

**PRESENT LAW AND BACKGROUND
RELATING TO TAX EXEMPTIONS AND INCENTIVES
FOR HIGHER EDUCATION**

Scheduled for a Hearing
Before the
SENATE COMMITTEE ON FINANCE
on December 5, 2006

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



December 4, 2006
JCX-49-06

CONTENTS

	<u>Page</u>
INTRODUCTION	1
I. EXECUTIVE SUMMARY	2
II. PRESENT LAW	4
A. Tax Exemption for Educational Organizations.....	4
B. Tax Incentives for Contributions to Educational Organizations.....	13
C. Tax-Exempt Financing for Facilities and Activities of Providers of Higher Education...	15
D. Tax Benefits for Education Expenses	20
III. SELECTED ISSUES AND ANALYSIS.....	25
A. Background Data on College Enrollment and Costs	25
B. The Economics of Subsidizing Education	29
C. Issues Relating to the Tax Benefits Provided to Higher Education Organizations.....	31
D. Issues With Respect to Tax Benefits for Individuals Relating to Higher Education Expenses	40

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on December 5, 2006, titled “Report Card on Tax Exemptions and Incentives for Higher Education: Pass, Fail, or Need Improvement?” This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present law and a discussion of selected issues arising with respect to Federal tax benefits provided to tax exempt colleges and universities and various education-related tax incentives.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Tax Exemptions and Incentives for Higher Education* (JCX-49-06), December 4, 2006.

I. EXECUTIVE SUMMARY

Present law

Public and private colleges and universities generally are exempt from Federal income tax on contributions received, income from activities that are substantially related to the purpose of the organization's tax exemption, and investment income, but generally must pay tax on income from a trade or business that is not substantially related to exempt purposes. Tax-exempt colleges and universities described in section 501(c)(3)² are classified as public charities and not as private foundations for tax purposes, and therefore are not subject to tax on investment income, payout requirements, or the other rules applicable to private foundations, and donors to colleges and universities and other public charities thus receive more favorable tax treatment on charitable contributions than do donors to private foundations.

The construction, renovation, and operation of public schools (including State colleges and universities) are activities eligible for financing with the proceeds of tax-exempt, governmental bonds. In addition, State and local governments may issue tax-exempt bonds to provide financing to nongovernmental persons such as section 501(c)(3) organizations. Both capital expenditures and limited working capital expenditures of charitable and educational organizations described in section 501(c)(3) of the Code – including post-secondary schools – generally may be financed with tax-exempt bonds. Unlike tax-exempt bonds issued on behalf of other private parties, there is no annual State limit on the amount of bonds that may be issued for section 501(c)(3) organizations.

Present law includes a variety of provisions that provide tax benefits to individual taxpayers for higher education expenses. These provisions include tax benefits for current expenses, such as the Hope and Lifetime Learning credits, the above-the-line deduction for certain higher education expenses,³ and the exclusions for employer-provided education assistance,⁴ qualified tuition reduction, and qualified scholarships. Present law also includes tax benefits for saving for future education expenses, including qualified tuition programs, Coverdell education savings accounts, and the exclusion of earnings on educational savings bonds. In addition, individuals may save for education expenses on a tax-favored basis through the use of other savings vehicles, such as Roth IRAs and deferred annuities, even though these vehicles are not designed specifically for education expenses. Tax benefits also are provided for past expenses, i.e., a deduction for the payment of certain student loan interest and an exclusion for the forgiveness of certain student loan indebtedness. These tax provisions result in significant tax expenditures.

² All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

³ The above-the-line deduction was available for taxable years beginning in 2004 and 2005.

⁴ Certain provisions relating to the tax benefits provided to individuals for higher education expenses expire after 2010 under the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

Selected issues and analysis

One issue in the educational context relates to the comparative treatment of endowments held by a college or university that is a public charity (no pay out required) versus the treatment of endowments held by a private foundation (pay out required). Arguably, such accumulations of income raise some of the same concerns whether the accumulation occurs in a private foundation or a public charity, such as a college or university.

Distinguishing between the activities of an educational institution that are truly educational in nature, and hence qualify for tax-exempt treatment, and those that lack a significant public purpose, is an important issue. The costs of acquiring a college education have generally risen at a much faster pace than inflation over the past several decades. Most economists generally have argued that there are important public benefits from education, and thus that public subsidization of education is likely economically efficient. Many also argue that, apart from any efficiency gains, subsidizing education for the less well off is desirable for reasons of equity, as education levels are highly correlated with future income. While the tax benefits provided for education expenses under present law may serve to make education more affordable for some taxpayers, these benefits have also been cited as a significant source of complexity, particularly given the number of different benefits and the varying qualifications for each benefit. The expiring nature of some of the provisions also adds to complexity and makes planning for education expenses more difficult. A number of proposals have been advanced that would simplify and rationalize the various provisions, such as combining the separate Hope and Lifetime Learning credits into a single credit.

Other issues relate to whether an activity is educational in nature, or the extent to which a noneducational activity nonetheless is exempt from the unrelated business income tax because income from the activity fits within a statutory exemption. This is the case with respect to commercial activities, such as operation of a university press, bookstore, or restaurant, and in the context of scientific research and technology transfers by colleges and universities. It is also the case for activities such as corporate sponsorship arrangements, which are treated as not subject to the unrelated business income tax so long as certain requirements are met. Issues often arise regarding whether certain types of receipts constitute royalties, which generally are excluded in determining an organization's unrelated business taxable income. In addition, some colleges and universities offer travel tours that are promoted as educational.

With respect to tax-exempt financing, one issue relates to the ability of educational organizations described in section 501(c)(3) to invest accumulated assets at yields higher than the yields on their tax-exempt borrowings. While the ability of issuers to earn and retain arbitrage profits through the investment of tax-exempt bond proceeds generally is restricted, the Code does not define arbitrage in a manner that eliminates every opportunity to earn such profits, i.e., the Code generally only restricts the investment of bond proceeds and amounts that replace such proceeds. The ability of tax-exempt entities to earn an untaxed return on their other investment assets in addition to the ability to borrow on a tax-exempt basis increases the incentive for such entities to issue tax-exempt bonds.

II. PRESENT LAW

A. Tax Exemption for Educational Organizations

Section 501(c)(3) organizations

In general

Charitable and educational organizations described in Code section 501(c)(3) generally are exempt from Federal income tax on contributions received, income from activities that are substantially related to the purpose of the organization's tax exemption, and investment income.⁵ A charitable or educational organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.⁶ The term "charitable" includes, for purposes of section 501(c)(3), the advancement of education or science.⁷ The term "educational," as used in section 501(c)(3), relates to the instruction or training of individuals for the purpose of improving or developing their capabilities, or the instruction of the public on subjects useful to individuals and beneficial to the community.⁸

The following types of organizations may qualify as educational within section 501(c)(3): (1) an organization, such as a primary or secondary school, a college, or a professional or trade school, that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled student body in attendance at a place where the educational activities are regularly carried on; (2) an organization whose activities consist of conducting public discussion groups, forums, panels, lectures, or other similar programs; (3) an organization that presents a course of instruction by correspondence or through the use of television or radio; (4) a museum, zoo, planetarium, symphony orchestra, or other similar organization; and (5) a nonprofit children's day care center. In addition, college athletic organizations that promote certain aspects of athletic competition have generally been held to be educational and, thus, exempt under section 501(c)(3). The exemption is based on the principle that an athletic program conducted for the physical development and betterment of the students is an integral part of a university's overall educational activities. In general, the revenue that a college or university derives from admission to athletic events is considered to be income from a business related to educational purposes and not subject to the tax on unrelated business income.⁹

⁵ Private foundations, a subset of section 501(c)(3) organizations, are subject to an excise tax on investment income of two percent (reduced to one percent if certain requirements are met). Sec. 4940.

⁶ Treas. Reg. sec. 1.501(c)(3)-1(c)(1).

⁷ Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

⁸ Treas. Reg. sec. 1.501(c)(3)-1(d)(3).

⁹ In the legislative history of the Revenue Act of 1950, Congress stated that "[a]thletic activities of schools are substantially related to their educational functions." Therefore, "a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were

A primary issue in determining whether something is educational is not the content of the information but the method the organization uses to convey information. In general, the analytical exercise is to determine whether an organization's presentation of information is objective and balanced, or whether the organization instead is an advocate for propaganda. This is a fine and difficult line to draw, and one with constitutional implications. Because the term "educational" is not defined in the statute and is "inherently general,"¹⁰ the IRS must be careful in administering the term not to deny tax exemption as an educational organization because of the content of the organization's speech. Indeed, part of the Treasury regulations defining educational were held unconstitutionally vague on the ground that the regulation left too much discretion over the content of speech to IRS determinations.¹¹ As an alternative, the IRS developed a four-part test, the "methodology test," which it now uses to determine whether the activities of an organization that advocates a particular viewpoint or position are educational. Regarding the methodology test, the IRS states that it is the long-standing position of the IRS "that the method used by an organization in advocating its position, rather than the position itself, is the standard for determining whether an organization has educational purposes."¹²

In addition to meeting the exempt purpose requirement, a section 501(c)(3) organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;¹³ (3) the organization may not be operated primarily to conduct an unrelated trade or business;¹⁴ (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

A private school that otherwise satisfies the requirements of section 501(c)(3) as an educational institution will not qualify for exemption unless it has a racially nondiscriminatory policy as to students. For example, a private school must include a statement in its charter, bylaws, other governing instrument, or in a resolution of its governing body, that it has a racially

composed of students of other schools." H. R. Rep. No. 2319, 81st Cong., 2d Sess., at 37 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. (1950).

¹⁰ *National Alliance v. United States*, 710 F.2d 868, 873 (D.C. Cir. 1983).

¹¹ The regulations in question provide that "[a]n organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion." Treas. Reg. sec. 1.501(c)(3)-1(d)(3)(i). The "full and fair exposition" test was held unconstitutional in *Big Mama Rag, Inc. v. United States*, 631 F.2d 1030 (D.C. Cir. 1980).

¹² Rev. Proc. 86-43, 1986-2 C.B. 729.

¹³ Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

¹⁴ Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

nondiscriminatory policy as to students and that it does not discriminate against applicants and students on the basis of race, color, or national or ethnic origin.¹⁵

Private inurement and private benefit prohibitions

The doctrine of private inurement generally prohibits a section 501(c)(3) organization, including educational organizations, from using its assets for the benefit of a person or entity with a close relationship to the organization, persons sometimes deemed “insiders” of the organization, such as directors, officers, and key employees. The issue of private inurement often arises where an organization pays unreasonable compensation (i.e., more than the value of the services) to such an insider. However, the inurement prohibition is designed to reach any transaction through which an insider is unduly benefited by an organization, either directly or indirectly.

There is no “de minimis” exception under the inurement prohibition, and an organization that engages in an inurement transaction may face revocation of its exempt status. Until 1996, there was no sanction short of revocation of exempt status in the event of an inurement transaction. In 1996, however, Congress imposed excise taxes, frequently referred to as “intermediate sanctions,” on “excess benefit transactions” between certain exempt organizations and “disqualified persons.”¹⁶ The intermediate sanctions rules, which apply only to transactions involving organizations exempt under sections 501(c)(3) and 501(c)(4), impose excise taxes on an insider (a “disqualified person”) who receives an excess benefit and, under certain circumstances, on organization managers who approved the transaction.

Section 501(c)(3) organizations (but not other organizations) also are subject to a prohibition against conferring more than incidental “private benefit.” The private benefit prohibition applies to non-fair market value transactions with individuals or entities, not merely with insiders, and thus is in some respects broader than the private inurement prohibition. As a general matter, colleges and universities confer some amount of private benefit on students in the form of an education, particularly in situations where students receive scholarships and thus do not pay the entire cost of the education. Nonetheless, the private benefit conferred on recipients of scholarships from a college or university generally is viewed as incidental to serving the broader public interest in education, provided that scholarship recipients are selected on the basis of appropriate criteria (not including, for example, on the basis of a relationship with a school insider).¹⁷

¹⁵ Rev. Proc. 75-50, 1975-2 C.B. 587 (establishing guidelines and recordkeeping requirements for determining whether private schools that are applying for recognition of exemption have racially nondiscriminatory policies as to students).

¹⁶ The term disqualified person is defined in section 4958(f)(1) and generally includes those in a position to exercise substantial influence over the affairs of the organization.

¹⁷ See Frances R. Hill & Douglas M. Mancino, *Taxation of Exempt Organizations*, sec. 4.02[1][b] (2006).

Governmental entities

In 1913, Congress specifically provided for the exclusion of the income of entities that perform an essential governmental function.¹⁸ The exclusion applies to (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or (2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whether activities involve the exercise of an “essential governmental function” is generally decided on a case-by-case basis. Relevant factors include whether the activity is one traditionally considered “governmental,” whether it involves the exercise of a governmental activity, and the extent of governmental financial interest in the activity. The income must be derived from a qualifying activity; it is not sufficient that the income be paid over to or benefit a qualifying activity. The second requirement, that the income “accrue to” a State or political subdivision, occurs when the State or subdivision has an unrestricted right to a proportionate share of the income.

The income of State colleges and universities generally is tax exempt. However, as described below, State colleges and universities are subject to the unrelated business income tax.

Public charity versus private foundation

In general

Once an organization qualifies for tax exempt status under section 501(c)(3), the organization must be classified as either a public charity or a private foundation.¹⁹ An organization may qualify as a public charity²⁰ in several ways. Certain specified types of organizations automatically are classified as public charities, including colleges and universities. Others include churches, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit.²¹ An organization that is not automatically classified as a public charity may qualify as a public charity in a variety of ways.

¹⁸ Sec. 115.

¹⁹ Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations. Operating foundations are not subject to the payout requirements of private foundations and are not considered a private foundation for purposes of the charitable contribution deduction rules.

²⁰ The Code does not expressly define the term “public charity,” but rather provides exceptions to those entities that are treated as private foundations.

²¹ Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

- It may qualify as a publicly supported public charity if at least one-third of its total support is from governmental units or the general public,²² or, failing this mechanical test, if it passes a “facts and circumstances” test.²³ In general, this includes publicly or governmentally supported museums of history, art, or science, libraries, community centers to promote the arts, organizations providing facilities for the support of an opera, symphony orchestra, ballet, or to the general public, and organizations such as the American Red Cross.²⁴
- It may qualify as a publicly supported public charity based on support received through the operation of trades or businesses that are related to such organization’s exempt purposes, i.e., if it normally receives more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization’s exempt purposes.²⁵
- It may qualify as a “supporting organization” by providing support to another section 501(c)(3) entity that is not a private foundation.²⁶
- It may qualify by being organized and operated exclusively for testing for public safety.²⁷

An organization that does not fit within any of the above categories is a private foundation. In general, private foundations are funded from a limited number of sources (e.g., an individual, a family, or a corporation).

Substantive rules

Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases).²⁸ Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are required to make a minimum amount of charitable distributions each year (a pay

²² Treas. Reg. sec. 1.170A-9(e)(2).

²³ Treas. Reg. sec. 1.170A-9(e)(3).

²⁴ Treas. Reg. sec. 1.170A-9(e)(1)(ii).

²⁵ Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

²⁶ Sec. 509(a)(3).

²⁷ Sec. 509(a)(4).

²⁸ Sec. 4940.

out requirement),²⁹ are limited in the extent to which they may control a business,³⁰ may not make speculative investments,³¹ and may not make certain expenditures (including expenditures for noncharitable purposes, lobbying, political activities, grants to individuals without prior IRS approval, and grants to organizations other than public charities and certain foundations unless special procedures are followed).³² Violations result in excise taxes on the foundation and, in the case of speculative investments and taxable expenditures, on the management of the foundation.

Although there are rules that regulate transactions between a public charity or a private foundation and a respective insider of the organization, the private foundation “self-dealing” regime³³ is much more restrictive than the public charity “intermediate sanctions” regime.³⁴ The self-dealing regime generally prohibits transactions between a foundation and an insider of the foundation, whereas the intermediate sanctions regime permits public charities to enter into insider transactions so long as no excess benefit is provided to the insider.³⁵ If the self-dealing or intermediate sanctions rules are violated, the resulting excise taxes on the insider generally are significantly more punitive with respect to transactions with private foundations than with public charities.³⁶

Contributions to private foundations generally do not receive as favorable tax treatment as do contributions to public charities for purposes of the charitable contribution deduction.

Unrelated business income tax

In general

In general, an exempt organization may have revenue from four sources: (1) contributions, gifts, and grants; (2) trade or business income that is related to exempt activities (e.g., program service revenue such as tuition); (3) investment income; and (4) trade or business income that is not related to exempt activities. The Federal income tax exemption generally

²⁹ Sec. 4942.

³⁰ Sec. 4943.

³¹ Sec. 4944.

³² Sec. 4945.

³³ Sec. 4941.

³⁴ Sec. 4958.

³⁵ The two regimes take a similar approach with respect to the payment of compensation to an organization insider, i.e., the payment of compensation is permitted so long as the amount paid is reasonable and not excessive.

³⁶ The self-dealing tax is imposed on the entire amount involved in the transaction (except for the payment of compensation, with respect to which the tax is imposed on the excess compensation), whereas the intermediate sanctions tax is imposed on the excess benefit provided.

extends to the first three categories, and does not extend to an organization's unrelated trade or business income.

The unrelated business income tax was introduced in 1950 to address the problem of unfair competition between for profit companies and nonprofit organizations conducting an unrelated for profit activity. The unrelated business income tax generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.³⁷ Most exempt organizations are subject to the tax.³⁸ Although most State and local governments generally are not subject to taxation on unrelated business taxable income,³⁹ State colleges and universities that are agencies or instrumentalities of any government or any political subdivision of a government, or that are owned or operated by a government or political subdivision of a government generally are subject to unrelated business income taxation.⁴⁰

An organization that is subject to the unrelated business income tax and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations generally may operate an unrelated trade or business so long as it is not a primary purpose of the organization. Therefore, engaging in a substantial amount of unrelated business activity is permitted and will not jeopardize exempt status.⁴¹ By contrast, a charitable organization may not operate an unrelated trade or business as a substantial part of its activities.⁴²

Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or, in some cases, from 50-percent controlled subsidiaries. Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is

³⁷ Secs. 511-514.

³⁸ Organizations subject to the unrelated business income tax include all organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2).

³⁹ Sec. 511(a)(2)(A).

⁴⁰ Sec. 511(a)(2)(B). For this purpose, government includes any foreign government (to the extent not contrary to a treaty), the United States and any of its possessions, any State, and the District of Columbia. The tax also applies in the case of a corporation wholly owned by one or more such colleges or universities.

⁴¹ Because the exempt purposes of organizations differ, there may be differences in application of the unrelated business income tax rules, in particular, the determination of whether an activity is substantially related to an organization's exempt purposes.

⁴² Treas. Reg. sec. 1.501(c)(3)-1(e).

performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

Debt-financed property

In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. For purposes of determining unrelated business income, debt-financed property generally means any property that is held to produce income and with respect to which there is acquisition indebtedness at any time during the taxable year. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness does not include, however, (1) certain indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption, (2) obligations to pay certain types of annuities, (3) an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons, or (4) indebtedness incurred by qualified organizations (certain educational organizations and pension plans) to acquire or improve real property. Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed income-producing property. An exempt organization's share of partnership income that is derived from such debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

Treatment of income from controlled entities

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary. The general rule treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization (to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt)). With respect to payments from a controlled subsidiary made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the general rule applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482 (generally, the excess amount above fair market value). A 20-percent penalty is imposed on the larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements.

In the case of a stock subsidiary, “control” means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital, or beneficial interests. In addition, the constructive ownership rules of section 318 apply for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

B. Tax Incentives for Contributions to Educational Organizations

Charitable contribution deduction

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity, including to most colleges and universities.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.⁴³ In general, as noted above, more generous charitable contribution deduction rules apply to gifts made to public charities, such as colleges and universities, than to gifts made to private foundations. Contributions to a public charity generally are deductible up to 50 percent of the donor's adjusted gross income (30 percent for capital gain property), whereas contributions to most private foundations generally are deductible up to 30 percent of the donor's adjusted gross income (20 percent for capital gain property).⁴⁴ In addition, gifts of capital gain property to a public charity generally are deductible at the property's fair market value,⁴⁵ whereas gifts of capital gain property (other than publicly traded stock) to most private foundations are deductible at the taxpayer's basis (cost) in the property.⁴⁶

Within certain limitations, donors also are entitled to deduct their contributions to a section 501(c)(3) organization or to a Federal, State, or local governmental entity, including to educational organizations such as colleges and universities, for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor, though such organizations are eligible for the exemption from Federal income tax with respect to such donations. Recipients of charitable assistance generally may exclude the assistance from income as a gift.⁴⁷

In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For example, amounts paid for tuition are not deductible as a charitable contribution.

⁴³ Secs. 170(b) and (e).

⁴⁴ Sec. 170(b)(1).

⁴⁵ Sec. 170(e)(1). However, contributions of tangible personal property not for an exempt purpose of the donee organization are deductible at the taxpayer's basis in the property. Sec. 170(e)(1)(B)(i). A special rule determines the aggregate deduction for contributions of certain intellectual property. Secs. 170(e)(1)(B)(iii) and 170(m).

⁴⁶ Sec. 170(e)(1)(B)(ii) and 170(e)(5).

⁴⁷ Sec. 102(a).

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of the contribution. In the case of a charitable contribution of money (regardless of the amount), applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.⁴⁸ In addition, no charitable deduction is allowed for a contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.⁴⁹ Additional substantiation rules apply to contributions for which deductions of more than \$500 and more than \$5,000 are claimed.

Distributions from individual retirement arrangements

In general, present law provides an exclusion from gross income for otherwise taxable distributions from a traditional or a Roth individual retirement arrangement (“IRA”) in the case of qualified charitable distributions.⁵⁰ The exclusion may not exceed \$100,000 per taxpayer per taxable year. A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). Colleges and universities generally are organizations described in section 170(b)(1)(A). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70½. Distributions made in taxable years beginning after December 31, 2007, do not qualify for the exclusion.

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable, determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution. Distributions that are excluded from gross income by reason of the provision are not taken into account in determining the deduction for charitable contributions under section 170.

⁴⁸ Sec. 170(f)(17).

⁴⁹ Sec. 170(f)(8).

⁵⁰ This does not include distributions from employer-sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions (“SEPs”).

C. Tax-Exempt Financing for Facilities and Activities of Providers of Higher Education

Overview

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes.⁵¹ Because the interest income is excluded from gross income, investors generally are willing to accept a lower rate on tax-exempt bonds than they might otherwise accept on a taxable investment. This, in turn, lowers the borrowing cost for the beneficiaries of such financing.

Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Like other activities carried out and paid for by State and local governments, the construction, renovation, and operation of public schools (including State universities) are activities eligible for financing with the proceeds of tax-exempt, governmental bonds.

Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For these purposes, the term “nongovernmental person” generally includes the Federal Government and all other individuals and entities, including section 501(c)(3) organizations, other than States or local governments. Present law provides two tests for determining whether a State or local bond is in substance a private activity bond, the private business test and the private loan test.⁵² The exclusion from income for interest on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”) and other Code requirements are met.

One type of qualified private activity bond is a qualified 501(c)(3) bond, which is a bond issued by a State or local government to finance the activities of an organization described in section 501(c)(3).⁵³ Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code – including elementary, secondary, and post-secondary schools – generally may be financed with tax-exempt, qualified private activity bonds. Unlike most qualified private activity bonds, qualified 501(c)(3) bonds are not subject to the State limits on the amount of qualified private activity bonds that may be issued. In addition, unlike most qualified private activity bonds, qualified 501(c)(3) bonds may be advance refunded.

⁵¹ Sec. 103(a).

⁵² Secs. 141(b) and (c).

⁵³ Sec. 141(e). Qualified activity bonds also include exempt facility bonds; qualified mortgage or veterans’ mortgage bonds; small issue and redevelopment bonds, and student loan bonds. Present law also provides special rules for qualified private activity bonds issued within certain geographic areas (e.g., enterprise or empowerment zones, the New York Liberty Zone, and the Gulf Opportunity Zone) to provide incentives for businesses to locate in those areas.

Private activity bond tests

As noted above, the Code provides two primary standards for determining whether a State or local bond is a private activity bond. The first standard is the two-part private business test. If the private business test is not satisfied, a bond can still be a private activity bond if the private loan test is met.

Private business tests

Private business use and private payments result in State and local bonds being private activity bonds if both parts of the two-part private business test are satisfied—

1. More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the “private business use test”); and
2. More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the “private payment test”).⁵⁴

Private loan test

The second standard for determining whether a State or local bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) \$5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

Qualified 501(c)(3) bonds

In general

A bond issue is not treated as a qualified 501(c)(3) bond (i.e., is not tax exempt) if such bond issue meets a modified version of the private business test. Under the modified version of the private business test, the maximum amount of private business use and private payments is five percent of the net proceeds⁵⁵ of the issue.⁵⁶ Facilities financed with qualified 501(c)(3)

⁵⁴ The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue.

⁵⁵ The term “net proceeds” means the proceeds of a bond issue reduced by amounts in a reasonably required reserve or replacement fund (which is generally limited to 10 percent of the proceeds). Sec. 150(a)(3).

bonds also are required to be owned by a section 501(c)(3) organization or by a governmental unit. Moreover, the use of bond proceeds or bond-financed property in unrelated trades or businesses (determined by applying section 513(a)) is treated as private business use. Thus, the use of bond proceeds by a section 501(c)(3) organization in an unrelated trade or business is limited to five-percent of the net proceeds of the bond issue.

Exemption from volume cap and certain other restrictions

Qualified 501(c)(3) bonds are not subject to a number of restrictions that apply to other qualified private activity bonds. For example, the aggregate volume of most qualified private activity bonds is restricted by the annual volume cap imposed on issuers within each State (the "State volume cap").⁵⁷ The State volume cap rules reflect Congress' intent to control the total volume of tax-exempt bonds issued for private activities. For calendar year 2006, these annual volume limits, which are indexed for inflation, equal \$80 per resident of the State, or \$246.61 million, if greater. Qualified 501(c)(3) bonds, which includes bonds issued to finance the activities of charitable educational organizations described in section 501(c)(3), are not subject to the State volume cap.⁵⁸ In addition, unlike most qualified private activity bonds issued after August 7, 1986,⁵⁹ the interest income from qualified 501(c)(3) bonds is not a preference item for purposes of calculating the alternative minimum tax.

Advance refunding of qualified 501(c)(3) bonds

The Code also provides more favorable refunding rules for qualified 501(c)(3) bonds than for other types of qualified private activity bonds. Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded.⁶⁰

⁵⁶ Sec. 145(a)(2).

⁵⁷ Sec. 146.

⁵⁸ Although qualified 501(c)(3) bonds are not subject to the State volume cap, prior to the Taxpayer Relief Act of 1997 (the "1997 Act"), the Code limited the amount of qualified 501(c)(3) outstanding bonds from which a section 501(c)(3) organization could benefit to \$150 million. In applying this "\$150 million limit," all section 501(c)(3) organizations under common management or control were treated as a single organization. The limit did not apply to bonds for hospital facilities, defined to include acute care, primarily inpatient, organizations. The 1997 Act repealed the \$150 million limit for bonds issued after the date of enactment (August 5, 1997), to finance capital expenditures incurred after such date. The \$150 million limit continues to govern the issuance of other non-hospital qualified 501(c)(3) bonds (e.g., advance refunding bonds with respect to capital expenditures incurred on or before such date, new-money bonds for capital expenditures incurred on or before such date, or new-money bonds for working capital expenditures).

⁵⁹ Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and certain bonds issued before September 1, 1986.

⁶⁰ As part of the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, a limited number of exempt facility bonds issued for airports, docks, and wharves also may be advance refunded.

A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). The Code contains different rules for “current” as opposed to “advance” refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding bond if it is issued more than 90 days before the redemption of the refunded bond.⁶¹ Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed. Thus, after issuance of an advance refunding bond, there is a period of time when both the refunding bonds and the refunded bonds remain outstanding.

There is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded. However, the Code limits the number of advance refundings with tax-exempt bonds. Generally, qualified 501(c)(3) bonds and governmental bonds may be advance refunded one time.⁶²

Arbitrage restrictions on tax-exempt bonds

To prevent tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than necessary, the income exclusion for interest paid on States and local bonds does not apply to any arbitrage bond.⁶³ An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or any replacement proceeds that are used to acquire higher yielding investments.⁶⁴ Treasury regulations define replacement proceeds as any amounts that have a sufficiently direct nexus to the bond issue or to the governmental purpose of the bond issue to conclude that such amounts would have been used for that governmental purpose if the proceeds of the bonds were not used for such purpose.⁶⁵ Examples of replacement proceeds include sinking funds and pledge funds that are used to pay principal or interest on the bond issue.

In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods” before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

⁶¹ Sec. 149(d)(5).

⁶² Sec. 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

⁶³ Secs. 103(a) and (b)(2).

⁶⁴ Sec. 148.

⁶⁵ Treas. Reg. sec. 1.148-1(c)(1).

Present law includes three exceptions to the arbitrage rebate rules applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance.⁶⁶ Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.⁶⁷ Third, governmental bonds issued by “small” governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than \$5 million of tax-exempt governmental bonds in a calendar year. The \$5 million limit is increased to \$15 million if at least \$10 million of the bonds are used to finance public schools.⁶⁸

⁶⁶ In the case of certain governmental bonds (including bonds to finance public schools), the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

⁶⁷ Retainage amounts are limited to no more than five percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued. Issuers qualifying for this “construction bond” exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

⁶⁸ The Economic Growth and Tax Reconciliation Act of 2001 (“EGTRA”) amended section 148(f)(4)(D)(vii) to increase the additional amount of governmental bonds that small governmental units may issue for public schools without being subject to the arbitrage rebate requirements from \$5 million to \$10 million. However, the amendment is subject to the general sunset provisions of EGTRA and will not be available after December 31, 2010.

D. Tax Benefits for Education Expenses

In general

Present law provides a variety of tax benefits for individuals who incur higher education expenses. Individuals may take advantage of a myriad of provisions, including provisions providing tax benefits for current higher education expenses, saving for future expenses, and expenses that have already been incurred (i.e., expenses relating to student loans).⁶⁹ These tax provisions result in significant tax expenditures. Tax benefits for individuals with respect to education expenses are estimated to result in a tax expenditure for fiscal years 2006-2010 of almost \$49 billion.⁷⁰

To the extent that one of these benefits does not apply, e.g., because there is a limit on the expenses eligible for a benefit, then higher education expenses generally are not deductible by the individual. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment.⁷¹ Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses are subject to the two-percent floor on itemized deductions, and also to the overall limit on itemized deductions.

Tax benefits for current expenses

Hope tax credit

The Hope tax credit is a nonrefundable tax credit of up to \$1,650 per year (2006 and 2007 amount indexed for inflation for future years) per eligible student for qualified tuition and fees for the first two years of post-secondary education.⁷² In order to qualify for the credit, the

⁶⁹ A brief description of these tax provisions is provided below. See Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education* (JCX-52-04), July 21, 2004, at 8-27, for further detail.

⁷⁰ See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010* (JCS-2-06), April 25, 2006, at 37. The tax expenditure items included in this total are the Hope and Lifetime Learning credits, the deduction for interest on student loans, the exclusion of earnings on amounts in qualified tuition programs and Coverdell education savings accounts, the exclusion of interest on educational savings bonds, the exclusion for discharge of certain student loan debt, and the exclusions for qualified scholarships and employer-provided educational assistance and tuition reduction. Tax expenditures are an estimate of the economic benefits that are provided through the tax laws by reference to a normal income tax law. For a variety of reasons, tax expenditures are not the same as revenue estimates and do not represent the revenue effect of a repeal of the provision. *Id.* at 2, 27.

⁷¹ Treas. Reg. sec. 1.162-5.

⁷² Sec. 25A.

student must be enrolled on at least a half-time basis in a degree program. The Hope credit is phased out ratably for taxpayers with modified adjusted gross income between \$45,000 and \$55,000 (\$90,000 and \$110,000 for married taxpayers filing a joint return) for 2006 and between \$47,000 and \$57,000 (\$94,000 and \$114,000 for married taxpayers filing a joint return) for 2007. The adjusted gross income phase-out ranges are indexed for inflation. A taxpayer may not claim the Hope credit and the Lifetime Learning credit or the above-the-line deduction with respect to the same student in the same year. In 2004, 7.2 million tax returns claimed education tax credits (i.e., either the Hope or Lifetime Learning credit) of \$6.0 billion.

Lifetime Learning credit

The Lifetime Learning credit is a nonrefundable tax credit of up to 20 percent of qualified tuition and fees.⁷³ Up to \$10,000 of such expenses per taxpayer return are eligible for the credit. In contrast to the Hope credit, the maximum credit is not indexed for inflation, the credit applies on a per-return rather than per-student basis, and the credit is not limited to the first two years of post-secondary education. The Lifetime Learning credit is available whether or not the student is enrolled on at least a half-time basis. The same income phaseout applies to the Lifetime Learning credit as applies to the Hope credit. A taxpayer may not claim the Lifetime Learning credit and the Hope credit or the above-the-line deduction with respect to the same student in the same year.

Above-the-line deduction

For 2004 and 2005, an above-the-line deduction of \$4,000 of higher education expenses is available to taxpayers whose adjusted gross income does not exceed \$65,000 (\$130,000 in the case of married taxpayers filing a joint return) and \$2,000 for individuals with adjusted gross income not in excess of \$80,000 (\$160,000 for married taxpayers filing a joint return).⁷⁴ The deduction applies to tuition and fees. A taxpayer may not claim the above-the-line deduction with respect to a student for whom a Hope or Lifetime Learning credit is claimed in the same year. The above-the-line deduction is not available after 2005.

Exclusion for employer-provided educational assistance

If certain requirements are satisfied, up to \$5,250 annually of employer-provided educational assistance is excludable from gross income and wages for employment tax purposes.⁷⁵ The exclusion expires after 2010 under the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).

⁷³ *Id.*

⁷⁴ Secs. 62(a)(18) and 222.

⁷⁵ Sec. 127.

Qualified scholarships and tuition reduction

Qualified scholarships for qualified tuition, fees, books, supplies, and equipment received by an individual who is a degree candidate are excludable from gross income.⁷⁶ Qualified tuition reduction for certain education provided to employees of an educational organization (and their spouses and dependents) is excludable from gross income and wages. These exclusions do not apply to any amount received that is compensation for services by the student as a condition of receiving the scholarship or tuition reduction.

Tax benefits for saving for higher education expenses

Section 529 qualified tuition programs

A qualified tuition program is a program established by a State (or instrumentality of the State) or a qualified educational institution.⁷⁷ In the case of a State program, the qualified tuition program may be either a prepaid tuition program or a savings account program. In the case of a program of a qualified educational institution, the program may only be a prepaid tuition program. Contributions to a qualified tuition program are not tax deductible for Federal income tax purposes. However, amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan is not subject to current income tax) and distributions are tax free if used for qualified educational expenses. Qualified expenses include tuition, fees, books, supplies and equipment and, in the case of a student enrolled on at least a half-time basis, room and board. Distributions that are not for qualified expenses are includible in gross income and subject to an additional 10-percent tax.

There is no dollar limit on the amount that can be contributed to a qualified tuition program; however, the program is required to provide adequate safeguards that the contributions will not exceed the amount necessary to provide for the qualified expenses of the account beneficiary.

Special estate and gift tax rules apply to qualified tuition programs. For example, an individual may contribute up to five times the annual gift tax exclusion amount in a single year (currently, the annual limit is \$12,000) on behalf of a beneficiary without adverse gift and generation skipping transfer tax consequences by electing to treat the contribution as having been made ratably over the 5-year period beginning with the calendar year in which the contribution is made.

Certain provisions relating to section 529 programs were subject to the EGTRRA sunset. The application of the sunset to these programs was repealed, however, by the Pension Protection Act of 2006. Thus, those provisions are now permanent. The Pension Protection Act also specifically authorized the Secretary to prescribe regulations as may be necessary or appropriate to carry out the purposes of the provisions relating to section 529 programs and to

⁷⁶ Sec. 117.

⁷⁷ Sec. 529.

prevent abuse of such purposes, including regulations relating to the gift, estate, and generation skipping transfer taxes.

Coverdell education savings accounts

A Coverdell education savings account is a trust or custodial account established on behalf of an eligible beneficiary.⁷⁸ Contributions to a Coverdell education savings account are not deductible for Federal income tax purposes; however, income on amounts in the account accumulates on a tax-free basis. Distributions from a Coverdell education savings account are tax-free if used for qualified expenses; other distributions are includable in gross income and subject to an additional 10-percent tax. Qualified expenses include higher education expenses as defined for purposes of qualified tuition programs (i.e., tuition, fees, books, supplies, equipment and, in some cases room and board expenses). In addition, qualified expenses include certain elementary and secondary expenses. The maximum amount that may be contributed to a Coverdell education savings account in any year by an individual contributor for a beneficiary is \$2,000. The contribution limit for individual contributors is phased out ratably for taxpayers with modified adjusted gross income between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the adjusted gross income of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

A number of provisions relating to Coverdell education savings accounts are subject to the EGTRRA sunset, including the increase in the contribution limit from \$500 to \$2,000.

Exclusion of earnings on education savings bonds

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed the qualified higher education expenses paid by the taxpayer during the year.⁷⁹ Qualified higher education expenses are defined as under the Hope and Lifetime Learning credits, and include qualified tuition and fees. For 2006, the exclusion is phased out ratably for taxpayers with modified adjusted gross income between \$63,100 and \$78,100 (\$94,700 and \$124,700 for married taxpayers filing a joint return). For 2007, the exclusion phases out for taxpayers with modified adjusted gross income between \$65,600 and \$80,600 (\$98,400 and \$128,400 for married taxpayers filing a joint return). The phase-out amounts are indexed for inflation.

Other tax-favored savings arrangements

Present law provides favorable tax treatment for a number of savings vehicles. While not designed specifically for saving for educational expenses, they may be used by taxpayers for such purpose. These savings vehicles include Roth IRAs, traditional IRAs, deferred annuities, and qualified retirement plans. The special rules relating to each type of arrangement vary.

⁷⁸ Sec. 530.

⁷⁹ Sec. 135.

Tax benefits relating to past expenses (provisions relating to student loans)

Deduction for student loan interest

Up to \$2,500 per year of student loan interest is deductible as an above-the-line deduction.⁸⁰ The deduction is phased out ratably for taxpayers with modified adjusted gross income between \$50,000 and \$65,000 (\$105,000 and \$135,000 for married taxpayers filing a joint return) for 2006 and between \$55,000 and \$70,000 (\$110,000 and \$140,000 for married taxpayers filing a joint return) for 2007. The adjusted gross income phase-out ranges are indexed for inflation. Certain provisions relating to the student loan interest deduction are subject to the EGTRRA sunset, including an increase in the income levels at which the deduction is phased out.

Exclusion of income for student loan forgiveness

Gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided the forgiveness is contingent upon the student working for a certain period of time in certain professions for any of a broad class of employers.⁸¹

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program or certain state loan repayment programs.

⁸⁰ Sec. 221.

⁸¹ Sec. 108(f).

III. SELECTED ISSUES AND ANALYSIS

A. Background Data on College Enrollment and Costs

Since 1991 more than 14 million students have enrolled annually in post-secondary education or training programs, with approximately 75 percent enrolled in public institutions and 25 percent in private institutions in 2004. The full-time equivalent enrollment has exceeded 10 million in every year since 1991. Of all those enrolled in 2004, 62 percent were enrolled in four-year institutions.

In the late 1970s, college costs lagged behind inflation, but they have generally risen faster than inflation since 1981. An exception to this has been for the cost for undergraduate tuition and fees at public two-year colleges, which began to moderate in the mid 1990s and rose by less than the rate of inflation in several years (see Table 1). However, more recently there have been sharp increases in costs at these institutions as well.

Since 1976, college tuition and fees generally have risen at a rate close to twice that of the economy's overall price level. For the 1976-77 academic year, the total cost⁸² of attending a four-year private college averaged \$3,977 (tuition and fees of \$2,534) and the total cost of attending a four-year public college averaged \$1,935 (tuition and fees of \$617). For the 1986-87 academic year, the comparable total cost figure had risen to \$10,039 (tuition and fees of \$6,658) for a four-year private college and to \$4,138 (tuition and fees of \$1,414) for a four-year public college. By the 2004-2005 academic year, the comparable total cost figure had risen to \$26,489 (tuition and fees of \$18,838) for a four-year private college and to \$11,441 (tuition and fees of \$5,038) for a four-year public college. For the 2004-2005 academic year, the average cost of tuition and fees at a two-year public college was \$1,847 and \$12,182 at a two-year private college.⁸³ Table 1 below details average tuition and fees by type of college in both current and constant (inflation adjusted) dollars since 1986.

Over the past decade, governmental funding of public higher education has declined as a share of total funding. Table 2 reports the revenues of public degree-granting institutions of higher education by source. As a percentage of all revenues, Federal funds have remained relatively constant, State and local funding has declined, tuition and fees have increased, and other funding has increased.

Private institutions of higher education rely less heavily on public sources of funding, though they are a significant source of funds. Private institutions rely more heavily on tuition and fees for revenue, and, in contrast to public institutions, receive a significant fraction of revenue from gifts and investment returns on endowments. Endowment returns are a highly variable source of revenues, however. Table 3 shows revenues of private not-for-profit postsecondary degree granting institutions for selected years.

⁸² "Total cost" includes tuition and fees, and on-campus room and board costs.

⁸³ Department of Education. National Center for Education Statistics, *Digest of Education Statistics 2005*.

Table 1.—Average Undergraduate Tuition and Fees, 1986-87 Through 2004-2005

Year	Current Dollars				Constant 2005 Dollars			
	Private four-year	Private two-year	Public four-year	Public two-year	Private four-year	Private two-year	Public four-year	Public two-year
1986-87	6,658	3,684	1,414	660	11,652	6,446	2,474	1,156
1987-88	7,116	4,161	1,537	706	11,986	7,008	2,589	1,189
1988-89	7,722	4,817	1,646	730	12,448	7,766	2,654	1,177
1989-90	8,396	5,196	1,780	756	12,876	7,969	2,729	1,159
1990-91	9,083	5,570	1,888	824	13,292	8,152	2,763	1,206
1991-92	9,759	5,754	2,117	936	13,786	8,128	2,991	1,322
1992-93	10,294	6,059	2,349	1,025	14,117	8,310	3,222	1,406
1993-94	10,952	6,370	2,537	1,125	14,615	8,501	3,385	1,501
1994-95	11,481	6,914	2,681	1,192	14,918	8,984	3,483	1,550
1995-96	12,243	7,094	2,848	1,239	15,461	8,959	3,596	1,565
1996-97	12,881	7,236	2,987	1,276	15,852	8,905	3,676	1,570
1997-98	13,344	7,464	3,110	1,314	16,112	9,012	3,755	1,587
1998-99	13,973	7,854	3,229	1,327	16,559	9,308	3,827	1,573
1999-00	14,588	8,235	3,349	1,338	16,818	9,494	3,861	1,543
2000-01	15,470	9,067	3,501	1,333	17,299	10,139	3,915	1,491
2001-02	16,211	10,076	3,735	1,380	17,737	11,024	4,087	1,510
2002-03	16,826	10,651	4,046	1,483	18,061	11,432	4,343	1,592
2003-04	17,777	11,546	4,587	1,702	18,621	12,094	4,805	1,783
2004-05	18,838	12,182	5,038	1,847	19,152	12,385	5,122	1,878

Note: Current dollar figures are adjusted to constant dollars by reference to the average CPI of the calendar years spanned by the academic year for which the tuition is reported.

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2005*.

**Table 2.—Current Funds and Revenues of Public Postsecondary Degree-Granting Institutions
By Source, Selected Years, 1985-1986 Through 2000-2001**

[Amount in Millions]

Year	Tuition and Fees		State and Local Sources		Federal Sources		Other Sources**		Total
	Dollar	Percent	Dollar	Percent	Dollar	Percent	Dollar	Percent	
1985-86	9,439	14.5	31,547	48.5	6,852	10.5	17,167	26.4	65,005
1995-96	23,257	18.8	49,322	39.9	13,672	11.1	37,250	30.2	123,501
2000-01	31,920	18.1	69,948	39.6	19,745	11.2	55,302	31.2	176,645

** Other sources includes income from educational activities, auxiliary enterprises, and hospitals.

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2005*.

**Table 3.—Revenues of Private Not-for-Profit Postsecondary Degree-Granting Institutions
By Source, Selected Years, 1997-1998 Through 2002-2003**

[Amount in Millions]

Year	Tuition and Fees		Federal State and Local Sources		Private Gifts, Grants and Contracts		Investment Returns		Other Sources**		Total
	Dollar	Percent	Dollar	Percent	Dollar	Percent	Dollar	Percent	Dollar	Percent	
1997-98	26,499	27.8	12,631	13.3	13,246	13.9	22,312	23.4	20,554	21.6	95,241
2002-03	36,024	34.1	18,629	17.6	14,375	13.6	9,340	8.8	27,315	25.8	105,683

** Other sources includes income from educational activities, auxiliary enterprises, and hospitals.

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2005*.

B. The Economics of Subsidizing Education

Overview of the goals of subsidies

All levels of government make substantial direct expenditures to subsidize post-secondary education, including both expenditures on educational institutions and grants to individuals for financial assistance. In addition, private educational organizations channel gifts from private persons into subsidies for the education of other persons. By exempting such organizations from income tax and permitting the gifts to such organizations to be deductible, additional implicit subsidies under the Code are created for education. Other subsidies for education provided by the Code permit students to receive tax-free qualified scholarships, tax-free employer-provided educational assistance, tax-free cancellation of certain governmental student loans, and a deduction for student loan interest. Students and parents also are provided the benefits of the Hope and Lifetime Learning credits, the deduction for qualified tuition and related expenses, the exclusion from income of earnings on education savings accounts and qualified tuition programs, and the exclusion from income of the interest on U.S. savings bonds used to pay for post-secondary education. Analysts attempt to evaluate subsidies in terms of their efficiency, equity, and administrability. In this regard, it has been argued that subsidies to post-secondary education improve both economic efficiency and promote economic equity.

Efficiency as a goal of subsidies to education

Economists generally have a predilection for favoring the outcomes of the free market and have reasoned that taxes or subsidies in the market generally lead to inefficient outcomes. That is, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. An example of such a good is a vaccination. The individual who is vaccinated benefits by not contracting an infectious disease, but the rest of society benefits as well, because by not contracting the disease the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a “positive externality.” On his or her own, the individual would weigh only his or her own reduced probability of contracting the disease against the cost of the vaccination. The individual would not account for the additional benefit the vaccination produces for society. As a result, the individual might choose not to be vaccinated, even though from society’s perspective, total reduction in the rate of infection throughout the population would be more than worth the cost of the vaccination. In this sense, the private market might produce too few of the vaccinations. The private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of the good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

While much evidence suggests that job skill acquisition and education benefit the private individual in terms of higher market wages reflecting the individual’s higher level of productivity, many people have long believed that education also produces positive externalities. Commentators argue that society functions better with an educated populace and that markets

function better with educated consumers. They observe that education promotes innovation and that, because ideas and innovations are easily copied in the market place, the market return (wage or profit) from ideas and innovations may not reflect the full value to society from the idea or innovation. Just as a single individual does not appreciate the full benefit of a vaccination, a single individual may not be able to reap the full benefit of an idea or innovation. Thus, it is argued, subsidies for education are needed to improve the efficiency of society.

On the other hand, recognizing that a subsidy might be justified does not identify the magnitude of the subsidy necessary to promote efficiency nor the best method for delivery of the subsidy. It is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. Given that the United States already provides substantial subsidies to post-secondary education, it is not possible to say whether new subsidies would increase or decrease economic efficiency without some empirical analysis of the social benefits that would arise from creating new subsidies.

Some observers note that, aside from potential spillover effects that education might create, the market for financing education may be inefficient. They observe that, while investors in housing or other tangible assets have property that can be pledged to secure financing to procure the asset, an individual cannot generally pledge his or her future earnings as security for a loan to obtain education or training designed to increase the individual's future earning potential. This inability to provide security for education loans constrains borrowing as an alternative to finance education for some taxpayers. Taxpayers who cannot borrow to finance education or training may forgo the education or training even though it would produce a high return for the investor. This inefficiency in the market for education finance may offer a justification for public subsidies. The inefficiency in the market for financing is likely most acute among lower-income taxpayers who generally do not have other assets that could be pledged as security for an education loan. This suggests that this potential source of market inefficiency also relates to the considerations of equity as a rationale for subsidies of education (discussed below).

Equity as a goal of subsidies to education

As noted above, there is evidence indicating that education and training are rewarded in the market place. Recognizing this market outcome, some argue that it is appropriate to subsidize education to ensure that educational opportunities are widely available, including to those less well off in society. Commentators argue that education can play an important role in reducing poverty and income inequality. They observe that even if there were no positive externalities from education, promoting economic equity within a market economy provides a basis for subsidizing education. If equity is the goal of expanded subsidies to education, the cost of the subsidies should be weighed in terms of the private benefits received by the target groups, rather than the social benefits that might be generated by any possible spillovers.

C. Issues Relating to the Tax Benefits Provided to Higher Education Organizations

Public charity - private foundation distinction

As indicated above, different rules apply to a section 501(c)(3) organization depending on whether the organization is classified as a public charity or a private foundation. Private foundations historically have accumulated income, and since 1950, Congress has provided for rules regarding unreasonable accumulations. Under the Revenue Act of 1950, certain charitable organizations (generally corresponding to private foundations) would lose their tax-exempt status if the organization's aggregate accumulated income was "unreasonable in amount or duration" in order for the organization to carry out its charitable functions. In the Tax Reform Act of 1969, Congress replaced this rule with a provision that required a payout based on a specified percentage of a private foundation's noncharitable-use assets.⁸⁴ Congress determined that the 1950 provision was defective in two respects.⁸⁵ First, the prohibition on unreasonable income accumulations failed to preclude private foundations from holding or investing in assets which produced no current income, such as undeveloped land. As a result, although a donor to a foundation would receive an immediate charitable deduction on making a gift of nonproductive assets (or of property converted into such assets by the foundation), there could be an indefinite delay between the loss of tax revenues due to the deduction and the benefit intended to accrue to the public from the gift. Second, the prohibition on unreasonable income accumulations was difficult to enforce both because of its vagueness and the subjective nature of the test, and because the penalty of loss of exempt status was either unduly harsh for minor violations or largely ineffective for more substantial violations. Court cases had sanctioned as reasonable accumulations of income for up to 10 years for the sole purpose of increasing the size of the foundation's corpus.⁸⁶

Arguably, the historical misgivings regarding accumulations of income, in the form of an endowment or otherwise, is relevant whether the accumulation occurs in a private foundation or a public charity, such as a college or university. Charitable contributions to an endowment result in an immediate tax benefit to the donor but, absent a payout requirement, may not result in an immediate benefit to the public. At some point, accumulations of income by a public charity may become unreasonable and antithetical to the requirement that a public charity be operated exclusively for exempt purposes.

⁸⁴ Sec. 4942. As enacted in 1969, the payout was the greater of a foundation's income or six percent of the foundation's investment assets. The Secretary of the Treasury had the authority to adjust the percentage periodically. The present law payout is five percent of a foundation's investment assets.

⁸⁵ See H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 25-27 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 34-38 (1969); Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 36-40 (1970); *Treasury Department Report on Private Foundations*, House Committee on Ways and Means, 89th Cong., 1st Sess. 23-30, 58-60, 92-96 (Comm. Print 1965).

⁸⁶ *Treasury Department Report on Private Foundations*, Committee on Finance United States Senate, 89th Cong., 1st Sess. (February 2, 1965) at 26.

In the years leading up to the Tax Reform Act of 1969, private foundations were widely seen as abusive because substantial contributors of foundations generally retained control of the foundation, calling into question the foundation's commitment to charitable purposes. Today, it may not be as clear, given the growth and diversity of public charities, why some of the private foundation rules are not relevant for certain public charities, or whether some of the private foundation rules are performing their intended purpose or should be reconsidered.⁸⁷ The retention of substantial holdings in a commercial business, the making of investments or expenditures that jeopardize or are inconsistent with exempt purposes, or, as noted above, the maintenance of large endowment funds may raise some of the same concerns whether conducted by a public charity or a private foundation. The relevance of a tax on the net investment income of private foundations also could be questioned, either as an anachronism or as a burden that should be shared equally among exempt or charitable organizations.

Scope of activities that are related to educational purposes

In general

For any exempt organization that is subject to the unrelated business income tax, there is always a question whether a particular activity is substantially related to the furtherance of an organization's exempt purposes. If an activity is not so related, then it may be subject to tax. A number of disparate issues arise in the educational context as to whether an activity is educational in nature, or the extent to which a noneducational activity nonetheless is exempt from the unrelated business income tax because income from the activity fits within a statutory exemption. As described below, many of the issues in this context are not new, but are illustrative of the ongoing tension as to whether an activity is educational or, even if not educational in nature, subject to tax.

Commercial activities

The operation of a restaurant, bookshop, publication, or retail shop are all commercial activities regularly conducted by for profit entities, and also frequently undertaken by tax-exempt educational organizations. The IRS has ruled that each such activity may be consistent with exempt status.⁸⁸ Two intertwined issues are the extent to which such commercial activity is substantially related to exempt purposes, and thus not subject to the unrelated business income tax, and whether such commercial activity is of a magnitude so as to jeopardize exempt status.

In the university context, in enacting the unrelated business income tax provisions in 1950, Congress explicitly recognized that certain publishing activities may be related to a university's exempt purposes in appropriate cases, stating: "[i]ncome from a university press would be exempt in the ordinary case since it would be derived from an activity that is

⁸⁷ See generally, Marion R. Fremont-Smith, Is It Time to Treat Private Foundations and Public Charities Alike? 52 *The Exempt Organization Tax Review* 257 (2006)

⁸⁸ See, e.g., Rev. Rul. 67-217, 1967-2 C.B. 181 (restaurant); Rev. Rul. 68-538, 1968-2 C.B. 116 (university store); Rev. Rul. 62-234, 1963-2 C.B. 210 (journal).

‘substantially related’ to the purposes of the university.”⁸⁹ Along these lines, the Treasury Regulations provide that “a university radio station or press is considered a related trade or business if operated primarily as an integral part of the educational program of the university.”⁹⁰ However, the regulations also provide that such an activity is not a related activity “if operated in substantially the same manner as a commercial radio station or publishing house.”⁹¹ Thus, in the first instance, the commercial nature of the activity affects the determination of whether income from the activity is subject to the unrelated business income tax. If so, then the question becomes whether the activity reaches a level substantial enough to jeopardize exempt status. In general, organizations that engage in substantial publishing activity will not qualify for exemption as an educational organization if the publishing activity takes on too much of a “commercial hue.”⁹² This determination is especially difficult because publishing clearly is a commercial activity yet also involves the dissemination of information to the public.⁹³ The IRS has successfully denied exemption to a number of publishing organizations (many of them religious organizations with a primary activity of publishing) on commerciality grounds. However, if an activity like publishing or operation of a bookshop does not jeopardize exemption under the commerciality doctrine, it in many cases will not result in unrelated business income tax, either because the activity is considered related to exempt educational purposes or because it is for the convenience of the organization’s members or students.⁹⁴

The issue of commerciality also arises in the context of scientific research and technology transfers by colleges and universities. University technology transfer – in general, the commercialization of technology developed through university research – was encouraged by the passage of the Bayh-Dole Patent and Trademark Act of 1980,⁹⁵ which allows universities and other nonprofit organizations to retain rights to inventions developed using Federal grant

⁸⁹ H.R. Rep. No. 2319, 81st Cong., 2d Sess. 37 (1950); S. Rep. No. 2375, 81st Cong. 2d Sess. 29 (1950).

⁹⁰ Treas. Reg. sec. 1.513-2(a)(4).

⁹¹ *Id.*

⁹² *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283-4 (1945).

⁹³ The IRS has ruled that a publication distributed below cost may be educational in nature if (1) the content of the publication is educational, (2) the preparation of material follows methods generally accepted as “educational” in character, (3) the distribution of the materials is necessary or valuable in achieving the organization’s educational and scientific purposes, and (4) the manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices. Rev. Rul. 67-4, 1967-1 C.B. 121.

⁹⁴ See also Gen. Couns. Mem. 38,691 (Apr. 14, 1981) (concluding that a university’s publication and distribution of a scholarly journal, where the journal’s content was selected and authored by an unrelated section 501(c)(3) organization, did not constitute an unrelated trade or business).

⁹⁵ Pub. L. No. 96-517, 94 Stat. 3015 (1980) (codified as amended at 35 U.S.C. secs. 200-212).

money.⁹⁶ Universities now frequently seek to profit financially through the licensing of university-developed research to third parties, often employing complex legal structures to facilitate such technology transfers. For example, although some universities license inventions directly to third parties in exchange for royalties, other institutions establish section 509(a)(3) supporting organizations and/or for-profit subsidiaries to engage in licensing and other commercialization activities on the universities' behalf. Universities sometimes engage not only in university- and government-sponsored research, but also in research sponsored by commercial enterprises.

The complexity of the structuring and financing of university technology transfer organizations gives rise to a number of tax issues. For example, in some situations questions may arise whether commercialization activities are consistent with a university's tax-exempt educational or scientific purposes and whether such activities give rise to unrelated business taxable income. In general, such an activity will escape unrelated business income taxation if the activity is scientific research carried on in the public interest⁹⁷ or is excepted from treatment as unrelated business taxable income under a specific provision of the Code.⁹⁸ An issue may arise whether commercially sponsored scientific research is carried on in the public interest, consistent with the requirements of section 501(c)(3), where the commercial sponsor has a right to ownership or control of intellectual property resulting from the research.⁹⁹

In other cases, a question may arise whether the terms of license arrangements with a for-profit subsidiary or third party result in the provision of impermissible private benefit to the subsidiary or third party, in violation of section 501(c)(3).¹⁰⁰ Private benefit and/or private

⁹⁶ See Mark L. Gordon, *University Controlled or Owned Technology: The State of Commercialization and Recommendations*, 30 J. Coll. & Univ. L. 641, 641-42 (2004); Milton Cerny, *Technology Transfer and the New Economy*, 47 Exempt Organization Tax Review 39, 39 (Jan. 2005).

⁹⁷ Scientific research generally is regarded as carried on in the public interest: (1) if the results are made available to the public on a nondiscriminatory basis; (2) if the research is performed for the United States or for a State or a political subdivision of a State; or (3) if the research is directed toward benefiting the public, e.g., if the research is carried on for the purpose of (1) aiding in the scientific education of college or university students, (2) obtaining scientific information that is published in a treatise, trade publication, etc., (3) discovering the cure for a disease, or (4) aiding a community or geographic area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area. Treas. Reg. sec. 1.501(c)(3)-1(d)(5)(iii).

⁹⁸ See secs. 512(b)(2) (excluding royalties from unrelated business taxable income), 512(b)(7) (excluding income from research for governmental units from unrelated business taxable income), 512(b)(8) (excluding income from research performed by a university or hospital from unrelated business taxable income), and 512(b)(9) (excluding income from fundamental research, the results of which are freely available to the general public, from unrelated business taxable income).

⁹⁹ See Rev. Rul. 76-296, 1976-2 C.B. 141 (finding that commercially sponsored research may, in certain circumstances, be regarded as carried on in the public research where the results are timely published in a form available to the interested public).

¹⁰⁰ See Priv. Ltr. Rul. 200326035 (Apr. 4, 2003) (finding that an exclusive license between a section 501(c)(3) organization and a for-profit subsidiary owned by a supporting organization of the

inurement concerns may also arise in connection with incentive compensation arrangements with researchers, e.g., where a professor is provided a percentage of royalties arising from the commercialization of the professor's research.

Corporate sponsorship payments

The unfair competition rationale underlying the unrelated business income tax is implicated when exempt organizations receive income from activities that are not subject to the tax but that may provide an exempt organization with a competitive advantage in conducting an activity over a for-profit organization. Congress addressed such a case in 1997 by enacting rules about the tax treatment of corporate sponsorship payments, which some have argued is a form of advertising. Corporate sponsorship payments generally are exempt from unrelated business income tax under a special rule, so long as certain requirements are met.¹⁰¹ Prior to enactment of the special rule, the IRS had often questioned whether such arrangements allow charitable entities the ability to offer advertising to corporations at a lower rate.

In general, a corporate sponsorship payment is a payment from a corporation to a tax-exempt organization in exchange for becoming an "official sponsor" of a particular event of the tax-exempt organization. For example, a corporate sponsorship payment may occur when a corporation pays a university to become an official sponsor of the university's football program, and the university in turn displays the corporation's name and logo on the university's football stadium where it can be seen by attendees and television viewers.¹⁰² Another example is payment to an educational organization that regularly broadcasts a program in exchange for being featured on the program as a sponsor.

For a number of years, the IRS was of the view that many corporate sponsorship payments were subject to the unrelated business income tax. One notable example concerned the 1991 Mobil Cotton Bowl, whereby the Cotton Bowl Athletic Association (a tax-exempt organization) received a \$1.5 million corporate sponsorship payment from Mobil Oil. The IRS challenged Mobil Oil's sponsorship payment and determined that the payment was for advertising.¹⁰³

section 501(c)(3) organization for the purpose of commercializing scientific research did not result in more than incidental private benefit, where the for-profit subsidiary did not have the right to control the research of the section 501(c)(3) organization).

¹⁰¹ Sec. 513(i).

¹⁰² In 1991 total corporate sponsorship payments to tax-exempt organizations was \$1.1 billion, of which about \$64 million was paid to the college football bowl organizations. Of this \$64 million, an estimated \$19.6 million was received for corporate title sponsorships rather than as corporate royalty payments. See Dennis Zimmerman, *Corporate Title Sponsorship Payments to Nonprofit College Football Bowl Games: Should They Be Taxed?*, Congressional Research Service 92-157E, Doc. 92-1744 (Feb. 11, 1992).

¹⁰³ See Frank James Vari, *The Unrelated Business Income Tax and its Effects Upon Collegiate Athletics*, 9 Akron Tax J. 111 (1992). Several key court decisions were used in support of the IRS's

In 1993, the IRS published proposed regulations to clarify the tax treatment of sponsorship payments and provide a safe harbor whereby sponsorship payments that met certain criteria would not be treated as unrelated business income. However, the proposed regulations generated controversy and left unanswered questions. Thus, in 1997, Congress added section 513(i) to the Code in order to reduce the uncertainty with regard to the tax treatment of corporate sponsorship payments to exempt organizations. Congress determined that it was appropriate to distinguish sponsorship payments for which the donor receives no substantial return benefit other than the use or acknowledgment of the donor's name or logo as part of a sponsored event from payments made in exchange for advertising provided by the recipient organization. The latter, but not the former, are subject to the unrelated business income tax.¹⁰⁴

Affinity credit card arrangements and mailing list rentals

Issues often arise regarding whether certain types of receipts constitute royalties, which generally are excluded in determining an organization's unrelated business taxable income.¹⁰⁵ Whether a particular income item is a royalty received in exchange for the passive license of an organization's intellectual property will be determined based on the facts and circumstances of the case.¹⁰⁶ Two issues that have been the source of considerable debate in this area are: (1) whether income from an affinity credit card program constitutes a royalty and (2) whether income from a mailing list rental constitutes a royalty.

position. Included among these cases is *United States v. American Bar Endowment*, 477 U.S. 105 (1986), in which the Supreme Court stated that the standard test for the existence of a "trade or business" is whether the provision of goods or services is entered into with the dominant hope and intent of realizing a profit. Using that rationale, the IRS concluded that by providing valuable services, including advertising services, in return for large payments, the organization was engaged in an activity for the production of income from the provision of services. Hence, the organization was engaged in a trade or business activity.

¹⁰⁴ Sec. 513(i). An exempt "qualified sponsorship payment" is defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities. However, if the business receives advertising (or other benefits) in exchange for making a payment, then the payment may be considered payment for the advertising or other benefits. In that case, only the amount of the payment (if any) that exceeds the fair market value of the advertising or other benefits is a qualified sponsorship payment. On April 24, 2002, the IRS issued final regulations providing a safe harbor from taxation for qualified sponsorship payments. The final regulations clarified that payments other than qualified sponsorship payments are not automatically subject to unrelated business income tax. Instead, the tax treatment of nonqualified payments is determined under otherwise applicable unrelated business income tax rules. Treas. Reg. sec. 1.513-4.

¹⁰⁵ Sec. 512(b)(1).

¹⁰⁶ Treas. Reg. sec. 1.512(b)-1.

Affinity credit card arrangements generally involve an agreement between an organization (such as a college or university) and a credit card issuer under which the organization's name and logo will appear on the issuer's credit cards. The cards are then marketed to an "affinity group," i.e., a group of individuals associated with the organization. The organization, in turn, receives a payment that is usually based on a percentage of charges on the affinity cards. The issue that generally arises is whether the payment to the exempt organization is in exchange for the passive license of valuable intellectual property or is instead a payment for services, and thus not a royalty. For example, in *Sierra Club v. Commissioner*,¹⁰⁷ the Tax Court considered whether the retention by Sierra Club of the right to review promotional and marketing materials constituted the provision of marketing services by Sierra Club such as would convert the payment from a payment for a passive license to a payment for Sierra Club's active participation in the marketing program. The court also considered whether an agreement by Sierra Club "to cooperate" in the solicitation and encouragement of Sierra Club's members to participate in the program. The court sided with the taxpayer on both issues, finding that neither the retained right to approve marketing materials nor the obligation to cooperate constituted the provision of services such as would defeat the characterization of the payment as a royalty. The right to approve marketing materials simply helped Sierra Club protect its valuable intellectual property. The obligation to cooperate did not constitute an impermissible endorsement of the card issuer beyond that which necessarily results from licensing a name, logo, etc. Therefore, the court held that the income Sierra Club received in connection with the affinity arrangement was excludable from Sierra Club's unrelated business taxable income.

Courts have taken a similar approach to income from the rental of an exempt organization's mailing list. For example, in *Oregon State University Alumni Association, Inc. v. Commissioner*,¹⁰⁸ the United States Court of Appeals for the Ninth Circuit held that income from mailing list rentals constituted a royalty even where the exempt organization that owned and licensed the list provided some clerical services and engaged in some promotional activity with regard to the arrangement.

Notwithstanding the holdings in the above-described affinity credit card and mailing list rental cases, a taxpayer that provides more than a small amount of clerical services may risk having payments received in exchange for a license classified as payments for services rather than as excludable royalties.

Travel tours

A number of exempt organizations, including colleges and universities, offer travel tours that are promoted as educational. The IRS takes the position that travel tours of a more social or recreational nature are not substantially related to an organization's exempt educational purpose, and the income from such tours is unrelated business taxable income. Where a travel tour is

¹⁰⁷ 65 T.C.M. (CCH) 2582 (1993).

¹⁰⁸ 193 F.3d 1098 (9th Cir. 1999).

truly educational, however, it may be related to an organization's exempt purposes.¹⁰⁹ The determination whether a particular travel tour is sufficiently educational to be considered substantially related to an organization exempt purposes is not always easy and thus has been the source of considerable controversy. In February 2000, the IRS issued final regulations that provide several examples in an effort to demonstrate when travel tours are educational, and thus related, and when they are not.¹¹⁰

Economic incentives to issue tax-exempt bonds

As discussed above, tax-exempt bonds lower the borrowing cost of State and local governments (or private parties in the case of qualified private activity bonds) because the bond investor is willing to accept a lower rate on the bonds than the investor might otherwise accept on a taxable investment. The lower borrowing cost also provides the parties to such financings with the opportunity to earn arbitrage profits. In the context of State and local bonds, arbitrage is the difference between the interest paid on tax-exempt bonds and the interest earned on higher yielding investments. Pure arbitrage transactions have no economic substance, but are made profitable solely through the ability to borrow at tax-exempt rates. If permitted to earn and retain arbitrage profits, issuers of tax-exempt bonds would have an economic incentive to issue more bonds, to issue them earlier, and to leave them outstanding longer than necessary to achieve the purpose of the financing. Arbitrage is an inefficient alternative to additional borrowing, because it is more costly to the Federal Government in terms of forgone tax revenue than the additional borrowing that would be necessary to produce the same amount of arbitrage profits.

While the ability of issuers to earn and retain arbitrage profits through the investment of tax-exempt bond proceeds generally is restricted under present law, the Code does not define arbitrage in a manner that eliminates every opportunity to earn such profits. For example, present law does not restrict the investment of assets that are not financed with tax-exempt bond proceeds and are not otherwise used to replace bond proceeds (e.g., by pledging the assets to pay debt service on tax-exempt bonds). As a practical matter, this means that organizations eligible to receive tax-exempt financing, such as educational organizations described in section 501(c)(3), generally may invest accumulated assets in investments earning yields higher than the yields on their tax-exempt borrowings. In addition, because these entities are tax exempt, the earnings on these investments are untaxed. The ability to earn an untaxed return on investment assets in addition to the ability to borrow on a tax-exempt basis increases the incentive for exempt entities to issue tax-exempt bonds beyond that which would exist if the only benefit received were the difference between tax-exempt and taxable borrowing rates. Contrast this with present law as it generally applies to individual and corporate taxpayers. Tax-exempt bonds also would provide individual and corporate taxpayers with an opportunity to earn tax arbitrage if such taxpayers were permitted to deduct interest on indebtedness incurred to purchase or carry obligations the interest on which is exempt from tax. Present law, however, generally restricts

¹⁰⁹ Rev. Rul. 70-534, 1970-2 C.B. 113.

¹¹⁰ Treas. Reg. sec. 1.513-7.

such transactions by disallowing a deduction for interest on indebtedness incurred to purchase or carry tax-exempt bonds.¹¹¹

Moreover, unlike most other types of qualified private activity bonds, qualified 501(c)(3) bonds are not subject to the State volume cap limitations. Thus, although there is an economic incentive for section 501(c)(3) organizations to finance projects through the use of tax-exempt bonds rather than accumulated assets, present law does not impose any limitation on the aggregate amount of qualified 501(c)(3) bonds that may be issued.¹¹² As a general matter, as the total volume of tax-exempt bonds increases it has the effect of increasing the borrowing costs for all issuers of tax-exempt bonds because of competition for investment in such obligations. Market forces generally will limit the ability of tax-exempt entities to leverage their accumulated assets by issuing tax-exempt bonds, but these same forces also may have the effect of increasing the cost of financing other services.

¹¹¹ Sec. 265.

¹¹² As discussed above, in limited instances, there is a \$150 million limitation on the outstanding amount of qualified 501(c)(3) bonds from which a section 501(c)(3) organization may benefit. In general, however, this rule only applies to working capital expenditures or bonds issued with respect to capital expenditures incurred after August 5, 1997.

D. Issues With Respect to Tax Benefits for Individuals Relating to Higher Education Expenses

As described above, there are numerous provisions in the Code that allow taxpayers to reduce the cost of post-secondary education. Although the existence of a variety of tax incentives for education may mean that more taxpayers are able to take advantage of one or more education incentives, understanding the tax benefits provided by the different provisions, the various eligibility requirements, the interactions between different incentives and provisions within each incentive, and the recordkeeping and reporting requirements, may be time consuming and confusing for taxpayers who are interested in reducing their current education expenses or saving for future expenses. Specific sources of complexity include the absence of a uniform definition of qualifying education expenses, different income limitations for the different incentives, and provisions designed to prevent duplicative tax benefits with respect to the same expenses. The complexities of the varying definitions of qualifying expenses are illustrated in Table 4. Taxpayers also must address uncertainties associated with the fact that some of the education tax provisions are not permanent, and that certain rules applicable to permanent tax incentives are set to expire in 2010 absent further Congressional action. This is in addition to complexity that may exist independent of tax rules, such as that arising from the differences in fee structures, investment performance, and plan features.

Complexity concerns in this area have prompted a number of simplification proposals in recent years. The staff of the Joint Committee on Taxation made several simplification proposals relating to education tax incentives in April 2001. These included: (1) establishing a uniform definition of qualified higher education expenses; (2) combining the Hope and Lifetime Learning credits; and (3) modifying the rules regarding the interaction of the various education tax incentives to provide a limitation that the same expenses could not qualify under more than one provision.¹¹³ In that report, the staff stated that “taxpayers are confronted with a confusing array of choices with respect to Federal tax incentives for financing education,” but noted that structural reform in this area would have to consider, among other things, the advantages and disadvantages of exclusion or deferral from income, income limits, and transition issues.¹¹⁴ The American Bar Association Section of Taxation, the Tax Division of the American Institute of Certified Public Accountants, and Tax Executives Institute have supported harmonization and simplification of education tax incentives, and identified as possible measures: (1) combining the Hope and Lifetime Learning credits; (2) simplifying the definition of student; (3) establishing a single amount of expenses eligible for the credit; (4) eliminating or standardizing the income ranges required for eligibility; (5) granting (in lieu of credits) exemption amounts to taxpayers who qualify for the credit under present law; (6) easing the requirements for the interest deduction and coordinating the phase-out amounts with other education incentives; and (7)

¹¹³ Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, 122-143 (JCS-3-01), April 2001. Some changes made by EGTRRA address the third category, interaction of the various provisions to limit the same expenses to only one type of benefit.

¹¹⁴ *Id.* at 135.

replacing current tax benefits with a new universal education deduction or credit, i.e., developing one or two education-related deductions or credits to replace the current provisions.¹¹⁵ The President's Advisory Panel on Federal Tax Reform has recommended replacing the present-law education savings vehicles (and present-law medical accounts, such as health savings accounts) with "Save for Family" accounts. Up to \$10,000 could be contributed to such accounts annually. Contributions would be after-tax and distributions would not be includible in gross income if made for education expenses, health expenses, expenses for the purchase of a primary residence, and education.¹¹⁶

One issue that arises in the context of simplifying education tax incentives is whether the present-law rules appropriately target the tax benefits. For example, some argue that credits for education expenses should be refundable in order to subsidize education for individuals who need the subsidy the most. Others argue that refundable tax credits are administratively complex and that there are Federal spending programs, such as the Pell Grant program, that provide direct grants for education to a demographic group of individuals that is generally similar to the group that would be eligible for a refundable credit. Some argue that the per student approach of the Hope credit (rather than the per tax return approach of the Lifetime Learning credit) is a more equitable approach and would provide a more appropriate level of subsidy. Some have also pointed out that certain of the tax benefits are available only to a limited class. For example, the exclusion for qualified tuition reduction is available only to employees of qualified institutions.¹¹⁷ While available to a broader group of potential beneficiaries than the tuition reduction, the exclusion for employer-provided educational assistance has also been criticized for being available only to individuals whose employer has such a program.¹¹⁸ The tuition reduction exclusion applies with respect to dependents of the employee, whereas the general exclusion applies only to education of the employee.

¹¹⁵ American Bar Association, American Institute of Certified Public Accountants Tax Division and the Tax Executives Institute; American Bar Association Section of Taxation, Government Submissions, *available at* <http://www.abanet.org/tax/pubpolicy/2001/01simple/7.html> (noting that "[f]or many taxpayers, analysis and application of the intended incentives are too cumbersome to deal with compared with the benefits received," and that "there are so many individual tests that must be satisfied for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or because they pay tuition or other qualifying expenses during the wrong tax year"), 6-7.

¹¹⁶ The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System* (November 2005), at 120.

¹¹⁷ The staff of the Joint Committee on Taxation has recommended repeal of the exclusion for tuition reduction for this reason. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005 at 44-46.

¹¹⁸ In addition to the objection of subsidizing education, the exclusion for employer-provided education assistance has also been justified on administrative and simplification grounds. In the absence of the exclusion certain employer-provided education that is job related would be excludable from income. The specific exclusion under section 127 avoids the need to make the factual determination as to whether the education is job related.

Table 4.—Treatment of Expenses Under Education Tax Benefits

Provision	Tuition	Required Fees	Books, Supplies, Equipment	Room and Board	Special Needs Services
1. Hope Credit (sec. 25A)	Included, except that tuition is a qualified expense with respect to any course or other education involving sports, games, or hobbies, only if such course or other education is part of the individual's degree program.	Included, except that (1) required fees with respect to any course or other education involving sports, games, or hobbies is included only if such course or other education is part of the individual's degree program; and (2) nonacademic fees are not included.	Not included.	Not included.	Not included.
2. Lifetime Learning Credit (sec. 25A)	Same as Hope credit.	Same as Hope credit.	Not included.	Not included.	Not included.
3. Exclusion for distributions from qualified tuition programs (sec. 529)	Included.	Included.	Included, if required for enrollment or attendance.	Included in the case of students enrolled on at least a half-time basis. Amount of room and board expenses taken into account may not exceed the greater of: (1) the room and board amount included in the institution's cost of attendance for Federal student aid	Included for special needs beneficiaries. ¹

Provision	Tuition	Required Fees	Books, Supplies, Equipment	Room and Board	Special Needs Services
				purposes, or (2) the actual invoiced amount for students residing in housing owned or operated by the institution.	
4. Exclusion for distributions from Coverdell education savings accounts (sec. 530)	Included.	Included.	Same as qualified tuition programs.	Same as qualified tuition programs.	Same as qualified tuition programs.
5. Savings bond interest exclusion (sec. 135)	Same as Hope credit.	Same as Hope credit, except that that nonacademic fees are not excluded from the definition of fees.	Not included.	Not included.	Not included.
6. Above-the-line deduction for interest on loans for qualified education expenses (sec. 221)	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Not included.
7. Temporary above-the-line deduction for higher education expenses (sec. 222)	Same as Hope credit.	Same as Hope credit.	Not included.	Not included.	Not included.
8. Exclusion for scholarships (sec. 117(a))	Included.	Included.	Included.	Not included.	Not included.

Provision	Tuition	Required Fees	Books, Supplies, Equipment	Room and Board	Special Needs Services
9. Exclusion for qualified tuition reduction (sec. 117(d))	Included.	Not included.	Not included.	Not included.	Not included.
10. Gift tax exclusion (sec. 2503(e))	Included.	Not included.	Not included.	Not included.	Not included.

¹ The term “special needs services” and “special needs beneficiary” are not defined in present law. Legislative history indicates that the Treasury Secretary is to define a “special needs beneficiary” to include an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education. Treasury has not yet issued regulations regarding this definition