

**DESCRIPTION OF H.R. 7
(THE “EDUCATION SAVINGS
AND SCHOOL EXCELLENCE ACT OF 1999”)**

Scheduled for Markup

By the

HOUSE COMMITTEE ON WAYS AND MEANS

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I. INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of H.R. 7, the “Education Savings and School Excellence Act of 1999,” scheduled for markup in the House Committee on Ways and Means.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 7 (the “Education Savings and School Excellence Act of 1999”)*, (JCX-30-00), March 21, 2000.

II. EDUCATION TAX INCENTIVES

A. Expand Education Savings Accounts

Present Law

In general

Section 530 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 named beneficiary.² Contributions to education IRAs may be made only in cash. Annual contributions to education IRAs may not exceed \$500 per designated beneficiary (except in cases involving certain tax-free rollovers, as described below), and may not be made after the designated beneficiary reaches age 18.³ Moreover, an excise tax is imposed if a contribution is made by any person to an education IRA established on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program (defined under sec. 529) on behalf of the same beneficiary.

Phaseout of contribution limit

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

Treatment of distributions

Amounts distributed from an education IRA are excludable from gross income to the extent that the amounts distributed do not exceed qualified higher education expenses of the designated beneficiary incurred during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). Distributions from an education IRA are generally deemed to consist of distributions of principal (which, under all circumstances, are excludable from gross income) and earnings (which may be excludable from gross income) by applying the ratio that the aggregate amount of contributions to the account for the beneficiary bears to the total balance of the

² Education IRAs generally are not subject to Federal income tax, but are subject to the unrelated business income tax (“UBIT”) imposed by section 511.

³ An excise tax may be imposed under present law to the extent that excess contributions above the \$500 annual limit are made to an education IRA.

account. If the qualified higher education expenses of the student for the year are at least equal to the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the earnings in their entirety are excludable from gross income. If, on the other hand, the qualified higher education expenses of the student for the year are less than the total amount of the distribution (i.e., principal 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., a 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 distributee's gross income.

To the extent that a distribution exceeds qualified higher education expenses of the designated beneficiary, an additional 10-percent tax is imposed on the earnings portion of such excess distribution, unless such distribution is made on account of the death or disability of, or scholarship received by, the designated beneficiary. 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), provided that such distribution is accompanied by the amount of income allocable to the contribution.

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefitting one beneficiary to another education IRA benefitting 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. For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws--and any spouse of such persons or of the original beneficiary.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the named 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 127.⁴

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 deductible under sec. 162), or exclusion (e.g., for expenses paid with interest on education savings bonds excludable under sec. 135), or credit is allowed with respect to such expenses.

Eligible educational institution

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.

Description of Proposal

Annual contribution limit

The proposal would increase the annual education IRA contribution limit to \$2,000. Thus, aggregate contributions that could 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.

Qualified expenses

The proposal would expand the definition of qualified education expenses that may be paid with tax-free distributions from an education IRA. Specifically, the definition of qualified education expenses would be expanded to include "qualified elementary and secondary education

⁴ No reduction of qualified higher education expenses is required, however, for a gift, bequest, devise, or inheritance.

expenses,” meaning (1) tuition, fees, academic tutoring, special needs services, books, supplies, and equipment (including computers and related software and services) incurred in connection with the enrollment or attendance of the designated beneficiary as an elementary or secondary student at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12), and (2) room and board, uniforms, transportation, and supplementary items and services (including extended-day programs) required or provided by such a school in connection with such enrollment or attendance of the designated beneficiary.⁵ “Qualified elementary and secondary education expenses” also would include certain homeschooling education expenses if the requirements of any applicable State or local law are met with respect to such homeschooling.

Under the proposal, the definition of “qualified higher education expenses” would be modified to mean expenses for 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 at an eligible educational institution.⁶ The proposal would not change the definition of “qualified higher education expenses” with respect to expenses for room and board.

Special needs beneficiaries

The proposal would also provide that, although contributions to an education IRA generally may not be made after the designated beneficiary reaches age 18, contributions may continue to be made to an education IRA in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, under the proposal, in the case of a special needs beneficiary, a deemed distribution of any balance in an education IRA would not occur when the 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

⁵ Contributions made to education IRAs prior to the effective date of the proposal, (and earnings thereon) could be used for distributions for qualified elementary and secondary education expenses made after January 1, 2001. Thus, it would not be necessary for trustees of education IRAs to keep separate accounts with respect to contributions made prior to the effective date of the proposal and earnings thereon.

⁶ “Qualified higher education expenses” for purposes of education IRAs are defined by reference to the definition of such expenses for purposes of qualified tuition programs (sec. 530(b)(2)(A)). Because the proposal modifies the definition of “qualified higher education expenses” for purposes of qualified tuition programs (sec. 529(e)(3)), the definition of “qualified higher education expenses” for education IRAs is also modified.

the corporation or entity during the year of the contribution.

Effective Date

The provisions modifying education IRAs would be effective for taxable years beginning after December 31, 1999.

B. Allow Tax-Free Distributions From State and Private Education Programs

Present Law

Section 529 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 institution⁷, 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 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 (e.g., when the beneficiary attends college) 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.⁸

A qualified State tuition program is required to provide that purchases or contributions

⁷ "Eligible educational institutions" are defined the same for purposes of education IRAs and qualified State tuition programs.

⁸ Distributions from qualified State tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

only be made in cash.⁹ Contributors and beneficiaries are not allowed to directly or indirectly 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 benefitting one designated beneficiary to another account benefitting 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 the beneficiaries are members of the same family. For this purpose, the term "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws--and any spouse of such persons or of the original beneficiary. 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 designated 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 distributee (or another taxpayer claiming the distributee as a dependent) may claim the HOPE credit or Lifetime Learning credit under section 25A 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 educational institutions, persons would be able to purchase tuition credits or certificates on behalf of a designated beneficiary (as described in section

⁹ Sections 529(c)(2), (c)(4), and (c)(5), and section 530(d)(3) provide special estate and gift tax rules for contributions made to, and distributions made from, qualified State tuition programs and education IRAs.

529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (described in section 529(b)(1)(A)(ii)).

Exclusion from gross income

Under the proposal, distributions from qualified State tuition programs and from qualified tuition programs established and maintained by an entity other than a State or agency or instrumentality thereof would be excludable from gross income to the extent that the distribution is used to pay for qualified higher education expenses (and provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year).

As under present law with respect to education IRAs, if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from a qualified tuition program, then no deduction (e.g., for trade or business expenses deductible under sec. 162), or exclusion (e.g., for expenses paid with interest on education savings bonds excludable under sec. 135), or credit would be allowed with respect to such expenses.

Definition of qualified higher education expenses

Under the proposal, the definition of “qualified higher education expenses” would be modified to mean expenses for 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 at an eligible educational institution. The proposal would not change the definition of “qualified higher education expenses” with respect to expenses for room and board.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

C. Exclusion for Employer-Provided Educational Assistance

Present Law

Educational expenses paid by an employer for its employees are generally deductible to 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. The exclusion for employer-provided educational assistance

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 5 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.¹⁰ 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.¹¹

Description of Proposal

The proposal would permanently extend the present-law exclusion for employer-provided educational assistance.

Effective Date

The proposal would be effective on the date of enactment.

D. Liberalize Tax-Exempt Bond Arbitrage Rebate Exceptions for Public School Construction Bonds

Present Law

Interest on debt incurred by States or local governments is excluded from income if the

¹⁰ These rules also apply in the event that section 127 expires and is not reinstated.

¹¹ 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 deductions, exceed two percent of the taxpayer's AGI. The two-percent floor limitation is disregarded in determining whether an item is excludable as a working condition fringe benefit.

proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Like other activities carried out and 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.

The Federal income tax does not apply to the income of State and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than necessary, 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.

The Code includes three exceptions 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. 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.

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 for construction proceeds. 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.

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 construction of public schools.

Description of Proposal

The additional amount of governmental bonds for public schools construction 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 to finance construction of public schools.

Effective Date

The proposal would be effective for obligations issued after December 31, 1999.

E. Eliminate Tax on Awards under 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 qualified scholarships received 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.

Section 117(c) specifically provides that 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 of scholarships in these programs 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 and 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 amounts received in taxable years beginning after December 31, 1993.