West 1998) (providing that the cost-of-living adjustment under I.R.C. § 1(f)(3) (West 1998), which is applied to the \$40,000 and \$60,000 limits, is to be read substituting "calendar year 1989" for "calendar year 1992").

35. See I.R.C. § 103(a) (West 1998) (excluding income interest on state and local (county, municipal, etc.) bonds, provided the bond is not excepted under I.R.C. § 103(b) (West 1998)).

36. Annuities can be effective tax-deferral vehicles that maximize internal growth on funds remaining within the annuity. The funds can be withdrawn in a tax-favored manner that allows a non-taxable recovery of investment with each payment. See generally I.R.C. § 72 (West 1998).

37. Growth securities tend to be issued by companies that re-invest earnings and pay only a small, if any, dividend. Consequently, as the value of the security increases there is not any adverse tax exposure (i.e., any dividends to include in income and unrealized appreciation). When the security is sold, the gain is realized, but can qualify for favorable capital gains rates. See I.R.C. § 1(h) (West 1998).

38. See I.R.C. § 163(h)(2)(D) (West 1998) (allowing a deduction for otherwise non-deductible personal (i.e., non-business) interest that is "qualified residence interest" (i.e., interest paid on a note secured by the taxpayer's residence)); see also I.R.C. § 163(h)(3) (West 1998).

39. See I.R.C. § 1(a)-(e) (West 1997) (establishing a graduated rate system whereby the marginal tax rate, the rate applied to the taxpayer's highest taxable income amount, increases with taxable income). In most instances parents will have taxable incomes greater than their children. Thus, tax savings can be accomplished by shifting the tax consequences down to the children and their lower marginal tax rates. Unfortunately, I.R.C. § 1(g) (West 1998) thwarts many of these efforts by forcing children under the age of 14 to apply their parents' marginal tax rate to a portion of their unearned income.

or a combination of all three.

Another popular strategy is to participate in state operated pre-paid tuition plans.⁴⁰ Although a creative approach to meeting college costs, originally these plans came with adverse tax consequences. The forerunner of these state tuition plans received a mixed treatment when first reviewed by the Internal Revenue Service.⁴¹ On the down side, contributions to the plan were not tax deductible. Distributions from the plan in the form of education benefits were income to the plan beneficiaries (usually the children and not the parent contributors) to the extent the value of the benefits received exceeded the contributions made (the contributor's basis in the contract). In essence, earnings on the contributions were taxed when used, but in return, either compounded growth on a deferred basis or a special tuition guarantee was obtained. This could be particularly beneficial if the tax consequences were shifted to a lower marginal-rate taxpayer.⁴² The potential benefit, however, came at a cost. The contributor was deemed to have made taxable gifts to the beneficiary in the amount of his contribution.⁴³ This treatment was consistent with allowing the income tax consequences to be shifted to the beneficiary. But neither the gift tax annual exclusion⁴⁴ nor the special exclusion available for education payments made on behalf of a third party⁴⁵ was held to apply. Thus, contributing to the plan gave rise to adverse gift tax consequences. Lastly, the government ruled that the

See infra notes 139-42 and accompanying text for a discussion of the so-called "kiddie tax."

40. At least a dozen states have adopted pre-paid tuition programs. *See, e.g.*, ALA. CODE § 16-33c-1 *et seq.* (1995); ALASKA STAT. § 14.40.803 *et seq.* (Michie 1996); FLA. STAT. ANN. § 240.552 (West 1998); GA. CODE ANN. § 20-3-600 *et seq.* (1996); KY. REV. STAT. ANN. § 164A.300 *et seq.* (Michie 1994 & Supp. 1998); LA. REV. STAT. ANN. § 17:3129.4 (West 1999); MICH. COMP. LAWS ANN. § 390.1421 *et seq.* (West 1997); OHIO REV. CODE ANN. § 3334.01 *et seq.* (West 1998); TEX. EDUC. CODE ANN. § 54.6001 *et seq.* (West 1996); VA. CODE ANN. § 23-38.75 *et seq.* (Michie 1997).

41. *See* Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988).

42. *See supra* note 39.

43. *See* I.R.C. § 2501(a) (West 1998) (imposing a gift tax on taxable gifts as defined in I.R.C. § 2503 (West 1998)).

44. *See* I.R.C. § 2503(b) (West 1998) (excluding the first \$10,000 of value of any present interest from the computation of taxable gifts).

45. *See* I.R.C. § 2503(e) (West 1998) (excluding the amount of any "qualified transfer" from any gift tax accounting). *See also* I.R.C. § 2503(e)(2) (West 1998) (providing that direct payments of tuition are "qualified transfers").

earnings on the contributions were income to the trust even though it was an adjunct of the state. In *Michigan v. United States*,⁴⁶ however, the Sixth Circuit held the trust's earnings were properly excludable from income. The government's other positions were not challenged, and thus, the decision offered no relief to private taxpayers. Subsequently, Congress gave its blessing to state operated pre-paid tuition plans.⁴⁷ The new rules provided that plan benefits were not income to the beneficiaries even if the benefit value exceeded the amount of the contributions.⁴⁸ The contributions qualified for the gift tax education expense exclusion and thus were not transfers subject to the gift tax,⁴⁹ but remained non-deductible for income tax purposes. TRA '97 reworked the tax treatment for these plans making them more attractive college funding opportunities.⁵⁰

III. LEGISLATIVE INITIATIVES

A. *The Proposals*

Creating tax breaks for college expenses was the political football of the 1990s. Everyone seemed to have a plan to assist taxpaying voters in their efforts to put themselves, their spouses, or their children through college. Amidst the crush of proposals two basic themes emerged. One provided "up front" tax relief by allowing qualifying expenditures to generate a presently usable tax deduction or credit. The other "back-ended" the tax benefit by excluding from income the earnings on the funds used to pay college expenses. Each theme has a number of variations.

President Clinton was the chief proponent of so-called front-end benefits. He initially proposed an education

46. 40 F.3d 817 (6th Cir. 1994).

47. See The Small Business Job Protection Act of 1996, Pub. L. No. 104-88 § 1806(a) (introducing I.R.C. § 529 (West 1998) into the Code). This Act provided rules for the tax treatment of contributions to, earnings on, and distributions from Qualified State Tuition Programs. See *id.*

48. See I.R.C. § 529(c) (West 1998).

49. See *id.*

50. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 211(a), (b)(3)(A)(i)-(ii), (b)(3)(B), (d), 111 Stat. 813 (1998) (codified as amended in 26 U.S.C. § 529 (West Supp. 1998)).

expense deduction⁵¹ and suggested instituting a tax credit for the first two years of community college.⁵² The former made an early appearance, but the latter did not come until final legislative drafting. The deduction initiative was a well-crafted proposal. It addressed a number of critical issues, including, what is deductible, who takes the deduction, and how the benefit fits into the overall tax structure. Ultimately, this approach was dropped in favor of a dual credit proposal.⁵³

"Back-end" benefits provide indirect tax relief. Instead of focusing on the expense payment itself, the benefit is given to income on investments or interest on debt incurred to make the payment. Some proposals would have exempted from income earnings on funds put aside in special accounts to pay for future college costs.⁵⁴ This approach mirrors the benefit accorded interest earned on qualifying federal savings bonds. However, instead of being limited to the special federal bonds, the taxpayer would be given a wider range of investment options.

One of the earliest of these tax-free pocketbook plans was dubbed the "Family Savings Account."⁵⁵ Earnings generated in the account, if used to pay college education expenses, were to be tax exempt. The account would be created through non-deductible contributions limited to no more than \$2,000 per year.⁵⁶ A variation on this theme increased the amount of the allowable contributions (up to \$5,000 per year for married couples and \$2,500 per year for individuals), but would have required the funds to be kept in the account for seven years and phased-out the benefits for upper-level taxpayers (\$120,000 for joint filers and

51. The idea first appeared in the BALANCED BUDGET BILL OF 1995 § 13012, and then again in the REVENUE RECONCILIATION BILL OF 1996 § 9102.

52. This proposal did not surface in a concrete legislative form, but instead was a "talking point" as the "education expense" discussions continued. This idea was adopted in the form of the Hope Scholarship and Lifetime Learning credits. See *infra* notes 67-87 and accompanying text.

53. See *infra* notes 54-60 and accompanying text.

54. See S. Res. 2023 § 1 (1990), 136 CONG. REC. S407-04 (1990); S. Res. 2071 § 292, 136 CONG. REC. S881-02 (1990).

55. S. Res. 2071 § 292, 136 CONG. REC. S881-02. The Family Savings Account as originally conceived would have allowed tax-free withdrawals of the non-deductible contributions and earnings thereon for a home purchase by a first-time homebuyer. See *id.*

56. See 136 CONG. REC. S881-89 (daily ed. Feb. 6, 1990); see also Contract with America Tax Relief Bill of 1995, H.R. 1215, § 103.

\$60,000 for individuals).⁵⁷ Neither proposal was adopted.

Subsequently, the Family Savings Account plan was re-incarnated as originally proposed under the name the "American Dream Savings Account."⁵⁸ As with its predecessor, the plan had a major drawback. These types of accounts offered no assistance for those unable to fund them, and thus were of dubious value in seeking to provide universally available relief. A college savings account plan was finally enacted,⁵⁹ but on a much smaller scale than discussed. Also, perhaps as a trade-off, distributions from pre-existing retirement accounts could be made for college expenses without incurring an early withdrawal penalty.⁶⁰

Another back-end benefit plan sought to give tax relief for any interest paid on loans that was used to pay education expenses. Normally such interest would be considered personal and non-deductible.⁶¹ One bill suggested an above-the-line deduction be allowed for all education loan interest, with the benefit gradually phased-out for joint return filers having adjusted gross incomes in excess of \$45,000.⁶² A Senate amendment to that plan would have allowed a tax credit for up to sixty months of education loan interest paid, capping the benefit at \$500 per loan for each college student.⁶³ The proposal conferring a tax benefit on the interest paid on education loans is appealing because it can be made available to all taxpayers. However, to some degree, it might be negatively viewed by individuals who have skimped and saved for years and are using after-tax dollars to pay for college costs. They will not

57. See Contract with America Tax Relief Bill of 1995, H.R. 1215, 104th Cong. § 103.

58. H.R. 6, 104th Cong. (1995). See also four different versions of H.R. 6, Feb. 6, 1995; Feb. 12, 1995; Feb. 13, 1995; and Feb. 14, 1995. *Id.*

59. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 213(a), 111 Stat. 813 (1998) (codified as amended at I.R.C. § 530 (West 1998) (creating the Education Individual Retirement Accounts ("Ed IRAs")). Ed IRAs are discussed *infra* notes 103-117 and accompanying text.

60. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 203(b), 111 Stat. 809 (1998) (amending I.R.C. § 72(t) (West 1998) by adding a new subsection (7)).

61. See generally I.R.C. § 163(a) (West 1998) (allowing a deduction for interest paid during the year); I.R.C. § 163(h)(1)-(2) (West 1998) (prohibiting personal interest from being deductible under subsection (a), but subsection (h)(2) identifies exceptions to the prohibition). College interest expenses are not an identified exception. See *id.*

62. See Revenue Reconciliation Bill of 1995, H.R. 2491, 104th Cong. § 11004.

63. See CONF. REPT. OF BALANCED BUDGET BILL OF 1994, H.R. 2491 (1995).

need to borrow to pay for these costs, and may feel penalized for having had the foresight to prepare for the future. Of course, these taxpayers could also take out loans for college costs and receive the tax benefit if they so desired. The money saved for college could then be put to other uses. But this is not a satisfactory response for many because borrowing comes with transaction costs over and above the interest charge. These costs are not deductible and would serve to reduce any available tax benefit. The back-end approaches have serious fairness drawbacks that make them undesirable as the principal method of providing college expense relief. Nonetheless, an education loan interest deduction did make its way into law.⁶⁴

IV. TRA '97

TRA '97 brought forth a diverse variety of tax benefits associated with higher education, including new ideas,⁶⁵ as well as some wrinkles on existing ones.⁶⁶ The most notable initiative may be the tax credits for qualifying expenses, but deductions and deferrals also were made a part of the mix. The end result is a hodge-podge of often mutually exclusive benefits. Now taxpayers are forced not only to decipher the sections, but also to do so in the context of their own situations so as to choose from among the available benefits. An already overly complex tax system becomes further complicated. A review of the new rules should assist in evaluating the overall usefulness of the legislation, and help predict its success.

Perhaps the most talked about innovations are the Hope Scholarship and Lifetime Learning credits, now permitted by the new tax code section 25A.⁶⁷ These innovations, although independent of one another, work hand in hand to produce a somewhat generous benefit.

64. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 202, 111 Stat. 806 (codified as amended at I.R.C. § 221 (West 1998)) (allowing qualifying education loan interest to be deducted). See *infra* notes 88-94 and accompanying text.

65. See *infra* notes 67-94, 103-17 and accompanying text. For an overview of the new rules together with a set of "Question and Answer" explanations see I.R.S. Notice 97-60, 1997-46 I.R.B. 1.

66. See *infra* notes 94-102 and accompanying text. See also I.R.S. Notice 97-60, 1997-46 I.R.B. 1.

67. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 202, 111 Stat. 799 (1998) (adding Hope Scholarship and Lifetime Learning Credits to the Code).

The Hope Scholarship permits a maximum \$2,000 credit⁶⁸ for each of a student's first two years of post-high school education.⁶⁹ Both college and vocational training expenses may qualify, provided the student is enrolled in an "eligible educational institution."⁷⁰ The credit is limited to "qualified tuition and related expenses" of an "eligible student" who is carrying at least fifty percent of the "work load required for the course of study" being pursued.⁷¹ Qualified expenses include tuition and fees required for enrollment in the student's course of study, excluding student activity fees, athletic fees, and other charges not actually related to the course of study.⁷² Of particular interest is that the provision specifically allows the credit for qualified expenses paid on behalf of the taxpayer-student,⁷³ the taxpayer's student-spouse,⁷⁴ or the taxpayer's student dependent.⁷⁵ The latter rule permits parents to take the credit for their children's qualified expenses, provided the children are eligible dependents under Section 151 of the Code.⁷⁶

68. See I.R.C. § 25A(b)(1)(A), (B) (West 1998). This section computes the credit in a two step process. See *id.* The student's entire first \$1,000 of qualified expenses are added to 50% of the remaining qualified expenses. *Id.* However, the latter amount cannot exceed \$1,000. See I.R.C. § 25A(b)(4) (West 1998) that imposes a limit equal to twice the amount specified in I.R.C. § 25A(b)(1)(A) (West 1998) so that when the 50% allowance of I.R.C. § 25A(b)(1)(B) (West 1998) is applied the result is an amount equal to the subsection (b)(1)(A) amount. The tortuous language is needed to simplify the computations in future years when the maximum credit amount increases by a cost of living adjustment determined under I.R.C. § 1(f)(3) (West 1998). The amounts increase for taxable years starting after 2001. See I.R.C. § 25A(h)(1) (West 1998).

69. See I.R.C. § 25A(b)(2)(A), (C) (West 1988).

70. I.R.C. § 25A(f)(2) (defining "eligible educational institution" with reference to the Higher Education Act of 1965, 20 U.S.C. 1088).

71. I.R.C. § 25A(b)(2)(B), (b)(3) (West 1998).

72. See I.R.C. § 25A(f)(1) (West 1998).

73. See I.R.C. § 25A(f)(1)(A)(i) (West 1998).

74. See I.R.C. § 25A(f)(1)(A)(ii) (West 1998).

75. See I.R.C. § 25A(f)(1)(A)(iii) (West 1998).

76. See I.R.C. § 151 (West 1998) (allowing a dependency exemption for any child of the taxpayer who qualifies as the taxpayer's dependent); I.R.C. § 152(a)(1), (2) (West 1998) (defining "dependent" to include a child or stepchild for whom the taxpayer has provided over one half of the support for the year); I.R.C. § 151(c)(1)(A), (B) (West 1998) (stating that a person whose gross income exceeds the exemption amount cannot be another taxpayer's dependent unless the child is either under 19, or both under 24 and a student); I.R.C. § 151(c)(4)(A), (B) (defining "student" for this purpose to be a child who is either a full-time student or pursuing a special on-farm training program).

The Lifetime Learning credit allows a maximum \$1,000 tax credit (targeted to increase to \$2,000 in 2003)⁷⁷ for qualified expenses. Unlike the Hope Scholarship, the Lifetime Learning benefit can be taken for any year of study.⁷⁸ Moreover, the qualified expenses are more broadly defined than their Hope Scholarship counterpart. Qualified expenses under the Lifetime Learning Benefit are "expenses with respect to any course of instruction at an eligible institution *to acquire or improve job skills.*" (emphasis supplied).⁷⁹ Thus, there is no need for the student to be matriculated in a formal course of study or to carry a pre-set course load in order to qualify for the credit.

These differences aside, the two credits are closely related. First, otherwise qualifying expenses cannot be used for both credits; the taxpayer must apply them to the Hope Scholarship credit if the student qualifies for it.⁸⁰ Consequently, if the taxpayer qualifies for the maximum Hope Scholarship credit, a Lifetime Learning credit is unavailable for that year. Second, both credits are phased-out for higher-income taxpayers based on a "modified adjusted gross income."⁸¹ A complete loss of benefits occurs at the relatively modest income level of \$100,000 for joint filers and \$50,000 for individual filers.⁸² Third, neither credit is available for married taxpayers filing separately.⁸³ Fourth, qualified expenses must be reduced by non-taxable scholarship amounts or other payments excludable from income, unless they are received as a gift or inheritance.⁸⁴ Fifth, neither credit is available for an expense that is

77. See I.R.C. § 25A(c)(1) (West 1998) (allowing a credit equal to 20% of the qualified expenses paid during the year and then capping the credit at pre-set levels).

78. See *id.* (providing the credit applies to expense incurred "for education furnished during *any academic period . . .*" (emphasis added).

79. I.R.C. § 25A(c)(2)(B) (West 1998).

80. See I.R.C. § 25A(c)(2)(A) (West 1998).

81. See I.R.C. § 62 (West 1998) (defining "modified gross income" as adjusted gross income "increased by any amount excluded gross income under section 911, 931, or 933."). Section 911 relates to foreign source income earned by citizens or residents living abroad; sections 931 and 933 relate to income earned in U.S. possessions and Puerto Rico, respectively. See also I.R.C. § 25A(d)(3) (West 1998).

82. See I.R.C. § 25A(d)(2) (West 1998).

83. See I.R.C. § 25A(g)(6) (West 1998).

84. See I.R.C. § 25A(g)(2) (West 1998).

taken as a deduction pursuant to another Code section.⁸⁵ Sixth, in no event can the taxpayer take either credit in a year in which an election is made to exclude from income a distribution from an Education Individual Retirement Account ("Ed IRA")⁸⁶ that is used to pay qualified higher education expenses.⁸⁷

TRA '97 also introduced a deduction for interest paid on a "qualified education loan."⁸⁸ "Qualified education loan" is defined in such a way as to ensure the loan proceeds are used for education expenses similar to those allowed a credit under Section 25A of the tax code.⁸⁹ There is an income ceiling above which the deduction begins to phase-out and ultimately is lost entirely.⁹⁰ Only sixty months of interest payments are deductible,⁹¹ and the benefit is not available at all to a taxpayer who can be claimed as a dependent by another taxpayer.⁹² Thus, interest on student loans will not generate deductible interest if the obligated student is still a dependent of his or her parents, or some other taxpayer. Notwithstanding the amount of interest paid, the maximum deductible amount is \$1,000 for 1998, and will increase to \$2,500 for tax years 2001 and thereafter.⁹³ On the plus side, the benefit comes as an above-the-line deduction, and thus is available regardless of whether or not the taxpayer itemizes deductions.⁹⁴

TRA '97 enhanced the tax benefits for Qualified State Tuition Programs ("QSTPs").⁹⁵ Qualifying expenses now may include room and board,⁹⁶ in addition to supplies and

85. See I.R.C. § 25A(g)(5) (West 1998).

86. For a discussion of Education Individual Retirement Accounts see *infra* notes 103-17 and accompanying text.

87. See I.R.C. § 25A(e)(2) (West 1998).

88. See I.R.C. § 221 (West 1998), enacted by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 202(a), 111 Stat. 806.

89. See *generally* I.R.C. § 221(e) (West 1998).

90. See I.R.C. § 221(b)(2)(A), (B) (West 1998) (phasing out the benefit against a modified adjusted gross income measure, but providing its own special definition of the term). See *also* I.R.C. § 25(b)(2)(C) (West 1998).

91. See I.R.C. § 221(d) (West 1998).

92. See I.R.C. § 221(c) (West 1998).

93. See I.R.C. § 221(b)(1) (West 1998).

94. See I.R.C. § 62(a)(17) (West 1998).

95. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 211(b)(3)(A), (B), 111 Stat. 810-11 (making a number of changes to I.R.C. § 529(c) that affect the tax treatment of account beneficiaries and contributors). For a recent application of the new rules see Priv. Ltr. Rul. 98-25-035 (Mar. 26, 1998).

96. See I.R.C. § 529(e)(3)(B) (West 1998), *amended by* Taxpayer Relief Act of

equipment necessary for coursework,⁹⁷ as well as the standard tuition and fees.⁹⁸ Contributions to the plan are now considered gifts,⁹⁹ but these can qualify for the gift tax annual exclusion. Moreover, if the contribution in any one year exceeds the annual exclusion amount for gift tax purposes, the donor-contributor (parent or other financial sponsor) may elect to amortize the gift over a five-year period.¹⁰⁰ This effectively will give the donor five years' worth of annual exclusions all at once. Finally, distributions from QSTPs will no longer be considered gifts from the contributor for gift tax purposes.¹⁰¹

TRA '97 made two other notable "self-help" changes to education funding initiatives. First, it liberalized the rules to allow taxpayers to make penalty-free distributions from traditional Individual Retirement Accounts ("IRAs") for qualified higher education expenses.¹⁰² Second, it created a new type of account, the Education Individual Retirement Account ("Ed IRA").¹⁰³ Although the Ed IRA shares some operational similarities with traditional IRAs, it is not a retirement vehicle, and unfortunately was poorly named. "Education Savings Account" and "Personal Education Expenses Plan" may have been better choices to capture the intended purpose. Misnomer aside, the Ed IRA is designed

1997, Pub. L. No. 105-34, § 211(b)(1), 111 Stat. 811.

97. See I.R.C. § 529(e)(3)(A) (West 1998).

98. See *id.*

99. See I.R.C. § 529(c)(2) (West 1998). Prior to Taxpayer Relief Act of 1997 contributions to a QSTP were not considered gifts for gift tax purposes. See I.R.C. § 529(c)(2) (West 1997); see also Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 211(b)(3)(A)(i), 111 Stat. 811 (amending I.R.C. § 529(c)(2) to treat the contributions as *completed* gifts that are not qualified transfers excused from gift tax accounting); I.R.C. §§ 529(c)(2)(A), 2503(e) (West 1998).

100. See I.R.C. § 529(c)(2)(A)(i) (West 1998), *codified by* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 211(b)(3)(A)(i), 111 Stat. 810-11 (making the contribution "not a future interest," and thus a present interest that can qualify for the annual exclusion under I.R.C. § 2503(b)).

101. See I.R.C. § 529(c)(5)(A) (West 1998), *amended by* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 211(b)(3)(A)(ii), 111 Stat. 810-11.

102. See I.R.C. § 72(t)(1) (West 1998) (imposing a 10% penalty on distributions from qualified retirement plans, including IRAs, that are to be included in income); I.R.C. § 72(t)(2) (providing numerous exceptions to the general rule); Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 203(b), 111 Stat. 809 (adding I.R.C. § 72(t)(7) which includes distributions for "qualified higher education expenses," as defined in I.R.C. § 529(e)(5), relating to Qualified State Tuition Programs in the list of exceptions to subsection 72(t)(1)).

103. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 213(a), 111 Stat. 813 (codified as amended at I.R.C. § 530 (West 1998)).

to provide tax benefits for education, not retirement expenses. These accounts can accept only cash contributions¹⁰⁴ on behalf of taxpayers under the age of eighteen.¹⁰⁵ Contributions are limited to \$500 per year,¹⁰⁶ and are phased-out for high-income contributors.¹⁰⁷ Income on deposits within the account is not taxed as earned,¹⁰⁸ and distributions of the income for qualified higher education expenses are excludable from income.¹⁰⁹ Contributions are withdrawn as a tax-free return of capital. Qualifying expenses are more broadly defined than they are for the education tax credits, and include required books, supplies, and equipment, as well as the standard tuition and fees.¹¹⁰ Also, room and board are qualifying expenses for students who are at least "half-time," as that term is defined in Section 25A(b)(3) of the tax code.¹¹¹ The price to be paid for the benefit is income inclusion of all earnings carried out by a non-qualifying distribution,¹¹² plus a ten percent penalty thereon,¹¹³ but some exceptions prevent harsh results for a number of special situations.¹¹⁴ Also, Congress has now made clear that funds remaining in an Ed IRA after the beneficiary reaches age thirty must be either distributed to the beneficiary¹¹⁵ or "rolled-over" into another qualifying Ed IRA.¹¹⁶ A required distribution would not only cause all the account income to be included in income, but the ten percent tax penalty would apply as well. Finally, the gift tax rules applicable to QSTP contributions and distributions apply equally to Ed IRAs.¹¹⁷

104. See I.R.C. § 530(b)(1)(A)(i) (West 1998).

105. See I.R.C. § 530(b)(1)(A)(ii) (West 1998).

106. See I.R.C. § 530(b)(1)(A)(iii) (West 1998).

107. See I.R.C. § 530(c) (West 1998).

108. See I.R.C. § 530(a) (West 1998).

109. See I.R.C. § 530(d)(2)(A) (West 1998).

110. See I.R.C. § 530(b)(2)(A) (West 1998) (incorporating the definition of "qualifying expenses" of I.R.C. § 529(e)(3) and denying double benefits to students who receive scholarships, federally sanctioned education assistance or tax-free receipts, other than ones excluded from income under I.R.C. § 102, attributable to attendance at an educational institution).

111. See I.R.C. § 530(b)(2)(B) (West 1998).

112. See I.R.C. § 530(d)(1) (West 1998).

113. See I.R.C. § 530(d)(4)(A) (West 1998).

114. See I.R.C. § 530(d)(4)(B) (West 1998).

115. See I.R.C. § 530(d)(8) (West 1998), as amended by IRS Restructuring and Reform Act of 1998 § 6004(a)(D)(2)(c).

116. See *id.*

117. See I.R.C. § 530(d)(3) (West 1998).

Although there are a number of new opportunities, each carries with it substantial restrictions. Additionally, the ubiquitous income level phase-outs effectively eliminate the benefits for a group of taxpayers, many of whom need the assistance because they cannot qualify for other need-based benefits. To the extent meaningful relief was sought, the effort fell short.

V. THE ROADS NOT TRAVELED

A. *Alternative Avenues*

If the underlying premise that drove the tax initiatives is sound—an educated workforce is essential to a vibrant, future economy—then some type of governmental support to achieve this goal may well be warranted. For years, the government has provided college students access to money through a federal loan and grant program¹¹⁸ and limited tax benefits.¹¹⁹ Apparently, these efforts were deemed insufficient, and more assistance was considered both wanted and needed. The critical question became how to best provide it.

There were a number of other alternatives available, some not tax related. Many, however, are quite dramatic and probably impractical for fiscal, administrative, or political reasons. For example, the government could establish its own federal university system and operate the colleges itself. Tuition could be pegged to the student's ability to pay on a sliding scale resulting in lower tuition for the less well-to-do. Alternatively, the entire education could be provided free. The cost of such an endeavor is, of course, prohibitive. Moreover, most citizens undoubtedly would view the idea of adding to the already vast number of governmental activities as ludicrous. Enrollments suggest the mix of state operated and private post-secondary and

118. The Stafford Loan and Pell Grant programs have been available for many years. There are also Federal Supplemental Educational Opportunity Grants and Federal Perkins Loans for selected students, as well as Robert C. Byrd Honors Scholarships and Paul Douglas Teacher, Teacher Corps and Robert Noyce Scholarships. For a discussion of these and other benefits, see DAVID L. GIBBERMAN, *PLANNING TO FINANCE YOUR CHILD'S COLLEGE EDUCATION*, 19-48 (3d ed. 1994).

119. See *supra* notes 11-34 and accompanying text.

vocational institutions is more than adequate to meet current needs.

Another non-tax related option would be to institute a national higher education voucher system. Under it, each student would receive a voucher worth a certain dollar amount per year usable to pay tuition or other qualifying education expenses. The student would remit the voucher to the educational institution which, in turn, would then submit it to the government for payment. The voucher system has been widely discussed as an alternative to the current funding of public elementary school systems. In those instances, however, the motivating force behind the voucher system is not cost, but providing parents a greater choice in their children's education because the public system may be failing or not meeting parental expectations. A voucher system would, nonetheless, allow parents to recover some of their tax dollars paid to support public schools while they send their children to private schools. Thus, indirectly, their own children's educations also receive some public support.

The downside to a federal voucher system is its cost. It would involve not only the actual dollar outlay for tuition, but also administrative costs to establish and maintain the system. The voucher outlay per student mathematically would be more expensive than any tax-based tuition credit plan. Under a voucher system each student receives an equal amount. Under a tax credit system there is a maximum credit amount, but not all taxpayers will receive it. Some taxpayers will not have sufficient means to generate a tax liability equal to the full credit amount. Thus, absent instituting a refundable credit, a tax credit system should be less expensive. Also, the costs associated with operating a federal voucher system bureaucracy are too frightening a matter to allow the proposal to get any serious attention. For similar reasons, a universally guaranteed federal scholarship program is also unthinkable.

Reasonable tax-related alternatives to the new tax regime do exist. For example, if the purpose of allowing tax relief for higher education expenses is to create a better prepared workforce, why not tie the deduction into reaching that result? Amending Section 162 of the Code or enacting a new Code provision to permit a deduction for education expenses *after* the student enters the workforce would move

toward reaching that result.¹²⁰ Present law prohibits any deduction for non-working students because they are neither pursuing a trade or business nor engaged in any income producing activity. For similar reasons, these costs presently cannot be capitalized and then amortized after the student begins to work. But there is no impediment to changing this rule by creating an "education asset." The cost recovery period could be either the taxpayer's life expectancy, or the difference between the number of years from graduation¹²¹ to a statutorily presumed retirement date. Alternatively, Congress could set any arbitrary time period over which the costs could be recovered once the taxpayer otherwise qualifies under Section 162 of the tax code. Certain business start-up costs are treated this way,¹²² why not work preparation expenses? Moreover, how can one challenge a five-year or ten-year amortization period as being unreasonable when Congress now allows taxpayers to "expense" higher education costs,¹²³ which essentially creates a one-year amortization period?

The selling point to the amortization proposal is cost and goal satisfaction. It should be less costly than direct write-offs or credits because not all students will enter the workforce, and thus some expenses will never be deductible. Also, by deferring the deduction and then spreading it over a period of years, the government will lose less revenue in the early years and should obtain some "time value of money" benefit attributable to the deferred deductions. Second, the deduction would be available only to those who actually fulfilled the motivating purpose for the benefit—improving one's skills to be a productive member of the

120. For a detailed discussion of applying a cost recovery system to tax account for education expenses, see David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793, 881-931 (1992). In this article the author also suggests that a student realize income on the difference between the full future value of her education and the actual out-of-pocket cost for it. See *id.* Under the suggested system, the realized income would be added to other costs to establish the student's basis that is to be recovered. See *id.*

121. For education expenses that were not part of a degree program and did not result in a "graduation date", the recovery period could begin to run from the later of the date the expense was paid or the education ended.

122. See I.R.C. § 195 (West 1998).

123. The Hope Scholarship and Lifetime Learning credits permit a current benefit for qualifying expenses. See *supra* notes 67-94 and accompanying text. As such it is similar to an immediate "write-off" or "expensing" of these costs.

workforce. Clearly, this approach has some theoretical and financial appeal.

Another alternative would be to exclude from income some amount of a taxpayer's earnings that is based upon the additional income generated by the taxpayer's "education asset." Ideally, one would like to exclude a percentage of income attributable to the "education asset" itself. Doing so would truly provide the incentive to improve one's job skills. But computing this figure would be extremely difficult, if not impossible. Who could say with complete accuracy what job and pay rate the taxpayer would have had if he did not obtain the education? Implementation of such a plan would necessitate reliance upon tables based on statistical data for the incremental income value of two-year, four-year, and professional degrees. Additional tables for specialized training, vocational and otherwise (including individual course work), would also be needed. Once the data is tabulated, simple tax schedules could be developed that would allow a percent of the incremental value of the education to be excluded from income each year for either a set number of years, or the balance of the taxpayer's working years. Retirement income generated by the "education asset" earnings differential could be similarly treated. The exclusion would work much like a depreciation deduction, except the taxpayer would use the schedule to compute the allowable exclusion instead of that year's allowable depreciation deduction.

One immediately apparent problem with the exclusion model is its complexity. Although the necessary information to establish the tables is to some degree available,¹²⁴ it is not particularly precise and would require continual updating. Consequently, the proposal carries potentially high administrative costs, never a good attribute for a tax provision. Along with its administrative drawbacks, the proposal would add to an already overly complex tax code. But perhaps its greatest drawback, and one shared by the higher education expense amortization deduction proposal,

124. See, e.g., OFFICE OF EDUCATIONAL RESEARCH AND DEVELOPMENT, U.S. DEPT. OF EDUCATION, PUB. NO. NCES 95-209, DIGEST OF EDUCATION STATISTICS 399 (1995). The digest is published by the National Center for Education Statistics pursuant to authority granted by the National Education Statistics Act of 1994, 20 U.S.C. 9001 § 402(b).

is that at its core it is a cost recovery system. It may encourage someone to obtain an education, but it does not help pay the way at the time when the money is needed. Taxpayers probably do not need the tax incentive to get an education as much as the wherewithal to get it. For this reason alone, both recovery system plans probably are inadequate alternatives to immediate benefits such as the education tax credits.

Although each alternative proposal has its own strengths, whether any is superior to the TRA '97 efforts can only be determined with reference to the objective sought. If the goal is generally to encourage people to improve themselves because greater rewards will await them, then the cost recovery systems may make the most sense. If, however, the primary objective is to provide the nation some financial assistance to become a better equipped workforce, then the tax credits are more suited to the task.

Regardless of the motivating criteria, one must question whether TRA '97 met the articulated goal. Most of the initiatives seem to be directed toward helping taxpayers pay the cost of their education *irrespective* of whether the education obtained is ever put to "workforce" use. The principal emphasis of both education tax credits and interest deductions is on tax relief for costs as they are incurred by taxpayers. Whereas proposals to provide cost recoveries and tax-free earnings for qualifying use provide financial relief, they do so primarily only for taxpayers in the future. Although some provisions offering future benefits were enacted, they are quite limited. Seemingly then, TRA '97 considers of paramount concern the need to provide immediate relief for expenses as they are incurred.

A more central criticism of the newly introduced hodgepodge of education tax incentives is that it does not focus directly on perhaps the most important group—the future students themselves. Yes, there are now tax credits to offset tuition payments made by students. Yes, a tax deduction is available for loan interest. And yes, the favorable tax treatment for qualifying state tuition programs has been enhanced. But each one of these benefits more naturally targets the students' financial sponsors—their parents—instead of the students themselves. The credits are specifically made available for payments made on behalf of

dependents¹²⁵—commonly, though not exclusively, a parent-child relationship. The Code embellishes this position by allowing full-time students up to age twenty-four to be considered as dependents even though they might not otherwise qualify as such.¹²⁶ Deductible loan interest will largely benefit parents, if for no other reason than many students will not have any income against which the deduction can be taken. The pre-paid tuition programs clearly target parents, or other benefactors, who are willing to make college-related payments many years prior to the students enrolling in college. The new Ed IRA also appears to be a vehicle designed for financial sponsors to meet future obligations. While it is true that allowing a trade or business deduction for qualifying education expenses is “student specific”, the benefit is not new and certainly was not expanded by TRA ‘97. If anything, one could argue the deduction was curtailed since selecting many of the new benefits will negatively impact the deductibility of the otherwise qualifying payments as a trade or business expense.¹²⁷

B. A Student-Oriented Benefit Proposal

Congress’s approach to solving the college cost crunch seems misdirected. Perhaps it would have been better served taking a cue from its efforts on the retirement savings front. The two challenges share similarities. Specifically, both are tangentially related to one’s employment—retirement savings are created while employed and enjoyed in post-work years; and college costs are often incurred prior to employment in preparation of entering the work force. Nonetheless, both have been addressed as principally personal, non-business tax items. IRAs are not related to one’s trade or business, and are allowed as a separate, personal deduction so long as there is earned income up to the amount contributed.¹²⁸ Similarly, both the

125. See I.R.C. § 25A(f)(1)(A)(iii) (West 1998).

126. An individual over the age of 19 who receives more than one-half of his support from another taxpayer is treated as a dependent of the taxpayer if such individual earns more than the dependency deduction amount. See I.R.C. § 151(c)(1)(B) (West 1998). But if the individual is a full-time student, the dependency deduction is nonetheless allowed. See *id.*

127. See, e.g., I.R.C. § 25A(g)(5) (West 1998).

128. See I.R.C. § 219(b)(1)(B) (West 1998).

Hope Scholarship and Lifetime Learning credits are available as long as there are qualifying education expenses. Further, these credits are totally unrelated to whether the student ever puts the education to use in a trade or business.

The difference between the two solutions provided by the Code is that in structuring the personal retirement tax benefits, the direct focus is on the individual benefited. The deduction or deferral enures principally to the benefit of the taxpayer who is the qualifying contributor. The education expense benefits seem to be geared to a student's sponsor or sponsors. The logic to this approach is that most traditional students do not have the financial ability to pay their own expenses, and some tax benefit should go to their parents, or other benefactors, who do. But perhaps the need for external support would be less pressing if the Code was not designed to tax future students, i.e., children, in such a way that hampers their own ability to build up substantial college funds. Some thought ought to be given to eliminating or reducing the pernicious effect the current tax rules have on allowing children to accumulate funds for their own future college costs. Congress should re-order its tax rules for providing college education expense benefits along the lines of self-determinism that works well elsewhere in the Code, specifically retirement funding.

The new specially designed Ed IRA is the closest TRA '97 comes to encouraging individuals to plan for the future, and providing incentives to those who will. These accounts allow a tax deferral on the earnings generated by qualifying contributions. But the annual contribution limit of \$500, is truly too small to make a serious dent in future educational cost needs, even with a savvy investment program.¹²⁹

129. Investing \$500 per year for 18 years (the maximum number of years contributions are allowed since no contribution can be made for child over age 18, see I.R.C. § 530(b)(1)(A)(ii) (West 1998)) can produce a \$22,800 fund if the contributions grow at a compound annual rate of 10%. Although this is a tidy sum, in order to achieve this result, consistent annual contributions have to be made starting in the child's year of birth, and a 10% growth rate must be sustained throughout the term. It may be quite difficult for many taxpayers to begin funding an Ed IRA that early in the child's life, especially since the contribution is not tax-deductible. Additionally, sustaining such a growth rate might be difficult. Moreover, if past history is any indication, 18 years hence the cost of higher education will have sufficiently increased so that the \$22,800 probably will cover a relatively smaller portion of the overall cost of the education than a similar amount would today.

Increasing the annual contribution limit (\$2,000 has already been recommended¹³⁰) will help, but it still does not create the same saving incentive as would an immediate tax deduction for the contribution as is allowed for retirement IRAs.¹³¹ Moreover, the provision presumes contributions will come from persons other than the student, and it places an income level cap on those contributors¹³² which can frustrate the purpose to be served. Nonetheless, conceptually the Ed IRA is a sound approach to the problem of providing adequate funds for future student expenses. It can, however, be improved, especially insofar as focusing attention on the future students themselves is concerned. Since the Ed IRA is designed to benefit future students, fashioning changes to meet their needs makes sense. Particularly useful would be innovations that encourage self-determinism and cut into the harsh tax treatment accorded tax dependents and young children. Consider the current rules for tax dependents and young children, and how an improved Ed IRA could help negate their impact on a child's ability to plan for his or her future.

The tax code may well be guilty of child abuse. For tax purposes, a child is anyone under the age of twenty-four who qualifies as a dependent of his or her parent(s), or some other person.¹³³ As long as the child can be taken as a dependent by another, the child loses his or her own personal dependency deduction, irrespective of whether or not the taxpayer entitled to the deduction uses it.¹³⁴ This, in turn, triggers the possibility of a reduced standard

130. A Senate bill to increase the annual contribution limit to \$2,000 was introduced shortly after the Taxpayer Relief Act of 1997 was enacted. Subsequently, Congress passed the Education Savings and School Excellence Act of 1998, H.R. 2646, 105th Cong. § 101(B), which would have increased the annual contribution limit to \$2,000; *see also* S. 1133, 105th Cong. (1997). The President vetoed the entire bill July 24, 1998, and thus the \$500 limit remains in place. *See* I.R.C. § 530(b)(1)(A)(iii) (West 1998).

131. *See* I.R.C. § 219(a) (West 1998) (allowing a deduction for the "qualified retirement contributions," as defined in I.R.C. § 219(c) (West 1998)).

132. *See* I.R.C. § 530(c) (West 1998).

133. This age limit applies because a full-time student under age 24 can still qualify as a dependent of another taxpayer notwithstanding the fact that the student earns more than the maximum amount of income allowed to be considered a dependent of another. *See supra* note 126; I.R.C. § 151(c)(1)(A), (B) (West 1998).

134. *See* I.R.C. § 151(d)(2) (West 1998). The Code forces this result by using the word "allowable" not "allowed" when referring to the personal exemption deduction. *See id.*

deduction for the dependent.¹³⁵ For tax year 1997, tax dependents were permitted only a \$650 standard deduction for unearned income,¹³⁶ substantially less than the \$4,150 available to a single taxpayer who is not someone else's dependent. Without a dependency deduction and limited to a reduced standard deduction, the dependent taxpayer will pay tax on income in excess of \$650—a sharp difference from the \$6,800 that normally can be shielded from income by non-dependent, single taxpayers.¹³⁷ At a minimum, the disparate treatment can amount to a \$922 tax bill.¹³⁸

The situation is even worse for younger taxpayers. The "minor children" tax ("kiddie tax")¹³⁹ potentially forces children under age fourteen to have a portion of their income taxed at their parent's marginal tax rate. All earned income plus a pre-set amount of unearned income (usually twice the amount of the standard deduction allowed to a dependent taxpayer) is excluded from the grasp of the kiddie tax,¹⁴⁰ but all else is not. Thus, a child whose parents' marginal tax rate is twenty-eight percent will incur a \$1,637 tax bill¹⁴¹ on the \$6,800 of unearned income that can escape taxation completely for a non-dependent, single taxpayer. For young children of higher income taxpayers, the burden can be worse.¹⁴² The tax penalty for being a

135. See I.R.C. § 63(c)(5) (West 1998), which limits the standard for deduction for dependent taxpayers to the greater of a set dollar amount (\$650 for tax year 1997, which includes the allowable inflationary adjustment) or the taxpayer's earned income plus \$250. The \$250 amount does not come into play when the taxpayer's earned income equals or exceeds the basic standard deduction allowed by I.R.C. § 63(c).

136. *But see* I.R.C. § 63(c)(5)(B), amended by Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1201(a)(1), 111 Stat. 993 (preventing a complete loss of the statutory amount for dependents who have some earned income). Now a dependent taxpayer is allowed as part of her standard deduction up to \$250 in excess of her earned income. *See id.*

137. This amount is the sum of the standard deduction (\$4,150) and the dependency deduction (\$2,650) for tax year 1997.

138. This is the product of multiplying \$6,150 (the difference between \$6,800 and \$650) by 15%, the lowest marginal tax rate. *See* I.R.C. § 1(a)-(c) (West 1998).

139. *See* I.R.C. § 1(g) (West 1998).

140. *See* I.R.C. § 1(g)(4)(A)(ii) (West 1998).

141. This amount is computed as follows: \$1,540 which is \$5,500 (the excess of \$6,800 over \$1,300) taxed at the parents' 28% rate, plus \$97, which is the child's 15% tax rate applied to the \$650 of the \$1,300, neither protected by the standard deduction nor subject to the kiddie tax. (The computations use the limits in place for tax year 1997).

142. *See* I.R.C. § 1(a)-(c) (West 1998) (applying to joint return filers, heads of

dependent child is not insignificant.

Congress should move to ameliorate the tax hardships of being a dependent child in a way that increases the opportunity to fund higher education costs. This can be accomplished by restructuring the Ed IRA to allow dependent children taxpayers an increased annual contribution limit. The increase should offset the penalty associated with being a tax dependent. The revised limit should equal the sum of the (1) lost dependency exemption deduction; plus (2) disqualified portion of the standard deduction. Allowing annual Ed IRA contributions based on this figure, the "dependent's reduced exemption and standard deductions amount," would serve as a fitting cure to present ills. Alternatively, the contributions could be made deductible. The benefit allowed in computing adjusted gross income would ensure its availability to taxpayers who do not itemize their deductions. Finally, irrespective of which option, if any, is pursued, the income limit on Ed IRA contributors should be re-worked.

Although combining an increased cap with deductible contributions would best meet the taxpayer's need, the cost of such an approach would prove prohibitive. Given the choice between the two options, the increased annual contribution limit is preferable. Whereas deductible contributions are the better incentive for Ed IRA funding, this option may not have universal appeal. First, many children, especially those of middle-income and lower-income families, will not have sufficient income to exceed even the reduced dependent child tax threshold. Therefore the deduction would be of no value to any of these taxpayers, irrespective of whether the parent supplied the funds for the contribution. (This specific objection can be eliminated if the deduction is given to the contributor. As long as a meaningful income level limit on qualifying contributors is imposed, such an approach may be defensible.) Second, merely providing a deduction will not necessarily satisfy a primary objective—increasing the size of the fund available to meet future expenses.¹⁴³ On the

households and other unmarried individuals, respectively, and providing for marginal tax rates of up to 39.6%). Thus, the kiddie tax could be more costly for the child whose parents' tax rate is at the higher end of the rate structure. See *id.*

143. See *supra* notes 129-30 and accompanying text.

other hand, increasing the annual contribution limit will provide taxpayers the opportunity to maximize Ed IRA funds that will be available in the future. Moreover, it is a more equitable approach because it is tax neutral to all. It is axiomatic that graduated marginal tax rates give higher income taxpayers a greater benefit for deductions than lower income taxpayers. Thus, a greater benefit enures to more well-to-do taxpayers when contributions are made deductible. This "upside down" inequity is eliminated if no deduction is involved. The increased Ed IRA contribution limit both fosters self-determinism and offers the opportunity today to make a meaningful effort to meet tomorrow's needs. Therefore, it merits the most serious consideration.

As previously discussed, Ed IRAs accept non-deductible contributions, the income from which is excused from tax so long as funds remain in the account.¹⁴⁴ Distributions are tax-free if made for qualifying purposes;¹⁴⁵ other distributions are may be included in income,¹⁴⁶ and may be subject to a ten percent penalty as well.¹⁴⁷ The Code imposes a \$500 limit on annual contributions to Ed IRAs,¹⁴⁸ and disallows contributions from upper income level taxpayers.¹⁴⁹ These latter two restrictions seriously hamper Ed

144. See I.R.C. § 530(d)(2) (West 1998); *supra* notes 104-08 and accompanying text.

145. See I.R.C. § 530(d)(2)(A) (West 1998); *supra* notes 110-11 and accompanying text.

146. See I.R.C. § 530(d)(1) (West 1998) (providing the general rule that distributions are includible in gross income according to the rules of I.R.C. § 72 (b) (West 1998)). I.R.C. § 72(b) sets out the "exclusion ratio" for amounts received from an annuity. Application of the ratio will result in contributions being received tax-free, and all earnings thereon included in income unless otherwise protected elsewhere in the section. See I.R.C. § 530(d)(2)(B) (making it clear that distributions in excess of the tax year's qualifying expenses are to be included in income on a pro rata basis).

147. See I.R.C. § 530(d)(4)(A) (West 1998).

148. See I.R.C. § 530(b)(1)(A)(iii) (West 1998).

149. See I.R.C. § 530(c) (West 1998) (establishing a formula for reducing the annual maximum contribution amount allowable based upon the contributor's "modified gross income"—adjusted gross income plus amounts "excluded from under section 911, 931, or 933"). See also I.R.C. § 530(d)(2) (West 1998). The phase-out begins for taxpayers whose modified gross incomes exceed \$150,000 for joint filers and \$95,000 for other filers. See I.R.C. § 530(c)(1)(A) (West 1998). Joint filers with modified adjusted gross incomes in excess of \$160,000, and other taxpayers with modified adjusted gross incomes in excess of \$110,000, can make no contributions.

IRA effectiveness. Each is of dubious value relative to stated overarching policy goals, and should be either eliminated or substantially modified in order to achieve the determined objectives of providing a reasonable means for taxpayers to plan for future higher education expenses when they might not otherwise be able to do so.

Consider first the income limitation on potential contributors. The purpose of the restriction seems clear — high-income taxpayers do not need tax breaks, and thus ought not to be given any additional federal assistance in saving for their own or their beneficiaries' college costs. The limitation is directed principally at the parent(s) or financial sponsor(s) of the future student, although it applies to the latter as well.¹⁵⁰

The income limitation is politically popular; it allows Congress to “pitch the plan” as being intended only for low-income and middle-income taxpayers. Consequently, the revenue loss generated by the benefit can be justified on the grounds the relief is directed exclusively to the deserving needy. This is a consistent theme for all of the new “education expense” benefits.¹⁵¹ For the Ed IRA, however, it may be only a “paper tiger,” and a costly one at that.

The Code places reporting requirements on the Ed IRA trustee.¹⁵² Regulations that flesh out the reporting requirements will be necessary. These regulations should identify who will be responsible for verifying income limitation compliance. Ed IRA contributions will be made to a trustee, presumably a bank or other financial institution that offers similar services for retirement plans.¹⁵³ Will the

150. There is no restriction on children making contributions to their own Ed IRAs. They would, however, be subject to the income limitation rules. See I.R.C. § 530(c) (West 1998). Whereas it is unlikely a child would run afoul of the limit, it is possible for it to happen. The limit does not apply exclusively to earned income, so children who have received large gifts, inheritances or other windfalls, or who have trust income, which results in substantial unearned income could be subjected to the limit. See *id.*

151. See I.R.C. § 25A(d) (West 1998) (establishing income limitations on both the Hope Scholarship and Lifetime Learning credits); I.R.C. § 221(b)(2) (West 1998) (establishing income limitations on the education interest deduction). There are no such limitations for qualified state tuition plan contributions under I.R.C. § 529 (West 1998).

152. See I.R.C. § 530(h) (West 1998).

153. I.R.C. § 530(b)(1)(B) qualifies those entities that may serve as Ed IRA trustees. It specifically refers to banks qualified to serve as IRA custodians as set out in I.R.C. § 408(n), and allows other persons who have demonstrated the

trustee be required to gather relevant income information before accepting contributions or, as is presently the case with retirement IRAs, will the trustee accept all payments and see the burden of proving eligibility fall on the contributor through some form filing procedure? Either alternative puts an extra administrative layer in place and adds some cost to this obtaining benefit. One can be fairly certain that trustees' fees will rise to meet any compliance cost expense imposed upon them. Alternatively, all taxpayers will share the cost generated by printing, disseminating, and auditing tax forms if the limit is made self-enforcing.

Perhaps what renders the income limit more problematic is that it can so easily be circumvented. The provision does not impose either a "tracing" or "attribution" rule as can be found in other Code sections.¹⁵⁴ Consequently, a high-income taxpayer otherwise ineligible to make an Ed IRA contribution could transfer funds to the minor, who in turn would make the contribution. (For children lacking capacity to execute the transaction, a simple custodial arrangement pursuant to the local transfer to minors act can be used.¹⁵⁵) Since both of these transfers are considered gifts of present interests and qualify for the annual exclusion,¹⁵⁶ there is no gift tax penalty for choosing one option over the other. As such, the decision to elect to make an Ed IRA contribution either directly or indirectly is gift tax neutral. There may, however, be an income tax advantage for opting to take the indirect route, i.e.; transferring the gift to the minor who then makes the Ed

ability to administer individual retirement plans to qualify.

154. See, e.g., I.R.C. § 2040(a) which "traces" gifts back to the donor for purposes of determining a donor-decedent's contribution to joint estates in order to determine the value includible in the decedent's gross estate under I.R.C. § 2031 (West 1998). See also I.R.C. § 318(a) (West 1998) (establishing rules attributing stock ownership from one individual or entity to others for a variety of income tax purposes identified in I.R.C. § 318(b) (West 1998)).

155. See, e.g., the Illinois Uniform Transfers to Minors Act, 760 ILL. COMP. STAT. 20/1 (West 1992) (recognizing custodial accounts). *Id.* 20/5, 20/10(2) (authorizing custodians to use custodial funds in a variety of ways for the benefit of the minor).

156. See I.R.C. § 2503(b) (excluding the first \$10,000 of transfers of present interests from being considered a "gift" for gift tax purposes). The \$10,000 is adjusted for inflation and will increase in \$1,000 increments in the future. See *id.* § 2503(b)(2). Gifts made pursuant to the Uniform Gifts to Minors Act qualify for the annual exclusion. See Rev. Rul. 59-357, 1959-2 C.B. 212.

IRA contribution. In lieu of transferring cash to the minor, a high-income taxpayer can gift appreciated property, which the minor can then sell to generate the cash needed to meet the Ed IRA contribution requirements.¹⁵⁷ This maneuver results in all gain being shifted from the presumably higher marginal rates of the donor-benefactor to the lower rates of the minor.¹⁵⁸ For children under age fourteen the kiddie tax will apply, but there is still the possibility of sheltering from tax income equal to up to twice the amount of a child's limited standard deduction.¹⁵⁹ In any event, even if a tax benefit cannot be achieved, no income tax penalty results from following this procedure.

The contributor income limit can also be attacked on "consistency" grounds. If the limit is designed to put the Ed IRA on the same playing field as the other education tax benefits, the effort missed its mark. The income limit on the education tax credits and the education interest expense deduction are "individual use" oriented. That is, the restriction is applied to the taxpayer claiming the benefit, i.e., the person paying either the expenses that qualify for the credit, or the interest on the loan. Thus, parents who pay for their child's qualifying expenses receive the tax credit or the interest deduction. Also, the availability of that credit or deduction is measured against the parent's income at the time the credit or deduction is claimed, not when the income used to pay the credit was earned or the qualifying loan proceeds were used to pay college costs. The true benefit of the Ed IRA is not making the contributions, but receiving the earnings on a tax-free basis. Thus, if an income limit is to be imposed, consistency suggests it ought to be used at the time of withdrawal—the tax year the

157. See I.R.C. § 530(b)(1)(A)(i) (West 1998) (stating that an Ed IRA can only accept cash contributions).

158. A gift is not a taxable event for income tax purposes. See *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954). But see *Diedrich v. Comm'r*, 457 U.S. 191 (1982) (ruling that donor realized income on gift to extent donee assumed liability in excess of donor's basis). All of the pre-transfer appreciation is essentially passed on to the donee through the basis rules of I.R.C. § 1015 (West 1998). Thus, a sale by the donee will shift the income tax consequences on the pre-transfer appreciation from the donor to the donee. For a complete discussion of the income tax benefits associated with gift-giving, see Malcolm L. Morris, *The Tax Posture of Gifts in Estate Planning: Dinosaur or Dynasty?* 64 NEB. L. REV. 25, 27-44 (1985).

159. See *supra* note 140.

benefit is to be elected.¹⁶⁰ Currently, however, the income limit operates as though the Ed IRA is a retirement vehicle (which, despite its name, it is not), applying restrictions at the time of contribution instead of at withdrawal.¹⁶¹ Section 135 of the tax code, a provision clearly analogous to Section 530, applies its income limits when the bond proceeds are used, not when the bonds are purchased. For the sake of consistency and fairness, the Ed IRA income limits, if they must exist, ought to be applied only when the funds are withdrawn. Such a change would more closely align the Ed IRA with its education benefit confreres, and move it away from the traditional IRA which, at best, is a distant cousin.

In sum, there seems to be no sound "tax" reason for retaining the "contributor income" limit. Unlike the income limits imposed in the other new education expense benefit provisions, this one can be circumvented.¹⁶² Since contributors can work around the limit without much difficulty, and perhaps may even have an income tax incentive to do so, what purpose does it serve? Admittedly, there may be some political advantage in crafting a provision that technically provides tax benefits to lower-income and middle-income taxpayers to the exclusion of their more well-to-do counterparts. But in this case, the spirit of the rule falls prey to reality. First, the cut-off point is arbitrarily drawn and cannot be said to be a useful guide in separating middle-income from upper-income taxpayers. This is especially true in that there is no distinction for taxpayers with more than one child. Second, the potential compliance costs for enforcing this falsely perceived "fairness" may be too high, and that alone justifies eliminating the limit. Perhaps more importantly, consistency with other education tax benefit sections dictate that the income limitation be reconsidered.

160. Since the education tax credits and Ed IRA income exclusion benefits are mutually exclusive, the Code gives the taxpayer the option to pick the preferred benefit. *See* I.R.C. § 530(d)(2)(C) (West 1998) (allowing the taxpayers to waive the benefits of tax-free withdrawal of deferred earnings). A similar election is found in I.R.C. § 25A(e)(1) (West 1998) with respect to taking the education tax credits. *See also* I.R.C. § 25A(e)(2) (coordinating the benefits of I.R.C. §§ 25A, 530 (West 1998)).

161. *See* I.R.C. § 219(g)(1)-(3) (West 1998) (placing income limits on deductible contributions for a taxpayer, or a taxpayer's spouse, who is an active participant in another qualified retirement plan). *See id.* § 219(g)(5).

162. *See* discussion *supra* notes 155-59 and accompanying text.

Far more significant than the contributor's income level limit is the cap imposed on the annual contribution amounts to Ed IRAs. As noted, the \$500 per year maximum contribution probably will not provide a substantial portion of the total funds needed for a full four-year college degree. Even if one were to consider the Ed IRA funds to be only complementary to other education-based tax incentives, the plan falls short. The new credits and other benefits are just too small to meet the need, especially given that some of the benefits are mutually exclusive in any given tax year.¹⁶³ Although prudent investing of consistent contributions in an Ed IRA could cover the full cost of less ambitious educational objectives, instituting a policy designed to achieve minimal targets is disingenuous at best.

The Ed IRA, however, has the potential to become a powerful college cost-funding vehicle and serve as the centerpiece for most low-income and middle-income families' education expense planning. This can be accomplished by raising the annual contribution amount. Raising the amount to \$1,000 or \$2,000 would provide a conscientious contributor the opportunity to generate meaningful college funds.¹⁶⁴

The suggested dollar figures are at the lower end of what would be an acceptable contribution cap. The higher the cap, the better the Ed IRA can serve the needs of the college-bound populace or, where appropriate, its financial sponsors. One way to permit increased contributions and ameliorate the negative impact of being a dependent taxpayer, is to interrelate the two. Thus, it is suggested that the cap rise in inverse proportion to the amount of benefit lost by reason of being a dependent taxpayer—the "dependent's reduced exemption and standard deductions amount."

This proposal does not come without a cost, but there

163. The mutual exclusivity of benefits only applies on a per student basis. Thus, for example, a taxpayer with more than one qualifying dependent in any given tax year could utilize a Hope Scholarship credit for one dependent and make a tax-free withdrawal from an Ed IRA for another.

164. Annual contributions of \$1,000 earning a 10% rate of return will create a fund worth approximately \$15,000 in 10 years and \$33,000 in 18 years. When the annual contribution is increased to \$2,000, the fund at the end of 10 years is worth \$35,000, and at the end of 18 years is worth \$100,000. These figures assume no withdrawal during the term and contributions made at the beginning of each year.

are safeguards to prevent an overwhelming revenue loss. Some are internal, having been built into the section itself. Others are external, the result of the interplay of the section with other tax rules.

Consider first the externalities at play that can minimize the overall tax cost incident to increasing the annual contribution cap in relation to the "dependent's reduced exemption and standard deduction amount." The new benefit could be fully available for only dependent children who have reportable taxable income. Presently, this would equate to \$5,850,¹⁶⁵ but it is unlikely many children would qualify for the full-proposed amount. A child would need to have substantial reportable *unearned* income to reach the proposed cap. Children with *earned* income would not necessarily benefit from the proposed increased cap because their standard deductions are not always limited. A dependent taxpayer is entitled to a standard deduction equal to his or her earned income up to the full amount allowable to non-dependent taxpayers.¹⁶⁶ Also, children who work can reduce their taxable incomes by making contributions to traditional IRAs.¹⁶⁷ By doing so, they may achieve the same, if not a better, benefit offered by an Ed IRA.¹⁶⁸ Thus, there is already an incentive for these taxpayers to make tax-favored contributions to an IRA. Since would-be contributors must choose which IRA to fund (contributions cannot exceed a set amount regardless what type of IRA is used), the proposal would not generate

165. This represents the sum of (a) the \$2,350 dependency exemption, and (b) \$3,500—the difference between the \$4,150 single taxpayer standard deduction and the \$650 allowed dependent taxpayers.

166. See I.R.C. § 63(c)(5)(B) (West 1998).

167. Deductible contributions to a traditional IRA are based on earned income. See I.R.C. § 219(f)(1) (West 1998). The deduction is used in computing adjusted gross income, so it is available to the taxpayer regardless of whether or not an election to itemize deductions has been made. See I.R.C. § 62(a)(7) (West 1998).

168. See I.R.C. § 72(t)(2)(E) (West 1998) (allowing distributions from an IRA for qualifying higher education expenses to avoid the normal 10% early withdrawal penalty). See *id.* § 72(t)(1). Thus, I.R.C. § 72(t)(7)(A) incorporates the definition of I.R.C. § 529(e)(3) (West 1998) for purposes of identifying "qualifying expenses." Although the withdrawn funds must be included in income, the benefit of penalty-free tax-deferred growth is obtained. The only added advantage of the Ed IRA is the tax-free withdrawal of the deferred earnings. Although in the traditional IRA withdrawn contributions may be included in income, that will only be true for those contributions which were deductible when made. See I.R.C. § 72(t)(1).

the full amount of expected revenue loss. The proposal, however, effectively would extend a college expense savings incentive presently available only for working children to non-working dependent children with unearned income. Also, the "bunching" effect (income earned over a period of years being withdrawn in one tax year) could push the taxpayer into a substantially higher tax bracket than would have been applicable during the years the income was actually earned. This should eliminate most of the benefits associated with the income tax accounting deferral, and further deter individuals from funding Ed IRAs with non-educational objectives in mind. Finally, transfers by parents to Ed IRAs on behalf of their children would constitute taxable gifts and have the potential to generate transfer tax liabilities. On the other hand, direct payments for college tuition by parents, or others are entirely excused from gift tax.¹⁶⁹ Thus, there are gift tax reasons to believe parents will not be so quick to fund Ed IRAs, even when some favorable income tax advantages are available.

The internal safeguards are equally effective cost control measures. Stringent withdrawal and transfer rules, together with applicable penalties, eliminate the incentive to create "tax-free" pocketbooks for children. Distributions of income that are not used for qualified expenses will be subject to tax, and a penalty, as well. Also, the beneficiary-taxpayer will only be able to use the benefit when certain other ones are not available. The current "no double benefit" rule for Ed IRAs would still apply. Finally, and quite importantly, Ed IRAs intrinsically do not provide any benefit that cannot otherwise be obtained. Remember, the taxpayer is not receiving a deduction for the contribution, but only excluding from income the earnings thereon. Distribution of the contributions themselves is treated as a return of capital and will be tax neutral. A would-be contributor could just as easily invest funds in a tax-free bond trust and receive similar tax treatment. The earnings would be tax-free, as would the return of the original investment. Moreover, if the investment appreciated in value, it would qualify for favorable capital gains rates;¹⁷⁰ if it declined in value a deductible loss would probably be

169. See I.R.C. § 2503(e)(1), (2)(A) (West 1998).

170. See I.R.C. § 1(g) (West 1998).

available.¹⁷¹ Neither is true for Ed IRAs. Although recognized asset appreciation will escape taxation if distributed for qualifying expenses, the trade-off is ordinary income tax treatment plus a potential penalty for non-qualified distributions; and in no event can a deduction ever be had if the underlying investments are sold at a loss.

Additionally, revising the contributor income level rules can eliminate some potential revenue loss. As earlier suggested, the limitation should be applied when distributions, rather than contributions, are made. By doing so, high-income taxpayers will not qualify to reap the benefit of income exclusion, although in these instances penalties should not be imposed. Moreover, the rules could operate similarly to those for the education credits, i.e., as long as the student was still a tax dependent, the income level of the taxpayer entitled to the deduction would apply.¹⁷² Such a rule would help prevent wholesale assignment of income-type transfers, and maintain the notion that the benefit is targeted to the needier taxpayers. Even if no other changes to Section 530 of the Code are made, the income contributor limitation should be revisited to determine its efficacy. Implementing the suggested changes will harmonize the restrictions with those of other Code sections. The end result will be a more consistent and appropriate tax policy.

There are ample reasons to believe expanding the Ed IRA annual contribution cap will not result in an overwhelming rush of dollars into these accounts so as to create a "budget-buster." Undoubtedly, at some point the Treasury would experience some downturn in revenues. The total amount of tax-free withdrawals should exceed any Ed IRA earnings required to be included in income plus applicable penalties thereon. If this were not the case, there would be no reason to use the tax code at all to address the problem. But the critical question is whether the expanded Ed IRA would successfully provide the financially challenged portion of the population a meaningful opportunity to meet the seemingly ever rising college costs of their children—our future workforce. If answered in the

171. See I.R.C. § 165(c)(2) (West 1998).

172. See I.R.C. § 25A(g)(3)(B) (West 1998). Moreover, this rule is not easily avoided because in defining "dependent," I.R.C. § 152(a) does not make the status elective. See *supra* note 134.

affirmative, the revenue loss is justified. Hopefully, Congress will take this view.

Any discussion directed to improving the Ed IRA that excluded the prospect of making contributions deductible would be incomplete. Clearly, immediate deductibility is a powerful incentive for contributions. But the concept is not problem-free. Some problems have already been identified, others also exist.

The most serious objection to deductible Ed IRA contributions is cost. Notwithstanding the current contributor income level limit, there are just too many taxpayers who would be eligible to take the deduction. Even with the annual contribution cap at \$500, this constitutes a per beneficiary amount, and can easily add up to a tidy sum per taxpayer. Of course, the cost for deductible contributions would be the loss of the tax-free withdrawals entirely. Both the contributions and the deferred earnings thereon would be included as income in the year withdrawn. This would be more than a fair trade-off for many taxpayers, especially if the deduction was given to the high-income bracket contributor and the withdrawals were reportable in income by a lower marginal bracket beneficiary. This model might create too attractive an assignment of income system for taxpayers to disregard.

Some objections can be addressed. The deductible amount could be adjusted to minimize the cost. It could be set at some percent of the amount contributed. Alternatively, the deduction could be allocated to the Ed IRA beneficiary, and be made available for the dependent child only as a method of minimizing the negative tax impact the current rules have on dependent taxpayers. Perhaps some fiscally responsible method of implementing a contribution deduction plan can be established, but a detailed cost-benefit analysis is in order before one is put into place. At this point, deductible Ed IRA contributions appear beyond reach.

Although deductible contributions may not be on the horizon, increasing the annual contribution amount and tinkering with the contributor income limit rules are obtainable goals. These relatively simple changes can bring big benefits. First, they will maximize the amount of money that can actually be put toward the desired goal—meeting college education expenses. The current rules are too stringent in both the limited amount that can be put away,

and the persons who qualify as contributors. Second, to the extent the change will minimize the unduly harsh impact of the kiddie tax and other child taxpayer rules, all the better.

If the purpose of the TRA '97 education package was to help taxpayers pay the way for college costs, then the improved Ed IRA complements that goal. Unlike some of the new rules, it is clearly objective-specific and thus may be better suited to meeting the stated goal. In any event, it offers a more meaningful response to the increasing costs of higher education by permitting taxpayers to make substantial down payments on their futures. To the extent approval has been given to similar state sponsored arrangements—the Qualified State Tuition Plans—it seems to make no sense to deny taxpayers without access to such plans similar rights of self-determinism. Surely, the retirement IRA was an appropriate response for taxpayers not covered by employer-sponsored plans. The expanded Ed IRA is an appropriate higher education expense analog.

CONCLUSION

The higher education expense tax rules are an unnecessarily complex set of intricately intertwined provisions. Moreover, restrictive income barriers and interrelated offsets impair their effectiveness. They do, however, represent a good start to solving a legitimate issue. If one accepts that the Code is a proper vehicle for providing this type of assistance, then perhaps it is best to do the job right. Present rules provide much too little. With some innovation, Ed IRAs can be efficient college cost funds providers. Increasing the annual contribution limit in proportion to deduction amounts that are otherwise unavailable to most children, provides a powerful incentive for self-funding and dampens the harsh tax rules applied to these individuals. Re-thinking the appropriate role of contributor income limits is also in order. Congress should not hesitate to improve upon its initial efforts and revitalize Ed IRAs with its own educational expense epiphany.