[JOINT COMMITTEE PRINT]

TAX INCENTIVES FOR EDUCATION

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON

MARCH 15, 1988

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 14, 1988

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INTRODUCTION

'he Senate Committee on Finance has scheduled a public hear- on March 15, 1988, on tax incentives for education. This pam- et,[1] prepared by the Staff of the Joint Committee on Taxation, vides a description of certain proposals for education tax incen- :s and an analysis of issues relating to such proposals.

'he first part of the pamphlet is a summary of present law and proposals. The second part describes present law and proposals ıting to education savings bonds, education savings accounts, :ional Education Savings Trust, interest deduction on education ıs, employer-provided educational assistance, and certain stu- t loan bonds. The third part is an analysis of issues relating to h proposals. An Appendix provides information on direct aid to lents for post-secondary education.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Incentives for* *:ation*, (JCS-5-88), March 14, 1988.

I. SUMMARY

Education Savings Bonds

Present law

Present law does not include an exclusion from gross income, deferral of taxation, for interest or other income specifically b cause the taxpayer uses the income for educational expenses. Ta ation of interest accruals on U.S. Series EE savings bonds may deferred by cash-basis taxpayers as long as the bonds are not deemed.

S. 1817 (Senators Kennedy and Pell)

Interest income on a qualified U.S. savings bond would be cluded from income when such bonds are transferred to an eligib educational institution as payment for the higher education penses of a taxpayer, taxpayer's spouse, or dependents. The excl sion would be phased out for taxpayers with adjusted gross incor between $75,000 and $150,000.

The bill would apply to transfers of qualified U.S. savings bon issued after the date of enactment.

S. 1662 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, a Wallop)

This bill would authorize issuance of educational savings bon (a special form of Series EE bonds) at the prevailing Federal lor term rate. A taxpayer could purchase annually for the benefit of dependent up to $1,000 of such bonds on which interest wou accrue tax-free. The accrued interest would be excluded fro income in the year of redemption if used for higher education penses. The interest exclusion would apply only if the taxpay holds the bonds for at least one year, and not more than 20 yea after issuance.

The bill would apply for taxable years beginning after Decemb 31, 1986.

Administration proposal

The President's budget proposals for fiscal year 1989 include recommendation to exclude from gross income the interest on c tain U.S. savings bonds that are redeemed to pay post-seconda educational expenses of the taxpayer or the taxpayer's spouse, ch dren, or other dependents. The exclusion would be phased out taxpayers with adjusted gross income above certain levels.

The exclusion would apply to bonds issued after December 1988.

Educational Savings Accounts

sent law

'resent law does not provide a specific deduction, credit, or ɔme exclusion for amounts contributed to a trust to fund educaı expenses of the taxpayer or a child of the taxpayer.

'533 (Senator DeConcini)

'axpayers would be allowed an above-the-line deduction for cash tributions (up to $1,000 per year) made to an education savings ɔunt established to pay for future education expenses of the taxer or a dependent at an institution of higher education or vocaıal school. The deduction would be reduced for taxpayers with ısted gross income above certain levels, similarly to the phase-of the IRA deduction. Income earned by the education savings ɔunt generally would be exempt from taxation.

he bill would be effective for taxable years beginning after Deıber 31, 1986.

'659 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

his bill includes provisions for educational savings accounts t generally are the same as the provisions in S. 1533, as summad above. However, S. 1659 would allow a 15-percent tax credit to $150 per year), rather than a deduction, for amounts paid in ı and the fair market value of stocks, bonds, or other readily leable securities transferred to an education savings account.

'660 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

his bill is the same as S. 1659, except that no credit or deducı would be allowed for contributions to an education savings acnt. Earnings on amounts transferred to such account generally ıld not be taxable unless distributed for noneducational pures.

'661 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

'his bill is the same as S. 1659, except that, for each taxable r, a 15-percent tax would be imposed on the taxable income of education savings account, i.e., the gross income of the account ıus any deductions directly allocable to such income.

National Education Savings Trust

Present law

Under present law, there is no provision that permits dedu for amounts contributed to a national trust to fund educatio penses of the taxpayer or a child of the taxpayer.

S. 1572 (Senators Pell, Kennedy, and Stafford)

This bill would establish a public corporation, the National cation Savings Trust, which would enter into advance tuition ment plan agreements with taxpayers. Amounts paid by a tax to the Trust pursuant to such an agreement would be deducti the taxpayer up to $2,000 per year; the deduction would be re for taxpayers with adjusted gross income above certain l Amounts paid by the Trust to post-secondary education institu would not be subject to Federal income tax.

Interest Deduction on Education Loans

Present law

Pursuant to the Tax Reform Act of 1986, the itemized dedu for personal interest (including interest on student loans) is phased out over 1987-1990.

S. 628 (Senators Grassley, Danforth, D'Amato, Kerry, Durenb and Hecht)

The bill provides that interest on loans incurred for qua education expenses would be deductible as an itemized dedu effective for taxable years beginning after December 31, 1986.

Employer-Provided Educational Assistance

Present law

An employee must include in income and wages, for incom employment tax purposes, the value of educational assistanc vided by an employer to the employee, unless the cost of su sistance qualifies as a deductible job-related expense of the en ee. Under prior law (Code sec. 127), an employee's gross incom wages for income and employment tax purposes did not in amounts (up to $5,250 per year) paid or incurred by the emp for educational assistance provided to the employee if amounts were paid or incurred pursuant to an educational ance program that met certain requirements. The section 1 clusion expired for taxable years beginning after Decemb 1987.

S. 39 (Senators Moynihan, Heinz, Boren, Pryor, Matsunaga Riegle)

The bill would reinstate the section 127 exclusion, effective its expiration date, on a permanent basis.

Certain Student Loan Bonds

esent law

Present law includes a special rule permitting qualified scholar-p funding corporations (rather than States or local governments emselves) to issue tax-exempt student loan bonds in connection h the Federal Guaranteed Student Loan (GSL) or PLUS pro-ams. Present law further includes two special exceptions provid- (1) that issuers of tax-exempt student loan bonds issued in con-ction with these Federal programs may invest bond proceeds to n arbitrage profits for a longer temporary period than applies to ilar types of bonds and (2) that all or a portion of these arbi-ge profits are exempt from the rebate requirement generally ap-cable to all other tax-exempt bonds. These two arbitrage excep-ns are scheduled to expire with respect to bonds issued after De-nber 31, 1988.

2149 (Senators Mitchell, Pryor, Durenberger, Boren, Danforth, and Rockefeller)

The bill would permit qualified scholarship funding corporations issue State supplemental student loan bonds, which are student n bonds not subject to the restrictions of or receiving the bene- of the Federal GSL or PLUS programs. Also, the bill would ke permanent the two special arbitrage exceptions and would end these provisions to issuers of supplemental student loan nds.

II. DESCRIPTION OF PROPOSALS

A. Education Savings Bonds

Present Law

Present law does not include an exclusion from gross income deferral of taxation, for interest or other income specifically cause the taxpayer uses the income for educational expenses.

Certain types of investment income are excluded from g income or are tax-deferred regardless of the taxpayer's use of s income. For example, interest income on qualified State and l government bonds generally is exempt from Federal income ation. Taxation of income credited to life insurance or annuity tracts ("inside buildup") is deferred until distributed to the pol holder; such income is not taxed if paid to a designated benefic after the death of the insured individual (in the case of a life in ance contract). In addition, taxation of income earned on amou contributed to an individual retirement arrangement (IRA) or employer-maintained qualified pension plan generally is defe until the amounts are distributed to the owner of the IRA or to employee participating in the employer-maintained plan.

Taxation of interest accruals on U.S. Series EE savings bo may be deferred by cash-basis taxpayers as long as the bonds not redeemed.

Explanation of Proposals

S. 1817 (Senators Kennedy and Pell)

Exclusion

S. 1817 would provide an exclusion from gross income for the terest income earned on a qualified U.S. savings bond if the bor transferred to an eligible educational institution as payment the higher education expenses of a taxpayer, or taxpayer's sp or dependents. The amount of exclusion allowed for a taxable would be the lesser of (1) the amount that otherwise would be cludible in gross income by reason of such transfer, or (2) amo of such higher education expenses.

The exclusion would be phased out for a taxpayer with adju gross income (AGI) of $75,000 or more for the taxable year amount could be excluded by a taxpayer whose AGI is $150,00 more. For a taxpayer with AGI between $75,000 and $125,000 percent of the eligible amount could be excluded; for AGI betw $125,000 and $150,000, 34 percent of the eligible amount coul excluded. The phase-out amounts would be indexed in cale years after 1988.

Only one-half of the dollar amounts described above would a in the case of a married individual filing separately. With res taxpayer who is a dependent of another taxpayer, the phase- would be applied by taking into account the AGI of both tax- ers.

Transferability of U.S. savings bonds

he ability to effect a transfer of a U.S. savings bond for the edu- onal purposes of the bill would be made possible by amending J.S. Code section 3105, which provides the Treasury with au- ity to prescribe the conditions, including restrictions on trans- relating to the issue of U.S. savings bonds. The amendment re- s to both the transfer of a qualified U.S. bond to an eligible cational institution and the redemption of such a bond by an ible educational institution.

Definitions

 qualified U.S. savings bond means a U.S. savings bond issued iscount under 31 U.S. Code section 3105, after the date of enact- nt.

igher education expenses means tuition and fees required for ollment or attendance at an eligible educational institution, and , books, supplies, and equipment required for courses of instruc- at an eligible educational institution. An eligible educational itution means (1) an institution of higher education described in ion 1201(a) or 481(a) of the Higher Education Act of 1965, or (2) area vocational education school as defined in subparagraph (C) D) of section 521(3) of the Carl D. Perkins Vocational Education , which is in any State (as defined in sec. 521(27) of such Act).

 dependent means any child of the taxpayer with respect to m a deduction is allowed under section 151 for the taxable r.

Effective date

he provisions would apply to transfers of qualified U.S. savings ds issued after the date of enactment.

1662 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

Authority to issue bonds

. 1662 would authorize the Treasury to issue educational sav- s bonds, in addition to the other forms of U.S. savings bonds. As he usual case with Series EE savings bonds, the interest on edu- ional savings bonds would be accrued until redemption, which ld not occur less than 12 months, nor later than 20 years, after ance. The bonds would not be transferable.

Vhen issued, an educational savings bond would bear interest at ate equal to the Federal long-term rate (i.e., for debt with more n nine years to maturity) in effect at the time. The rate could adjusted upwards from the rate in effect at the time of issue m time-to-time to reflect the differential between such rate and rate on other debt obligations issued by the Treasury.

Interest exclusion from

Under the bill, a taxpayer could purchase annually for the be fit of a dependent up to $1,000 of educational savings bonds which interest would accrue tax-free.

Interest or investment yield on an educational savings b would be included in the gross income of the taxpayer for the t able year in which the bond is redeemed only to the extent t the amount of such interest exceeded the sum of the higher edu tion expenses paid or incurred by the taxpayer with respect t dependent for that taxable year, or if the bond was redeemed m than 25 years after the date of its issuance. This limitation wo not to apply for any taxable year during which the educational s ings bond is redeemed if the registered owner is disabled or taxable year is ended by the death of the registered owner.

Definitions

Higher education expenses.—This term means expenses at any igible educational institution for tuition and fees for enrollmen attendance; fees, books, supplies, and equipment required courses of instruction; and a reasonable allowance for meals lodging while in attendance.

Eligible educational institution.—This term means (1) an inst tion of higher education as described in section 1201(a) or 481(a the Higher Education Act of 1965, or (2) an area vocational edu tion school as defined in subparagraph (C) or (D) of section 521(3 the Carl D. Perkins Vocational Education Act which is in any St (as defined in sec. 521(27) of such Act).

Effective date

The provisions would apply with respect to taxable years beg ning after December 31, 1986.

Administration proposal

The President's budget proposals for fiscal year 1989 includ recommendation to exclude from gross income the interest on tain U.S. savings bonds that are redeemed to pay certain post- ondary educational expenses of the taxpayer or the taxpay spouse, children, or other dependents.

The exclusion would be phased out for taxpayers with adjus gross income above certain levels; the phase-out levels would be justed annually for inflation beginning in 1990. The amount of terest eligible for the exclusion would be limited to the total qu fied educational expenses incurred. The Administration has not forwarded to the Congress a more detailed explanation of this posal.

The exclusion would apply to bonds issued after December 1988.

B. Education Savings Accounts

Present Law

'resent law does not provide a specific deduction for amounts tributed to a trust to fund educational expenses of the taxpayer ı child of the taxpayer.

ducation expenses that qualify as trade or business expenses ler section 162 generally are deductible. Expenditures made by individual for his or her own education generally are deductible ncurred for education that (1) maintains or improves skills rered by the individual's current employment or other trade or iness, or (2) meets the express requirements of the individual's ployer or the requirements of applicable law or regulations imed as a condition to the retention by the individual of an estabıed employment relationship, status, or rate of compensation eas Reg. sec. 1.162-5(a)). In the case of an employee, such exıses (if not reimbursed by the employer) are deductible only to extent that, when aggregated with other miscellaneous item-l deductions, they exceed two percent of the taxpayer's adjusted ss income.

Jnder prior law, educational assistance provided by an employer employees pursuant to an educational assistance program meetcertain requirements was excludable from the employee's gross ome or wages for income or employment tax purposes (sec. 127). is exclusion expired for taxable years beginning after December 1987.

Explanation of Proposals

1533 (Senator DeConcini)

In general

Jnder S. 1533, an above-the-line deduction would be allowed (up certain limits) for amounts paid in cash during the calendar ır to an education savings account for the benefit of an eligible lividual. (An education savings account could not be established the benefit of more than one individual.) No deduction would be owed for contributions to an account for the benefit of an individual who reached age 19 before the close of the year.

The deduction would be limited to the lesser of (1) $1,000 or (2) compensation (earned income in the case of a self-employed inidual) includible in the taxpayer's gross income for the year. In dition, the deduction would be reduced for taxpayers with adjustgross income (AGI) above certain levels, similarly to the phaset of the IRA deduction. The phase-out would begin at AGI of),000 in the case of a married couple filing a joint return, $25,000 the case of an unmarried individual, and zero in the case of a ırried couple filing separate returns.

Contributions made to an education savings account by the due te of the taxpayer's return would be deemed to have been made the last day of the prior year.

Requirements

Under the bill, an education savings account would have to sa fy the following requirements: (1) aggregate contributions in exc of $1,000 for one year could not be accepted; (2) the trustee must a bank or other person who would administer the trust in acc ance with the requirements of the bill; (3) trust assets could not invested in life insurance contracts unless certain requirements satisfied; (4) the taxpayer contributing to an account genera would be permitted to direct the investments of the account; (5) assets of the trust could not be commingled with other ass except in a common trust fund or common investment fund; and any balance in the account remaining when the individual whom the account was established attains age 27 (or, if earl when such individual dies) must be distributed proportionately the taxpayers who have contributed to the account.

The account could be established only to fund educational penses, defined to mean expenses incurred at an eligible institut for (1) tuition and fees, (2) fees, books, supplies, and equipment quired for courses, and (3) a reasonable allowance for meals lodging. An eligible educational institution means an institution higher education (within the meaning of secs. 1201(a) or 481(a the Higher Education Act of 1965) or a vocational school (wit the meaning of secs. 521(3)(C) or 521(3)(D) of the Carl D. Perk Vocational Education Act).

Tax treatment of distributions

Under the bill, except in the case of distributions used exclus ly for education expenses of the individual on whose behalf the count was established, any amount paid or distributed from an e cation savings account is included in the gross income of the payer who contributed to the account, in the same proportion the taxpayer's contribution bears to total contributions to the count. An exception would be provided for certain contributions excess of the deductible limit returned before the due date of taxpayer's tax return for the taxable year of the contribution.

In addition, an additional income tax of 10 percent would ap if a distribution from an education savings account is not used connection with the payment of educational expenses, unless distribution is made after the death or disability of the individ on whose behalf the account was established.

Tax treatment of accounts

An education savings account generally would be exempt fr Federal income tax, but would be subject to the tax on unrela business income of exempt organizations (sec. 511). An educat savings account would cease to be exempt from taxation if (1) account engages in a prohibited transaction (within the meanin sec. 4975) or (2) the individual on whose behalf the account is est lished pledges all or any portion of the account as security fo loan.

Gift tax treatment

'he bill provides that contributions made by a taxpayer to an .cation savings account would not be treated as a gift of a future ›rest in property to the extent that the contributions are deduct- › by the taxpayer.

Reporting requirements

'he trustee of an education savings account would be required to ke such reports as may be required by Treasury regulations. A penalty would be imposed for each reporting failure unless wn to be due to reasonable cause.

Effective date

'he bill would be effective for taxable years beginning after De- ıber 31, 1986.

1659 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, and Wallop)

In general

'his bill includes provisions for educational savings accounts t generally are the same as the provisions in S. 1533, as de- ibed above, with the following exceptions.

. 1659 would provide a 15-percent tax credit, rather than a de- :tion, for contributions up to $1,000 per year to an educational ings account. The maximum amount allowable in one year as a dit would be $150, allocated proportionately among the taxpay- contributing to the account; the limitation would be indexed for .ation. Under S. 1659, contributions to the account could be de in cash or in the form of stocks, bonds, or other securities, if h stocks, etc., are readily tradeable on an established securities rket.

Jnder S. 1659, as under S. 1533, an individual could not be the ıeficiary of more than one education savings account. The bill vides that no credit would be allowed for a contribution to an ıcation savings account if, before the close of the year in which contribution is made, the beneficiary has attained age 21 or ;un attendance at an eligible educational institution. Any bal- :e remaining when the individual for whom the account was es- lished attains age 25 (rather than age 27, as under S. 1533) or, if lier, dies is required to be distributed proportionately to the tax- 'ers who have contributed to the account.

Tax treatment of distributions

Jnder S. 1659, the gross income of a beneficiary of an education 'ings account would be increased by 10 percent of the amounts d or distributed from the account that were used exclusively to the educational expenses incurred by the beneficiary, for the :able year in which the beneficiary attains age 25 and in each of following nine taxable years. If the amounts credited to the ac- ınt are not used for educational purposes, then, as under S. 1533, ıounts distributed from the account are includible in the gross :ome of the recipient and are subject to an additional 10-percent :ome tax.

Tax on excess contributions

Under S. 1659, in the case of contributions to an education s ings account that exceed the allowable contributions, the exc contributions would be subject to the excise tax on excess contri tions to an individual retirement account (sec. 4973).

S. 1660 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, a Wallop)

This bill is the same as S. 1659 except that no credit or deduct would be allowed for contributions to an education savings accou Earnings on amounts contributed to such an account genera would be excluded from income unless distributed for nonedu tional purposes.

S. 1661 (Senators Dole, Chafee, Danforth, Durenberger, Heinz, a Wallop)

This bill is the same as S. 1659 except that, for each taxa year, a 15-percent tax would be imposed on the taxable income an education savings account, i.e., the gross income of the acco minus any deductions directly allocable to such income.

C. National Education Savings Trust

Present Law

Under present law, there is no provision that permits deducti for amounts contributed to a trust to fund education expenses the taxpayer or a child of the taxpayer.

Explanation of Proposal

S. 1572 (Senators Pell, Kennedy, and Stafford)

In general

Under S. 1572, a taxpayer would be allowed an above-the-line duction for certain amounts paid in cash pursuant to an adva tuition payment plan agreement entered into between the taxpa and the National Education Savings Trust (the "Trust"), a pul corporation established by the bill. Payments made by the taxpa would be placed into a fund managed by the Trust to provide future postsecondary education expenses (at a public or private stitution) of a qualified beneficiary designated by the taxpa Amounts paid by the Trust to meet a qualified beneficiary's penses at a postsecondary educational institution would not be cludible in the taxpayer's income or the beneficiary's income.

Deduction limitations and phaseout

A taxpayer would be permitted to enter into more than one vance tuition payment plan agreement to provide for future edu tional expenses of more than one qualified beneficiary. Howe the bill limits the amount a taxpayer could pay to the Trust un each advance tuition payment plan for each qualified beneficiar $2,000 for any taxable year, and $48,000 for all years.

'he bill further provides that amounts paid by a taxpayer to the ıst during the year would be deductible in full only if the tax- 'er's adjusted gross income (AGI) for that year is not more than ,000. If the taxpayer's AGI is more than $25,000 but not more n $60,000, then 50 percent of the amount paid to the Trust ıld be deductible. If the taxpayer's AGI is more than $60,000 but more than $100,000, then 25 percent of the amount paid to the ıst would be deductible.[2] These amounts would be indexed for ation beginning after 1988.

ı taxpayer with AGI exceeding $100,000 would not be allowed deduction for amounts paid to the Trust during that year. wever, income earned on nondeductible payments to the Trust ıld still be tax-free, provided that such income is used to pay for tsecondary education expenses of a qualified beneficiary.[3]

'he bill requires that the beneficiary of an advance tuition pay- nt plan agreement must already have been born and must be ıer the taxpayer who entered into the agreement or a dependent he taxpayer (within the meaning of Code sec. 151). In addition, deduction would be allowed for payments made to the Trust if: the beneficiary dies or attains age 30 during the year; (2) the payer making the payment is a dependent of any other person; (3) the beneficiary is the spouse of the taxpayer, unless the tax- 'er and spouse file a joint return for the year the deduction is imed.

)eductions for amounts paid to the Trust would be allowed ether or not the taxpayer itemizes deductions. A taxpayer would deemed to have made a payment to the Trust on the last day of preceding year if such payment is made on account of the pre- ing year and is made by the due date for filing the taxpayer's urn for that year.

ıefits furnished by the Trust

'he bill provides that payments from the Trust to a postsecond- education institution pursuant to an advance tuition payment n agreement would not be included in the gross income of any 'son. Any amount disbursed by the Trust which is not paid to a ıtsecondary education institution, including amounts refunded to taxpayer on termination of the agreement (as described below), uld be included in the gross income of the person receiving the yment and would be subject to income tax. Also, the recipient uld be subject to a penalty equal to 20 percent of the amount eived (10 percent if the beneficiary has not attained the age of in the year the payment is made by the Trust). The penalty uld not apply, however, if a payment is made to a person other ın a postsecondary education institution by reason of the death

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In the case of a married taxpayer filing a separate return, 100 percent of the amount paid to Trust would be deductible only if the taxpayer's AGI is not more than $12,500; 50 percent of amount paid, if the taxpayer's AGI is more than $12,500 but not more than $30,000; and 25 ent of the amount paid, if the taxpayer's AGI is more than $30,000 but not more than ,000. A married taxpayer filing a separate return would not be allowed a deduction for pay- ıts made to the Trust if the taxpayer's AGI exceeds $50,000.

While not explicitly stated, the bill apparently assumes that the Trust is not subject to Fed- l income tax.

of the beneficiary under an advance tuition payment plan agr ment.

The term postsecondary education institution means an insti tion of higher education as described in section 1201(a) of t Higher Education Act of 1965.

Termination of plan agreements

An advance tuition payment plan would be terminated if (1) t beneficiary dies; (2) the beneficiary attains the age of 30; (3) t taxpayer certifies to the Trust that the beneficiary, after attaini the age of majority, has decided not to attend a postsecondary e cation institution or has completed as much of the course of po secondary education as the qualified beneficiary intends to co plete; or (4) other circumstances determined by the Trust and forth in the agreement.[4] Upon termination of the agreement, t Trust would be required to refund to the taxpayer the face amou of the payments or installments, plus any interest or dividends crued thereon. The refund would be disbursed by the Trust to t taxpayer in a single payment and would be reported to the IRS.

Board of Trustees

With respect to the Trust, the bill would create a Board of Tru ees composed of: (1) the Secretary of Education and the Secreta of the Treasury; (2) five representatives of postsecondary educat institutions and five members of the general public, appointed the President with the advice and consent of the Senate;[5] and one chairman, appointed by the President with the advice and c sent of the Senate.[6]

The Secretary of the Treasury would be the Managing Trustee the Board with respect to managing the assets of the Trust, wh could be invested only in interest-bearing obligations of the Uni States or in obligations guaranteed as to both principal and int est by the United States.

The Board would be required to report to Congress on an ann basis on the operation and status of the Trust during the preced fiscal year and on its expected operation and status during t next five years.

Effective date

The amendments to the Internal Revenue Code made by the b would apply to taxable years ending after the date of enactme

D. Deduction for Interest on Education Loans

Present Law

Pursuant to the Tax Reform Act of 1986, the itemized deducti for personal interest is being phased out over 1987-1990 and will

[4] The bill provides that the agreement may permit the taxpayer, with the approval of Trust, to substitute another qualified beneficiary for the qualified beneficiary originally na in lieu of termination of the agreement.

[5] These representatives and members would generally be eligible to serve no more than terms of four years each.

[6] The chairman would be appointed for a term of five years and would not be eligible reappointment.

olly disallowed after 1990 (Code sec. 163(h)). Personal interest is y interest *other than* interest incurred in connection with a de or business (other than of performing services as an employ-, investment interest, interest taken into account in computing taxpayer's income or loss from passive activities, qualified resice interest, or interest on certain deferred estate tax.

Qualified residence interest, which is not subject to the limitan on personal interest, is interest on debt secured by a security erest valid against a subsequent purchaser on the taxpayer's ncipal residence or a second residence of the taxpayer. For taxle years beginning in 1987, interest on such debt was generally ductible to the extent that the debt did not exceed the amount of taxpayer's basis for the residence (including the cost of home provements).

In addition, the law for 1987 allowed a taxpayer to deduct as alified residence interest the interest on certain loans incurred qualified educational or medical expenses up to the fair market lue of the residence. For this purpose, qualified educational exnses meant reasonable living expenses while away from home, d any tuition and related expenses that would qualify as scholarip (under sec. 117(b)), for the taxpayer, a spouse, or dependent, ile a student at an educational institution. Thus, tuition exnses for primary, secondary, college, and graduate level education were generally included in qualified educational expenses. The alified educational expenses must have been incurred within a asonable period of time before or after the debt was incurred. Rebursed expenses were not treated as qualified educational exnses.

For taxable years beginning after 1987, the Revenue Act of 1987 nended the definition of qualified residence interest that is treatas deductible. Under the 1987 Act, qualified residence interest cludes interest on acquisition indebtedness (up to $1 million) and me equity indebtedness (up to $100,000) with respect to a princil and a second residence of the taxpayer. No special rules apply education or medical loans.

Explanation of Proposal

. 628 (Senators Grassley, Danforth, D'Amato, Kerry, Durenberger, and Hecht)

S. 628 provides that interest on a qualified education loan would deductible as an itemized deduction. A qualified education loan ould be defined as indebtedness incurred to pay qualified educaonal expenses if such expenses are paid or incurred within a reanable period of time before or after the indebtedness is incurred. ualified educational expenses would have the same meaning as nder the law relating to qualified residence indebtedness as in fect in 1987 (described above).

The bill would be effective for taxable years beginning after Dember 31, 1986.

E. Employer-Provided Educational Assistance

Present Law

General rules

Under present law, an employee must include in income a wages, for income and employment tax purposes, the value of ed cational assistance provided by an employer to an employee, unle the cost of such assistance qualifies (under sec. 162) as a deductib job-related expense of the employee. Amounts expended for educ tion qualify as deductible job-related expenses if the education maintains or improves skills required for the employee's curre job, or (2) meets the express requirements of the individual's e ployer that are imposed as a condition of continued employme (Treas. Reg. sec. 1.162-5(a)). In the case of an employee, such e penses (if not reimbursed by the employer) are deductible only the extent that, when aggregated with other miscellaneous ite ized deductions, they exceed two percent of the taxpayer's adjust gross income. No deduction is allowed for expenses incurred qualify for a new trade or business (e.g., for law school tuition pa by a paralegal or accountant).

Under prior law, an employee's gross income and wages f income and employment tax purposes did not include amounts pa or incurred by the employer for educational assistance provided the employee if such amounts were paid or incurred pursuant to educational assistance program that met certain requirements (s 127). This exclusion, which expired for taxable years beginni after December 31, 1987, was limited to $5,250 of educational assi ance with respect to an individual during a calendar year.

Section 127 required, among other things, that educational assi ance provided under such a program not discriminate in favor highly compensated employees in certain respects. The Stateme of Managers for the Tax Reform Act of 1986 indicated that if t section 127 exclusion for educational assistance were extended, t new nondiscrimination rules for employee benefits added by t 1986 Act (sec. 89) were to be applied to the exclusion in lieu of t prior-law rules.

In 1984, Congress required that employers file information turns with respect to educational assistance programs under s tion 127 (sec. 6039D). This requirement is intended to collect da with respect to the use of such programs so that Congress m evaluate the effectiveness of the exclusion.

Tuition reduction for graduate teaching assistants

Pursuant to section 127(c)(8) (prior to its expiration), the exc sion under section 117 relating to qualified tuition reductions w made applicable with respect to graduate-level courses in the ca of graduate teaching or research assistants at colleges or univer ties. Under the section 117 rules, as amended by the Tax Refo Act of 1986, the amount of qualified tuition reduction provided an employee of an educational institution is includible in gr income and wages to the extent the tuition reduction constitut payment for teaching, research, or other services (sec. 117(c)). A amount of qualified tuition reduction (up to the amount of tuitio excess of such payment may qualify for exclusion pursuant to ction 117(d).

By virtue of the expiration of section 127, no amount of tuition luction for graduate-level courses is excludable under section 7(d)(2) for 1988 or later years.

Explanation of Proposal

S. 39 (Senators Moynihan, Heinz, Boren, Pryor, Matsunaga, and Riegle)

S. 39 would reinstate the section 127 exclusion on a permanent sis, effective as of the termination date of the prior-law exclu- n.

F. Certain Student Loan Bonds

Present Law

rposes for which tax-exemption permitted

Interest on State and local government bonds to finance activi- s of those governmental units generally is tax-exempt (Code sec. 3). Interest on private activity bonds is taxable unless a specific ception is provided in the Internal Revenue Code. Private activi- bonds are bonds that satisfy one or both of (1) a private business e and private payment test and (2) a private loan test. One of the rposes for which tax-exempt private activity bonds may be issued the financing of student loans.

Tax-exempt student loan bonds may be issued in connection with e Federal Government's Qualified Student Loan (GSL) and Par- t's Loans for Undergraduate Students (PLUS) programs. Student an bonds issued in connection with the GSL and PLUS programs e Federally guaranteed, and in the case of GSL bonds, receive a deral interest subsidy beyond tax-exemption, so-called "special sistance payments." The Federal Government imposes limits on e incomes of individuals who may receive loans financed with nds issued in connection with these Federal programs.

Since 1986, tax-exempt student loan bonds also may be issued to nance State supplemental student loan programs. These programs e not subject to the income limits applicable to Federally guaran- ed student loan bonds.

ualified issuers of tax-exempt bonds

In general, tax-exempt bonds must be issued by or "on behalf of" State or local government. In addition, student loan bonds issued connection with the GSL and PLUS programs may be issued di- ctly by a "qualified scholarship funding corporation." A qualified holarship funding corporation is a not-for-profit corporation orga- zed exclusively for the purpose of issuing student loan bonds to quire student loan notes incurred under the Higher Education ct of 1965. Qualified scholarship funding corporations may not sued supplemental student loan bonds.

Arbitrage restrictions

All governmental and private activity bonds must satisfy restri tions on the amount of arbitrage profits that may be earned an retained for the interest thereon to qualify for tax exemption. I general, these restrictions limit the period in which bond proceed may be invested in materially higher yielding investments to (certain prescribed temporary periods and (2) amounts invested a part of a reasonably required reserve or replacement fund.

Bonds issued as a pooled financing (e.g., bonds used to mak loans to multiple parties) generally are limited to an initial temp rary period of six months. A special exception applies to studer loan bonds issued in connection with the Federal GSL and PLU student loan programs. These bonds are eligible for an 18-mont initial temporary period when bond proceeds may be invested i materially higher yielding investments. This special exception, e acted in 1986, is scheduled to expire with respect to bonds issue after December 31, 1988.

Issuers of all governmental and private activity bonds generall must rebate to the Federal Government all arbitrage profits earne on investments of the bond proceeds that are unrelated to the go ernmental purpose of the issue. An exception permits retention these arbitrage profits if all gross proceeds of the issue are spe for the governmental purpose of the issue within six months aft the bonds are issued.

A special exception applies to student loan bonds issued in co nection with the Federal GSL and PLUS student loan programs. I suers of these bonds may retain arbitrage profits earned in the 1 month initial temporary period, described above, if the procee are used to pay administrative costs of the student loan progra and costs of issuing the bonds. This exception applies only to t extent such costs are financed with the bond proceeds and only the extent the issuer is not otherwise reimbursed. Interest pa ments by student borrowers are not treated as reimbursements f this purpose.

Additionally, under a special provision of Treasury Departme regulations, costs paid from student-borrower interest paymen are not taken into account in determining the yield on stude loans. Thus, issuers of these student loan bonds may earn an retain an amount up to two times their administrative costs an costs of issuance without violating the present-law arbitrage r strictions. The special exemption from the arbitrage rebate requir ment is scheduled to expire with respect to bonds issued after D cember 31, 1988.

Explanation of Proposal

S. 2149 (Senators Mitchell, Pryor, Durenberger, Boren, Danforth, and Rockefeller)

S. 2149 would make permanent the special 18-month initial te porary period when issuers of GSL- and PLUS-student loan bon may invest bond proceeds in nonpurpose investments witho regard to yield restrictions.

he bill also would make permanent the special exemption from arbitrage rebate requirement under which issuers of these stu-t loan bonds may retain arbitrage profits to pay administrative s and costs of issuing the bonds.

urther, the bill would extend these two special exceptions to plemental student loan bonds and also would authorize quali-scholarship funding corporations to issue supplemental student ı bonds.

he bill would be effective on the date of enactment.

III. ECONOMIC ANALYSIS

A. Education Savings Bonds; Education Savings Accounts; an National Education Savings Trust

A number of bills introduced in the 100th Congress would p vide tax incentives for education by creating either education s ings bonds (S. 1662 and S. 1817), education savings accounts 1533, S. 1659, S. 1660, and S. 1661), or a national education savi trust (S. 1572). Each of these bills would provide tax incentives encourage parents to save to finance the post-secondary educati of their children. These bills would provide either deferral of, or clusion from, tax for income that is used to finance qualified edu tional expenditures.

Deferral vs. exemption

Exempting income from taxation is always more valuable to t taxpayer than deferring taxation on the same income. For exa ple, if $1,000 could be invested for 10 years to earn eight perc annually and those earnings were exempt from taxation, this vestment would have accumulated $1,158.93 in interest by the e of the 10-year period. If the earnings instead were taxed annua to a taxpayer at the 28-percent marginal tax rate, the accumula interest, net of taxes, would be $750.71 after 10 years. If the ea ings were not taxed annually, but rather the tax was deferred 10 years and assessed on the accumulated interest at the end of t 10-year period, the value of the taxpayer's net earnings would $834.43. In this example, deferral increases the taxpayer's retu by 11.2 percent over the 10-year period compared to annual t ation. Exemption is 38.9 percent more beneficial than deferral o the same period.

The benefit of tax exemption generally is greater to a high income taxpayer than a lower-income taxpayer, because the tax ability saved per dollar of Tax-exempt income is greater for taxp ers in higher tax brackets. The benefit of deferral depends not o on the taxpayer's current tax rate, but also on his or her future rate. The benefit of deferral is increased for a taxpayer who c rently is taxed at a high marginal rate, but who can defer the liability until a lower marginal rate applies. The benefit of defer is decreased if the taxpayer currently is taxed at a low margi rate and defers the tax liability to a year when a higher margi tax rate applies. In this circumstance, because of the taxpaye low initial tax rate, the taxes deferred may actually be worth l than the taxes owed at the later date when the taxpayer is i higher tax bracket.

ovisions of present law providing saving incentives

Present law contains various tax incentives for savings. While ; earmarked for education, these incentives may provide the op-·tunity to save for education expenses. Given the existence of se tax-preferred savings instruments, some argue that addition- savings incentives are not justified.

For example, the interest on qualified bonds issued by State and al governments is exempt from Federal income taxation. The in-est on U.S. Series EE savings bonds is taxed on a deferred basis. der certain circumstances, benefits accrued under a qualified ısion plan may be borrowed or withdrawn to pay education ex-ıses. Interest earned on a life insurance contract accrues annual- (inside buildup). The interest income which has accrued to the icy is subject to taxation on a tax-deferred basis. The policy ıld be redeemed to pay education expenses. Alternatively, a loan ıinst the cash surrender value of a life insurance contract can be d to pay education expenses, generally without current tax on inside buildup. Parents can establish a trust under section)3(c) the income of which may be taxed at lower marginal tax es than the parents' rate; the trust can then be used to pay edu-ion expenses. In addition, assets may be shifted to children and eive the benefit of the children's lower marginal tax rates if the ldren are over 14 years old.

Others argue that the existing tax incentives are insufficient to courage systematic, long-term saving for education expenses, ich have risen rapidly in recent years (see Appendix, below). ey argue that the national saving rate is too low and further in-cements to save are warranted. Moreover, they argue that the nomy would benefit from having a more educated, more skilled or force. Incentives for education would induce more individuals seek post-secondary education or training.

ıo benefits from savings incentives for education?

The immediate beneficiaries of the tax incentives to save for edu-ion provided by the bills are parents who want to fund future ıcation expenses of their children. By providing an exemption m income, or a deferral of tax liability, the bills generally would ovide more benefit to higher-income taxpayers than to lower-come taxpayers. Individuals without any income tax liability uld not receive any benefit from these proposals.

The recipients of the education also could benefit, because gener-y additional education or training increases an individual's earn-; potential. In addition, the recipients may benefit by completing eir education with a smaller burden of debt than they otherwise uld have incurred. However, some would argue that to the tent these incentives would not lead to more individuals enroll-; in post-secondary education or training programs, there would no benefit to the recipients since they would have obtained the ıining even if no such incentives were enacted

Some of the benefit of the incentives may accrue to the educa-nal institutions and their employees, rather than to the taxpay-s and their children. Some believe that such incentives, by in-easing the demand for post-secondary education, would drive up the prices that educational institutions and their employees cha for their services. To that extent, higher prices could transfer benefit from the taxpayer to the educational institution.

The benefit the parents may receive from tax exemption or ferral can significantly increase the rate of return on saving education. This higher return might induce parents to save mo for their children's education that they otherwise would not. If this inducement could increase the national saving rate, leading greater economic growth.

Equity considerations

Some believe it is inappropriate to permit any taxpayer an emption, full or partial, for interest on savings for education. Suc full or partial exemption is equivalent to a deduction for tuit costs. They argue that such a deduction more often benefits high income taxpayers than lower-income taxpayers, and that it is in propriate to extend tax incentives to save to higher-income taxp ers because they already possess the means to save for their c dren's education without added inducement. Others argue that costs of education have risen for everyone and that broadly appl ble tax incentives are justified.

Benefits for higher-income taxpayers could be restricted in number of ways. The amount of the annual contribution could limited. For example, S. 1533 and S. 1572 limit the amount annual contributions that may be deducted and phase out the duction for higher-income taxpayers. Similarly, S. 1817 would permit exemption of the earnings of education savings bonds taxpayers with adjusted gross income in excess of $150,000, would provide only partial exclusion for taxpayers with adjus gross income between $75,000 and $150,000. However, even these taxpayers, the benefit of tax deferral remains.

Credits for annual contributions, rather than deductions, co be utilized. For example, S. 1659 and S. 1661 would provide a credit for contributions made to an education savings account the intended beneficiary. In general, a credit provides the same duction in tax to all taxpayers regardless of their tax rate. Depe ing upon the size of the credit, the credit could be more or less g erous than a deduction. However, deductions and credits, if not fundable, provide no benefit to individuals who have no tax lia ity.

Limiting the ability of higher-income taxpayers to benefit fr exemption does not necessarily remove the benefit of deferral 1662 would limit the annual tax deferral for all taxpayers to deferral of the tax which would be due on no more than $1,00 education savings bonds.

Some who believe that the benefit of the incentives accrues the recipients of the education feel it is unfair that the recipi does not pay tax on at least a portion of the benefits received. T suggest that some of the benefits granted to current taxpay should be recaptured from the taxpayers' children upon the c pletion of their education. For example, S. 1659, S. 1660, and 1661 each would recapture at least part of the benefits by addin the taxable income of the child 10 percent of the benefits, in equal installments starting in the year the child reaches age 25.

From a family's perspective, these bills would provide deferral of x liability. However, from the parents' perspective, the benefit ould be one of exclusion from income, because the deferred tax ould be collected from the children. If the parents view the educa- n savings account as full or partial exclusion, the bill would pro- le a clear incentive to establish these accounts. If the parents xe the family perspective, the benefit of deferral depends, in rt, upon the rate at which the tax is deferred and the rate at ich the tax is ultimately due. Most typically, children are sub- t to lower tax rates upon their completion of post-secondary ining than their parents face. When this is true, deferral can rry a substantial benefit. The benefit of deferral will be greater if e deferred amounts are taxed at a lower rate than the rate that ould apply if such amounts were included in the parents' income. hen the children are subject to higher tax rates than their par- ts, the benefit of deferral decreases but is not necessarily elimi- ted.

Some would view the concept of assigning the ultimate tax liabil- to the children as appropriate because it is the children who re- ve the benefit of the education. On the other hand, assigning the x liability to the children may increase the financial burden of ung individuals. For example, $50,000 in college expenses would assigned to the child beginning at age 25. If the child is taxed at e 15-percent marginal tax rate, tax liability would be increased $750 per year. The child would owe $1,400 per year in additional xes at a 28-percent marginal rate. Some would argue that this is propriate, since a higher income could result from a greater ben- t received from education. However, since the typical case is for e parents' income to exceed their children's income, this would a regressive shift of the tax burden.

An additional consideration in taxing the educational benefit to e child is administrative complexity. One or more taxpayers may ntribute to the account of a single beneficiary; the taxable por- n of the benefits must be traced to the beneficiary at age 25, ich is three years beyond the age at which the average college ident graduates. Distributions not expended on education create ax liability for the contributors. This could create significant en- cement burdens for the IRS, which would be required to identify e contributors to whom the tax liability applies and the portion liability applicable to each contributor.

vings incentives for education and the national savings rate

Some argue that, as a nation, we save too little. All the above- scribed bills would increase the after-tax return for savings, ereby making saving a relatively more attractive option than rrent consumption. As a result, the taxpayer may choose to save ore. However, if the taxpayer saves with certain goals or target ounts in mind, increasing the net return to saving could lead e taxpayer to save less because the same amount could be saved th a smaller investment of principal. For example, a taxpayer in e 28-percent marginal bracket may set aside $1,300 today to help fray tuition expenses 15 years from now. If the taxpayer's invest- ent earns eight percent annually and those earnings are taxed nually, 15 years from now his investment will be worth $3,000. If the taxpayer could defer the tax owed on the earnings for 15 year an investment of only $1,025 today would be worth $3,000 15 yea from now. Empirical investigation of the responsiveness of person saving to after-tax returns provides no conclusive results. Son find personal saving responds strongly to increases in the n return,[7] while others find little or a negative response.[8]

Creating new tax-favored saving arrangements does not necessa ily create new saving. The higher net return and the increas awareness of the need to save for college expenses which cou arise from the private market advertising for education savings a counts or the sale of education savings bonds could induce taxpa ers to save more. On the other hand, the taxpayer might mere transfer existing savings accounts into a tax-advantaged educati account. The proposed structure for education savings bonds, ed cation savings accounts, and the education savings trust is simil in structure to present-law deductible and nondeductible individu retirement accounts ("IRA"). Some believe that IRAs have been r sponsible for new saving, i.e., saving which would not otherwi have occurred.[9] Others argue that IRAs have for the most pa been financed by taxpayers either shifting funds from their exi ing holdings of securities into IRAs, or by placing in IRAs fun which they would have saved anyway.[10] In addition, it would possible to finance the account with borrowed funds, in which ca no net saving would occur. If a home equity loan were used, t interest on the borrowed funds would be deductible as well.

As discussed above, some of the bills would limit the ability higher-income taxpayers to utilize fully all of the incentives. Ex rience with IRAs prior to the restrictions imposed by the T Reform Act of 1986 on contributions by higher-income individu indicated that although many lower-income individuals contribut to IRAs, the percentage of participation was greatest amo higher-income taxpayers. Higher-income taxpayers made larg contributions as well. Taxpayers with adjusted gross incomes excess of $50,000 constituted approximately 29 percent of all II contributors, but accounted for more than 35 percent of 1985 II contributions.

Distributions for expenses other than education

It may be possible for taxpayers to use these incentives to ac mulate more funds than they need to meet post-secondary edu tion expenses. The bills establishing education saving accounts the National Education Saving Trust would include in the inco of the contributors their pro rata share of any distributions fr the accounts which are not spent on qualified education expens In addition, each bill would provide for an additional 10-perc income tax on such distributions to recapture partially the tax b

[7] *See* M. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Econ* April 1978, 86.

[8] *See* G. von Furstenberg, "Saving," in H. Aaron and J. Pechman (eds.), *How Taxes A Economic Behavior*, Brookings Instiution, 1981.

[9] *See*, Venti, Steven F. and David A. Wise, "The Evidence on IRAs," *Tax Notes*, vol. 38, J ary 25, 1988, pp. 411-16.

[10] *See*, Galper, Harvey and Charles Bryce, "Individual Retirement Accounts: Facts Issues," *Tax Notes*, vol. 31, June 2, 1986, pp. 917-21.

t or deferral for such distributions. S. 1572 would increase the ditional tax to 20 percent if the distribution occurs after the med beneficiary's 25th birthday.

Establishing an account or buying education saving bonds could advantageous for taxpayers even if they have no intention of iding post-secondary education for their children. This is because the benefit of tax deferral that the accounts would provide. For ample, for a taxpayer with a 28-percent marginal tax rate, $1,000 income would leave $720 available after tax to be saved. If this iount is invested to earn eight percent annually and the earn- gs are taxed annually, at the end of 10 years the taxpayer will ve $1,260.51. If, however, the taxpayer can deduct the $1,000 and cumulate the interest tax-free, at the end of 10 years he or she ll have $2,158.93. After including the distribution in income, sub- t to the additional 10-percent tax, the taxpayer would net 338.54 (six percent more than if the account had not been used). e result would be different if the initial contribution is not de- ctible.

In both S. 1662 and S. 1817, the education savings bonds would registered to the purchaser. The purchaser need not have chil- en to buy the bond. If not used for qualified education expenses, e proceeds would be taxed as ordinary income in the year in iich the bond is redeemed. These bonds could become vehicles for ving for purposes other than financing education, because they er any taxpayer the advantage of tax deferral on his or her in- stment. While an IRA currently offers the benefit of tax deferral, penalty is imposed for withdrawal before retirement age. As a sult, these bonds should be a more preferred saving instrument. S. 1662 would moderate this potential effect by limiting the nual tax deferral to interest on the first $1,000 of such bonds. In dition, S. 1662 would require that no interest be paid on any nd held longer than 20 years. On the other hand, S. 1662 would empt from taxation the accumulated interest if the taxpayer died became disabled. To the extent that taxpayers use these bonds a general saving instrument at the expense of Federal revenues, ey could operate as an inefficient means of aiding education.

Some might argue that providing the tax benefit of deferral ien the proceeds are not spent on education is inappropriate. The nalties in the bills may be sufficient to keep taxpayers from ing these tax preferred instruments for expenses other than edu- tion. However, the penalties also could discourage taxpayers om using these instruments. Many high school graduates do not on to college or other formal post-secondary training. If parents tablished these tax-preferred accounts or purchased education vings bonds, they would not know if their children will gain ad- ittance to college. If their children do not enroll in a post-second- y education program, the parents would be subject to the penal- es. Depending upon the size of the potential penalties compared the tax saving, this could create a financial risk the parents ould not want to assume. This could lead to the accounts being tablished by those who are most sure that their children will be ing on to college. These parents are also most likely to save for llege expenses in the absence of tax incentives.

On the other hand, parents who establish accounts might mor readily encourage their children to seek post-secondary trainin This additional training could be valuable to the economy as whole.

Other issues in saving for post-secondary education

Investment of the account or trust monies

S. 1533, S. 1659, S. 1660, and S. 1661 would create individuall directed saving accounts. The contributor could direct the truste to invest in stock, bonds, etc. S. 1572, S. 1662, and S. 1817 woul require that proceeds be invested in Federal securities or Federall backed securities. Typically, Federal securities generate lower ave age earnings than corporate stock or other financial instrument Some would argue that restricting investment to lower-earning s curities would diminish the incentive effect of a savings plan. I addition, they argue that freedom of choice would allow parents t earn higher yields and thereby more easily accumulate the nece sary funds to meet post-secondary education expenses.

On the other hand, Federal securities are risk-free. Funds save for education through Federal securities are assured of havin their full face value plus accumulated interest available for futu education expenses. The stock market and other investments a inherently risky and neither principal nor earnings are assure thus, parents could accumulate less money than needed for the children's education.

For many taxpayers, the interest on the education savings bon would be exempt from tax, or at least are more favorably tax than other income. At the same time, the interest the bonds wou pay could be significantly higher than that offered by existing ta exempt bonds.[11] If so, such bonds would provide strong direct co petition for the municipal bond market. This could force States a municipalities to offer higher yields to attract lenders, thereby i creasing borrowing costs of State and local governments.

Other financial aid

Children of parents who have not accumulated sufficient funds pay for college expenses are often eligible for other financial ai either private or governmental (see the Appendix, below, for inf mation on Pell grants, Perkins Loans, Guaranteed Student Loa etc.). In general, eligibility for this aid depends upon parents' cu rent income and parents' accumulated assets. The greater the pa ents' income and the greater their accumulated assets, the le likely the student will qualify for financial aid. Reducing t amount or likelihood of Federal or other aid to the student impos an implicit tax on the accumulation of assets. This might redu the effectiveness of these bills in stimulating saving for college ed cation.

[11] Under S. 1662, the bonds would pay the Federal long-term rate. S. 1817 does not author the Treasury to issue a new series of bonds, but rather would permit purchasers to qualify purchasing any existing Treasury issue. The Treasury currently issues, as Series EE bo bonds whose interest earnings are not taxable until the bonds are redeemed. Thus, the exist Series EE bonds provide the benefit of deferral.

;. 1572 explicitly would require that the proceeds of an educa-
nal savings trust not be included in any computation of Federal, ıte, or private financial aid. While this removes the implicit pen- y on accumulation, it also means that certain programs designed aid lower-income families may be opened to high-income fami- ;.

;ome would argue that it is appropriate to ask those who are althier to assume a greater burden of the expense of education m their own sources. Others would respond that this encourages ›ple not to save for their children's education but rather to rely subsidies provided by Federal, State and private programs, and ınfairly burdens those parents who do sacrifice to save for their ldren's education.

Definition of education expense

n general, the bills would provide savings incentives for ounts of qualified education expenses, including tuition, fees, l reasonable room and board expenses. S. 1817 would exclude ex- ıses for room and board. Some would argue that since parents uld provide for their children's room and board if they did not away to school, it is inappropriate to provide tax benefits for se expenses; also, it can be argued that these are not expenses urred directly for education purposes. In addition, they argue it uld be unfair because parents whose children continue to live at ne do not receive the same benefit. On the other hand, expenses room and board typically cost more if one lives away from ne. For children who do not attend a local college, such expenses necessary if they are to receive the post-secondary training.

B. Deduction for Interest on Education Loans

S. 628 would permit the full amount of interest on qualified ed cation loans to be deducted by individuals as an itemized dedu tion. To the extent deductibility reduces the cost of debt associat with education expenses, this provision may reduce the cost of ed cation and thereby make college more affordable to a great number of individuals. Also, it is argued that student loans oft impose a heavy burden on graduates at the beginning of their c reers; interest deductibility under the bill may ameliorate th burden.

S. 628 would reduce education costs only to the extent that de is incurred. Because the bill may reduce the effective cost of de relative to other financing methods, opponents may argue that i terest deductibility might encourage students to assume addition debt instead of using current earnings or previous savings for ed cation expenses.

Further, it is argued that the deductibility of student loan inte est might benefit predominantly middle- and upper-income taxpa ers, since college graduates generally earn higher levels of incor than individuals who do not attend college. Because education loan interest would only be deductible by itemizers, and the pe centage of individuals who itemize increases with income, highe income taxpayers may benefit more than lower-income individua In addition, the value of the deduction would be greatest for ta payers in the highest bracket. Also, the highest level of loans ge erally would be obtained by students who continue on with prof sional or graduate education and who typically would have t highest income levels during the repayment period.[12]

On the other hand, some argue that the benefits of deductibili would accrue more to lower- and middle-income individuals b cause higher-income individuals may not need to borrow to finan education costs. To the extent that higher-income students wou borrow to take advantage of the deduction while spending their r sources on other goods or services, however, this argument may n be as persuasive.

Some believe that interest deductibility is desirable to allevia the excessive burden that student loan repayments place on sor graduates.[13] To the extent any excessive burden stems from lo income or unemployment rather than high levels of debt, the effe of deductibility of interest payments might provide limited reli

[12] The Guaranteed Student Loan (GSL) program limits aggregate loans at $17,250 for und graduates and $54,750 for graduate and professional students.

[13] For 1984 graduates of four-year educational institutions with educational debt and w held full-time jobs the year after graduation, a third had debt repayments amounting to m than six percent of pre-tax income in the first year of repayment. Ten percent of the gradua had repayments greater than 10 percent of income. See Cathy Henderson, "College Debts Recent Graduates," American Council on Education, December 1987.

r Federally subsidized loans, a reduction in repayment rates or :reased deferments might be of greater value in reducing the rden on lower-income graduates than would interest deductibil- .[14] Similarly, some argue that high debt levels and correspond- ;ly high after-tax interest payments prevent graduates from ac-)ting lower-paying public service jobs.

ndividuals who incurred debt for educational purposes prior to the x Reform Act of 1986 may have expected to be able to deduct erest charges when the debt was to be repaid. Some consider the ase-out of the personal interest deduction enacted in 1986 as ıcing an unfair, additional burden on these individuals that ıld not have been expected when the debt was incurred. Others ;pond, however, that the phase-out applies to interest on all per- ıal debt, not just that on student loans.

\ccording to one study, 43 percent of graduates of four-year insti- ions of higher education in 1984 had borrowed money for educa- nal expenses.[15] Of 1984 graduates who borrowed funds, the aver- ; indebtedness was $5,470. For the average debtor, interest de- ctibility under the bill would reduce the net-of-tax loan repay- nt cost by a maximum of $72 in any year when compared to :sent law; the maximum present value reduction in the total cost education from the year of enrollment would be under $350.[16] n another example, a 1987 college graduate who had accumulat- the four-year GSL maximum total debt of $13,250 (under :sent law) would receive, from the enactment of S. 628, no more ın $200 of tax benefits in any year; the present value of the tax ıefits due to the bill would be less than $1,050. Likewise, the av- ıge 1987 entering freshman who borrows for educational purposes projected to accumulate a total educational debt of $11,360.[17] e tax benefit for this 1991 graduate would not exceed $250 in the st year of repayment, while the present value of the tax benefits uld be under $1,200. If the student is not able to itemize for ne years of debt repayment, the benefit might be significantly ver.

[4] The GSL program already provides several deferments, including up to two years due to mployment and for periods of additional study.

[5] The data in this paragraph are based on an analysis of the Department of Education "1985 ent College Graduate Survey" presented in Henderson, *supra*. The analysis omits graduates) were at the time enrolled in a further degree program.

[6] These calculations assume a nominal interest rate on the loan of eight percent, that debt is ıted as a GSL with deferment until six months after graduation and a ten-year repayment iod, and that in each repayment period year the borrower itemizes and is in the 28-percent rginal tax bracket. It also is assumed that the borrower graduates in four years. Present ues are are calculated using a five-percent annual discount rate and using the initial year of ollment as the base year. This makes the present value amounts comparable to total college ts discounted to the freshman year.

[7] This projection is based on an 11-percent growth in the average 1984 graduate debt level e Henderson, *supra*).

C. Employer-Provided Educational Assistance

S. 39 would reinstate the prior-law exclusion (sec. 127 of tl Code) from income and employment taxes for employer-provid educational assistance; this exclusion expired at the end of 198 Under present law, the value of employer-provided education th relates directly to the taxpayer's current job remains excludabl however, the value of expenses of training for a new job or occup tion is not excludable.

The prior-law exclusion for employer-provided educational assis ance can be viewed as a means for advancing the goal of increas educational opportunities. In this view, encouraging employers retrain employees for new jobs or careers is an efficient means increase the skills and productivity of the workforce. Educati which employers provide is more likely to be of direct econom value to both the employee and the firm. Some believe, howev that the most useful employer-provided expenditures already a excludable as job-related education expenses.

Some also could argue that the prior-law exclusion provided t benefits in an unfair manner. An individual who incurred non-jo related education expenses directly would not be entitled to a dedu tion for such expenses, while an individual covered by an employ provided plan would be able to exclude from income the same e penses.

Compared to the excludability of job-related expenses, an exc sion for all employer-provided educational assistance arguably p vides a greater benefit to less-skilled individuals. Higher-incon higher-skilled employees often can more easily justify education expenses as related to their current job while, for example, a cle may have difficulty in justifying most educational expenses as rectly related to his or her current job.

Others believe that the section 127 exclusion would favor high income individuals, in part because exclusions are more valuable higher-income taxpayers. Also, the exclusion might be utilized to greater extent by higher-income taxpayers. Nondiscriminati rules would help ensure that lower-income taxpayers also bene though not necessarily to the same extent.

The section 127 exclusion was viewed by some as a method avoid considerable uncertainty for employers and employees garding eligible job-related educational expenditures. Many belie that it is administratively difficult for taxpayers and the IRS to d tinguish job-related from other educational expenses, and that t prior-law exclusion provided a useful simplification. Others belie that if the prior-law exclusion is not reinstated, the IRS could p vide additional guidance defining job-related education.

D. Certain Student Loan Bonds

eption to arbitrage rebate rules

ypically, student loan bonds are issued by qualified scholar- funding corporations or other issuers which have been specifi- y created to administer these programs. Generally, qualified olarship funding corporations do not receive direct assistance n State governments. Recognizing this fact, Congress permitted se issuers to utilize arbitrage earned on their bond issues to fi- ce their operations for a transitional period while they sought e permanent financing from the State government or other rces. Since arbitrage earnings on the issue of tax-exempt securi- largely come at the expense of lost Federal revenue, this spe- exemption is equivalent to the Federal Government funding operation of these independent corporations. S. 2149 would ke permanent this implicit Federal funding of these independ- corporations.

ome argue that Federal funding of these corporations is appro- ate because they administer the operation of Federal education stance programs (the GSL and PLUS education loans). Since benefits derived from higher education do not accrue to any State, but to the nation as a whole, Federal assistance to these porations links program costs to program benefits. In addition, rating these loan programs through corporations at the State el decentralizes the administration of the programs and places it er to those receiving the loans. This decentralization can create ortunities for experimentation at the State level and also may litate monitoring of the program. Permitting these corporations finance themselves through arbitrage earnings removes their gets from the political process and assures their continued oth functioning.

thers argue that while the Federal Government provides inter- subsidies for GSL and PLUS loans, these programs are State- ninistered programs which direct the loans to State residents. ce the immediate benefits are directed to State residents, the tes should pay the administration costs. The purpose of these leral programs is to utilize tax-exempt bonds to lower the bor- ving costs of eligible students, not to provide an indirect subsidy program operating expenses. Early issuance of tax-exempt bonds maximize profits is inefficient. The cost of arbitrage to the Fed- l Government is greater than the revenue lost to an equal incre- ntal issue of tax-exempt bonds used to lower student borrowing ts.

n addition, it is argued that financing the operation of these cor- ations by arbitrage earnings removes the administration of se programs from Federal or State budgetary oversight. Unlim- d use of arbitrage earnings permits the corporations to determine their own administrative budget. Lastly, making perman this transitional exception would establish for these private co rations more favorable arbitrage rules than those that apply to other tax-exempt bond. For example, State and local governme are not permitted such treatment on their general obligat bonds.

Issuance of supplemental student loan bonds

States may issue supplemental student loan bonds as private tivity bonds S. 2149 would permit private corporations to is bonds which are presently the purview of the States. In additi by extending the exception from arbitrage rebate rules to these porations, the bill would implicitly fund the administration of St supplemental student loan program with foregone Federal re nues.

Some believe that consolidating these programs would lo overall administrative costs. In addition, exempting the State s plemental student loan bonds from arbitrage rules would furt the Federal goal of providing low-cost funding for post-second education.

Opponents argue that while GSL and PLUS loans both carry plicit Federal subsidies and guarantees, the State supplemen student loan bonds do not. Moreover, the loans made from the ceeds of supplemental student loan bonds are not subject to Federally mandated income targetting rules. Since the supplem tal student loans are purely a State program, and do not necess ly fulfill Federal policy goals of aiding lower-income families may be inappropriate to finance the administration of the St program through the Federal revenue loss which arbitrage ger ates.

APPENDIX

Direct Aid to Students for Post-Secondary Education

ckground

Throughout the 1980's, more than 12 million students have enled annually in post-secondary education or training programs, :h approximately 80 percent enrolled in public institutions and percent in private institutions. From the average high school iduating class, 65.8 percent enroll in some form of post-secondary ication or training program at some point in the four years folving their high school graduation. During this period, 45.2 perit attend a four-year college or university, 27.9 percent attend a o-year college, and 7.6 percent attend a vocational or technical iining school.[1]

In every year since 1981, the costs of attending a two- or fourar college have risen faster than the rate of inflation; by conist, in the late 1970's college costs lagged behind inflation. As ble 1 below details, since 1976 college tuition and fees generally ve risen 30 percent more than the economy's overall price level. r the 1975–76 academic year, the total cost of attending a fourar private college averaged $4,391 (tuition of $2,240) and the total it of attending a four-year public college averaged $2,679 (tuition $578). For the 1986–87 academic year, the comparable total cost ure had risen to $10,199 (tuition of $5,793) for a four-year private lege and to $5,604 (tuition of $1,337) for a four-year public col;e.

Center for Education Statistics, *The Condition of Education 1987.* The subcategories do not d to 65.8 percent because an individual may be counted in more than one category. For exam-, a student might attend a junior college before attending a four-year college.

Table 1.—Annual Percentage Change in Average College Costs, 1976–1987

Year [1]	2-year colleges				4-year colleges				Change in Consumer Price Index (CPI)
	Public		Private		Public		Private		
	Tuition and fees	Total cost of resident students	Tuition and fees	Total cost of resident students	Tuition and fees	Total cost of resident students	Tuition and fees	Total cost of resident students	
1977	28.6	1.8	5.3	5.9	7.4	4.1	4.0	4.0	6.5
1978	0.5	3.9	4.1	2.8	0.0	4.2	6.3	5.3	7.7
1979	4.9	4.5	6.5	6.2	4.8	5.1	6.9	6.2	11.3
1980	−4.7	3.5	5.9	6.7	4.5	6.7	10.4	8.1	13.5
1981	19.3	13.1	1.8	8.8	3.8	4.6	12.2	10.1	10.4
1982	1.1	3.4	26.6	22.0	16.0	13.6	13.1	13.2	6.1
1983	26.9	10.3	−5.5	2.6	19.5	13.3	8.4	8.6	3.2
1984	4.4	8.6	24.5	15.0	12.9	7.6	15.1	12.9	4.3
1985	−3.7	3.4	10.0	6.9	1.9	3.4	8.4	6.9	3.6
1986	10.2	[2] NA	9.3	8.9	10.3	8.9	8.0	7.1	1.9
1987	0.6	[2] NA	5.1	4.7	7.6	5.5	6.9	5.6	3.7
1976–1987	120.2	[2] NA	136.7	118.3	131.2	109.2	158.6	132.2	99.6

[1] Change is measured from preceding year. Hence, 1979 measures the change from 1978 to 1979.
[2] Not available.

Source: S. Boren, "Selected Tables and Readings Related to College Costs," Congressional Research Service, September 16, 1987.

leral direct aid to post-secondary students

Pell Grants

'ell Grants provide a foundation of financial aid, to which aid m other Federal and non-Federal sources may be added. To ılify, the student must be an undergraduate enrolled at least f-time. In addition, the student or his or her parents must satis- a needs test based on the student's or parents' current income l accumulated assets.

'he maximum award for the 1987–88 academic year is $2,100; no ayment is required. Pell Grants are usually limited to providing istance for five years of study. Pell Grants are awarded without ard to the school the student chooses to attend.

Supplemental Educational Opportunity Grants

\ Supplemental Educational Opportunity Grant ("SEOG") is an ard for undergraduates with exceptional financial need, with ority given to Pell Grant recipients. As a grant, it does not have e repaid.

'he maximum SEOG is $4,000 per year. The size of the grant a dent receives depends upon need and the availability of SEOG ıds at the school. Financial need is determined by reference to Uniform Methodology.[2] The Uniform Methodology makes a dif- ent calculation of need than does the Pell Grant, but like the l Grant bases its calculation on the student's or his or her par- s' current income and accumulated assets.

College Work-Study

'he College Work-Study ("CWS") Program provides wage subsi- s to colleges for jobs held by undergraduate and graduate stu- ıts who need financial aid. The student must be paid at least the leral minimum wage, but may be paid more depending upon the e of work. A student's award of CWS funds depends upon need determined by the Uniform Methodology, the availability of ıds at the school, and other sources of aid.

Perkins Loans

'erkins Loans, formerly National Direct Student Loans, are low- erest loans (currently five percent) to students for post-second- / undergraduate or graduate education. Eligibility is needs-tested sed on the Uniform Methodology.

The student may borrow up to $4,500 if enrolled in a vocational gram or if he or she has completed less than two years of a pro- am leading to a bachelor's degree; up to $18,000 if the student s completed two years of study toward a bachelor's degree; and to $18,000 for graduate or professional study. This latter total ludes any Perkins Loans received to finance undergraduate ıdies.

No payment of principal or interest is required until nine nths after the student graduates or leaves school. Interest pay-

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See, S. Boren, "Provisions of the Pell Grant Family Contribution Schedule and the Uniform thodology As Contained in the Higher Education Amendments of 1986," Congressional Re- rch Service, July 9, 1987.

ments may be deferred thereafter under certain circumstanc such as service in the Armed Forces. The borrower has up to years to repay.

Guaranteed Student Loans

A Guaranteed Student Loan ("GSL") is a low-interest loan ma to the student by a private lender such as a bank; these loans a insured by a State guarantee agency and reinsured by the Fede Government. The interest rate for GSLs commencing July 1, 19 will be eight percent. The Federal Government pays a special lowance to lenders to bring the GSL borrower's rate up to appro mately the fair market rate. Eligibility is determined by the U form Methodology. The GSL program is a needs-tested entitleme program, the only entitlements program in the Department of Ec cation.

Depending upon need, the student may borrow up to $2,625 p year if a first- or second-year undergraduate student; up to $4,000 two years of undergraduate study have been completed; and up $7,500 per year if a graduate student. As an undergraduate, t total amount of GSL debt the student may have outstanding $17,250. The total for graduate study is $54,750, including loans ceived as an undergraduate.

Loan repayments begin six months after the completion of stu Loan payments may be deferred under certain circumstances. T Federal Government makes interest payments on behalf of the s dent while the student is enrolled in school and during defer periods. The lender must permit at least five years and may all up to 10 years to repay.

PLUS Loans and Supplemental Loans for Students

PLUS loans are for parent borrowers and Supplemental Loa for Students ("SLS") are for independent student borrowers. Li GSLs, they are made by private lenders to the parents or the s dent. SLS and PLUS loans carry a variable interest rate, adjust annually. The variable rate is based on the bond equivalent rate the 52 week Treasury-bill plus 3.25 pecentage points. For the 198 88 academic year, the interest rate is 10.27 percent. PLUS and S loans are not needs-based.

The loans are insured by the State guarantee agency and re sured by the Federal Government. Unlike GSL loans, the Fede Government does not pay interest during deferral periods. The on direct Federal subsidy, aside from insuring defaults, occurs if t calculated interest rate for PLUS and SLS loans rises above 12 p cent. In that circumstance, the loan rate is capped at 12 perce and the Federal Government pays a special allowance to lende

PLUS enables parents to borrow no more than $4,000 per ye up to a total of $20,000, for each child who is enrolled at least ha time. Under SLS, graduate students and independent undergrad ates may borrow no more than $4,000 per year, up to a total $20,000. This amount is in addition to the GSL limits.

State Student Incentive Grants

State Student Incentive Grants provide grants to those Sta which establish a scholarship program and use State funds ıtch the Federal funds. The maximum grant a student may re- ve under this program is $2,500. The States establish the eligibil- criteria.

ɔpe of direct aid to students

n addition to Federal aid, direct aid is available to post-second- ɾ students from State programs and from private institutions. ble 2, below, shows the trend in direct aid to students since 1970. ıce 1975, total aid available and institutional aid have risen ıghly at the rate of overall inflation, but somewhat less than the ɪre rapidly rising college costs. Because total enrollment in insti- ions of higher education has risen from 11.2 million to 12.2 mil- n, student aid per enrolled student has not kept up with the ɜrall inflation rate.[3]

'able 2.—Sources of Student Aid to Higher Education, Selected School Years 1970–71 to 1985–86

[In million of dollars]

Source	1970–71	1975–76	1980–81	1985–86
ɪeral student aid:				
Pell grants		936	2,387	3,749
SEOG grants	134	201	366	396
College work study	227	295	658	693
Perkins loans	240	460	695	841
Guaranteed student loans, PLUS, and SLS	1,015	1,267	6,201	9,411
State student incentive grants		20	76	76
Subtotal	1,616	3,179	10,383	15,166
her Federal aid:				
Veterans	1,121	4,180	1,714	746
Social Security	499	1,093	1,883	0
Other aid	109	180	190	[1] NA
ɜtitutionally awarded aid	965	1,435	2,138	3,426
ate grant programs	236	490	801	1,374
Total	**4,495**	**10,486**	**17,099**	**21,008**

Not available.

ɔource: S. Boren, "Selected Tables and Readings Related to College Costs," ngressional Research Service, September 16, 1987.

S. Boren, "Selected Tables and Readings Related to College Cost," Congressional Research vice, September 16, 1987.

Table 2 indicates that loans are the fastest growing component Federal aid. However, the growth of total borrowing does not nec- sarily imply that real indebtedness of students has increased.

Table 3 shows that while the number of students receiving F- erally sponsored loans has increased substantially, the avera GSL and Perkins loans, measured in constant dollars, has creased slightly. More students are using Federally sponsored loa rather than each student taking a larger loan. On a per-stud basis, this suggests that nonloan direct aid to students has declin even more.

Table 3.—Post-Secondary Student Borrowing by Program, Selected School Years 1970–71 to 1985–86

[Number of loans in thousands]

Program	1970–71	1975–76	1980–81	1985
Guaranteed Student Loans				
Number of loans	1,017	922	2,899	[illegible]
Average loan:				
Current dollars	$998	$1,374	$2,134	[illegible]
Constant 1986 dollars	$2,824	$2,784	$2,770	[illegible]
Perkins Loans				
Number of loans	452	690	813	[illegible]
Average loan:				
Current dollars	$532	$667	$853	[illegible]
Constant 1986 dollars	$1,505	$1,351	$1,107	[illegible]
PLUS Loans				
Number of loans	[1] NA	[1] NA	6	[illegible]
Average loan:				
Current dollars	[1] NA	[1] NA	$2,333	[illegible]
Constant 1986 dollars	[1] NA	[1] NA	$3,029	[illegible]

[1] Not applicable.

Source: J. Hansen, "Student Loans: Are They Overburdening A Generatio College Entrance Examination Board, February 1987.

able 4 indicates that student debt, from all sources, has risen as ercentage of college costs. In conjunction with Table 3 data, this ht suggest that non-Federally sponsored borrowing has in- ised in importance.

Table 4.—Comparison of Cumulative Debts of 1977 and 1984 College Graduates

	1977 Graduates		1984 Graduates	
	Public	Private	Public	Private
rage cumulative debts	$2,348	$3,114	$4,970	$6,350
rage cost of 4 years of llege	$10,500	$17,900	$17,100	$32,500
ts as percentage of costs ..	22	17	29	20

tes: Based on Department of Education surveys of college graduates. Cumula- lebt is defined as total educational debt from all sources. Data only includes ime employed graduates of four-year institutions who incurred some positive int of educational debt.

irce: C. Henderson, "College Debts of Recent Graduates," American Council lucation, December 1987.

expenditures for education

esent law contains several provisions which directly benefit ation and training. For example, scholarship and fellowship me is excluded from taxation (up to certain limitations). Par- may claim an exemption for students age 19 or over. The in- st on State and local government student loan bonds is tax- npt. Contributions to educational institutions are tax-deductible itemizers, subject to certain limitations. Over the next five s, fiscal years 1989–1993, the various tax expenditures related ducation and training are estimated to be worth $17.2 billion.[4]

oint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1989–* (JCS-3-88), March 8, 1988.

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