Financing A College Education: A Taxing Dilemma

David Williams, II*

I. Introduction

The cost of sending a child to college in the United States is rapidly increasing. As a result, the need for families to plan ahead to meet this cost has never been greater. Paramount in making those plans is the consideration of factors relating to the proper vehicles, the investment risk, the rate of return, and the tax consequences of various plans thereby providing for optimization of a family's resources to better prepare for the cost of tuition increases, lodging, application fees, preparatory seminars, and exams. These increased costs have presented to lower and middle class families, as well as to the higher education community, an economic dilemma that challenges the most financially capable. The federal government, state governments, and universities, through the enactment of various types of prepaid tuition programs and incentives, have emerged to become our partners in this challenge. They have involved themselves in helping families plan for, and pay for, the future cost of higher education.

This Article will provide an analysis of the structure, the tax consequences, and the tax benefits of some of these prepaid tuition programs.[1]

Part II of the Article will look at the federal government's involvement as a participant in the prepaid tuition concept. It will discuss the proposals that Congress considered, and the provision Congress wrote on this topic in the Technical and Miscellaneous Revenue Act of 1988.[2]

Part III of the Article will examine state involvement in the prepaid tuition concept. It will analyze two prototypes of state plans, the Michigan-type plan and the Illinois-type plan. Part IV will make suggestions to help bridge the gaps between the various programs and piece the puzzle together.

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* Assistant Professor of Law, The Ohio State University College of Law. B.S. 1969, M.A. 1970 Northern Michigan University; M.B.A. 1979, J.D. 1982, University of Detroit; LL.M. (Taxation) 1984, New York University. The author wishes to express his gratitude to Professors John Quigley and Alan Samansky for their helpful comments. Also, the author thanks Darnell Carr-Newsum for reading earlier drafts of this Article. Finally, the author thanks Deborah Sanders and Dannia Edwards, his law student Research Aides, as well as Carole Hinchcliff for her valuable library assistance.

1. While there are many techniques, such as Clifford Trusts, § 2503(c) Trusts, Crummey Trusts, Outright Gifts, Gift/Leasebacks, Spousal Remainder Trusts, and Short Term Charitable Remainder Trusts to help finance a child's education, they are beyond the scope of this Article. These techniques are usually tax-motivated and require the aid of experienced tax attorneys. In addition, new tax acts like the Tax Reform Act of 1986 can completely change the outcome of these plans. For a good discussion of many of these, see *Trust and Gift Techniques for Financing Children's Education*, in ALI-ABA Video Law Review Materials (Feb. 13, 1986); Elsworth, *Financial Planning for Your Children's College Education*, 64 Mich. B.J. 437 (1985); Coppage & Baxendale, *Timing Gifts to Children to Maximize Tax Benefits After TRA '86*, in Tax'n for Law. 152 (1988); Westin, *Financing Higher Education After the Kiddie Tax*, 11 Rev. of Tax'n of Individuals 255 (1987).

2. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988).

II. The Federal Government

A. *Proposed Legislation*

Prior to the enactment of the Technical and Miscellaneous Revenue Act of 1988,[3] the Senate and the House of Representatives considered several bills designed to assist families in meeting the increasing cost of higher education. During the first and second sessions of the One Hundredth Congress, no fewer than eleven bills were introduced addressing the role of the federal government in the financing of citizens' higher education cost. The bills may be separated into three groups: Educational Savings Accounts, Educational Savings Trusts, and Educational Savings Bonds and Certificates.

1. *Educational Savings Accounts*

On August 7, 1987, Senator Robert Dole of Kansas introduced three separate bills[4] that, among other things, would have established an entity called an Educational Savings Account.

The first of these bills, Senate Bill 1659 (S. 1659), would have amended the Internal Revenue Code of 1986 (I.R.C.) by establishing an Educational Savings Account and creating a new section that would allow an individual a credit against his or her taxes for a portion of the amount contributed to the Educational Savings Account.[5] This credit would be limited to fifteen percent of the sum of the individual's contribution of cash and fair market value of stocks, bonds, and other readily tradable securities transferred during the calendar year.[6] However, a maximum credit for an individual for any calendar year could not exceed $150.[7] In addition, the maximum contribution for any calendar year could not exceed $1000.[8]

The Educational Savings Account would be exempt from taxation,[9] therefore allowing the earnings from investments to grow tax free. Notwithstanding that exemption, the account would be subject to taxes imposed by section 511 of the I.R.C.[10] In addition, the account would run the risk of the loss of exempt status if the contributing individual engaged in any prohibited transaction under section 4975 of the I.R.C.[11] If the Educational Savings Account lost its exempt status due to a prohibited transaction, the fair market value of all assets in the account would be deemed distributed to the contributing individual and included in his gross income for that calendar year.[12] In addition, distribution from the Educational Savings Account

3. *Id.*
4. S. 1659, S. 1660, S. 1661, 100th Cong., 1st Sess. (1987).
5. S. 1659, 100th Cong., 1st Sess. § 1(a) (1987).
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.* I.R.C. § 511 relates to the imposition of tax on unrelated business income of tax-exempt organizations.
11. S. 1659, 100th Cong., 1st Sess. § 1(a) (1987). *See* I.R.C. § 4975, which provides for a tax on any prohibited transaction on qualified, tax-exempt plans. The section also defines a prohibited transaction.
12. S. 1659, 100th Cong., 1st Sess. § 1(a) (1987).

would be included in the gross income of the contributing individual, unless used to pay the educational expenses of the beneficiary.[13]

S. 1659 defined "educational expenses" to include:

> 1) [T]uition and fees required for the enrollment or attendance of a student at an eligible educational institution,
> 2) fees, books, supplies, and equipment required for courses of instruction at an eligible educational institution, and
> 3) a reasonable allowance for meals and lodging while attending an eligible educational institution.[14]

This bill defined "eligible educational institution" as "any institution of higher education"[15] or "any vocational school."[16] For purposes of S. 1659, an Educational Savings Account would have been a trust created or organized in the United States exclusively for the purpose of paying the educational expenses of a beneficiary individual. This trust would have a bank or other person who meets the satisfaction of the Secretary of the Treasury as a trustee.[17] S. 1659 would also have amended section 2503 of the I.R.C.[18] to allow any qualified payment by an individual to an Educational Savings Account to be exempt from being a gift of a future interest in property.[19]

Senate Bills 1660 (S. 1660)[20] and 1661 (S. 1661)[21] were substantially the same as S. 1659, but with minor variations. S. 1660, in addition to providing for an Educational Savings Account, would have amended Subchapter F of Chapter 1 of the Internal Revenue Code of 1986[22] by authorizing the exemption of the Educational Savings Account from the federal income tax;[23] in essence, making an Educational Savings Account a tax-exempt entity. S. 1661 would only have changed the provisions of S. 1659 by maintaining the tax status of the Educational Savings Account, although restricting the tax imposed on the annual taxable income of the Account to fifteen percent.

2. *National Education Savings Trust*

During 1987, at least three bills[24] were introduced that would have established either a Natioinal Education Savings Trust or a National Postsecondary Education

13. *Id.*
14. *Id.*
15. *See* § 4(b)(1) of the Higher Education Act of 1965, Pub. L. No. 89-329, 79 Stat. 1219, 1251 (1965).
16. *See* § 521(3)(C) & (D) of the Carl D. Perkins Vocational Education Act, Pub. L. No. 98-524, 98 Stat. 2435, 2483 (1984).
17. S. 1659, 100th Cong., 1st Sess. § 1(a) (1987).
18. S. 1659, 100th Cong., 1st Sess. § 1(c) (1987). I.R.C. § 2503 defines what are taxable gifts.
19. S. 1659, 100th Cong., 1st Sess. § 1(c) (1987). This is important because it allows the gift to be within the $10,000 exclusion provision.
20. S. 1660, 100th Cong., 1st Sess. (1987).
21. S. 1661, 100th Cong., 1st Sess. (1987).
22. Subchapter F of Chapter 1 of the I.R.C. deals with the definition and taxation of exempt organizations.
23. S. 1660, 100th Cong., 1st Sess. § 1(a) (1987).
24. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. (1987).

Trust.[25] In order to develop a more educated citizenry and acknowledge the difficulty many families would have in predicting and affording the cost of higher education, the encouragement of attendance at institutions of higher education had to be recognized as an essential function of the government. Therefore, the concept of a National Education Savings Trust was born. The purposes of the National Education Savings Trust would include the following:

1. To provide students and their parents assistance in financing postsecondary education;
2. To provide students and their parents protection against rising tuition costs;
3. To provide wide and affordable access to postsecondary educational institutions; and
4. To encourage education and the means of education so as to benefit the Nation.[26]

The bills would have established a public body corporation known as the National Education Savings Trust.[27] The National Education Savings Trust would be exempt from all taxation imposed by any state, territory, possession, commonwealth, or dependency of the United States, or by the District of Columbia, or by any county, municipality, or local taxing authority.[28] The Board of Trustees of the National Education Savings Trust would be composed of the Secretary of Education and the Secretary of the Treasury, both serving *ex officio*. In addition, five representatives of postsecondary educational institutions and five members of the general public, all appointed by the President with the advice and consent of the Senate,[29] would serve on the Board. The duties of the Board would be as follows:

1. [T]o hold the funds of the Trust;
2. to establish policies, procedures, and eligibility criteria to implement this Act, including policies and procedures—
   A. to enable purchasers to alter the amount of funds invested in advance tuition payment plan agreements to better conform such agreements to meet the changing postsecondary education needs of eligible beneficiaries;
   B. for combining payments, when one purchaser has signed agreements to provide for more than one eligible beneficiary;
   C. for receiving periodic installment payments on advance tuition payment plan agreements; and
   D. for enabling purchasers to have their installment payments deducted from salary;
3. to pay money from the Trust directly to a postsecondary education institution for cost of attendance at the postsecondary education institution, upon receipt of appropriate documentation, as provided for in the advance tuition payment plan agreement of an eligible beneficiary enrolled in that institution;
4. to charge, impose, and collect admininstrative fees and charges in connection with any transaction and provide for reasonable penalties, including default, for delinquent payment of fees or charges or for fraud;
5. to impose reasonable time limits on use of the tuition benefits provided by the Trust, in accordance with the terms provided in the agreement;

25. S. 1572 and H.R. 3252 would have created a National Education Savings Trust, whereas H.R. 2509 would have established a National Postsecondary Education Trust.

26. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 102(b) (1987).

27. H.R. 2509 would have established a similar public body corporation to be known as the National Postsecondary Education Trust.

28. S. 1572, H.R. 3252, 100th Cong., 1st Sess. § 104(a)(2) (1987).

29. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 104(d) (1987).

6. to define and incorporate in the agreement, consistent with Section 106 and Sections 135 and 220 of the Internal Revenue Code of 1986, the terms and conditions under which money may be withdrawn or refunded from the Trust, including reasonable charges or fees for any such withdrawal or refund;
7. to obtain for such goods and services and employ such personnel as is necessary and to engage the services of private consultants, actuaries, managers, legal counsel, and auditors for rendering professional, management, and technical assistance and advice, payable out of any money of the Trust;
8. to make [annual reports];
9. to report immediately to the Congress whenever the Board is of the opinion that the amount of funds in the Trust is inadequate to meet its obligations; and
10. to review the general policies followed in managing the Trust, and recommend changes in such policies, including necessary changes in the provisions of the law which governs the way in which the Trust is to be managed.[30]

Under the National Education Savings Trust, a purchaser[31] would have been allowed to enter into an agreement with the Trust, on behalf of himself and the federal government, for the purchase of an advance tuition payment[32] plan for use by a qualified beneficiary[33] to pay a portion of the cost of attendance[34] at a postsecondary educational institution.[35] The bills would have required each advance tuition payment plan agreement to contain all of the following:

1. The amount of the payment or installments required from the purchaser on behalf of the qualified beneficiary, subject to the limitations contained in section 220(c) of the Internal Revenue Code of 1986.
2. The terms and conditions for making such payment or installments, including the date or dates upon which the payment or installments shall be due. Such terms and conditions may include provisions to permit another person to make such payment on installments in the event that the purchaser, becomes disabled, or otherwise becomes unable to make such payment or installment.
3. Provisions for late payment changes and for default.
4. The name and date of birth of the qualified beneficiary under the agreement. The agreement may permit the purchaser, with the approval of the Trust and on conditions set forth in the agreement, to substitute another qualified beneficiary for the qualified beneficiary originally named, in lieu of termination of the agreement.
5. The name of the person entitled to terminate the agreement, which as provided by the agreement, may be the purchaser or a person to act on behalf of the purchaser.

30. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 104(d) (1987).

31. S. 1572, H.R. 3252, 100th Cong., 1st Sess. § 103(7) (1987). Purchaser is defined as a person who makes or is obligated to make advance tuition payments pursuant to an advance tuition payment plan agreement.

32. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 103(1) (1987). An advance tuition payment plan agreement is an agreement entered into by the Trust and a purchaser to yield future resources to assist in providing for the postsecondary education of a qualified beneficiary through payments to meet part or all of the costs of attendance at a postsecondary educational institution.

33. S. 1572, H.R. 3252, 100th Cong., 1st Sess. § 103(8) (1987); H.R. 2509, 100th Cong., 1st Sess. § 103(5) (1987). Qualified beneficiary was defined as any individual named in the advance tuition payment plan agreement who meets the eligibility criteria established by the Trust.

34. S. 1572, H.R. 3252, 100th Cong., 1st Sess. § 103(3) (1987). Cost of attendance has the same meaning given under § 472 of the Higher Education Act of 1965. H.R. 2509 does not define cost of attendance.

35. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 103(b) (1987). For definition of postsecondary educational institution, see § 461 of the Higher Education Act of 1965, Pub. L. No. 89-329, 79 Stat. 1219, 1251 (1965).

6. The terms and conditions under which the agreement may be terminated and the conditions and the method of computation of the amount of any refund to which the person terminating the agreement, or specifically the purchaser or designated qualified beneficiary if the agreement so provides, shall be entitled upon termination.

7. The assumption of a contractual obligation by the Trust to the qualified beneficiary, on its own behalf and on behalf of the Federal Government, to provide for the costs specified in an advance tuition payment plan agreement.

8. The period of time from the beginning to the end of which the qualified beneficiary may receive the benefits under the agreement, such period ending no later than the date upon which any qualified beneficiary under the agreement attains the age of 30 years.

9. The agreement may permit the purchaser who has been unemployed for more than one year and who has been eligible for unemployment compensation benefits during such year to direct the payment of the cost of attendance by the purchaser at a postsecondary education institution for the purpose of job training or retraining. Such payment may only occur during the period described in paragraph 8 above.

10. Other terms, conditions, and provisions as the Trust considers in its sole discretion to be necessary or appropriate.[36]

The Trust would be designed to offer the purchaser a plan that would, on the basis of actuarial projections, attempt to achieve sufficient return to pay costs of attendance at a postsecondary educational institution. The purchaser would be able to purchase an advance tuition payment plan at any time following the birth of the eligible beneficiary. The payments would vary depending on the age of the eligible beneficiary at the time of the purchase.

If the qualified beneficiary died, attained the age of thirty, decided not to attend a postsecondary educational institution after attaining the age of majority, or completed as much of the course of postsecondary education as he intended to complete, and had not exhausted the benefits to which he was entitled, the agreement would terminate. In the event of termination, the Trust would refund the face amount of the payments, plus any interest or dividends accrued.

The tax treatment afforded the National Education Savings Trust would have been threefold. First, the Trust would have been a tax-exempt entity, free from any federal, state, or local tax.[37] Second, section 220 of the I.R.C.[38] would be redesignated as section 221 and a new section 220 would be enacted, entitled "PAYMENTS UNDER CERTAIN ADVANCE TUITION PAYMENT PLAN AGREEMENTS." New section 220 would have allowed an individual to take an itemized deduction for cash paid into the National Education Savings Trust under any advance tuition payment plan agreement.[39] The size of the deduction would vary depending on the taxpayer's adjusted gross income—the higher the adjusted gross

36. S. 1572, H.R. 3252, 100th Cong. 1st Sess. § 105(b) (1987). Section 105(b) of H.R. 2509 enumerates the same requirements, with the exception of paragraph 9, which is omitted.

37. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 104(a)(2) (1987).

38. I.R.C. § 220 presently reads as follows:

Sec. 220. CROSS REFERENCE. For deductions in respect of a decedent, see section 691.

39. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 201(a) (1987). Section 201(b) of each bill would also amend I.R.C. § 62, which defines adjusted gross income, to allow individuals who do not itemize their deductions to receive a similar benefit. *See supra* note 32 for the definition of advance tuition payment plan.

income, the lower the deduction.[40] If the taxpayer's adjusted gross income was $25,000 or less, all of the amount paid could be deducted. At an adjusted gross income of $25,001 to $60,000, fifty percent could be deducted.[41] At an adjusted gross income of $60,001 to $100,000, twenty-five percent could be deducted. No deduction would be allowed if adjusted gross income for the calendar year exceeded $100,000.[42]

If an individual, pursuant to an advance tuition payment plan agreement, paid $2000 in cash to the National Education Savings Trust, his deduction would be as follows:

If His AGI Was	His Deduction Would Be
$25,000 or less	$2000.00
$25,001 to $60,000	$1000.00
$60,001 to $100,000	$ 500.00
$101,000 or more	0

The new section 220 provided that the adjusted gross income numbers would be reduced by fifty percent in the case of a married taxpayer filing a separate return.[43] In addition, the adjusted gross income dollar amounts would have been adjusted for cost of living increases each year.[44]

The new section 220 would have limited the deduction in two other important ways. First, the deduction would have been allowed to a taxpayer only if the taxpayer was the qualified beneficiary under the agreement,[45] or if the taxpayer would be entitled to a deduction under section 151(c) with respect to the qualified beneficiary under the agreement for the year in question.[46] The second limitation related to the

40. S. 1572, H.R. 3252, 100th Cong., 1st Sess. § 201(a) (1987). However, one version of the National Education Savings Trust did not require the application of any applicable percentage to reduce the deduction. *See* H.R. 2509, 100th Cong., 1st Sess. § 201(a) (1987).

41. S. 1572, H.R. 3252, 100th Cong., 1st Sess. § 201(a) (1987).

42. *Id.*

43. *Id.* In this case the married individual taxpayer filing a separate return would have the following schedule:

Adjusted Gross Income	*Applicable Percentage*
Not over $12,500	100%
Over $12,500 but not over $30,000	50%
Over $30,000 but not over $50,000	25%
Over $50,000	0%

44. *Id.*

45. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 201(a) (1987). However, no deduction would have been allowed for a taxpayer who was a dependent of any other person for the taxable year. This would prohibit a child from purchasing an agreement for herself and gaining a deduction while her parents were claiming her as a dependent on their tax return.

46. *Id.* Section 151(c) reads as follows:

Sec. 151 Allowance of Deductions for Personal Exemptions.

(c) Additional Exemption for Dependents.—

(1) In General.—An exemption amount for each dependent (as defined in section 152)—

(A) whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than the exemption amount, or

(B) who is a child of the taxpayer and who (i) has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or (ii) is a student.

(2) Exemption Denied in Case of Certain Married Dependents.—No exemption shall be allowed under this subsection for any dependent who has made a joint return with his spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

actual amount of the deduction. While an individual might contribute any amount to the Trust, the amount allowed as a deduction with respect to payments under each plan for each qualified beneficiary would have been limited to $2000 for any taxable year and $48,000 in total for all taxable years.[47] While unclear, it appears that the language of the new section 220 would actually have allowed an individual more than a maximum $2000 deduction in a given year, if that taxpayer was purchasing an advance tuition payment plan for more than one qualified beneficiary.

New section 220 would also have provided three additional special rules. First, an individual taxpayer would not be entitled to any deduction for any amount paid pursuant to any advance tuition payment plan agreement for the taxable year in which the qualified beneficiary either dies or attains the age of thirty years.[48] Second, a deduction for amounts paid pursuant to an advance tuition payment plan agreement when the qualified beneficiary is the taxpayer's spouse would only be allowed if two conditions were met. The taxpayer must be entitled to an exemption for his or her spouse under section 151(b) of the I.R.C. for the taxable year.[49] Additionally, the taxpayer must file a joint return with such spouse or qualified beneficiary for such taxable year.[50] In essence, the only way in which a deduction would be allowed for payments with respect to a spouse is if the couple filed a joint return and the qualified beneficiary had no gross income for the calendar year. The final special rule would

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(3) Child Defined.—For purposes of paragraph (1)(B), the term "child" means an individual who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer.

(4) Student Defined.—For purposes of paragraph (1)(B)(ii), the term "student" means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins—

(A) is a full-time student at an educational organization described in section 170(b)(1)(A)(ii); or

(B) is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in section 170(b)(1)(A)(ii) or of a State or political subdivision of a State.

(5) Certain Income of Handicapped Dependents Not Taken Into Account.—

(A) In General.—For purposes of paragraph (1)(A), the gross income of an individual who is permanently and totally disabled shall not include income attributable to services performed by the individual at a sheltered workshop if-

(i) the availability of medical care at such workshop is the principal reason for his presence there, and

(ii) the income arises solely from activities at such workshop which are incident to such medical care.

(B) Sheltered Workshop Defined.—For purposes of subparagraph (A), the term "sheltered workshop" means a school—

(i) which provides special instruction or training designed to alleviate the disability of the individual, and

(ii) which is operated by—

(I) an organization described in section 501(c)(3) and exempt from tax under section 501(a), or

(II) a State, a possession of the United States, any political subdivision of any of the foregoing, the United States, or the District of Columbia.

(C) Permanent and Total Disability Defined.—An individual shall be treated as permanently and totally disabled for purposes of this paragraph if such individual would be so treated under paragraph (3) of section 22(e).

47. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 201(a) (1987).

48. *Id.*

49. *Id.* Section 151(b) reads as follows:

Sec. 151 Allowance of Deductions for Personal Exemptions.

(b) Taxpayer and Spouse - An exemption of the exemption amount for the taxpayer; and an additional exemption of the exemption amount for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

50. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 201(a) (1987).

have allowed a deduction for a taxable year even if the amount paid to the Trust, pursuant to the advance tuition payment plan agreement, occurred after the last day of such taxable year.[51] However, a contradiction was presented in the proposed bills. The caption was entitled "Contributions Made Within 2 1/2 Months After the Close of Taxable Year,"[52] which would account for contributions made up until March 15th of the following year. The paragraph actually stated that a taxpayer would be:

> deemed to have made a payment pursuant to an advance tuition payment plan agreement on the last day of the preceding taxable year if such payment is made on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (not including extensions thereof).[53]

Since an individual's tax return is not due until April 15th of the following year, the actual language of the statute would have allowed a payment up to April 15th.[54]

The National Education Savings Trust legislation would have redesignated section 135 of the I.R.C. as section 136[55] and inserted a new section 135.[56] New section 135 would have treated the actual and constructive distributions from the Trust quite differently.

Pursuant to the advance tuition payment plan agreement, payments of the Trust plan agreement would go directly to the postsecondary educational institution for the benefit of the named qualified beneficiary. Since these payments are paid on behalf of the qualified beneficiary at the direction of the taxpayer who purchased the agreement,[57] a constructive distribution would be made to one of these parties. While the determination of which of these parties would be responsible for the inclusion of the Trust income could be an interesting debate, the section would have made that a moot issue. The payments made from the National Education Savings Trust to any postsecondary eduational institution pursuant to any advance tuition payment plan

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51. *Id.*
52. *Id.*
53. *Id.*
54. *See* I.R.C. § 6072(a), which states that returns made on the basis of the calendar year shall be filed *on* or before the 15th day of April following the close of the calendar year. This would actually allow contributions to be made within 3 1/2 months after the close of the taxable year. This appears to be an oversight that hopefully would have been caught and corrected if this bill were actually adopted.
55. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 202(a) (1987). Section 135 reads as follows:
    Section 135. Cross References to Other Acts.
    (a) For exemption of—
    (1) Allowances and expenditures to meet losses sustained by persons serving the United States abroad, due to appreciation of foreign currencies, see section 5943 of title 5, United States Code.
    (2) Amounts credited to the Maritime Administration under section 9(b)(6) of the Merchant Ship Sales Act of 1946, see section 9(c)(1) of that Act (50 U.S.C. App. 1742).
    (3) Benefits under laws administered by the Veterans' Administration, see section 3101 of title 38, United States Code.
    (4) Earnings of slip contractors deposited in special reserve funds, see section 607(d) of the Merchant Marine Act, 1936 (46 U.S.C. 1177).
    (5) Income derived from Federal Reserve banks, including capital stock and surplus, see section 7 of the Federal Reserve Act (12 U.S.C. 531).
    (6) Special pensions of persons on Army and Navy medal of honor roll, see 38 U.S.C. 562(a)-(c).
    (b) For extension of military income-tax-exemption benefits to commissioned officers of Public Health Service in certain circumstances, see section 212 of the Public Health Service Act (42 U.S.C. 213).
56. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 202(a) (1987).
57. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 104(d)(3) (1987).

agreement would have been excluded from the gross income of any person under new section 135.[58]

If any amount were paid from the National Education Savings Trust to an individual rather than to a postsecondary educational institution, that individual would have to include the amount in gross income for the taxable year in which he received the payments.[59] Additionally, if an amount would be includible in the gross income of an individual because of a payment from the National Education Savings Trust, that individual's tax for the taxable year would be increased by an amount equal to twenty percent of the amount required to be included in gross income because of the payment.[60] If an individual received a $20,000 payment from the National Education Savings Trust, he would include the $20,000 in his gross income and, as a penalty, increase his tax for the year by $4000. If the payment occurred by reason of the death of the qualified beneficiary, there would be no penalty.[61] However, the payment would still be required to be included in the recipient's gross income.

3. *Educational Savings Bonds and Certificates*

The third category of bills would have created Educational Savings Bonds and Certificates. Four versions of this concept were actually introduced. H.R. 3873, introduced in 1988,[62] would have created a vehicle entitled the "Parental Assistance with Tuition Savings Certificate,"[63] to be issued to the public by the Secretary of Education.[64] The certificates, in varying denominations, would be issued at a discount with varying maturities not exceeding twenty-five years. The proceeds from the certificates would have been deposited in the general fund of the United States.[65] The Secretary would have been authorized to redeem certificates from both the general public and institutions of postsecondary education.

A postsecondary educational institution that accepted certificates as payment and kept tuition increases within three percent of the Consumer Price Index would receive an incentive payment based on its pro rata share of all certificates redeemed for postsecondary education.[66] The Act would have also provided that it should not be construed to affect the applicability of the Internal Revenue Code of 1986 to the savings certificates.[67] Therefore, the earnings from the savings certificates[68] would

58. S. 1572, H.R. 3252, H.R. 2509, 100th Cong., 1st Sess. § 202(a) (1987).

59. *Id.*

60. *Id.* The tax increase would only be ten percent if this happened in any taxable year before the qualified beneficiary of the advance tuition payment plan agreement attained the age of twenty-five. Under § 202(a) of H.R. 2509, however, the penalty in all circumstances would be only ten percent.

61. *Id.*

62. H.R. 3873, 100th Cong., 2d Sess. (1988).

63. *Id.* at § 2(b).

64. *Id.* at § 4(a)(1).

65. *Id.* at § 4(a)(2). This concept is similar to that of Zero-Coupon Bonds. The purchaser purchases a $10,000 bond today for $6000 with a maturity date 10 years from the date of purchase. On the maturity date, the purchaser will receive $10,000.

66. *Id.* at § 4(e)(1).

67. *Id.* at § 4(b)(4).

68. The earnings represent the difference between the purchase price (at discount) and the price the purchaser will

have to be included in gross income.[69] However, the statute was silent as to whether the purchaser of the certificate or the named beneficiary would be the responsible party for the inclusion in gross income. Also, the timing of the income inclusion was left open. Should it be included in gross income on redemption or pro rata over the life of the certificate?[70]

H.R. 3874[71] would have taken the tuition savings certificate idea and improved it. It would have created the "Parental Assistance with Tuition Bonds Act of 1987."[72] H.R. 3874 would have established a United States Savings Bond program to help families:

(1) Finance postsecondary education,
(2) Protect themselves against rising college costs,
(3) Obtain access to postsecondary educational institutions, and
(4) Participate in education so as to benefit the nation.[73]

H.R. 3874 would have authorized the Secretary to issue, in varying maturities, a series of United States Savings Bonds called "Tuition Bonds."[74]

By amending the Internal Revenue Code of 1986, H.R. 3874 would have redesignated section 220 of the Code[75] as section 221 and enacted and inserted a new section 220. In addition, section 135[76] would have been redesignated section 136 and a new section 135 would have been enacted and inserted into the Code.

New section 220 would have been entitled "Purchase of Tuition Bonds," and would have allowed an individual to deduct from his gross income an amount equal to the applicable percentage of the amount paid for the purchase of any Tuition Bond during that taxable year.[77] The applicable percentage started at 100 percent, but was reduced by one percentage point for each $700 amount of the purchaser's adjusted gross income that exceeded $30,000.[78] The following serves as an illustration:

> If Mr. Jones paid $2000 in 1989 for a Tuition Bond, his allowable deduction would depend on his 1989 adjusted gross income. If his AGI were $30,000 or less, then he would be allowed the full $2000 deduction. However, if Mr. Jones' AGI were greater than $30,000 the applicable percentage, as well as the actual deduction, would be reduced. If his AGI were $58,000, the applicable percentage would be reduced by forty percentage points.[79]

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receive, or the fair market value of the benefits to be received, on redemption at maturity or before. For example, Mr. Smith purchased a $10,000 certificate for $6000 on December 31, 1989, which would mature on December 31, 1999. On maturity, Mr. Smith will receive either $10,000 in cash or $10,000 worth of tuition benefits. The difference of $4000 ($10,000 - $6000) represents the taxable earnings. *See* I.R.C. § 1001(a).

69. *See* I.R.C. § 61.

70. *See supra* note 68. If the income is reported at redemption, then Mr. Smith (or the named beneficiary, if different) would have $4000 of gross income in 1999. If the pro rata approach were followed, Mr. Smith (or the named beneficiary) would include $400 a year (between 1990 and 1999) in gross income.

71. H.R. 3874, 100th Cong., 2d Sess. (1988).

72. *Id.* at § 1.

73. *Id.* at § 2(b).

74. *Id.* at § 3.

75. *Id.* at § 4(a). *See supra* note 38 for old § 220.

76. H.R. 3874, 100th Cong., 2d Sess. § 5(a) (1988). *See supra* note 55 for old § 135.

77. H.R. 3874, 100th Cong., 2d Sess. § 4(a) (1988).

78. *Id.*

79. An AGI of $58,000 exceeds $30,000 by a total of $28,000. Since the applicable percentage must be reduced

This leaves Mr. Jones with a sixty percent applicable percentage and a $1200 deduction (.60 x $2000). If Mr. Jones' AGI were $100,000 or more, his applicable percentage would be reduced to zero and his allowable deduction would be zero.

The aggregate payments an individual would be allowed to treat as payments for any taxable year could not exceed the lesser of:

(1) $10,000, or
(2) the product of $2000 and the number of individuals—
(A) with respect to whom the taxpayer is entitled to an exemption under section 151 for such taxable year, and
(B) who have not attained age 19 as of the close of the calendar year in which the taxable year begins.[80]

The new section 220 would not have allowed a deduction to any individual who was a dependent of any other person during the taxable year in question.[81] Also, an eligible taxpayer would be allowed to purchase the Tuition Bonds sometime after the close of the taxable year and still be deemed to have purchased it on the last day of the preceding taxable year.[82] In addition, the new bill would have provided for an inflation adjustment in determining the applicable percentage in future years.[83] Finally, the Tuition Bond's sole registered owner had to be a dependent, under the age of nineteen, of the purchasing taxpayer.[84]

While new section 220 would have defined the tax treatment of the purchase of the bonds, new section 135 defined the tax treatment of the redemption of the bonds. New section 135 would have allowed an individual to exclude from gross income any money received on the redemption of a Tuition Bond.[85] However, the exclusion could not exceed the unreimbursed cost of attendance[86] incurred by, and for the education of, the taxpayer during the taxable year.[87] While the new section 220 deduction would have applied to the purchaser of the bond, the new section 135 exclusion would have benefited the individual for whom the bond was purchased, the registered owner. If the redemption proceeds exceeded the unreimbursed cost of attendance, the excess would be includible in the gross income of the redeeming taxpayer, and the taxpayer's tax for that taxable year would be further increased by an amount equal to ten percent of the includible amount.[88] The ten percent tax would apply if the bond was redeemed after the death of the registered owner, unless the registered owner had

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one percentage point per $700 increase over $30,000, the applicable percentage of 100 must be reduced by 40 ($28,000/ $700).

80. H.R. 3874, 100th Cong., 2d Sess. § 4(a) (1988). The maximum deduction would be $10,000 and would only be for an individual with five dependents under nineteen years of age who has an AGI of $30,000 or less and pays $10,000 for Tuition Bonds during the year.

81. *Id.*

82. *Id. See supra* note 54 for discussion of 2 1/2 months problem.

83. H.R. 3874, 100th Cong., 2d Sess. § 4(a) (1988).

84. *Id.*

85. *Id.* at § 5(a).

86. *See supra* note 34 for definition of cost of attendance.

87. H.R. 3874, 100th Cong., 2d Sess. § 5(a) (1988).

88. *Id.* If the taxpayer redeemed $25,000 of Tuition Bonds in the taxable year but her unreimbursed cost of attendance was only $18,000, the excess, or $7000, must be included in her gross income for the year of redemption. In addition, her tax for the taxable year would be increased by $700 (.10 of $7000).

a brother or sister under age twenty-four at the time of the registered owner's death, and the bond was not passed or acquired from the decedent to that brother or sister pursuant to section 1014.[89]

An interesting aspect of new section 135 was its coverage. Not only would it have afforded tax exclusion privileges to the Tuition Bonds, it would have allowed the same treatment to any savings bonds purchased prior to the enactment date of new section 135, as long as the sole registered owner would have been an eligible individual under the new legislation.[90]

Three other bills, H.R. 3064,[91] H.R. 3570,[92] and S. 1817,[93] would have excluded from gross income certain interest income from United States Savings Bonds. H.R. 3064 would have created a United States Savings Bond called a United States College Bond.[94] An individual could exclude from gross income amounts received on the redemption of a College Bond, if used to pay qualified tuition expenses[95] defined by section 117(b)(2).[96] Since there would have been no deduction for the purchase of the College Bond, there would be no penalty tax if the redeemed amount exceeded the qualified tuition expenses. However, the excess would be included in the redeeming individual's gross income for the taxable year of redemption. H.R. 3064 centered around a qualified United States Savings Bond which was nothing more than a United States savings bond issued at a discount after the enactment date of this bill.[97] The exclusion from gross income would only apply if the qualified United States Savings Bond was transferred to an eligible educational institution as payment for the higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents.[98] The exclusion would be limited to the lesser of:

> (1) the amount which (but for this section) would be includible in gross income by reason of such transfer, or
> (2) the amount of such higher education expenses.[99]

The term "higher education expenses" encompassed the tuition and fees required for enrollment, as well as the fees, books, supplies, and equipment required for courses, but not for room and board.[100] H.R. 3570 and S. 1817 would have phased out the

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89. *Id.* I.R.C. § 1014 deals with the basis of property acquired from a decedent.

90. H.R. 3874, 100th Cong., 2d Sess. § 5(a) (1988). However, the ten percent additional penalty tax would not apply to this class.

91. H.R. 3064, 100th Cong., 1st Sess. (1987).

92. H.R. 3570, 100th Cong., 1st Sess. (1987).

93. S. 1817, 100th Cong., 1st Sess. (1987).

94. H.R. 3570, 100th Cong., 1st Sess. § 1(b) (1987).

95. H.R. 3064, 100th Cong., 1st Sess. § 1(a) (1987).

96. *Id.* I.R.C. § 117(b)(2) defines qualified tuition expenses as:

(A) tuition and fees required for the enrollment or attendance of a student at an educational organization described in section 170(b)(1)(A)(ii), and

(B) fees, books, supplies, and equipment required for courses of instruction at such an educational organization.

97. H.R. 3064, 100th Cong., 1st Sess. § 1(a) (1987); *see also* S. 1817, 100th Cong., 1st Sess. § 2(a) (1987).

98. S. 1817, 100th Cong., 1st Sess. § 2(a) (1987).

99. *Id.*

100. *Id.*

exclusion for taxpayers with an AGI of $75,000 or more in the taxable year in which the qualified United States Savings Bond was transferred.[101] With AGI of $75,000 to $124,999, sixty-seven percent of the amount that normally would be excluded, could be excluded.[102] For AGI between $125,000 and $149,999 the percentage would have dropped to thirty-four percent. With AGI of $150,00 or more, no exclusion would have been allowed.[103]

B. *Technical and Miscellaneous Revenue Act of 1988 (TAMRA)*[104]

1. *The Final Bill*

While Congress was faced with a difficult task, the choices available to it were both plentiful and varied.[105] However, Congress provided the taxpayer with only a partial victory over rising costs by selecting a watered down version of S. 1817.[106] TAMRA redesignated section 135 of the Code as section 136 and enacted a new section 135 entitled "Income From United States Savings Bonds Used To Pay Higher Education Tuition and Fees."[107] It allows an individual who pays qualified higher education expenses to exclude from gross income amounts received from the redemption of qualified United States Savings Bonds.[108] A qualified United States Savings Bond is defined as "any United States Savings Bond issued at a discount to an individual twenty-four years or older and after December 31, 1989."[109] Since only savings bonds purchased after December 31, 1989, can be qualified bonds, any pre-existing savings bonds, or savings bonds purchased during 1989, will not qualify for this exclusion. "Qualified higher education expenses" includes tuition and fees of the taxpayer, the taxpayer's spouse, or any dependent for whom the taxpayer can claim a deduction under section 151.[110] These expenses must be paid to an eligible educational institution in the same year the bond is redeemed in order to be considered qualified.[111] They must be reduced by any excludible scholarship or fellowship, employer-provided educational assistance, and other tuition reduction amounts received by the individual.[112] The cost of any course or education involving

101. H.R. 3570, S. 1817, 100th Cong., 1st Sess. § 2(a) (1987).

102. *Id.*

103. *Id.*

104. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988).

105. *See supra* notes 4–103 and accompanying text.

106. *See supra* notes 93, 97–103 and accompanying text.

107. TAMRA, Pub. L. No. 100-647, tit. VI § 6009, 102 Stat. 3342, 3688 (1988).

108. *Id.* at § 6009(a).

109. *Id.* United States Savings Bonds are issued at a discount by charging the purchaser an amount less than the face amount of the bond. If the face amount of the bond is $200, the purchase price would normally be $100. If the purchaser holds the bond to maturity date, she will receive $200, of which $100 is return of capital and nontaxable and $100 is interest income and must be included in her gross income. If she holds the bonds beyond the maturity date, interest will continue to accrue, and when she redeems the bond, she will receive in excess of the $200 face amount. Once again, all but the $100 return of capital is interest income and must be included in her gross income. If she redeems the bond prior to its maturity date, the purchaser will receive only $100, the price she paid for the bond and there will be no tax consequences.

110. *Id.* I.R.C. § 151 deals with the allowance of deductions for personal exemptions.

111. TAMRA, Pub. L. No. 100-647, tit. VI, § 6009(a), 102 Stat. 3342, 3688 (1988).

112. *Id.* To illustrate: If the taxpayer purchased a $2000 qualified United States Savings Bond in 1990 for $1000

sports, games, or hobbies cannot qualify unless the course or education is part of a degree program.[113]

The exclusion is not without limitations. The first limitation is really a phaseout of the exclusion based on the redeeming individual's AGI.[114] The interest income excluded is phased out for taxpayers with modified AGI above certain levels.[115] For those married and filing joint returns, the phaseout range is from $60,000 to $90,000, while those taxpayers filing single or head of household will have a phaseout range of $40,000 to $55,000.[116] If the modified AGI exceeds $60,000 ($40,000 for single and head of household filers), the amount that would otherwise be excludible is reduced, but not below zero, by an amount that bears the same ratio to the amount otherwise excludible as the excess modified adjusted gross income bears to $30,000 ($15,000 for single and head of household filers).[117] The following example can serve as an illustration:

> Mr. and Mrs. Smith, who file a joint return, redeem a $10,000 qualified United States Savings Bond to apply to qualified higher education expenses for their son, Robert. The $10,000 the Smiths receive represents $5000 of principal and $5000 of interest income. Since the qualified higher education expenses for the year were $10,000, the entire $5000 of interest income appears to be excluded from the Smiths' gross income. However, if their modified AGI exceeds $60,000 there must be a phaseout reduction. If their modified AGI is $80,000, then the phaseout reduction is $3333, and the excludible amount is $1667, instead of $5000. The Smiths arrived at the phaseout reduction by taking the otherwise excludible amount ($5000) and reducing it by an amount that bears the same ratio to it ($5000) as the $20,000 excess modified AGI ($80,000 modified AGI minus $60,000 modified AGI limit) bears to $30,000.[118] If the Smiths modified AGI were $60,000, they would have a zero excess modified AGI and be entitled to the full $5000 exlusion. If their modified AGI is $90,000 or more, then the phaseout reduction would be $5000 and their exclusion amount would be zero.

For the purpose of this statute, modified AGI is adjusted gross income after the application of sections 86, 469, and 219, without regard to the sections 911, 931, and 933 exclusions.[119]

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and redeemed it in 1997 for $2200, he would normally have $1200 ($2200 - $1000) of interest income in 1997. However, if the taxpayer uses the $1200 for qualified higher education expenses, he may exclude the $1200 interest income from his gross income. If his only expense is $2200 of tuition and he pays his tuition with the $2200, there will be no tax consequences. However, if he receives a $300 scholarship, he must reduce his qualified higher education expenses by the portion of the scholarship that is excluded from gross income. If all $300 goes to tuition, then his qualified higher education expenses for purposes of this section must be reduced to $1900 ($2200 - $300). Therefore, the taxpayer could only exclude a portion of the $1200 interest income from the redemption of the qualified United States Savings Bonds, and the remaining interest income must be included in his gross income.

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. The formula would be: Phaseout Reduction = Otherwise Excludable Amount multiplied by the Excess Modified AGI/$30,000 (or $15,000 if filing single or head of household). Thus, $3333 = $5000 multiplied by $20,000/$30,000.

119. TAMRA, Pub. L. No. 100-647, tit. VI, § 6009(a), 102 Stat. 3342, 3688 (1988). While the mentioned sections are beyond the scope of this paper, they relate to:

§ 86 - Social Security and Tier 1 Railroad Retirement Benefits

§ 219 - Retirement Savings

The second limitation of the TAMRA exclusion involves the redemption amounts and qualified higher education expenses and their relationship to the amount excludible. If the total redemption amount, including principal and interest, of bonds redeemed during the taxable year does not exceed qualified higher education expenses paid during the taxable year, and there is no excess modified AGI, then all the interest on the bonds is excludible. However, if the redemption amount is more than the qualified higher education expenses, only a proportionate amount of the interest on the bonds is excludible.[120] The amount excludible is arrived at by multiplying the total interest on the redeemed bonds by the fraction of qualified education expenses paid during the tax year over the total redemption amount of qualified bonds redeemed during the year.[121] A return to the prior example helps illustrate this limitation:

> The Smiths, who file a joint return, have a modified AGI of $50,000 and received $10,000 in redemption of qualified bonds. The $10,000 received represented $4000 of principal and $6000 of interest income. In the same year, the Smiths pay $7000 of qualified higher education expenses for their son Robert's first year of college. The Smiths can exclude $4200 of the $6000 interest income ($6000 interest x ($7000 qualified expenses / $10,000 total redeemed amount)).

The final limitation relates to the purchaser and owner of the bonds. The exclusion is not available for bonds that are purchased by an individual other than the owner of the bonds.[122] Therefore, bonds purchased by a parent, grandparent, or other relative and put in a child's name will not qualify, nor will bonds purchased by a grandparent and placed in the parent's name.[123] The only exception to this rule is for bonds owned jointly with a spouse or bonds purchased by one spouse and owned by the other spouse.[124] Since a bond purchased by an individual under the age of twenty-four cannot be a qualified bond, a bond purchased by the child, and later redeemed, will not be eligible for the exclusion treatment.

2. *Analysis of the Bill*

While the Bill that Congress finally passed represents a step in the right direction, there remain several areas for legitimate criticism. If the federal government is sincerely interested in aiding families with postsecondary educational expenses, the drafters of the Bill must respond to certain questions. The first concerns the effective date. Since the Bill provides for the new qualified United States Savings Bonds to be nothing more than Series EE United States Savings Bonds, there is no

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§ 469 - Passive Activity Losses and Credits Limited

§ 911 - Citizens or Residents of the United States Living Abroad (Earned Income Exclusion)

§ 931 - Income from Sources within Guam, American Samoa, or the Northern Mariana Islands (Exclusion)

§ 933 - Income from sources within Puerto Rico (Exclusion).

120. *Id.*

121. *Id.*

122. *See* CONF. REP. to accompany TAMRA, Pub. L. No. 100-647, tit. VI, 102 Stat. 3342 (1988).

123. *Id.*

124. *Id.*

need to create a new type of bond. The same Series EE bonds presently on the market can become qualified bonds, if purchased by the proper person and redeemed at the proper time. Therefore, the public should not have to wait until 1990 to begin planning for this future cost and purchasing the bonds. Since the Bill was signed into law in late 1988, it makes little sense to eliminate the entire year of 1989 as a savings year.

The second area of criticism evolves from the limitations imposed by the phaseout. If helping with education is the main goal of the Bill, the benefits should not be contingent on an individual's adjusted gross income for the given year. If the concern is not to aid the wealthy, the drafters have overlooked an important aspect. If a couple redeemed qualified bonds to pay qualified educational expenses and their modified AGI is $75,000, they will receive zero exclusion. This is the case whether they have two or ten children. This problem could be corrected by redefining the term "modified adjusted gross income" to take into account the portion of the personal exemptions that relates to qualified dependents.[125] While this would not eliminate the phaseout based on the modified adjusted gross income, it would, at least, make it more fair.

The other area of discontent involving the phaseout centers on the effect of its timing and the issue of income uncertainty. If a couple is making $40,000 in 1990 with two children, ages one and three, does this Bill really help or add greater confusion? If the first child will not be ready for college until 2015 and the couple has no idea what their income will be at that time, the purchase of qualified United States Savings Bonds might not be a wise choice in 1990. If the couple's modified adjusted gross income exceeds the allowable limit in 2015, all the interest will be taxed and the money spent on the bonds in 1990 could have possibly gone to a better investment. The Bill forces an individual to make a decision without all the facts on the table.

One solution is to eliminate the phaseout altogether. Once again, education aids the entire nation and all its citizens. A bill that helps with educational expenses should not be limited in its reach. Several other tax incentives have broad-based application. The tax deduction for state and local taxes paid is not restricted by income,[126] nor is the deduction for mortgage interest phased out as one's income increases.[127] The tax deferral of the selling and buying of a personal residence is not dependent on income.[128] The exemption from federal tax for interest received on behalf of municipal bonds is available to all, with no income limitations or restrictions.[129]

Another area open for attack is the unclear definition of "qualified higher education expenses." The Bill refers to tuition and fees required for enrollment and

125. This would work by reducing the so-called modified AGI by the number of children/dependents multiplied by the personal exemption amount. For example, take two couples, both with a so-called modified AGI of $80,000, but couple A has two children/dependents and couple B has ten. Couple A's real modified AGI for 1988 would be $76,100 ($80,000 minus (2 x $1950)). Couple B's real modified AGI for 1988 would be $60,500 ($80,000 minus (10 x $1950)).

126. *See* I.R.C. § 164.

127. *See* I.R.C. § 163(h).

128. *See* I.R.C. § 1034.

129. *See* I.R.C. § 103.

attendance but fails to define fees. Since there are no regulations on this new section, the meaning of fees is left to speculation. On one hand, section 117[130] can be a guide that would exclude lodging and meals from the definition of educational expenses. On the other hand, the phrase "related fees," in section 117, could provide the distinguishing element needed to take the section 135 "fees" out of section 117's restrictive view. In this case, an argument could be made for the inclusion of meals and lodging paid for while attending college in the definition of fees, and therefore, in the definition of qualified higher education expenses. This uncertainty is troublesome for two reasons. Once again, the taxpayer is being asked to make an important educational investment decision without benefit of all the facts. Additionally, if the government is trying to help, a restricted definition of higher education expenses that excludes meals and lodging cost is only a half-hearted approach.

The final layer of criticism is reserved for the incomplete tax treatment afforded the entire transaction. While the debate between deferral versus exemption will continue, the ideal program would be a combination of deduction and exemption. Unfortunately, only an exemption is provided in this Bill. While that is superior to a pure deferral, a more helpful structure could have been designed. For example:

> If a taxpayer in the twenty-eight percent marginal tax rate invested $1000 for ten years earning eight percent interest annually, there would be no deferral or exemption, and the interest will be taxed each year at twenty-eight percent. At the end of the ten-year period, the accumulated interest, net taxes, would be $750.71. If the earnings were not taxed annually, but the tax was deferred for ten years and assessed on the accumulated interest at the end of the ten-year period, the taxpayer's net earnings would be $834.43. The rate of return is 11.2 percent better by deferral. However, if the earnings were completely exempted from tax, the ten-year total of earnings would be $1158.93, which represents a 38.9 percent increase in the rate of return from deferral.[131]

While the statute affords the advantages of exemption, it could go one step further and provide for an income tax deduction for the initial investment. In that case, the $1000 invested in 1990 for the purchase of the qualified savings bond would be allowed as a deduction in that year. This would provide an additional tax savings of $280 (.28 x $1000) that could also be used to help finance the child's education ten years later. Remember, every little bit helps.

III. The States

A. *In General*

> Facing the unthinkable possibility that higher education in the United States is being priced out of the grasp of most Americans, many state legislatures are seeking to prevent the American Dream from turning into a financial nightmare.[132]

Using the above quote as a launching pad, many states have aggressively entered into the prepaid tuition program concept in one form or another. While nearly every

130. *See* I.R.C. § 117.

131. *See* Joint Committee on Taxation, 100th Cong., 2d Sess., Report on Tax Incentives for Education (1988).

132. King, *Paying Today for College Tomorrow*, State Legislatures, Oct. 1987, at 28.

state has either formed a committee to study a plan or has introduced a bill,[133] nineteen states have actually enacted a program.[134] The types of state programs fall into two groups. The first, the so-called Michigan Plan, is a Guaranteed-Tuition Program;[135] while the second, the Illinois Plan, takes a College Savings Bond-type approach.[136] While the types of plans differ in their structure, they share the objective of making the financing of college education a bit more bearable.

B. *Guaranteed-Tuition Programs: The Michigan Plan*

1. *Introduction*

Several states have designed programs that allow an individual or family to purchase future college tuition presently.[137] The Michigan Plan is an example of such a program.

2. *The Michigan Education Trust Act*[138]

The Michigan legislature found:

> a. It [was] an essential function of state government to forever encourage schools and the means of education . . . .
> b. It [was] the responsibility of state government to maintain state instituions of higher education . . . .
> c. It [was] an essential function of state government to encourage attendance at state institutions of higher education.
> d. Tuition cost at public institutions of higher education [were] difficult for many to afford and difficult to predict in order to enable individuals and families to plan.
> e. It [was] in the best interest of the people of the State of Michigan to foster public higher education in order to provide well-educated citizens.
> f. It [was] in the best interest of the people of Michigan to encourage state residents desiring a public higher education to enroll in state public institutions of higher learning.
> g. It [was] in the best interest of the people of Michigan to enhance and foster the ability of Michigan residents to choose an independent, nonprofit higher education in order to provide well-educated citizens and to encourage state residents desiring an independent higher education to enroll in an independent degree-granting college or university located in [Michigan].
> h. Students in elementary and secondary schools tend to achieve a higher standard of performance when the payment of tuition for their higher education is secured.

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133. *See* Leatherman, *States' Interest in Tuition Plans Grows: Focus Shifts Toward Savings Programs*, CHRONICLE OF HIGHER EDUC., Sept. 14, 1988, at A1 (stating that only Arizona and Idaho have taken no action in this regard).

134. As of Jan. 1, 1989, the following states had some sort of program enacted: Colorado, Connecticut, Delaware, Florida, Illinois, Indiana, Iowa, Kentucky, Maine, Michigan, Missouri, North Carolina, North Dakota, Oklahoma, Rhode Island, Tennessee, Virginia, Washington, and Wyoming.

135. While Michigan was the first to introduce this type of plan, Florida, Indiana, Maine, Missouri, Oklahoma, Tennessee, and Wyoming have similar or identical plans.

136. A college savings bond type program has been enacted in Colorado, Connecticut, Delaware, Iowa, Kentucky, Missouri, North Carolina, North Dakota, Rhode Island, Virginia, Washington, as well as in Illinois.

137. *See supra* note 135. While most of these only allow for tuition cost, both the Wyoming and Florida plans cover room, board, and housing expenses.

138. Michigan Education Trust Act (also known as the Michigan Baccalaureate Education Student Trust) MICH. COMP. LAWS §§ 390.1421–44 (1988).

i. Providing assistance to assure the higher education of the citizens of [Michigan] . . . was necessary and desirable for the public health, safety, and welfare.[139]

Therefore, the 83rd Michigan Legislature passed the Michigan Education Trust Act.[140] On December 23, 1986, Michigan's Governor, James J. Blanchard, signed the Act into law. The Bill stated the following eight objectives:

a. To encourage education and the means of education.
b. To maintain state institutions of higher education by helping to provide a stable financial base to those institutions.
c. To provide wide and affordable access to state institutions of higher education for the residents of [Michigan] . . . .
d. To encourage attendance at state institutions of higher education.
e. To provide students and their parents economic protection against rising tuition costs.
f. To provide students and their parents financing assistance for postsecondary education at a Michigan instituion of higher education of their choice.
g. To help provide the benefits of higher education to the people of [Michigan] . . . .
h. To encourage elementary and secondary students in Michigan to achieve high standards of performance.[141]

To this end, the Bill created the Michigan Education Trust (MET).[142]

a. *What is the MET?*

The MET is a public body corporation created within the Michigan Department of Treasury. It is empowered to exercise its prescribed statutory powers, duties, and functions by a Board of Directors acting independently of the head of the Department of Treasury.[143] The Board of Directors consists of the state Treasurer and eight other members appointed by the Governor of Michigan, by and with the advice and consent of the Michigan Senate.[144] No more than two of the eight appointed members can be officials, appointees, or employees of the State of Michigan.[145] Of the remaining six appointed members,

1. one shall be appointed from one or more nominees of the Majority Leader of the State Senate,
2. one shall be appointed from one or more nominees of the Speaker of the House of Representatives,
3. one shall be a President of a state institution of higher education who shall be appointed from nominees of the President's Council of State Colleges and Universities,
4. one shall be a President of a community or junior college who shall be appointed from nominees of the Michigan Community College Association, and
5. one shall represent the interests of independent degree-granting colleges and universities located in Michigan.[146]

139. *Id.* at § 390.1422.
140. *Id.* at § 390.1443.
141. *Id.* at § 390.1423.
142. *Id.* at §§ 390.1421–44.
143. *Id.* at § 390.1425.
144. *Id.* at § 390.1430.
145. *Id.*
146. *Id.*

In order to effectuate the aforementioned objectives of the Act, the Board of Directors of the MET was given certain powers. The powers included, but were not limited to:

> a. Invest[ing] any money of the trust, at the board's discretion, in any instruments, obligations, securities, or property determined proper by the board, and name and use depositories for its money.
> b. Pay[ing] money to state institutions of higher education from the trust.
> c. Impos[ing] reasonable residency requirements for qualified beneficiaries.
> d. Impos[ing] reasonable limits on the number of participants in the trust.
> e. Segregat[ing] contributions and payments to the trusts into various accounts and funds.
> f. Contract[ing] for goods and services and engag[ing] personnel as is necessary and engag[ing] the services of private consultants, actuaries, managers, legal counsel, and auditors for rendering professional, management, and technical assistance and advice, payable out of any money of the trust.
> g. Solicit[ing] and accept[ing] gifts, grants, loans, and other aids from any person or the federal, state, or a local government or any agency of the federal, state, or a local government, or . . . participat[ing] in any other way in any federal, state, or local government program.
> h. Charg[ing], impos[ing], and collect[ing] administrative fees and charges in connection with any transaction and provid[ing] reasonable penalties, including default, for delinquent payment of fees or charges or for fraud.
> i. Procur[ing] insurance against any loss in connection with the trust's property, assets, or activities.
> j. Su[ing] and be[ing] sued; . . . hav[ing] a seal and alter[ing] the same at pleasure; . . . hav[ing] perpetual succession; . . . mak[ing], execut[ing], and deliver[ing] contracts, conveyances, and other instruments necessary or convenient to the exercise of its powers; and . . . mak[ing] and amend[ing] bylaws.
> k. Enter[ing] into contracts on behalf of the state.
> l. Administer[ing] the funds of the trust.
> m. Indemnify[ing] or procur[ing] insurance indemnifying any member of the Board from personal loss or accountability from liability resulting from a member's action or inaction as a member of the Board, including, but not limited to, liability asserted by a person on any bonds or notes of the authority.
> n. Impos[ing] reasonable time limits on the use of the tuition benefits provided by the trust, if the limits are made a part of the contract.
> o. Defin[ing] the terms and conditions under which money may be withdrawn from the trust, including, but not limited to, reasonable charges and fees for any such withdrawal, if the terms and conditions are made a part of the contract.
> p. Provid[ing] for receiving contributions in lump sums or periodic sums.
> q. Establish[ing] policies, procedures, and eligibility criteria to implement this act.
> r. Enter[ing] into arrangements with Michigan institutions of higher education for the trust to offer on behalf of the institution advance tuition payments contracts under which the Michigan instituion of higher education will be contractually obligated to provide a beneficiary under the contract with credit hours of higher education in addition to those required for a baccalaureate degree.[147]

Two additional powers given to the MET Board include: "Administer[ing] the trust in a manner reasonably designed to be actuarially sound such that the assets of the

147. *Id.* at § 390.1431.

trust will be sufficient to defray the obligations of the trust''[148] and ''[a]nnually prepar[ing] or caus[ing] to be prepared an accounting of the trust.''[149]

b. *How Does the MET Work?*

An individual can purchase an advance tuition payment contract from the State of Michigan. This obligates the state to pay full tuition and fees for a qualified beneficiary.[150] This enables parents, years before their child reaches college age, to guarantee the payment of tuition and fees by paying a set sum of money. The amount of money paid will depend on the age of the child at the time of entering into the contract.[151] The purchase price can be paid at once or as a series of payments and is deductible from the purchaser's state income tax.[152] Both the purchaser and the qualified beneficiary must be Michigan residents.[153]

All the payments are placed in an advance tuition payment fund to be invested by direction of the Board of Directors.[154] The assets of the trust will not be considered state money or common cash of the state,[155] and will be used to:

1. Make payments to state institutions of higher education on behalf of qualified beneficiaries,
2. Make refunds upon termination of an advance tuition payment contract, and
3. Pay the costs of administration and organization of the trust and the fund.[156]

While the purpose of the Trust is to provide for guaranteed tuition and fees for a qualified beneficiary to attend a four-year public institution of higher education in the State of Michigan, this is not always what happens. Taking this into account, the Act provides termination and refund provisions in a number of alternatives. The contract can terminate under two different scenarios with differing results. If the benefits of the contract (*i.e.*, prepaid tuition) have not been used within the time specified in the contract, and no other arrangements have been made, the contract is terminated. In this case, a refund is in order. However, if neither the purchaser, the qualified beneficiary, nor their agents can be located after reasonable effort, the Trust may retain that amount which would have been refunded.[157] The contract is terminated and a refund will be in order if the qualified beneficiary: dies; is not admitted to a state institution of higher education; certifies that he has been accepted by, and will attend, a Michigan independent degree-granting institution; or certifies that he has decided not

148. *Id.* at § 390.1433.
149. *Id.* at § 390.1432.
150. *Id.* at § 390.1434.
151. *Id.* For example, a parent with a newborn child would pay $6800 to guarantee four years of tuition when the child turns eighteen. For a lower cost, a guarantee of less than four years can be obtained.
152. *Id.* at § 390.1440.
153. *Id.* at § 390.1438.
154. *Id.* at § 390.1437. The assets of the Trust may be invested in any instrument, obligation, security, or property considered appropriate by the Trust.
155. *Id.* at § 390.1429. While the fund is not state money, the assets can be pooled with investments of state money by the state for investment purposes.
156. *Id.* at § 390.1429.
157. *Id.* at § 390.1428. In order to terminate the contract and get a refund based on nonacceptance to a Michigan public institution, the qualified beneficiary is required to show that he has made an effort to gain admission.

to attend a state institution of higher education.[158] If the plan is an "A-type,"[159] and the qualified beneficiary dies before age eighteen, or fails to graduate from high school, the refund will consist of all prepayments made into the trust on behalf of the qualified beneficiary, less trust administrative fees.[160] Under the "B-type" contract, the refund will also include some payment of interest earned.[161] If the qualified beneficiary is not admitted, or just decides not to go to college, the refund under both types of contracts will be equal to the lowest tuition cost among the fifteen public state universities.[162]

If a qualified beneficiary decides to attend a community college in Michigan, the Trust will pay full tuition and fees to obtain an Associate's Degree, plus the remaining tuition and fees to earn a Bachelor's Degree.[163] If the qualified beneficiary decides not to get a Bachelor's Degree after completion of the Associate's Degree, the qualified beneficiary will receive a partial refund.[164] If the qualified beneficiary decides to attend a Michigan four-year private institution, a refund, equal to the weighted average tuition of all fifteen public state universities, will be paid to that private institution.[165] If the qualified beneficiary attends an out-of-state institution, the lesser of an amount equal to the simple average tuition of all public institutions, or the prepayments to the Trust plus interest, will be refunded.[166] In the event that the family has moved out of state, thereby making the purchaser and the qualified beneficiary nonresidents, and the qualified beneficary decides to attend a Michigan public institution, he will be treated as a nonresident for tuition purposes. In this case, the contract will only cover the in-state tuition, while the difference between out-of-state and in-state tuition must be borne by the qualified beneficiary and his family.[167] Any refund to be paid to the qualified beneficiary will be paid in four equal annual installments; however, no refund will be paid if a qualified beneficiary has completed more than one-half the credit hours required for a Bachelor's Degree.[168]

While the State, through the MET, could offer its residents guaranteed tuition at a relatively low purchase price and state and local tax incentives on interest and purchase price,[169] the tax consequences at the federal level were unclear. The determination of whether the purchaser of an advance tuition contract would be subject to federal income tax on purchase of the contract or the interest earned by the Trust had to be answered before the State could offer the contracts to the public.[170]

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158. *Id.* at § 390.1428.
159. *Id.* at § 390.1427. The statute authorizes the Trust to offer A- and B-type contracts.
160. *Id.* at § 390.1428.
161. *Id.*
162. *Id.*
163. *Id.* at § 390.1429.
164. *Id.* at § 390.1428.
165. *Id.* at § 390.1426.
166. *Id.*
167. *Id.*
168. *Id.*
169. *Id.* In addition to allowing the purchaser a state income tax deduction for the purchase price of the contract, the interest earned on the investment was also exempted from state and local tax.
170. *Id.* at § 390.1443.

To determine the federal tax aspects, the State of Michigan requested an Advance Revenue Ruling.[171]

3. *The Private Letter Ruling*

In 1987, Michigan asked the Internal Revenue Service to rule on the tax consequences of the Michigan Education Trust. The statute prohibited issuance of MET contracts until the State obtained a favorable ruling. The State hoped that the IRS would find that the purchaser of the contract would not be subject to federal income tax on the purchase of the contract or on the interest earned by the trust. On March 29, 1988, the IRS issued the long-awaited ruling to the State of Michigan.[172] The IRS ruling satisfied the requirements of the Michigan Education Trust Act by holding that the purchaser of the contract was not subject to federal income tax on the purchase of the contract or on the interest earned by the Trust.[173] However, the IRS did not stop at that point. Along with this victory, the ruling contained other tax consequences that essentially taxed everything else in the transaction. The IRS ruled that the MET transaction had three taxable consequences within its framework: The purchase of the contract, the providing of the tuition-free education, and the investment earnings of the Trust.[174]

a. *Purchase of the MET Contract*

The first step in the MET process is the purchase of a MET contract, usually by parents for a child, the qualified beneficiary. The only restriction is that both the purchaser and designated qualified beneficiary be residents of the State of Michigan.[175] In reviewing this initial step, the IRS uncovered three main issues. First, by purchasing a MET contract for the benefit of another person, has the purchaser made a completed gift? Second, if the purchase of the contract is a completed gift, will the transfer be excluded from gift tax under section 2503(e)(2)(A) of the Internal Revenue Code of 1986? Finally, if the purchase is a completed gift not excluded under section 2403(e)(2)(A), will it qualify for the section 2503(b) annual exclusion? If the purchase of the contract is viewed as a completed gift and there are no exclusions, then a gift tax will be imposed on the purchaser or donor.[176]

i. *Was the Purchase of the MET Contract a Completed Gift?*

Section 2511(a) of the Code provides that the federal gift tax shall apply whether a transfer is *in trust* or otherwise: whether the gift is direct or indirect; and whether

171. An advance ruling is a procedure by which the taxpayer can request the Internal Revenue Service to rule on a proposed transaction. *See* R. MELDMAN & T. MOUNTIN, FEDERAL TAXATION: PRACTICE AND PROCEDURE (2d ed. 1986).

172. Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988).

173. *Id.*

174. *Id.*

175. MICH. COMP. LAWS § 390.1426 (1988).

176. I.R.C. § 2501(a)(1) imposes a tax on the transfer of property by gift.

the property is real or personal, tangible or intangible. The IRS found that the purchase of the MET contract on behalf of the qualified beneficiary, while indirect, was in fact a transfer to a trust of personal property.[177] In making this finding, the IRS deferred to the example under section 25.2511-1(h)(3) of the Gift Tax Regulations which read:

> The payment of money or the transfer of property to B in consideration of B's promise to render a service to C is a gift to C, or to both B and C, depending on whether the service to be rendered to C is or is not an adequate and full consideration in money or money's worth for that which is received by B.[178]

To determine if the transfer or gift was a completed gift, the IRS did not have to search very far. Regulation 25.2511-2(b) states: "As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete."[179]

Since the purchaser of the contract transfers money to the MET in consideration for the MET's promise to provide, at a future time, educational services on behalf of the qualified beneficiary, a gift has been made. Because the designation of the qualified beneficiary is irrevocable, the purchaser has parted with dominion and control over the money transferred to the MET. Thus, there is a completed gift for federal gift tax purposes at the time the contract is purchased.

ii. *Is the Transfer Excluded from Gift Tax Under Section 2503(e)(2)(a)?*

Section 2503(e)(2)(A) of the Code provides for the exclusion from the gift tax of any amount paid on behalf of an individual as tuition to an educational organization described in section 170(b)(1)(A)(ii).[180] With the exception of the refund possibility, the purchaser of a MET contract is indirectly paying tuition to an educational institution by way of the MET. However, this is precisely the problem. The regulations provide that in order to qualify for the section 2503(e)(2)(A) gift tax exclusion, a payment must be made directly to an educational organization, and that the determination is to be made when the gift becomes complete for gift tax purposes.[181] The regulations further state by example:

> A transfers $100,000 to a trust, the provisions of which state that the funds are to be used for tuition expenses incurred by A's grandchildren. A's transfer to the trust is a completed gift for federal gift tax purposes and is not a direct transfer to an educational organization as provided in paragraph (b)(2) of this section and does not qualify for the unlimited exclusion from gift tax under section 2503(e).[182]

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177. Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988).

178. Treas. Reg. § 25.2511-1(h)(3) (1986).

179. Treas. Reg. § 25.2511-2(b) (1986).

180. I.R.C. § 2503(e)(2)(A). I.R.C. § 170(b)(1)(A)(ii) describes an educational organization as an organization which normally maintains a regular faculty and curriculum and normally has a regular enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

181. Treas. Reg. § 25.2503-6(b)(2) (1986).

182. Treas. Reg. § 25.2503-6(c) Example 2 (1986).

While the payment made by the purchaser to the MET is a completed gift, the MET is not an educational organization pursuant to section 2503(e)(2)(a). Therefore, the payment is not directly made to an educational organization and cannot be excluded from the application of gift tax under section 2503(e)(2)(A).

iii. *Will the Gift Qualify for the Section 2503(b) Exclusion?*

Section 2503, entitled Taxable Gifts, provides:

> (b) Exclusion from gifts.—In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year. While there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in applying this subsection, if no part of such interest will at any time pass to any other person.[183]

This $10,000 annual exclusion allows an individual to make $10,000 gifts to as many people as he wishes in a taxable year and have them all excluded from the definition of taxable gifts, thereby avoiding gift tax. Even though the purchase of the MET contract is a completed gift, the price of the contract would rarely, if ever, exceed $10,000.[184] This being the case, it appears the gift can be excluded from taxation under the section 2503(b) $10,000 annual exclusion. In fact, it appears that an individual could purchase, in a single year, ten MET contracts at $7000 each for ten different individuals and exclude all of them under section 2503(b). However, the italicized portion of section 2503(b) excludes gifts of future interests from the section 2503(b) exclusion. Pursuant to section 25.2503-3(b) of the Regulations, only when the beneficiary of the gift is entitled to an unrestricted right to the immediate use, possession, or enjoyment of the property will the gift be of a present interest.[185]

Since the qualified beneficiary's enjoyment of the payment made to the MET by the purchaser will be delayed until the MET either provides educational services or makes a refund, the purchaser's payment does not constitute a gift of a present interest in property. Therefore, it is not eligible for the $10,000 section 2503(b) annual exclusion.

As to the first issue, the IRS ruled that the purchaser of a MET contract will have made a completed gift that is not eligible for either the section 2503(b) or section 2503(e)(2)(A) exclusion. Hence, the purchaser will be subject to gift tax. However, this part of the ruling is expected to have little or no effect, since there is a unified estate and gift tax credit of $192,800 that can be used against gift tax liability.[186] As Ellin Rosenthal has stated: "The tax most likely would be felt by wealthy,

183. I.R.C. § 2503(b).

184. While none of the MET contracts presently costs $10,000 or more, there is no guarantee that future MET contracts will be as "inexpensive."

185. Treas. Reg. § 25.2503-3(b) (1986).

186. I.R.C. § 2505. However, the purchaser will be required to file a Federal Gift Tax Return.

philanthropic taxpayers who purchase and then donate contracts to children of families that could not afford to purchase a contract themselves."[187]

A related issue involves the federal income tax consequences to the qualified beneficiary on the complete gift. Although section 61 provides that "gross income includes income from whatever source derived" and income is defined as all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion,"[188] section 102 of the Code provides that gross income does not include the value of property acquired by gift. In *Commissioner v. Duberstein*, [189] the United States Supreme Court held that a transfer of property is excludible from income by the recipient as a gift if the property is transferred out of a detached and disinterested generosity. When the purchaser executes the contract with the MET and designates the qualified beneficiary, the qualified beneficiary has realized an accession to wealth. Since the contract rights, which are property, are transferred out of a detached and disinterested generosity, the transfer constitutes a gift for tax purposes and is not includible in the qualified beneficiary's gross income.[190]

b. *Receipt of Educational Services*

When the qualified beneficiary attends college, he will realize educational services with an ascertainable fair market value. In *Fulton v. Commissioner*,[191] the Tax Court held that the receipt of educational services constitutes an "accession to wealth" and therefore, income. As previously stated, gross income includes "all income from whatever source derived."[192] While the receipt of property by the qualified beneficiary at the time of purchase is excludible from gross income under section 102, section 102 does not exclude any income realized from such property subsequent to its receipt.[193] To the extent that the fair market value of the educational services received by the qualified beneficiary under the contract exceeds the qualified beneficiary's basis in the property received by gift, the qualified beneficiary will have an accession to wealth and thus, gross income.

In order to compute the amount of gross income the qualified beneficiary has realized, the basis must be determined. Generally the basis of property acquired by gift in the hands of a donee is the same as it would be in the hands of the donor.[194] Therefore, the qualified beneficiary's basis in the property is the basis the purchaser had in the MET contract. Since the purchaser's basis in the MET contract is the purchase price,[195] the purchase price becomes the qualified beneficiary's basis.

187. Rosenthal, *Tax Implications of Michigan Tuition Prepayment Program Remain Unsettled*, 39 TAX NOTES 676 (1988). While this is true, many other individuals could be concerned about the decrease in the amount of gift and estate unified credit they have remaining. As the value of one's assets increase, the need for as much unified credit as possible becomes important.

188. United States v. Glenshaw Glass, 348 U.S. 426, 431 (1955).

189. 363 U.S. 278 (1960).

190. The results would be the same if a refund is made instead of the qualified beneficiary attending school.

191. 38 T.C.M. (CCH) 1046 (1979).

192. I.R.C. § 61.

193. Treas. Reg. § 1.102-1(a) (1986).

194. I.R.C. § 1015(a).

195. I.R.C. § 1012 generally provides that the basis of property shall be the cost of such property.

Since the MET program is designed to provide for educational services over a four-year period, the qualified beneficiary's basis must be recovered annually over the four-year period during which the qualified beneficiary attends school.[196] Therefore, as the MET provides educational services to the qualified beneficiary each year, the qualified beneficiary will recognize income to the extent that the fair market value of the educational services received in that year exceed one-fourth of the qualified beneficiary's basis.[197]

Since the qualified beneficiary is usually the child of the purchaser, this part of the ruling is not as harsh as it appears. Instead of income being taxed at the parent's tax rate, the income will be taxed at the child's tax rate, which will generally be lower. However, one concern should be obvious. The child or qualified beneficiary will have taxable income and possibly a tax liability, and although he has received property in the form of educational services, he may have a tax bill due with no money to pay it

c. *The Earnings of the MET*

The key goal of the MET arrangement is to provide guaranteed paid tuition. In order to do this, the MET would sell contracts, invest the proceeds, and pay the future tuition cost. In order to make this happen, two things would have to occur. First, the projection of future tuition cost would have to be accurate. Second, the MET's earnings on its investment would have to be strong enough to meet the future tuition projections. The IRS delivered the crucial blow on this second point.

Investments grow faster when the taxation of earnings is either exempted or deferred.[198] The State of Michigan hoped that the Trust would be exempted from taxation. This was based on a two-part analysis. First, the income of the MET was earned by an integral part of the State and therefore, absent specific statutory authority, would not be taxable.[199] Alternatively, gross income does not include any income derived from the exercise of any essential government function that accrues to a state or any political subdivision of a state.[200]

In response to the first part of Michigan's exemption analysis, the Service stated the following about the State of Michigan and the Michigan Education Trust:

> Trust was created as a corporation to operate independently from State *X* under an appointed board of directors. Decisions by Trust's board of directors, including those involving investment discretion, may not be overridden by any state agency. Trust's funds are not derived from State *X* or one of its political subdivisions, and by statute are not subject to the claims of State *X*'s creditors and are not considered state money or common cash of the state. State *X* may not loan, transfer, or use Trust's funds for any purpose. Trust's funds may only be used by the Trust for the tuition payment or refund purposes expressly provided in the enabling legislation. These factors indicate that Trust is not an integral part of State *X* or one

196. *See* Treas. Reg. § 1.61-6 (1986).

197. If, in lieu of educational services, a refund is given, the receivor of the refund will realize income to the extent the amount of the refund received in that year exceeds an allocable portion of the receivor's basis.

198. *See supra* note 131 and accompanying text.

199. Rev. Rul. 87-2, 1987-2 I.R.B. 4.

200. I.R.C. § 115(a).

of its political subdivisions. Therefore, Trust's income, unless otherwise excluded by statute, is subject to federal income tax.[201]

In resolving the second part of the inquiry, the ruling develops a test for qualification under section 115(1). The IRS stated:

> To qualify under section 115, it must be established that the income does not serve private interests such as designated individuals, shareholders of organizations, or persons controlled, directly or indirectly, by such private interest. Thus, even if the income serves a public interest, the requirements of section 115 are not satisfied if the income also serves a private interest that is not incidental to the public interest. The basic principle underlying section 115 is that property (including any income thereon) must be devoted to purposes which are considered beneficial to the community in general, rather than particular individuals.[202]

While the IRS agreed that education provided a public benefit, it felt that a direct economic benefit,[203] available only to qualified beneficiaries of the MET contracts, was accruing to a private interest and that such accrual was not merely incidental to the public interest.[204] Since the requirements of the section 115 were not satisfied, the IRS ruled that the income of the Trust earned during the administration of the program, while not taxed to the purchaser of the contract, was includible in the gross income of the MET.[205]

d. *Uncertainty*

What the Internal Revenue Service failed to make clear was the method by which the MET would be taxed. Would it be taxed as a corporation, as a complex trust, or as a simple trust? One commentator provides the following discussion:

> If taxed as a corporation, the trust would be taxed at the 34 percent corporate rate on the interest from the funds. Then the child, upon redemption, would be taxed at either the child's rate or the parent's rate depending on the amount of interest involved and the age of the child.
>
> If the trust were treated as a complex trust, the marginal tax rate on the trust during the period it has the money most likely would be 28 percent, according to the Michigan Finance Committee report. The child, upon redemption, would be taxed on the buildup in value minus the amount of taxes paid over time by the trust.
>
> Should the IRS decide that a trust is a simple trust, the net tax on the trust as an entity will be zero. If it is a simple trust, the tax is essentially on the individual because the trust gets to deduct disbursements to which the child has a current right. In a simple trust, the child would have a right to the yearly interest but would in this case, direct the MET not to disburse it. The MET would withhold 15 percent of the earnings and reinvest the amount not taxed. If it is later determined that the child's earnings will actually be subject to the parent's

201. Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988). This is where Florida thinks its program differs. Florida believes its Trust is an integral part of the state.

202. *Id.*

203. The direct economic benefit is in the form of education, the value of which is expected to be substantially in excess of the purchase price of the contract.

204. Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988).

205. *Id.*

> higher rate under 1986 law, the parent would then be responsible for supplying the 13 percent not paid by the trust . . . .[206]

While sources in the Michigan legislature have adopted the best scenario, the simple trust,[207] this issue has not been resolved.

4. *Post-Ruling Period*

Since the release of the Private Letter Ruling, there have been contrasting opinions on the merit of the plan. While Michigan's Governor Blanchard and Michigan State Treasurer Robert A. Bowman have viewed the IRS ruling as a victory, others have classified it as a defeat.[208]

While the ruling is not binding on any other state's plan, it could serve as a barometer for future IRS rulings. In referring to the MET and the Private Letter Ruling, Indiana's Chief Deputy Treasurer, James C. Snyder stated: "We had hopes the trust would be considered a [tax-free] state entity. With the trust being taxable, it kind of cuts into the amount you can earn to stay up with inflation. 'The IRS ruling will influence how Indiana proceeds.' "[209] Lawrence Cable, Director of the Research Division of the Maine Bureau of Taxation, said he would not second guess his state's legislature which had enacted a similar plan and was waiting for a ruling.[210] However, he expressed some concern by stating that "most of the benefit of having a trust has been removed."[211] One of the people who helped draft the Maine statute, Mark Mogensen, said, "We had hoped for a more favorable ruling. I think this will make us reassess the trust as a vehicle for providing educational incentives."[212] Florida's Board of Regents General Counsel Greg Gleason felt that the ruling would discourage those states with enacted plans or planning prepayment programs;[213] and one of the drafters of the Florida program, Benjamin Phipps, found fault with the IRS' logic and said, "The ruling will not have a large impact on Florida's program, however, because its trust is an entity of the state, unlike Michigan's MET."[214]

"I don't agree with Governor Blanchard's view that it's a victory," stated University of Minnesota law professor Leo J. Raskind.[215] Arthur Hauptman, an American Council on Education consultant said, "The ruling is more a deterrent than an encouragement, notwithstanding what Blanchard said . . . . It may be favorable, but it's far from the most favorable ruling they could have gotten."[216] Aims C. McGuinness Jr., Assistant Executive Director of the Education Commission of the States added, "there is not likely to be a 'bandwagon' for such plans in state

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206. Rosenthal, *supra* note 187, at 677.
207. *Id.* at 676.
208. *Id.*
209. *Id.* at 678–79. However, Indiana did adopt a prepaid tuition program similar to the MET.
210. *Id.*
211. *Id.* at 679.
212. *Id.*
213. Rothman, *Hopes for Tuition Plans Tempered*, EDUC. WEEK, Mar. 1988, at 39.
214. *Id.*
215. *Id.*
216. *Id.*

legislatures."[217] In fact, anticipating an unfavorable IRS ruling, the governors of California and Illinois vetoed programs similar to Michigan's MET.[218]

Since the earnings of the MET are includible in gross income, the after-tax yield will be lower than projected. The State of Michigan will either have to increase the cost of the contracts or invest the funds in lower yield tax-exempt bonds. However, Michigan officials have been more upbeat. Michigan Treasury spokesman Robert Kolt stated: "The IRS ruled that the contract is tax free to the purchaser. That's what we wanted. It allows us to go forward and issue contracts . . . . If you focus on taxes, you miss the point of the program. The key is the tuition guarantee . . . . Forget the tax implications."[219] In regard to the earning power of the MET and its taxability, Kolt said, "We are experienced money managers. We have had a 20 percent annual compound rate of return on the state's pension fund. We think we can beat the spread."[220]

Residents of the State of Michigan must have agreed with Mr. Kolt, as 82,495 of them paid the $25 fee to apply to the program.[221] Approximately 27,000 of these actually signed agreements and made payments.[222] Many Michigan banks and savings and loans structures have offered special loan packages to help the people who wanted to participate but were short of money. At one bank, officials stated that parents who borrowed the purchase price on the contract for their two-year-old at 9.75 percent could spread the payments over sixteen years and spend approximately $13,000.[223] If tuition at the University of Michigan is $25,000 when their child is ready to attend, they will still be a great deal ahead. In addition, if the loan is secured by their personal residence, the interest paid on the loan will be fully deductible.[224] Commenting on the loan programs, Mr. Kolt said, "That made the program feasible to many people who could not pay cash. You must compare this to home ownership or car ownership. If you pay cash today, it's cheaper. If you finance, it's more affordable."[225] Richard E. Anderson, Director of the Forum for College Financing Alternatives, added, "If I am relatively certain that my kids are going to go to a Michigan school, that's a hell of an investment. I don't believe I could make that good an investment on my own."[226] William Montjoy, Director of Florida's Tuition-Prepayment Plan summed it up best by stating, "Having 25,000 people signing up for a state program is pretty significant. Twenty-five thousand is a lot of people to do anything for the first year."[227]

It appears that the promise of guaranteed tuition and a relatively low purchase

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217. *Id.*
218. Rosenthal, *supra* note 187, at 678.
219. *Id.* at 679.
220. *Id.*
221. Leatherman, *One-Third of Those Who Applied Buy into Mich. Prepaid Tuition Plan*, CHRONICLE OF HIGHER EDUC., Dec. 7, 1988, at A25.
222. *Id.*
223. *Id.*
224. *See* I.R.C. § 163(h), which allows a deduction for interest paid on the mortgage of a qualified residence.
225. Rosenthal, *supra* note 187, at 679.
226. *Id.*
227. *Id.*

price, coupled with the opportunity to borrow, is more important to the residents of Michigan than the apparent adverse tax consequences of the program. The people of Michigan were hungry for help in financing future college costs. They must believe in the soundness and the solvency of the Trust. If the MET is unable to remain actuarially sound and goes broke, the parents who bought contracts are only entitled to their initial investment, plus some, but not all, of the interest earned to date.[228] In addition, the State of Michigan is not liable if the Trust fails.[229] Therefore, parents who had stopped saving after purchasing the MET contract would have to start saving again, but they would then be years behind.

a. *College Savings Bonds: The Illinois Plan*

i. *Introduction*

While some other states have adopted a tuition-prepayment plan,[230] most states that have some kind of program have opted for a college savings bond approach. While there are some differences in the two types of plans,[231] the Illinois Program is representative of the savings bond type.

ii. *The Baccalaureate Savings Act of Illinois*[232]

> It is declared that for the benefit of the people of the State of Illinois, the conduct and increase of their commerce, the protection and enhancement of their welfare, the development of continued prosperity and the improvement of their health and living conditions, it is essential that this and future generations of youth be given the fullest opportunity to learn and to develop their intellectual and mental capacities and skills; that to achieve these ends it is of the utmost importance that Illinois residents be provided with investment alternatives to enhance their financial access to Institutions of Higher Education.[233]

With the above as a purpose, the Illinois General Assembly enacted the "Baccalaureate Savings Act."[234] The stated intention of the Act was "to provide to the State of Illinois an alternative low cost method of borrowing for the purposes authorized in the General Obligation Bond Act and to encourage enrollment in Institutions of Higher Education located in the State of Illinois . . . ."[235] To achieve its goal, the Act created the Baccalaureate Trust Authority (The Authority).[236]

228. MICH. COMP. LAWS § 390.1428 (1988).
229. *Id.* at § 390.1426.
230. *See supra* notes 138–227 and accompanying text.
231. The major difference involves the type of bonds issued and the federal tax consequences afforded each. The Illinois bond is a zero-coupon type bond issued under its General Obligation Bonds, and its interest is exempted from state, local, and federal income tax. The type of bond offered in North Carolina is a zero-coupon bond, the interest of which is only exempted from state and local tax.
232. The Baccalaureate Savings Act of Illinois, ILL. ANN. STAT. ch. 144, para. 2401–11 (Smith-Hurd 1986 & Supp. 1988).
233. *Id.* at para. 2401.
234. *Id.*
235. *Id.* at para. 2402.
236. *Id.* at para. 2411.

The Authority is a creation of the State of Illinois which will consist of thirteen members.[237] Eight of the members shall be appointed as follows:

1. The Minority Leader of the State House shall appoint one,
2. The Speaker of the State House shall appoint one,
3. The President of the State Senate shall appoint one,
4. The Minority Leader of the State Senate shall appoint one, and
5. The Governor of Illinois shall appoint four.[238]

In making these appointments, the Governor and other legislative leaders shall consider selecting members from the following categories:

1. A trustee, director, officer, or employee of a private institution of higher education,
2. A person having a favorable reputation for skill, knowledge and experience in the field of state and municipal finance, and
3. A person experienced in and having a favorable reputation for skill, knowledge and experience in the higher education loan finance field.[239]

The remaining five members will be:

1. The Treasurer of the State of Illinois,
2. The Executive Director of the Illinois Board of Higher Education,
3. The Executive Director of the Illinois State Scholarship Commission,
4. The Director of the Bureau of the Budget, and
5. The Director of the Illinois Economic and Fiscal Commission.[240]

The responsibilities of The Authority are:

1. To make recommendations to the Bureau of the Budget regarding the marketing of college savings bonds to ensure their broad distribution throughout the state for educational purposes,
2. To advise the Bureau of the Budget on an effective advertising campaign to inform the general public about College Savings Bonds and their availability,
3. To advise the Governor and the Director of the Bureau of the Budget regarding the increments in which to market the bonds and recommend maturity dates which will make funds available to purchasers at the time when such funds are needed for educational purposes,
4. To advise the Governor and Bureau of the Budget regarding additional financial incentives as provided in the Act,
5. To advise the Bureau of the Budget on limits they may impose on the amount of College Savings Bonds that may be purchased by individual households,
6. To advise the Bureau of the Budget on the minimum denominations to market the College Savings Bonds so that they are affordable by individuals,
7. To evaluate the feasibility of staggered or periodic forms of payments for College Savings Bonds, and to advise the Bureau of the Budget regarding such evaluation,
8. After the initial sale of College Savings Bonds, to assess the effectiveness of the program and recommend constructive changes to the Bureau of the Budget regarding future bond sales,

237. *Id.*
238. *Id.*
239. *Id.*
240. *Id.*

9. To study and review alternative investment instruments with respect to their suitability for a college savings program.[241]

b. *What Are the College Savings Bonds and How Do They Work?*

The College Savings Bonds are general obligation bonds of the State of Illinois issued under the General Obligation Bond Act.[242] The Authority is authorized to issue up to $300,000,000 of the general obligation bonds as General Obligation College Savings Bonds.[243] Since the Bonds are of a zero-coupon type,[244] the issue price will be less than the value at maturity. The program allows individuals to buy bonds in denominations ranging from $1120 to $3695 that will be worth $5000 in five to twenty years.[245] A purchaser of the bonds must pay the purchase price at a fixed date, without benefit of installment-type payments.[246]

The Bonds are state bonds and the interest paid is excluded from federal gross income.[247] The statute provides exemption from state and local income taxation, but not from estate, transfer, and inheritance taxes.[248]

While purchase of the Bonds is not restricted to residents of Illinois, nor is the use of the proceeds confined to an institution in Illinois, the intent is to benefit Illinois residents by helping them pursue studies at Illinois institutions of higher education.[249] To this end, two incentives are built into the bonds. First, the interest rate of the bonds will be increased by one-half of one percent if the bonds are used to finance higher education in the state.[250] Additionally, the first $25,000 in bond principal and interest

241. *Id.*

242. *Id.* at para. 2405. General Obligation Bonds are debts issued by states or their political subdivisions. The debts can be repaid out of the general funds of the issuer and are backed by the full faith and credit of the issuer. The General Obligation Bond Act authorized the State of Illinois to issue, sell, and provide for the retirement of General Obligation Bonds of the State of Illinois in the total amount of $2,796,433,072.

243. *Id.* at para. 2404.

244. A zero-coupon bond is a bond issued at a discount with the principal and the earnings being paid at a later maturity date. For example, *X* buys a $10,000 ten-year zero-coupon bond today for $6000. *X* would pay $6000 and receive $10,000 ten years from today. $6000 is *X*'s return of principal, while the other $4000 represents interest.

245. Leatherman, *supra* note 133, at A32.

246. The Baccalaureate Savings Act of Illinois, ILL. ANN. STAT. ch. 144, para. 2401–11 (Smith-Hurd 1986 & Supp. 1988).

247. I.R.C. § 103(a) excludes from gross income interest on any state or local bond commonly referred to as muni-bonds.

248. The Baccalaureate Savings Act of Illinois, ILL. ANN. STAT. ch. 144, para. 2407 (Smith-Hurd 1986 & Supp. 1988).

249. *Id.* at para. 2403. The statute defines "Institution of Higher Education" to include:

> The University of Illinois; Southern Illinois University; the several universities and colleges under the governance of the Board of Governors of State Colleges and Universities; the several Regency Universities under the jurisdiction of the Board of Regents; the public community colleges of the state; any public universities, colleges and community colleges now or hereafter established or authorized by the General Assembly; any nonpublicly supported post-secondary educational organization located and authorized to operate in this state which operates privately, not-for-profit. Institution of higher education does not include any educational organization used for sectarian instruction, as a place of religious teaching or worship or for any religious denomination or the training of ministers, priests, rabbis or other professional persons in the field of religion.

250. The Baccalaureate Savings Act of Illinois, ILL. STAT. ANN. ch. 144, para. 2408 (Smith-Hurd 1986 & Supp. 1988).

will be excluded from the analysis used to determine whether a student is eligible to receive financial aid from the state.[251]

c. *The Results*

As with the Michigan Plan, the Illinois College Savings Bond Plan has both supporters and critics. While the Illinois Plan offers tax-free interest with no income cap, the ability to use the proceeds to attend college outside of Illinois, and the opportunity for nonresidents of Illinois to purchase the bonds, it still has problems. Unlike Michigan's Plan, it does not guarantee the prepayment of tuition cost. It only provides a set sum of money at a future date. As Richard E. Anderson of the Forum for College Financing Alternatives has stated,

> Bonds may be a reasonable deal for parents, they may even be a fantastic deal for parents, but there's a real possiblity that they will be disastrous. Since the bond programs are based on fixed interest rates, either the parents or states will face serious financial difficulties if rates rise or fall. If rates rise, the parents could have made a better investment without the state plan. If rates fall, states might not earn enough money to pay for the college costs.[252]

Since the lowest cost to participate is $1120, the Illinois Plan, like Michigan's, is not as accessible to the lower economic class of the population. In contrast, participation in the federal savings bonds program can be done with as little as $25.

Regardless of the criticism, the biggest support for the Illinois Plan is its record. In January 1988, Illinois sold $90,000,000 of its bonds.[253] Nine months later a second sale of $175,000,000 was conducted.[254] Of the $300,000,000 authorized, $265,000,000 were sold in one year.

IV. Observations and Recommendations

State guaranteed prepaid tuition plans, state college savings bonds, federal college savings bonds, and even universities' prepaid tuition plans[255] are increasing

251. *Id.* at para. 2409.

252. *See* Leatherman, *supra* note 133.

253. *Id.*

254. *Id.*

255. While university plans are not the focus of this article, more than twenty universities have programs in place. The programs are very similar in structure to the Michigan Plan. However, the choice of colleges that a student can attend are restricted to the university sponsoring the plan, but the interest earned on the investment by the university will be tax free to the university. Duquesne University, in Pittsburgh, was one of the first to develop a plan, but closed it down in early 1988, citing an inability to invest the money in a fashion to ensure a profitable return.

Indiana University, in Bloomington, has developed a program with a new twist. Parents who are Indiana residents can presently purchase "Guaranteed Tuition Certificates" and use them at any of the Indiana University's eight campuses during any four year period between 1990 and 2009. Buyers pay $62.90 for each credit hour, which is the current tuition rate. In addition they must pay a six percent administrative fee per credit hour. The minimum initial purchase is $1000 for fifteen credit hours. If a child decides not to attend Indiana University or cannot gain admittance, the certificates can be sold. Three Indiana banks have established a secondary market to help investors who want to sell their certificates. While this will help protect parents from fluctuating interest rates and tuition increases, the redemption or sale of the certificates could generate gain that is subject to federal income tax. If tuition really climbs, this could become an investment, even for someone not worried about college costs. *See* Magner, *Indiana U. Offers Parents a Chance to Buy Credit Hours in Advance, for Use After 1990*, Chronicle of Higher Educ., Dec. 14, 1988, at A26.

As recently as July 1989, Hemar Corporation, a private, closely held education-finance company which buys and services college loans, introduced the first nationwide tuition-prepaid plan and invited colleges across the United States to take part in it. In essence, parents would purchase, on behalf of their children, a contract from the corporation and pick at a fast rate. The choice of the best plan to fit one situation is quickly becoming a complicated and confusing ordeal. If sanity and order are to be maintained and made of this process, steps need to be taken to reduce the variations and provide some clear, simple methods to help families finance future college costs. In this regard, the federal government must take the lead.

First, the IRS needs to review its position in the Michigan ruling. Holding the Trust liable for tax on the earnings is clearly counter-productive to effective tuition planning. As Leo Raskind stated, "The ruling on the state's liability was 'surprising,' . . . since the IRS has traditionally exempted state entities from federal taxation. States sell alcohol without paying federal taxes on the profits . . . . Education should have a higher value than liquor."[256] If the IRS is prohibited by the nonstate entity issue from readdressing its position, Congress should step in and include the Michigan-type programs in its definition of tax-exempt entitites.

Second, Congress should remove the income limitation on its College Savings Bond Program.[257] By including this income cap, Congress took a very simple program and made it complicated. There is no way families can adequately plan for the future with this restriction.

Next, interest paid on loans to finance college cost should be given the same status as qualified residence interest.[258] To allow a federal income tax deduction for interest on loans to purchase a home and deny that same treatment to an individual who is preparing to better himself by attending college is confusing. Does our nation value home ownership more than education? At the least, they should be equal.

Fourth, an IRA-type vehicle designed for meeting higher education costs should be developed.[259] The money invested in this special account would be tax deductible and could have an annual limit. The account would be tax-exempt, therefore the earnings would grow tax free. On distribution, the total amount would be exempt from tax to the extent the proceeds were used for college tuition, fees, and lodging. With limited exception, if the proceeds were not used for college cost, the taxpayer must include all proceeds in gross income and pay a substantial penalty.

Finally, allow any monies expended for college tuition and fees to be a deduction on the payor's federal income tax return in the year in which paid. While all these measures will cost the federal government in the form of lost revenues, the education of a greater portion of our citizens will make up for this; both in increased revenues in the future, and a more educated citizenry.

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a designated school in the plan. The corporation would invest the money and when the child is ready to attend college, tuition at designated university would be insured. However, if the child decides that he or she does not want to attend the designated university, the parent and child would be guaranteed credit at other colleges participating in the plan, equal to the ratio that prevailed between the two schools at the time the contract was furnished. In addition, if the child dies or does not attend a participating institution, the credits could be transferred to siblings or first cousins, or the purchaser could receive the original investment back, with no return. Because this is a private investment, approval from the Securities and Exchange Commission must be obtained before the plan can be offered. Also, Hemar Corporation is presently seeking a tax ruling from the IRS as to the tax consequence.

256. *See* Rothman, *supra* note 213.

257. *See supra* notes 104–24 and accompanying text.

258. *See* I.R.C. § 163(h).

259. *See supra* notes 37–61 and accompanying text.

V. Conclusion

As things presently stand, preparation for future college attendance is three-fold. First, the child must study hard and prepare himself academically to gain admission to and succeed in college. Second, the parents and child must together explore the many options individual colleges offer to a prospective student. Curriculum, location, faculty, alumni, placement, social life, reputation, and cost are just some of the major concerns. Finally, the financing of the college education is very important. If the parents need help and are considering the available programs, they will need the assistance of a tax advisor, a contract lawyer, a financial planner, and a crystal ball to make a wise choice. For a nation that allegedly values education as we do, all this confusion is truly unnecessary.