

**DESCRIPTION OF CHAIRMAN'S MARK OF THE
"AFFORDABLE EDUCATION ACT OF 2001"**

Scheduled for Markup

By the

SENATE COMMITTEE ON FINANCE

on March 13, 2001

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION



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CONTENTS

	<u>Page</u>
INTRODUCTION	1
I. MODIFICATIONS TO EDUCATION IRAS	2
II. PRIVATE PRE-PAID TUITION PROGRAMS; EXCLUSION FROM GROSS INCOME OF EDUCATION DISTRIBUTIONS FROM QUALIFIED TUITION PROGRAMS	6
III. EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE	9
IV. MODIFICATIONS TO STUDENT LOAN INTEREST DEDUCTION	11
V. ELIMINATE TAX ON AWARDS UNDER THE NATIONAL HEALTH SERVICE CORPS SCHOLARSHIP PROGRAM AND THE F. EDWARD HEBERT ARMED FORCES HEALTH PROFESSIONS SCHOLARSHIP AND FINANCIAL ASSISTANCE PROGRAM	12
VI. TAX BENEFITS FOR CERTAIN TYPES OF BONDS FOR EDUCATIONAL FACILITIES AND ACTIVITIES	13

INTRODUCTION

The Senate Committee on Finance has scheduled a markup on March 13, 2001, on a proposed Chairman's mark of the "Affordable Education Act of 2001". This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark. It contains a description of proposals to (1) modify the rules relating to Education IRAs; (2) establish private-prepaid tuition programs and provide an exclusion from gross income for certain distributions from qualified tuition programs; (3) expand and extend the exclusion for employer-provided educational assistance; (4) modify the student loan interest deduction; (5) eliminate tax on certain awards; and (6) modify the tax treatment of certain types of bonds for educational facilities and activities.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Mark of the "Affordable Education Act of 2001"* (JCX-9-01), March 9, 2001.

I. MODIFICATIONS TO EDUCATION IRAS

Present Law

In general

Section 530 of the Internal Revenue Code (the “Code”) provides tax-exempt status to education individual retirement accounts (“education IRAs”), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary. Contributions to education IRAs may be made only in cash.² Annual contributions to education IRAs may not exceed \$500 per beneficiary (except in cases involving certain tax-free rollovers, as described below) and may not be made after the designated beneficiary reaches age 18.

Phase-out of contribution limit

The \$500 annual contribution limit for education IRAs is generally phased out ratably for contributors with modified adjusted gross income (“AGI”) between \$95,000 and \$110,000. The phase-out range for married taxpayers filing a joint return is \$150,000 to \$160,000 of modified AGI. Individuals with modified AGI applicable above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any individual.

Treatment of distributions

Earnings on contributions to an education IRA generally are subject to tax when withdrawn. However, distributions from an education IRA are excludable from the gross income of the beneficiary to the extent that the total distribution does not exceed the “qualified higher education expenses” incurred by the beneficiary during the year the distribution is made.

If the qualified higher education expenses of the beneficiary for the year are less than the total amount of the distribution (i.e., contributions and earnings combined) from an education IRA, then the qualified higher education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable (i.e., the portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary’s gross income.

The earnings portion of a distribution from an education IRA that is includible in income is also subject to an additional 10-percent tax. The 10-percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

² Special estate and gift tax rules apply to contributions made to and distributions made from education IRAs.

The additional 10-percent tax also does not apply to the distribution of any contribution to an education IRA made during the taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

Qualified higher education expenses

The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Moreover, the term qualified higher education expenses includes certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee’s gross income under section 127.

Present law also provides that, if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from an education IRA, then no deduction (e.g., for trade or business expenses), exclusion (e.g., for interest on education savings bonds) or credit is allowed with respect to such expenses.

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary

institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Time for making contributions

Contributions to an education IRA for a taxable year are taken into account for the taxable year in which they are made.

Coordination with HOPE and Lifetime Learning credits

If an exclusion from gross income is allowed for distributions from an education IRA with respect to an individual, then neither the HOPE nor Lifetime Learning credit may be claimed in the same taxable year with respect to the same individual. However, an individual may elect to waive the exclusion with respect to distributions from an education IRA. If such a waiver is made, then the HOPE or Lifetime Learning credit may be claimed with respect to the individual for the taxable year.

Coordination with qualified tuition programs

An excise tax is imposed if a contribution is made by any person to an education IRA during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

Description of Proposal

Annual contribution limit

The proposal would increase the annual education IRA contribution limit from \$500 to \$2,000. Thus, under the proposal, aggregate contributions that may be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary would be limited to \$2,000 for each year.

Special needs beneficiaries

The proposal would provide that the rule prohibiting contributions to an education IRA after the beneficiary attains 18 would not apply in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA would not occur when a special needs beneficiary reaches age 30.

Contributions by persons other than individuals

The proposal would clarify that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution.

Contributions permitted until April 15

Under the proposal, individual contributors to education IRAs would be deemed to have

made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's Federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally would be allowed to make contributions for a year until April 15 of the following year.

Coordination with HOPE and Lifetime Learning credits

The proposal would allow a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the contributions and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

Coordination with qualified tuition programs

The proposal would repeal the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

Redesignation of education IRAs as education savings accounts

The proposal would rename "education IRAs" as "education savings accounts."

Effective Date

The provisions modifying education IRAs would be effective for taxable years beginning after December 31, 2001.

II. PRIVATE PRE-PAID TUITION PROGRAMS; EXCLUSION FROM GROSS INCOME OF EDUCATION DISTRIBUTIONS FROM QUALIFIED TUITION PROGRAMS

Present Law

Section 529 of the Code provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a "savings account plan"). The term "qualified higher education expenses" generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution,³ as well as certain room and board expenses for any period during which the student is at least a half-time student.

No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.⁴

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.⁵ Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified State tuition program), unless

³ An "eligible education institution" is defined the same for purposes of education IRAs (described in Part I, above) and qualified State tuition programs.

⁴ Distributions from qualified State tuition programs are treated as representing a pro-rata share of the contributions and earnings in the account.

⁵ Special estate and gift tax rules apply to contributions made to and distributions made from qualified State tuition programs.

the beneficiaries are members of the same family. For this purpose, the term "member of the family" means: (1) the spouse of the beneficiary; (2) a son or daughter of the beneficiary or a descendent of either; (3) a stepson or stepdaughter of the beneficiary; (4) a brother, sister, stepbrother or stepsister of the beneficiary; (5) the father or mother of the beneficiary or an ancestor of either; (6) a stepfather or stepmother of the beneficiary; (7) a son or daughter of a brother or sister of the beneficiary; (8) a brother or sister of the father or mother of the beneficiary; (9) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; or (10) the spouse of any person described in (2)-(9).

Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses.

To the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may claim the HOPE credit or Lifetime Learning credit with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

Description of Proposal

Qualified tuition program

The proposal would expand the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law State sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons would be able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (as described in section 529(b)(1)(A)(ii)).

Exclusion from gross income

Under the proposal, an exclusion from gross income would be provided for distributions made in taxable years beginning after December 31, 2001, from qualified State tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a State or agency or instrumentality thereof, for distributions made in taxable years after December 31, 2003.

Coordination with HOPE and Lifetime Learning credits

The proposal would allow a taxpayer to claim a HOPE credit or Lifetime Learning credit

for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

Rollovers for benefit of same beneficiary

The proposal would provide that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary would not be considered a distribution for a maximum of three such transfers.

Member of family

The proposal would provide that, for purposes of tax-free rollovers and changes of designated beneficiaries, a “member of the family” includes first cousins of the original beneficiary.

Effective Date

The provision would be effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a State (or agency or instrumentality thereof) would be effective for taxable years beginning after December 31, 2003.

III. EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Present Law

Educational expenses paid by an employer for its employees are generally deductible by the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of \$5,250 annually for employer-provided educational assistance. The exclusion does not apply to graduate courses beginning after June 30, 1996. The exclusion for employer-provided educational assistance for undergraduate courses expires with respect to courses beginning after December 31, 2001.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than 5-percent owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.⁶ In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.⁷

Description of Proposal

The proposal would extend the exclusion for employer-provided educational assistance to graduate education, and would make the exclusion (as applied to both undergraduate and graduate education) permanent.

⁶ These rules also apply in the event that section 127 expires.

⁷ In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous expenses, exceed two percent of the taxpayer's AGI. An individual's total deductions may also be reduced by the overall limitation of itemized deductions under section 68. These limitations do not apply in determining whether an item is excludable from income as a working condition fringe benefit.

Effective Date

The provision would be effective with respect to courses beginning after December 31, 2001.

IV. MODIFICATIONS TO STUDENT LOAN INTEREST DEDUCTION

Present Law

Certain individuals may claim an above-the-time deduction for interest paid on qualified education loans, subject to a maximum annual deduction limit. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The maximum allowable deduction per tax return is \$2,500. The deduction is phased out ratably for single taxpayers with modified AGI between \$40,000 and \$55,000 and for married taxpayers filing joint returns with modified AGI between \$60,000 and \$75,000. The income ranges will be indexed for inflation after 2002.

Description of Proposal

The proposal would increase the income phase-out ranges for eligibility for the student loan interest deduction to \$50,000 to \$65,000 for single taxpayers and to \$100,000 to \$130,000 for married taxpayers filing joint returns. These income phase-out ranges would be indexed for inflation after 2002.

The proposal would repeal both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible.

Effective Date

The proposal would be effective for interest paid on qualified education loans after December 31, 2001.

**V. ELIMINATE TAX ON AWARDS UNDER THE
NATIONAL HEALTH SERVICE CORPS SCHOLARSHIP PROGRAM
AND THE F. EDWARD HEBERT ARMED FORCES HEALTH
PROFESSIONS SCHOLARSHIP AND FINANCIAL ASSISTANCE PROGRAM**

Present Law

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

The National Health Service Corps Scholarship Program (the “NHSC Scholarship Program”) and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”) provide education awards to participants on condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

Description of Proposal

The proposal would provide that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient. As with other qualified scholarships under section 117, the tax-free treatment would not apply to amounts received by students for regular living expenses, including room and board.

Effective Date

The proposal would be effective for education awards received after December 31, 2001.

VI. TAX BENEFITS FOR CERTAIN TYPES OF BONDS FOR EDUCATIONAL FACILITIES AND ACTIVITIES

Present Law

Tax-exempt bonds

In general

Interest on debt⁸ incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (Code sec. 103).⁹ Like other activities carried out or paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds."¹⁰ The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code -- including elementary, secondary, and post-secondary schools -- may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds").

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

⁸ Hereinafter referred to as "State or local government bonds."

⁹ Interest on this debt is included in calculating the "adjusted current earnings" preference of the corporate alternative minimum tax.

¹⁰ Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing (“qualified mortgage bonds” and “qualified veterans’ mortgage bonds”).

Private activity tax-exempt bonds may not be issued to finance schools for private, for-profit businesses.

In most cases, the aggregate volume of private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. These annual volume limits are equal to \$62.50 per resident of the State, or \$187.5 million if greater. The volume limits are scheduled to increase to the greater of \$75 per resident of the State or \$225 million in calendar year 2002. After 2002, the volume limits will be indexed annually for inflation.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods” before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Present law includes three exceptions to the arbitrage rebate requirements applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance.¹¹ Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.¹² Issuers qualifying for this “construction bond” exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

¹¹ In the case of governmental bonds (including bonds to finance public schools), the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

¹² Retainage amounts are limited to no more than five percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued.

Third, governmental bonds issued by “small” governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than \$5 million of tax-exempt governmental bonds in a calendar year. The \$5 million limit is increased to \$10 million if at least \$5 million of the bonds are used to finance public schools.¹³

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue “qualified zone academy bonds.” Under present law, a total of \$400 million of qualified zone academy bonds may be issued in each of 1998 through 2001. The \$400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation for up to two years (three years for authority arising before 2000).

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. An eligible financial institution holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate daily at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Present value is determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

“Qualified zone academy bonds” are defined as bonds issued by a State or local government, provided that: (1) at least 95 percent of the proceeds is used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase

¹³ The Small Business Job Protection Act of 1996 permitted issuance of the additional \$5 million in public school bonds by small governments. Previously, small governments were defined as governments that issued no more than \$5 million of governmental bonds without regard to the purpose of the financing.

graduation and employment rates, and (3) either (a) the school is located in a designated empowerment zone or a designated enterprise community, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

Description of Proposal

Increase amount of governmental bonds that may be issued by governments qualifying for the “small governmental unit” arbitrage rebate exception

The additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirement would be increased from \$5 million to \$10 million. Thus, these governmental units could issue up to \$15 million of governmental bonds in a calendar year provided that at least \$10 million of the bonds were used for public schools.

Allow issuance of tax-exempt bonds for privately owned public school facilities

The private activities for which tax-exempt bonds may be issued would be expanded to include elementary and secondary public school facilities which are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. The school facilities for which these bonds are issued would be required to be operated by a public educational agency as part of a system of public schools. Issuance of these bonds would be subject to an annual per-State volume limit equal to the greater of \$10 per resident (\$5 million, if greater) in lieu of the present-law State private activity bond volume limits.

Effective Date

The provisions would be effective for bonds issued after December 31, 2001.