DESCRIPTION OF EDUCATION SAVINGS ACT FOR PUBLIC AND PRIVATE SCHOOLS AND A REVENUE OFFSET

Scheduled for Markup

By the

HOUSE COMMITTEE ON WAYS AND MEANS

On October 9, 1997

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

October 8, 1997

JCX-59-97

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the "Education Savings Act for Public and Private Schools" and present law relating to "education IRAs" as enacted in the Taxpayer Relief Act of 1997. This document also provides a description of present law and a proposal relating to the treatment of employer deductions for vacation pay.

The House Committee on Ways and Means has scheduled a markup of these items on October 9, 1997.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Education Savings Act for Public and Private Schools and a Revenue Offset (JCX-59-97), October 8, 1997.

I. DESCRIPTION OF EDUCATION SAVINGS ACT FOR PUBLIC AND PRIVATE SCHOOLS

Present Law

Code section 530--enacted as part of the Taxpayer Relief Act of 1997 ("1997 Act")--provides that taxpayers may establish "education IRAs," meaning certain trusts or custodial accounts created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary. Annual contributions to education IRAs may not exceed $500 per designated beneficiary, and may not be made after the designated beneficiary reaches age 18. Contributions to an education IRA may not be made by certain higher-income taxpayers--i.e., the contribution limit is phased out for individuals with modified adjusted gross income between $95,000 and $110,000 ($150,000 and $160,000 for taxpayers filing joint returns). No contribution may be made to an education IRA during any year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.[2]

Until a distribution is made from an education IRA, earnings on contributions to the account generally are not subject to tax.[3] In addition, distributions from an education IRA are excludable from gross income to the extent that the distribution does not exceed qualified higher education expenses incurred by the beneficiary during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year).[4] The earnings portion of an education IRA distribution not used to pay

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[2] Consistent with the legislative history to the 1997 Act, a technical correction is needed to provide that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the named beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

[3] However, education IRAs are subject to the unrelated business income tax ("UBIT") imposed by section 511.

[4] For example, if an education IRA has a total balance of $10,000, of which $4,000 represents principal (i.e., contributions) and $6,000 represents earnings, and if a distribution of $2,000 is made from such an account, then $800 of that distribution will be treated as a return of principal (which under no event is includible in the gross income of the distributee) and $1,200 of the distribution will be treated as accumulated earnings. In such a case, if qualified higher education expenses of the beneficiary during the year of the distribution are at least equal to the $2,000 total amount of the distribution (i.e., principal plus earnings), then the entire earnings portion of the distribution will be excludible under section 530, provided that a Hope credit or Lifetime Learning credit is not claimed for that same taxable year on behalf of the beneficiary. If, however, the qualified higher education expenses of the beneficiary for the taxable year are less than the total amount of the distribution, then only a portion of the earnings will be excludable from gross income under section 530. Thus, in the example discussed above, if the beneficiary incurs only $1,500 of qualified higher education expenses in the year that a $2,000

qualified higher education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[5] However, the additional 10-percent tax does not apply if a distribution is made of excess contributions above the $500 limit (and any earnings attributable to such excess contributions) if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the year in which the excess contribution was made.[6] In addition, section 530 allows tax-free rollovers of account balances from an education IRA benefiting one family member to an education IRA benefiting another family member. Section 530 is effective for taxable years beginning after December 31, 1997.

The term "qualified higher education expenses" means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an "eligible educational institution" (defined by reference to sec. 481 of the Higher Education Act of 1965 and generally including accredited post-secondary educational institutions offering credit toward a bachelors degree, an associate's degree, a graduate-level or professional degree, another recognized post-secondary credential and including certain proprietary and vocational institutions). The institution must be eligible to participate in Department of Education student aid programs. Certain room and board expenses also may be qualified higher education expenses, but only if the student is enrolled at an eligible educational institution on at least a half-time basis. Qualified higher education expenses do not include elementary or secondary school expenses.

Description of Proposal

The proposal[7] would increase to $2,500 the present-law annual contribution limit of $500

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distribution is made, then only $900 of the earnings will be excludable from gross income under section 530 (i.e., an exclusion will be provided for the pro-rata portion of the earnings, based on the ratio that the $1,500 of qualified higher education expenses bears to the $2,000 distribution) and the remaining $300 of earnings portion of the distribution will be includible in the distributee's gross income.

[5] This 10-percent additional tax does not apply if a distribution from an education IRA is made on account of the death, disability, or scholarship received by the designated beneficiary.

[6] A technical correction to the 1997 Act is needed to clarify that the additional 10-percent tax will not apply to the distribution of any contribution to an education IRA made during a taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

[7] An earlier version of this proposal was introduced by Speaker Gingrich and others on August 1, 1997, as H.R. 2373 ("Parents and Students Savings Account Plus Act").

that currently applies to education IRAs. Thus, under the proposal, aggregate contributions that could be made by all contributors to one (or more) education IRAs established on behalf of any particular designated beneficiary would be limited to $2,500 per year.

In addition, the proposal would expand the definition of qualified education expenses that could be paid with tax-free distributions from an education IRA. Specifically, the definition of qualified education expenses would be expanded to include "qualified elementary and secondary education expenses," meaning tuition, fees, tutoring, special needs services, books, supplies, equipment, transportation, and supplementary expenses required for the enrollment or attendance of a designated beneficiary at a public, private, or religious elementary or secondary school (through grade 12). "Qualified elementary and secondary education expenses" also would include homeschooling education expenses if the requirements of any applicable State or local law are met with respect to such homeschooling.

The proposal also would provide that, although contributions to an education IRA generally could not be made after the designated beneficiary reaches age 18, contributions could continue to be made to an education IRA in the case of a special needs beneficiary (as defined by Treasury Department regulations). Moreover, under the proposal, in the case of a special needs beneficiary, a deemed distribution of any balance in an education IRA would not be required when the beneficiary reaches age 30.

The proposal would clarify that corporations are permitted to make contributions to education IRAs, regardless of the income of the corporation during the year of the contribution. As under present law, certain higher-income individuals would not be eligible to make contributions to an education IRA.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

II. EMPLOYER DEDUCTIONS FOR VACATION PAY

Present Law

For deduction purposes, any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees is treated as a deferred compensation plan (sec. 404(b)). In general, contributions under a deferred compensation plan (other than certain pension, profit-sharing and similar plans) are deductible in the taxable year in which an amount attributable to the contribution is includible in income. However, vacation pay which is treated as deferred compensation is deductible for the taxable year of the employer in which the vacation pay is paid to the employee (sec. 404(a)(5)).

Temporary Treasury regulations provide that a plan, method, or arrangement defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. A plan, method or arrangement is presumed to defer the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered (the "2-1/2 month" period). A plan, method or arrangement is not considered to defer the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2-1/2 month period. (Temp. Treas. Reg. Sec. 1.404(b)-1T A-2.)

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in Schmidt Baking Co., Inc., 107 T.C. 271 (1996). In Schmidt Baking, the taxpayer was an accrual basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of substantially vested interest in property to employees for purposes of section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer.[8] The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2-1/2 month period. Thus, the vacation and severance pay were treated as received by the employees withing the 2-1/2 period and were not treated as deferred compensation. The vacation pay and severance pay were deductible by the taxpayer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

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[8] While the rules of section 83 may govern the income inclusion, section 404 governs the deduction if the amount involved is deferred compensation.

Description of Proposal

The proposal would specifically overrule the result in Schmidt Baking and provide that, except with respect to severance pay,[9] the Internal Revenue Code will be applied without regard to the result reached in that case. Thus, under the proposal, the fact that an item is includible income would not be taken into account in determining whether or not payment had been made. For example, with respect to the determination of wether an item of compensation (other than severance pay) is deferred compensation, the fact that the item is includible in the income of employees within the applicable 2-1/2 month period would not be taken into account in determining whether there has been payment or receipt by the employees. Rather, the item must have been actually paid or received within the 2-1/2 period in order for the compensation not to be treated as deferred compensation.

While Schmidt Baking involved only vacation pay and severance pay, there is concern that this type of arrangement may be tried to circumvent other provisions of the Code where payment is required in order for a deduction to occur. Thus, the proposal is not limited to vacation pay or the determination of whether compensation is deferred compensation.

It is intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, do not constitute payment, even if there is an income inclusion. Thus, for example, payment would not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument or by any third party. As a further example, payment would not include a promise of the taxpayer to provide service or property in the future (whether or not the promise is evidenced by a contract or other written agreement). In addition, payment would not include an amount transferred as a loan, refundable deposit, or contingent payment.

The proposal would not affect the determination of whether an item is includible in income. Thus, for example, using the mechanism in Schmidt Baking for vacation pay would still result in income inclusion to the employees, but the employer would not be entitled to a deduction for the vacation until actually paid to and received by the employees.

Effective Date

The proposal would be effective for taxable years ending after October 8, 1997. Any change in method of accounting required by the proposal would be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by section 481 as a result of the change would be taken into account in the year of the change.

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[9] The Committee on Ways and Means is separately marking up a proposal that would apply to severance pay.