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Education Savings Accounts for Elementary and Secondary Education

Bob Lyke and James B. Stedman
Specialists in Social Legislation
Domestic Social Policy Division

Summary

The Taxpayer Relief Act of 1997 (P.L. 105-34) authorized new education savings accounts ("education IRAs") for higher education expenses. From the time of enactment, attempts have been made to raise the $500 annual contribution limit and allow accounts to be used for elementary and secondary education, including private and home schooling. Legislation to accomplish these objectives passed in the 105th Congress (H.R. 2646) but was vetoed by the President. In the 106th Congress, similar provisions were included in the omnibus tax bill (H.R. 2488) that the President vetoed in September, 1999 and in bills that the Senate passed on March 2, 2000 (S. 1134) and that the House Ways and Means Committee approved March 22 (H.R. 7).

During the election campaign, President-elect Bush also advocated raising contribution limits to and allowing accounts to be used for elementary and secondary education.

The most prominent issue raised by these proposals is whether the federal government should assist families whose children are educated in private schools or at home. Policy questions include what effect such assistance would have on public schools and student performance, and whether it would be constitutional. Concerns have also been expressed that the legislation would create compliance problems and is most likely to benefit better-off families.

Current Law

Education individual retirement accounts (education IRAs) are investment accounts for individuals that families can use to save for higher education expenses. The accounts were authorized by the Taxpayer Relief Act of 1997 (P.L. 105-34) along with other measures to help parents and students pay college costs. Contributions to education IRAs can be made until beneficiaries are age 18; the annual limit is $500, though this amount is reduced and then eliminated for contributors with modified adjusted gross incomes

between $95,000 and $110,000 ($150,000 and $160,000 for joint returns). Contributions are not deductible, but accounts are exempt from taxation and distributions are excluded from beneficiaries' gross income if used for qualified higher education expenses: tuition, fees, books, supplies, equipment required for enrollment or attendance, and certain room and board expenses.[1] Qualifying expenses must be incurred at institutions eligible to participate in federal student aid programs under Title IV of the Higher Education Act. This includes nearly all public and private colleges and universities, as well as many vocational and proprietary schools (for-profit trade schools). Distributions for other purposes generally are taxable, and a 10% penalty applies. The exclusion cannot be claimed the same year either the Hope or the Lifetime Learning credit is claimed for the student (see CRS Report 97-915, *Tax Benefits for Education in the Taxpayer Relief Act of 1997: New Legislative Developments*). Remaining balances must be distributed when beneficiaries reach age 30.

106th Congress Legislation

The Affordable Education Act of 2000 (S. 1134) that the Senate passed on March 2, 2000, would have changed the education IRA provisions in a number of ways. Almost identical changes would have been made by the Education Savings and School Excellence Act of 2000 that the House Ways and Means Committee approved on March 22nd.[2] Both bills would have raised the annual contribution limit from $500 to $2,000 and allowed contributions to be made up until the regular filing date for the tax year (normally April 15th). Distributions would have been tax-free if used either for qualified higher education expenses (as under current law) or for qualified elementary and secondary education expenses. The latter would have included:

(1) tuition, fees, academic tutoring, special needs services, books, supplies, computer equipment (including related software and services) and other equipment which are incurred in connection with the enrollment or attendance of the designated beneficiary of the trust as an elementary or secondary school student at a public, private, or religious school, and

(2) room and board expenses, uniforms, transportation, and supplementary items and services (including extended day programs) which are required or provided by a public, private, or religious school in connection with such enrollment or attendance.

These provisions would have applied to students attending schools which provide kindergarten through grade 12 education as determined under state law, including homeschooling if it operates as a private or homeschool under state law (in S. 1134) or if it meets requirements of applicable state and local law (in H.R. 7).

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[1] Qualifying expenses include contributions to state tuition programs.

[2] Comparable provisions had been in the Taxpayer Refund and Relief Act of 1999 (H.R. 2488) that the President vetoed on September 23, 1999.

Additional changes would have included the following: (1) the accounts would have been renamed "education savings accounts"; (2) contributions to accounts of beneficiaries with special needs (i.e., with disabilities) could have occurred after age 18 and their accounts could have continued after age 30; (3) contributors other than individuals (e.g., corporations) would not have been subject to income ceilings; (4) beneficiaries could have excluded distributions from their accounts and claim the Hope Scholarship or Lifetime Learning tax credit the same year (though not for the same expenses); and (5) in S. 1134 only, eligibility for the credit for joint returns would have phased out between $190,000 and $220,000, not $150,000 to $160,000.

Both S. 1134 and H.R. 7 would have amended other tax provisions dealing with education, such as exempting distributions from state tuition plans from taxation and allowing schools to set up prepaid tuition plans; S. 1134 included non-tax education provisions as well.

Issues

The most prominent issue raised by these proposals is whether the federal government should assist families whose children are educated in private schools or at home. Concerns have also been expressed that the amendments would create compliance problems and are more likely to benefit affluent families.

Private and Home Schooling

Expanding education savings accounts to cover private elementary and secondary school and home schooling expenses is a matter of contentious debate. To some observers, it would be a significant departure from the traditional federal role in elementary and secondary education, potentially contributing to a shift of enrollment and resources from public schools; to others, it would be an appropriate addition to the nationwide movement for more parental choice among schools. This section considers whether the proposed expansion would be precedent setting and the extent of the assistance it might provide. It also addresses the issues that arise within the school choice context, including the impact on public schools, impact on student achievement, and constitutionality of providing this aid.

Federal Assistance for Private Elementary and Secondary Education. S. 1134 and H.R. 7 would not have provided the first federal subsidy for private schooling. Current tax law allows a deduction for charitable contributions to private schools (for taxpayers who itemize and corporations), and also exempts the income of those schools from taxation. Scholarships are also not taxed unless used for room and board. In addition, many federal education programs require states and local school districts to ensure that eligible private school students and their teachers participate in federally funded services on an equitable basis. These programs do not require that federally funded services be provided to students being schooled at home, though some may permit local school districts to do so.

It could be questioned whether the proposed change would have resulted in enough tax savings to affect enrollment decisions; the principal effect might be to subsidize families that would choose private schools anyway. Tax benefits might not be of consequence

unless maximum contributions were made each year and distributions were delayed until the children were in secondary school. For example, $2,000 contributions made each year and invested at 6% would increase in 5 years to $13,373 if earnings were taxed at 28% and $13,950 if they were untaxed, a difference of only $578. After 10 years, the difference would be $2,519. If the family were in the 15% tax bracket, the tax savings would be $313 after 5 years and $1,381 after 10 years.

Furthermore, only a portion of the aggregate subsidy for all families would likely go to private or home schooling. Many families — even those with private school students — might prefer to use their accounts only for higher education expenses. Of those that withdrew funds earlier, many would still have children enrolled in public schools, using the distribution for tutoring, books and supplies, etc.

School Choice. Expanding education savings accounts to include private schools can be viewed as another option to increase family choice in elementary and secondary education. The motivation for this effort arises from various sources, including widespread dissatisfaction with the performance of public schools, a belief by some that private schools are more effective educationally, a desire on the part of many parents to create better matches between school programs and students' abilities and interests, and advocacy by some policymakers and others that, in principle, public funding be available to schools that are not organized and run by governmental agencies.

Public financing or support of private school attendance is currently provided in a few states and localities in the form of vouchers used to pay for private school expenses or tax benefits. Publicly funded vouchers to finance enrollment at private schools, including religiously affiliated schools, have been established in Florida (for students in failing public schools), Wisconsin (for low-income students in Milwaukee) and Ohio (for low-income students in Cleveland). Iowa and Minnesota provide state tax deductions for private school tuition and fees. Arizona provides a state income tax credit for contributions to scholarship programs that cover private and religious school tuition. For information on the current status of these programs and recent court decisions affecting them, see CRS Issue Brief IB98035, *School Choice: Current Legislation*.

Impact on Public Schools. In general, there is no consensus as to the impact that school choice involving private schools and home schooling might have on public schools. If total public support for education is fixed, then increased allocations (through direct grants and tax subsidies) for private schooling would leave less for public schools. Further, overall public financial and other support for public schools might diminish if the public aid prompted additional families to turn to private schools or home schooling, particularly if these families had previously worked to improve their public schools.

To the extent that education savings accounts foster movement from the public sector, it may affect the distribution of students from different racial, ethnic, or income groups among schools. Whether this movement will lead to appreciably greater separation of these groups than already exists is open to debate. Nevertheless, as noted below, the benefits of education savings accounts are likely to be concentrated among students from middle income families.

A loss of students to the private sector or home schooling may prompt public schools to identify problems that led to this exodus and take steps to retain students and attract

others. Advocates of public aid for private education often anticipate such a marketplace response by public schools. Whether this will occur is uncertain. An enrollment loss might reduce the financial resources that public schools could use for reform. Further, the potentially modest benefits for most families from expanded education savings accounts might not lead enough students to change sectors to encourage reform by public schools.

Student Achievement. One argument for including private schools in publicly-funded choice programs is that students who select those schools will improve their academic performance. This contention is hotly debated with no conclusive evidence that simply by virtue of enrolling in a private school, a student's academic achievement will be higher than if that same student enrolled in a public school. Much of the current research on this issue is being done on the Milwaukee and Cleveland voucher programs with different analysts reaching significantly different conclusions.

Constitutionality. A central question is whether the U.S. Constitution would permit public support for private elementary and secondary education when students attend religiously-affiliated schools. CRS Report RL30165, *Education Vouchers: Constitutional Issues and Cases*, concludes that indirect public aid to private sectarian schools is likely to be found constitutional by the U.S. Supreme Court "if the benefits are made available on a religion-neutral basis and if the initial beneficiaries (the taxpayers or voucher recipients) have a genuine choice about where to use the assistance." Education savings accounts as they would have been expanded under S. 1134 and H.R. 7 appear to have these attributes since accounts could be used for public school expenses. However, recent state and federal court decisions on education voucher programs have conflicting conclusions with respect to constitutionality.

Compliance

Under current law, distributions from education savings accounts are tax-exempt if used for tuition, fees, books, supplies, equipment required for enrollment or attendance at eligible institutions of higher education, and for certain room and board expenses. Most of these expenses are determinable and can be traced.[3] In contrast, the proposed list of qualified elementary and secondary school expenses in S. 1134 and H.R. 7 is more open-ended. Aside from tuition and fees, expenses that would be allowed *in connection with* enrollment or attendance (those included in category (1) on page 2) do not have clear limits. Unlike qualified higher education expenses, they would not have to be required by the school; thus, taxpayers would have more leeway to purchase what they want. For example, families might spend $500 to get a basic computer and monitor, or they might spend $3,000 to get a computer with more speed and capacity and a monitor that is more stylish. For the most part families would use their own resources for these expenditures (that is, they would be spending what they contributed to the accounts), so arguably they would make prudent purchases. But even prudent purchases might be questioned to the extent they involve publicly subsidized tax benefits.

There are two separate questions involved. One is whether education expenses are inherently difficult to define. While tuition payments have a clear purpose, expenditures

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[3] Whether the Internal Revenue Service can easily verify these expenses is another matter. Complications arise when taxpayers receive scholarships or withdraw from courses.

for computers, software, books, and room and board may involve a mixture of educational and personal objectives that cannot easily be separated.[4] The problem may be especially complex in the case of home schooling. Perhaps regulatory language could resolve most questions (or at least set reasonable limits), just as it does in other areas of taxation. But at the moment such guidance is not available for education at the elementary and secondary level. The other question is what documentation would be required to demonstrate compliance. What receipts should families be required to keep, and what information should be included on them? Would families have to list their expenses on their tax returns? Would schools and tutors have to submit information returns to the Internal Revenue Service? As in other areas of taxation, appropriate documentation involves balancing compliance needs against paperwork burdens and other administrative costs.

Equity

Education savings accounts would largely benefit families that have the wherewithal to save. Most would be middle income. High income families — those with incomes above the contribution ceilings (currently $160,000 for married couples filing jointly) — generally would not have accounts, though contributions might be made by grandparents and other family members, friends, or even the children themselves.[5] Lower income families generally would be unlikely to save, at least not $2,000 a year, though contributions for their children could also come from others. Among middle income families, those with higher incomes and the discipline to save would be the most likely contributors.[6]

For families that do save, the tax benefits of an education savings account would depend on their marginal tax rate and thus would also be related to income. Families in the 15% statutory tax bracket (in 2000, taxable incomes up to $43,850 for married couples filing jointly) generally would save $15 each year on $100 of account earnings, while those in the 28% bracket (taxable incomes over $43,850 but not over $105,950) would save $28. If families had no tax liability (if their income were completely offset by their standard deduction and personal and dependent exemptions), they would not benefit.

To the extent education savings accounts are used for higher education, the higher tax benefits might be justified since lower income families often are eligible for additional student aid. For elementary and secondary education, however, the federal government does not provide direct assistance to lower income families. For this education, it would seem inequitable to provide larger tax benefits to higher income families and possibly none to lower income families. On the other hand, lower income families do have access to free public education.

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[4] For computers in particular, personal benefits may extend to other family members.

[5] Some higher income families may have started education savings accounts when their income was lower. The legislation does not explicitly preclude parents from transferring assets to their children so they can make contributions.

[6] As is the case with other tax-advantaged accounts, some families might transfer funds from taxable accounts into their education savings accounts rather than increase their total saving.