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Tax Benefits for Education in the Taxpayer Relief Act of 1997

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Summary

The Taxpayer Relief Act of 1997 (P.L. 105-34) substantially expanded tax benefits for education. Four widely publicized provisions — two new tax credits, new tax-exempt education savings accounts, and a new deduction for interest payments on education loans — can help families pay for college and other postsecondary education expenses.

Other provisions in the legislation extended the tax exclusion for employer education assistance, exempted individual retirement account (IRA) withdrawals used for higher education from early withdrawal penalties, expanded the tax exclusion for student loans that are forgiven, and authorized an enhanced deduction for corporate contributions of computer technology and equipment to elementary and secondary schools. The legislation also created new qualified zone academy bonds for public school construction

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Tax Benefits for Education in the Taxpayer Relief Act of 1997

Introduction

The Taxpayer Relief Act of 1997 that the President signed on August 5, 1997, contained tax benefits for higher education expenses paid by students and their families. With some exceptions, qualifying expenses must be incurred at institutions eligible to participate in federal student aid programs under Title IV of the Higher Education Act (hereafter called Title IV HEA institutions). Nearly all public and private colleges and universities have this eligibility, as do many vocational and proprietary schools (for-profit trade and technical schools). The Act also made other changes that affect bonds for school construction and donations of computers to elementary and secondary schools. While the Internal Revenue Code previously had provisions favoring education, the new legislation marks a significant expansion in the use of tax policy to encourage enrollment and to help families and communities pay for schools. The numerous special tax benefits for education and other purposes distinguishes the Taxpayer Relief Act from the Tax Reform Act of 1986 (P.L. 99-514), which generally reduced special incentives. For further information about these incentives, see CRS Report 97-854, *The Taxpayer Relief Act of 1997: An Overview*, by David L. Brumbaugh.

The new legislation offers families multiple ways to get tax subsidies for higher education. They can benefit in years when they save for college, when they pay tuition costs, and when they repay loans. The legislation thus supports different approaches families might take toward financing postsecondary education and gives them flexibility to change as their plans evolve.

At the same time, the new options make financial planning for college more complicated. The extent to which the tax benefits will supplement or supplant assistance provided by the Higher Education Act is not yet clear. The added complexity raises concerns that families in similar economic circumstances will receive different levels of benefits.

It is also unclear whether the new tax benefits, estimated to cost nearly $40 billion over FY1997 through FY2002, will result in additional enrollment or other investment in education. The benefits may influence some students to continue their studies (particularly after obtaining their initial degree) and some to consider a wider range of schools. However, it is likely that most of the benefits will accrue to families

whose students would enroll anyway and that some will be captured by the schools through higher tuition.[1]

This report summarizes highlights of education provisions of the Taxpayer Relief Act. It provides general information and does not cover all provisions. For more details, readers might consult either the Act itself or the statement of the conference committee, both of which are printed in part II of the *Congressional Record* for July 30, 1997.

Tax Credits

The Taxpayer Relief Act of 1997 authorized two new tax credits for family postsecondary education expenses. The **HOPE Scholarship Credit**, effective January 1, 1998, is equal to 100% of the first $1,000 of qualified tuition and fees and 50% of the next $1,000 that taxpayers pay for themselves, their spouse, or their dependents.[2] The credit may be claimed for 2 taxable years with respect to each *student*, provided the student has not completed the first 2 years of postsecondary education before the beginning of the year for which the credit is claimed. An eligible student must be enrolled (or accepted for enrollment) in a degree, certificate, or other program leading to a recognized educational credential and must carry at least one-half the normal full-time work load. The HOPE credit is not allowed for a student who has been convicted of a felony drug offense.

The **Lifetime Learning Credit**, effective July 1, 1998, is equal to 20% of the first $5,000 of qualified tuition and fees (the first $10,000 after 2002) that taxpayers pay for themselves, their spouse, or their dependents. The credit may be claimed any number of years for any level of postsecondary education; it can also apply to students who are enrolled in a single course to acquire or improve job skills.

For a particular student, either the HOPE credit, the Lifetime Learning credit, or the exclusion of distributions from education IRAs (described below) may be claimed in 1 year. However, all three tax benefits might be claimed the same year, even by one taxpayer, with respect to three different students.

The HOPE and Lifetime Learning credits are allowed for payments made to Title IV HEA institutions. Education involving sports, games, and hobbies does not qualify unless required as part of a degree program. Qualified tuition and fees do not include amounts attributable to scholarships, veterans' educational assistance, or most other payments that are excludable from gross income for tax purposes (such as certain employer tuition reimbursements). However, payments made from gifts and inheritances may be considered for the credits, as may payments made from loans.

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[1]For a discussion of these issues, see CRS Report 97-581, *Tax Subsidies for Higher Education: An Analysis of the Administration's Proposals*, by Jane Gravelle and Dennis Zimmerman.

[2]The limits on qualified tuition and fees for the credits and the modified adjusted gross income limits are indexed for inflation after 2001.

To give a simple example, consider an independent student who attends a school with tuition and fees charges of $5,000. If the student receives a $1,000 Pell Grant, a $1,000 scholarship from the school, and a $1,500 loan, qualified tuition and fees would equal $3,000 (this is, $5,000 minus the two scholarships). Subject to limitations in the following paragraph, the HOPE credit (if the student were eligible) would be $1,500 (that is, 100% of the first $1,000 paid and 50% of the next $1,000). The Lifetime Learning credit (if the student were not eligible for the HOPE credit) would be $600 (20% of the $3,000 paid).

The education credits are phased out for taxpayers with modified adjusted gross incomes over $40,000 ($80,000 in the case of a joint return). The two credits are not refundable: the sum of them and other nonrefundable credits is limited to the excess of the taxpayer's regular income tax liability over the tentative minimum tax.[3] Thus some middle income families may receive smaller education credits than would first appear to be the case. Taxpayers are not eligible for either the HOPE or Lifetime Learning credit if they can be claimed as dependents by another taxpayer (for example, students who can be claimed by their parents); however, the payments they make may be counted by the taxpayer who claims their exemption.

Education IRAs

The Taxpayer Relief Act authorized new education savings accounts which, like individual retirement accounts generally, are designated trusts held by banks and other financial entities. Custodial accounts may be treated as such trusts. Beginning January 1, 1998, annual contributions up to $500 may be made until the beneficiary for whom the account is established turns 18. The annual allowable contribution is reduced for contributors (not restricted to parents) with modified adjusted gross incomes over $95,000 ($150,000 in the case of a joint return). Contributions may not be made in years when contributions for the beneficiary are made by anyone to qualified state tuition programs.

Contributions to education IRAs are not deductible, but accounts are exempt from taxation and distributions are excluded from the beneficiary's gross income if used for qualified higher education expenses. These expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at Title IV HEA institutions, plus (in the case of students attending at least half-time) reasonable costs for room and board. The expenses do not include amounts attributable to scholarships, veterans' educational assistance, or most other payments that are excludable from gross income. Distributions are included in gross income and subject to a 10% penalty to the extent account *earnings* are not used for qualified expenses; for this purpose, it is assumed that contributions and earnings are used proportionally

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[3]The tentative minimum tax is calculated under the formula for determining the alternative minimum tax (AMT). Taxpayers can have a positive tentative minimum tax (and thus a reduction of their allowable credits) even though they do not have an AMT liability. For purposes of determining the limitation on nonrefundable credits, the regular tax liability and the tentative minimum tax are calculated in special ways.

for qualified and non-qualified expenses.[4] The 10% penalty does not apply in certain cases. Education IRA distributions cannot be excluded the same year that either the HOPE or Lifetime Learning credit is claimed for a particular student.

State Tuition Programs

The Small Business Job Protection Act of 1996 (P.L. 104-188) clarified the tax treatment of qualified state tuition programs (including prepaid tuition contracts); it generally provided that account earnings are to be included in designated beneficiaries' gross income only in the years when they receive distributions to attend school. The Taxpayer Relief Act expanded the definition of qualified higher education expenses for these programs to include reasonable costs for room and board in the case of students attending at least half-time. (As under prior law, qualified expenses also include tuition, fees, books, supplies, and equipment required for enrollment or attendance.) Among other changes, the Act also expanded the definition of eligible institution to include all Title IV HEA institutions. The former change is effective as if it had been included in the Small Business job Protection Act; the latter change is effective beginning January 1, 1998.

IRA Early Withdrawal Penalty

The Taxpayer Relief Act exempted IRA distributions used for qualified higher education expenses from the early withdrawal penalty, beginning in January 1, 1998. (The penalty otherwise applies to IRA distributions before age 59½, with a number of exceptions. It equals 10% of the amount of the distribution that is included in gross income.) Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at Title IV HEA institutions, plus (in the case of students attending at least half-time) reasonable costs for room and board. The education must be for the taxpayer or the taxpayer's spouse or child (including stepchildren), or for a grandchild of the taxpayer or of the taxpayer's spouse.

Interest Deduction

The Taxpayer Relief Act authorized a new deduction for interest payments on qualified education loans, effective January 1, 1998. The deduction is taken in calculating adjusted gross income (an "above-the-line" deduction) and so is not restricted to taxpayers who itemize. The deduction is allowed only with respect to interest paid during the first 60 months (whether or not consecutive) in which interest payments are required; it is limited to $1,000 in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001 and thereafter. The maximum allowable deduction is reduced for taxpayers with modified adjusted gross incomes over $40,000 ($60,000

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[4]For example, if a $1,000 distribution consisted of $600 in contributions and $400 in earnings and if qualified expenses were $750, then the amount excluded from gross income would be $100 (that is, $400 times [750/1,000]).

in the case of a joint return).[5] Taxpayers are not eligible for the deduction if they can be claimed as a dependent by another taxpayer.

Qualified education loans are any indebtedness incurred to pay qualified expenses of taxpayers, their spouse, or their dependents at Title IV HEA institutions or at institutions of higher education, hospitals, or health care facilities conducting internship or residency programs leading to a certificate or degree.[6] At the time the debt is incurred, students must be enrolled (or accepted for enrollment) in a degree, certificate, or other program leading to a recognized educational credential and must carry at least one-half the normal full-time work load. Qualified expenses generally equal the cost of attendance minus scholarships and other education payments excluded from taxes.

Employer Education Assistance

The Taxpayer Relief Act extended the exclusion for employer education assistance through May 31, 2000. The exclusion, in Section 127 of the Internal Revenue Code, allows tuition reimbursements and other forms of employer education assistance to be exempt from taxes of the recipient even if the education does not qualify as a deductible business expense. Qualifying education is not restricted to Title IV HEA schools. The extension does not apply to graduate-level courses.[7]

Student Loan Forgiveness

The Taxpayer Relief Act expanded the tax exclusion allowed student loans that are forgiven (in whole or in part) to include loans made by tax-exempt educational institutions (for example, private colleges) even if the funds originated from a private, nongovernmental source.[8] As under prior law, the exclusion applies only if the borrower works for a certain period of time in certain professions for any of a broad class of employers (for example, teaches in an inner-city school). There is an additional requirement for loans made by tax-exempt educational institutions from private nongovernmental sources: the loans must be issued pursuant to a program designed to encourage students to work in an occupation or area with unmet needs and provide services either for or under the direction of a tax-exempt charitable organization of governmental entity. The provision is effective for loan forgiveness after August 5, 1997.

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[5]Indexed for inflation after 2002.

[6]Qualified loans include indebtedness to refinance qualified education loans.

[7]For additional information, see CRS Report 97-243, *Employer Education Assistance: Overview of Tax Status in 1997*, by Bob Lyke.

[8]The provision also extends the exclusion to refinancing loans issued by tax-exempt entities, provided the requirement about working in an area or occupation with unmet needs is met.

Contributions of Computer Technology and Equipment

The Taxpayer Relief Act authorized an enhanced deduction for contributions of computer technology and equipment to elementary and secondary schools or to tax-exempt charitable organizations supporting elementary and secondary education. Contributions to these entities may be made through a private foundation. The property must be donated within two years after it was acquired or constructed, and it must be originally used by either the donor or the donee. The enhanced deduction, like others allowed under prior law, is limited to certain corporations; it is equal to the fair market value of the contributed property minus 50% of the ordinary income that would have been recognized had the property been sold for its fair market value. (Without this exception, the deduction would equal the corporation's basis in the property, which usually is less.) However, the enhanced deduction is limited to twice the basis of the property. The provision is effective for taxable years beginning after December 31, 1997 and before January 1, 2000 (or before January 1, 2001 according to the conference report).

Bonds

The Taxpayer Relief Act authorized tax credits for a new form of obligation called **qualified zone academy bonds**.[9] Qualified zone academies are public schools and programs that provide education and training below the postsecondary level; they must be designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, and better prepare students for college and the workforce. The academies must either be located in empowerment zones or enterprise communities[10] or have 35% or more of their students eligible for free or reduced price lunches. State and local governments may issue qualified zone academy bonds only in 1998 and 1999, subject to a national limitation of $400 million each year that is allocated proportionally to their share of the population in poverty. At least 95% of bond proceeds must be used for rehabilitating or repairing public school facilities, providing equipment, developing course materials, or training teachers and other school personnel. Private entities must contribute equipment, technical assistance, employee services, educational opportunities, and other property worth at least 10% of bond proceeds.

Qualified zone academy bonds are not tax-exempt; however, bondholders are allowed a nonrefundable tax credit based upon a credit rate that the Secretary of the Treasury determines would allow bonds to be issued without discount or interest cost to the issuer. Thus, unlike tax-exempt bonds, the federal government will pay all the interest costs. Qualified zone academy bondholders are limited to banks, insurance companies, and corporations actively engaged in the business of lending money.

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[9]For additional information and analysis of qualified zone academy bonds, see CRS Report 97-828, *Tax-Exempt Bond Provisions of the Taxpayer Relief Act of 1997*, by Dennis Zimmerman.

[10]Empowerment zones and enterprise communities are economically distressed areas that qualify for special tax incentives and other federal assistance under P.L. 103-66. See CRS Report 97-257, *Empowerment Zones/Enterprise Communities Program: Background and Analysis of Economic Issues*, by Bruce Mulock.

The Taxpayer Relief Act also repealed the $150 million ceiling on the total amount of tax-exempt bonds that can be issued by a **501(c)(3)** nonprofit organization, which include private universities. The repeal applies to bonds issued after August 5, 1997. In addition, the Act expands the **arbitrage rebate exception** allowed smaller issuers of governmental bonds. The general rule is that governmental units that do not issue more than $5 million annually in governmental bonds do not have to refund arbitrage earnings to the federal government. The Act provides that up to $5 million annually in school construction bonds issued after 1997 need not be counted for purposes of the $5 million ceiling.

Provisions not included in Act

The Taxpayer Relief Act did **not** include several education provisions that had been in the House bill (H.R. 2014) when it was first passed. One would have terminated the exclusion for qualified tuition reductions given employees (including graduate teaching assistants) of educational institutions; a second would have authorized a 50% nonrefundable credit (limited to $150) for amounts families paid for supplementary elementary and secondary education services.

Similarly, several provisions that had been in the Senate bill (S. 949) were not included: one would have allowed elementary and secondary school teachers who itemize deductions to deduct professional development expenses without regard to the 2% adjusted gross income floor; a second would have allowed tax-free withdrawals from education IRAs for elementary and secondary school expenses.[11]

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[11]The latter provision was introduced as an amendment by Senator Coverdell; it has been reintroduced as separate legislation in both the House and Senate. For details, see CRS Report 97-852, *Education Savings Accounts for Elementary and Secondary Education*, by Bob Lyke.