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Education Savings Accounts for Elementary and Secondary Education

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Summary

The Taxpayer Relief Act of 1997 (P.L. 105-34) that President Clinton signed on August 5, 1997, authorized new education individual retirement accounts (education IRAs) for higher education expenses. When the legislation was enacted, identical bills were introduced in both the House (H.R. 2373) and Senate (S. 1133) to increase annual contribution limits from $500 to $2,000 and allow accounts to be used for elementary and secondary education expenses. The bills are similar to an amendment introduced by Senator Coverdell that the Senate adopted during initial floor consideration of the Taxpayer Relief Act. The amendment was not included in the conference agreement because of a threatened veto by the President.

Legislation similar to these bills was approved by the House on October 23, 1997 (a modified version of H.R. 2646) and the Senate on April 23, 1998 (an amendment to H.R. 2646). The June 10th conference agreement would increase the annual contribution limit to $2,000 through the year 2002; thereafter, annual contributions would again be limited to $500. The agreement would also make several technical amendments to education IRAs and permit contributions and accounts to continue without age limit for special needs students. In addition, it would expand other education tax incentives and make other changes to federal education law. The House approved the conference agreement on June 18th. The President has said he would veto it.

The principal issue raised by these bills is whether the federal government should support more family choice of elementary and secondary schools, both public and private. Questions have also been raised about possible compliance problems and whether the legislation would help lower income families.

Current Law

Current law provides a number of tax allowances for family higher education expenses, including tax credits (the HOPE and Lifetime Learning credits), exclusions and deferrals to encourage saving (for Education IRAs, U.S. savings bonds, and state prepaid tuition programs), a deduction for interest payments on student loans, and an exclusion for employer education assistance. In contrast, there are no comparable tax allowances for what families spend on elementary and secondary education: tuition, books, equipment, activity fees, uniforms, transportation, and other costs. Congress has several times debated elementary and secondary school tuition tax credits, but no legislation that would authorize them has been reported from committee since 1983.[1]

Elementary and secondary education receives some indirect tax benefits. Public schools benefit from the deduction of state and local taxes (limited to taxpayers who itemize) and the exclusion of interest on school construction bonds. Public and private schools both benefit from the deduction for charitable contributions (for taxpayers who itemize and corporations). Private schools are tax-exempt, so their income is not subject to taxation. Their scholarships are also not taxed. The sum of these indirect tax benefits may be comparable to federal grants currently available for elementary and secondary education.

Current Legislation

The legislation discussed in this report would amend the Education IRA provisions of the Internal Revenue Code that were included in the Taxpayer Relief Act of 1997.[2] These provisions authorize contributions of up to $500 a year to education investment accounts for beneficiaries under age 18, beginning in 1998. The $500 limit is reduced for taxpayers with modified adjusted gross incomes over $95,000 ($150,000 for joint returns). Contributions are not deductible, but accounts are exempt from taxation and distributions are excluded from beneficiaries' gross income if used for higher education tuition, fees, books, supplies, equipment, and certain room and board expenses. The exclusion cannot be claimed the same year that either the HOPE or the Lifetime Learning credit is claimed for the student. The conference report states that account balances will be deemed to be distributed when the beneficiary reaches age 30.[3]

The "Parents and Students Savings Account PLUS Act" (H.R. 2373 and S. 1133, introduced by Speaker Gingrich and Senator Coverdell, respectively) would raise the annual contribution limit of Education IRAs to $2,000 and allow accounts to be used in any proportion for elementary and secondary as well as higher education expenses. Qualifying K-12 expenses would include "tuition, fees, tutoring, special needs services, books, supplies, equipment, transportation, and supplementary expenses required for the enrollment or attendance of the designated beneficiary of the trust at a public, private, or sectarian school." Homeschooling expenses would also qualify if that education met State or local requirements.

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[1] For information about family higher education tax allowances, see CRS Report 97-915, *Tax Benefits for Education in the Taxpayer Relief Act of 1997*, by Bob Lyke.

[2] New Code Section 530 established by Section 213 of the Act.

[3] The age limitation is not included in the statutory language of the Taxpayer Relief Act. The "Tax Technical Corrections Act of 1997" (H.R. 2645) that the House Committee on Ways and Means approved on October 9, 1997, would amend the statutory language to include it.

House Legislation. H.R. 2646 (the "Education Savings Act for Public and Private Schools") is similar to H.R. 2373 and S. 1133, but it would allow contributions of up to $2,500 a year. It would clarify that contributions may be made by corporations. (If contributions were made to employees' children's accounts, they would be taxable to the employees.) In addition, it would allow contributions for a special needs beneficiary (as defined by Treasury Department regulations) to continue after the child turned 18. Accounts for such children would not have to be terminated at age 30. The House Ways and Means Committee approved H.R. 2646 on October 9, 1997, and the House passed it on October 23, 1997, (with a provision restricting the increased annual contribution limit to 5 years. Thus, after December 31, 2002, contributions to accounts would be limited to $500 and could be used only for higher education expenses. To offset the revenue loss, the House bill would prospectively overturn a Tax Court decision (*Schmidt Baking Company, Inc. v. Commissioner*) regarding deductions for accrued vacation and severance pay.

Senate Legislation. On February 10, 1998, the Senate Committee on Finance approved S. 1133 (the "Parent and Student Savings Account PLUS Act") with an amendment in the nature of a substitute. As reported, the legislation would increase the annual contribution limit to $2,000 for 5 years (subject to the same sunset provision as in H.R. 2646) and also allow contributions for a special needs beneficiary to continue after the child turned 18. Accounts for such children would not have to be terminated at age 30. It too would clarify that corporations could make contributions. In addition, the reported legislation would expand other education tax incentives: (1) it would allow an exclusion for distributions from qualified state tuition programs (currently, distributions are partly included in the gross income of the student); (2) it would expand the exclusion for employer education assistance to include graduate-level courses and through 2002);[4] (3) it would increase the small issuer arbitrage rebate exception for tax-exempt bonds to $15 million, provided at least $10 million of the bonds are issued to finance public schools; and (4) it would allow an exclusion for certain amounts received under the National Health Corps scholarship program notwithstanding obligations of recipients to provide medical services in the future. Two revenue loss offsets were included: one similar to the House provision regarding accrued vacation pay (but not accrued severance pay) and another changing the foreign tax credit carryover period.

The Senate had begun debating H.R. 2646 on October 29, 1997, but suspended further consideration on November 4, 1997, after the failure of a second cloture motion. Reconsideration resumed on March 13, 1998. On March 18th, the Senate adopted amendment number 2019 (introduced by Senator Roth) which incorporated S. 1133 as reported; it also included a provision allowing tax exempt facility bonds to be used for certain public school construction.[5] On March 27th, there was a unanimous consent agreement to postpone further debate until April 20th.

During the week of April 20th, the Senate concluded debate on the legislation. In addition to the March 18th amendment, the Senate adopted amendments dealing with federally sponsored testing, student improvement incentive awards, teacher testing and

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[4] For further information, see CRS Report 97-243, *Employer Education Assistance: Overview of Tax Status in 1998*, by Bob Lyke.

[5] Amendment 2019 is printed in the *Congressional Record* for March 18, 1998, p. S2222-2224.

merit pay, same gender schools and classrooms, block grants, programs to encourage reading, dropout prevention, multilingualism, and safer schools.[6]

Conference Agreement. The conference committee on H.R. 2646 (renamed the "Education Savings and School Excellence Act of 1998") announced its agreement on June 10, 1998. The agreement includes the following tax provisions, among others:

- it would increase the annual contribution limit from $500 to $2,000 beginning in 1999 and continuing through the year 2002;
- with respect to contributions made from 1999 through 2002 (and the earnings thereon), it would allow tax-free distributions from Education IRAs for elementary and secondary education, including private schools;
- it would clarify that income limits on contributors apply only to individuals, not corporations or other entities;
- it would waive the age limits for contributions and continuation of accounts for special needs students;
- it would exempt from taxation disbursements from qualified state tuition programs that are used for qualified higher education expenses (currently, only amounts attributable to contributions are excluded);
- it would allow private colleges to offer qualified tuition programs as well (with the same tax treatment as state programs) beginning in 2006, though only for prepaid tuition programs and only if contributions for a beneficiary do not exceed $5,000 annually or $50,000 in total;
- it would extend the exclusion for employer education assistance (Section 127) for courses below the graduate level from May 31, 2000 to December 31, 2002;
- it would increase the small issuer arbitrage rebate exception for tax-exempt bonds to $15 million, provided at least $10 million of the bonds are issued to finance public schools;
- it would provide that National Health Corps Scholarships and F. Edward Herbert Armed Forces Health Professions Scholarships would be eligible for tax-free treatment under Section 117;
- it would overturn the Tax Court decision in *Schmidt Baking Company, Inc. v. Commissioner* regarding deductions for accrued vacation and severance pay, effective for taxable years ending after December 31, 2001.

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[6] For additional information on these issues, see CRS Report 97-774, *National Tests: Administration Initiative*, by Wayne Riddle; CRS Report 97-972, *Reading Instruction: New Federal Initiatives*, by Wayne Riddle; and CRS Issue Brief 98013, *Elementary and Secondary Education Block Grant Proposals in the 105th Congress*, by Wayne C. Riddle and Paul M. Irwin.

In addition, the conference agreement adopted some non-revenue education measures. The House approved the agreement on June 18th by a vote of 225 to 197. In a June 16th letter, the President said that he would veto the legislation if Congress approved it.

Education Savings Account Issues

Extending Education IRAs to elementary and secondary education would demonstrate greater federal commitment for school choice. Whether families should have more options in selecting schools is a matter of increasing debate, particularly if sectarian and other private schools are included. Proponents of choice argue that parents should be allowed to choose schools for their children without losing public subsidies. Opponents maintain that allowing greater choice would fragment the school age population and erode support for public education. Conflicting concerns about the continuing problems of public schools (particularly in inner cities), academic standards, racial integration, and constitutionality complicate the issue.[7]

The tax benefits of Education IRAs would grow slowly: $2,500 invested at 6% would increase in 5 years to $3,089 if it were taxed (at 28%) and $3,346 if it were tax exempt, a difference of $257.[8] Even after 10 years, the difference would be only $661. Whether tax savings of this magnitude would change enrollment decisions might be doubted; the principal effect might be to subsidize families that would elect other schools anyway. Of course, the tax savings would be greater if $2,500 were saved each year and no withdrawals were made until the child were in high school. However, tax savings would be smaller if a family's marginal tax rate were 15% ($140 after 5 years and $366 after 10 years), and they would be nonexistent if the family did not have any tax liability or otherwise were unable to save. Some of what families save on taxes would be offset if schools increased fees in response to the legislation.

The proposed legislation raises several compliance questions. While payments families make for tuition could easily be traced, what they spend for tutoring, books, supplies, equipment, transportation, and supplementary expenses might not be. Receipts might not have adequate documentation (or be kept), and they might not prove that only the student benefitted. Documentation may be especially difficult for homeschooling. Education expenses are not inherently difficult to trace, but procedures (possibly involving schools) would be to be developed that ensure compliance without burdening either families or the Internal Revenue Service.

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[7] For a discussion of issues regarding school choice, see CRS Report 95-344, *Federal Support of School Choice: Background and Options,* by Wayne C. Riddle and James B. Stedman.

[8] In 1997, married couples filing joint returns are taxed at 15% on the first $41,200 of taxable income and 28% on taxable income over $41,200 up through $99,600.