Order Code RS20289
Updated August 23, 2001

CRS Report for Congress

Received through the CRS Web

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 (then called education IRAs) for higher education expenses. From the time of enactment, attempts were made to increase the $500 annual contribution limit and allow accounts to be used for elementary and secondary education, including private and religious schools. Legislation to accomplish these objectives passed in both the 105th and 106th Congresses but was vetoed by President Clinton.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) that President Bush signed on June 7, 2001, includes these changes, effective after 2001. The most prominent issue they raise is whether the federal government should assist families whose children are educated in private schools. Policy questions include what effect such assistance might 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. P.L. 107-22 renamed the accounts Coverdell education savings accounts.

Current Law for 2001

Coverdell education savings accounts 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; they were then called education individual retirement accounts (education IRAs). Contributions to Coverdell education savings accounts can be made until beneficiaries are age 18; the annual limit is $500 per beneficiary, 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 may not be made in any year if they are also made to a qualified state tuition savings plan for the same beneficiary. 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. 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.

107th Congress Legislation

The Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836, P.L. 107-16) that President Bush signed on June 7, 2001, includes provisions raising contribution limits and extending use of the accounts to elementary and secondary education.[1] The changes are effective for tax years that begin after December 31, 2001.

Specifically, P.L. 107-16 does the following:

- raises the annual contribution limit per beneficiary to $2,000;
- expands qualified distributions to include certain elementary and secondary education expenses (as defined below);
- raises the income phase-out range for married couples making contributions to $190,000 to $220,000;
- allows contributions for special needs beneficiaries to continue beyond age 18 and does not require their accounts to be distributed by age 30;
- clarifies that corporations and other entities (such as tax-exempt organizations) may make contributions without regard to income limits;
- allows contributions for a year to be made up until the normal due date for tax returns (usually April 15th);
- allows beneficiaries to exclude distributions and claim the Hope Scholarship or Lifetime Learning tax credit the same year (though not for the same expenses); and
- allows contributions the same year that contributions are made to a qualified tuition savings plan.

Qualified elementary and secondary education expenses are defined as follows:

---

[1] Similar provisions were in S. 763, which the Senate Finance Committee reported on April 24, 2001 (S.Rept. 107-12). President Bush included the expansions in his Fiscal year 2002 budget except that he recommended a $5,000 annual contribution limit.

- expenses for tuition, fees, academic tutoring, special needs services in the case of a special needs beneficiary, books, supplies, and other equipment which are in connection with the beneficiary's enrollment or attendance at a public, private, or religious school;

- expenses for room and board, 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; and

- expenses for the purchase of any computer technology or equipment or internet access and related services if they are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school.[2]

The term "school" means any school which provides elementary or secondary education (kindergarten through grade 12) as determined by state law. In contrast to legislation in previous Congresses, homeschooling expenses were not explicitly included.

P.L. 107-22 (S. 1190), signed July 26, 2001, changed the name of the accounts from education IRAs to Coverdell education savings accounts in honor of the late Senator.

Issues

Private Schooling

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

Federal Assistance for Private Elementary and Secondary Education. The Coverdell education savings account expansion does not provide 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.

---

[2] Not included are expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.

One might question whether Coverdell education savings account expansion will result in enough tax savings to affect enrollment decisions; the principal effect might be to subsidize families that would choose private schools anyway. Tax benefits may not be of consequence unless maximum contributions are made each year and distributions are 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.

Only a portion of the aggregate subsidy for all families is likely go to private schooling. Many families — even those with private school students — might prefer to use their accounts 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 Coverdell 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. There is no consensus as to the impact that school choice involving private schools 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 public aid prompted additional families to turn to private schools, 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, they 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 may prompt public schools to identify problems that led to this exodus and take steps to retain students. Advocates of public aid for private education often anticipate such a marketplace response by public schools. How often this will occur is uncertain. An enrollment loss might reduce the financial resources that public schools could use for reform. Further, the modest benefits for most families from expanded Coverdell education savings accounts might not lead to enough students changing 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." The current expansion of Coverdell education savings accounts appears 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.

Compliance

Currently, distributions from Coverdell 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 list of qualified elementary and secondary school expenses is more open-ended and in some cases without clear limits. Taxpayers may have more leeway to spend what they want: for example, families might spend $800 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. Families would largely use their own resources for these expenditures (that is, they would be spending what they contributed to the accounts), so arguably they will make prudent purchases. But even prudent purchases might be questioned to the extent they involve publicly subsidized tax benefits.

Two separate questions are involved. One is whether education expenses are inherently difficult to define. While tuition payments have a clear purpose, expenditures for computers, software, books, and room and board often involve a mixture of educational and other objectives (e.g. family or recreational) that cannot easily be

---

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

separated.[4] 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 will be required to demonstrate compliance. What receipts should families be required to keep, and what information should be included on them? Will 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 largely benefit families that have the wherewithal to save. Probably most will be middle income. High income families — those with incomes above the contribution ceilings — generally will 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 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 a Coverdell education savings account depend on their marginal tax rate and thus are also related to income. Families in the 15% statutory tax bracket (in 2001, taxable incomes up to $45,200 for married couples filing jointly) generally would save $15 each year on $100 of account earnings, while those in the new 27% bracket (taxable incomes over $45,200 but not over $109,250) would save $27. 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 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.

---

[4] The conference committee on H.R. 1836 was particularly concerned about this issue with respect to computers and changed the language that had been in the Senate amendment.

[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.