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## Tax Benefits for Education in the Taxpayer Relief Act of 1997: New Legislative Developments

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# Tax Benefits for Education in the Taxpayer Relief Act of 1997: New Legislative Developments

## Summary

The Taxpayer Relief Act of 1997 (P.L. 105-34) substantially expanded tax benefits for education. Four widely publicized provisions — two new tax credits, new tax-exempt education savings accounts, and a new deduction for interest payments on education loans — can help families pay for college and other postsecondary education expenses.

Other provisions in the legislation extended the tax exclusion for employer education assistance, exempted individual retirement account (IRA) withdrawals used for higher education from early withdrawal penalties, expanded the tax exclusion for student loans that are forgiven, and authorized an enhanced deduction for corporate contributions of computer technology and equipment to elementary and secondary schools. The legislation also created new qualified zone academy bonds for public school renovation and program improvement.

The Internal Revenue Service Restructuring and Reform Act of 1998 (P.L. 105-206) made minor amendments, largely technical, in several education provisions of the 1997 Act. Other changes would have occurred in these provisions under the Taxpayer Refund and Relief Act of 1999 (H.R. 2488), which the President vetoed. Some provisions were extended by the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170).

In the closing days of the 106<sup>th</sup> Congress, it is unclear whether the education tax benefits created by the Taxpayer Relief Act of 1997 will be expanded or otherwise revised. This report will track relevant legislation that is reported from committee or is scheduled for floor consideration. Among these bills are the Affordable Education Act of 2000 (S. 1134), passed by the Senate on March 2, 2000, and the Education Savings and School Excellence Act of 2000 (H.R. 7), reported by the House Ways and Means Committee on March 24, 2000.

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# Tax Benefits for Education in the Taxpayer Relief Act of 1997: New Legislative Developments

## Introduction

The Taxpayer Relief Act of 1997 (P.L. 105-34) that President Clinton signed on August 5, 1997, contained new higher education tax benefits for students and their families. Most notable were two tax credits (the HOPE Scholarship and Lifetime Learning credits), tax-exempt education savings accounts called education IRAs, and a deduction for interest payments on education loans. The Act also made other changes regarding state tuition savings programs, IRA withdrawal penalties, employer education assistance, and student loan forgiveness. In addition, it authorized new bonds for public school renovation and program improvement and an enhanced deduction for corporations that donate computers to elementary and secondary schools. While the Internal Revenue Code previously had provisions favoring education, the new legislation marked a significant expansion in the use of tax policy to encourage enrollment and to help families and communities pay for schools. The numerous special tax benefits for education and other purposes distinguish this legislation from the Tax Reform Act of 1986 (P.L. 99-514), which generally reduced special incentives.

The Taxpayer Relief Act of 1997 offered families multiple ways to get tax subsidies for higher education. They can benefit in years when they save for college, when they pay tuition costs, and when they repay loans. The legislation thus supported different approaches toward financing postsecondary education and gives families flexibility to adapt their plans as circumstances change.

At the same time, the new options make financial planning for college more complicated. The added complexity raises concerns that families in similar economic circumstances will receive different levels of benefits. The extent to which the tax benefits will supplement or supplant assistance provided by state or other federal sources remains unclear.

It is also unclear whether the new tax benefits, estimated by the Joint Committee on Taxation to cost \$30 billion over FY2000 through FY2004, are resulting in additional enrollment or other investment in education. The benefits may encourage some students to continue their studies, particularly after obtaining their initial degree, and some to consider a wider range of schools. However, it is likely that most of the

benefits are accruing to families whose students would have enrolled anyway. Some of the benefits may be captured by the schools through higher tuition.<sup>1</sup>

This report summarizes highlights of the education provisions of the Taxpayer Relief Act of 1997. It provides general information and does not cover all provisions that individual taxpayers may consider important. For more details, readers might consult either the Act itself or the conference committee report, both of which are printed in part II of the *Congressional Record* for July 30, 1997.

The report also tracks legislative developments at the end of the 106<sup>th</sup> Congress that would affect the tax benefits enacted in 1997. It identifies bills that have been reported by either the Senate Finance or House Ways and Means Committee.<sup>2</sup> Referenced legislation includes the Affordable Education Act of 2000 (S. 1134), passed by the Senate on March 2, 2000, and the Education Savings and School Excellence Act of 2000 (H.R. 7), reported by the House Ways and Means Committee on March 24, 2000.

## Tax Credits

The Taxpayer Relief Act of 1997 is perhaps best known for the two new education tax credit it authorized. The **HOPE Scholarship credit** equals 100% of the first \$1,000 of qualified tuition and fees and 50% of the next \$1,000 that taxpayers pay for themselves, their spouse, or their dependents. The credit may be claimed for two taxable years with respect to each *student*, provided the student has not completed the first two years of postsecondary education before the beginning of the year for which the credit is claimed. An eligible student must be enrolled (or accepted for enrollment) in a degree, certificate, or other program leading to a recognized educational credential and must carry at least one-half the normal full-time work load. The HOPE credit is not allowed for a student who has been convicted of a felony drug offense.

The **Lifetime Learning credit** equals 20% of the first \$5,000 of qualified tuition and fees (the first \$10,000 after 2002) that taxpayers pay for themselves, their spouse, or their dependents. The credit may be claimed any number of years for any level of postsecondary education; it can also apply to students who are enrolled in a single course to acquire or improve job skills. For a particular student, either the HOPE credit, the Lifetime Learning credit, or the exclusion of distributions from an

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<sup>1</sup> For a discussion of these issues, see CRS Report 97-581, *Tax Subsidies for Higher Education: An Analysis of the Administration's Proposals*, by Jane Gravelle and Dennis Zimmerman.

<sup>2</sup> Congressional offices can construct comprehensive lists of bills on particular proposals by using the Legislative Information System (LIS) available through the CRS home page. Under the Legislation heading, click on the LIS and then on Bill Text: Adv. In the Word/Phrase box, type either a term like "HOPE Scholarship" or a combination of words and connectors like "deduction adj/5 education" and then click on Search. Search results may yield some irrelevant bills without identifying all relevant ones; thus, the lists should be reviewed carefully. For technical assistance with searches, offices might call the La Follette Congressional Reading Room at 7-7100.

education IRA may be claimed in one year. However, all three tax benefits might be claimed the same year, even by one taxpayer, with respect to three different students.

The HOPE and Lifetime Learning credits are allowed for payment of qualified tuition and fees at institutions eligible to participate in student aid programs authorized by title IV of the Higher Education Act (HEA); this includes nearly all colleges and universities as well as many proprietary (for-profit) trade schools. Payments attributable to scholarships, veterans' educational assistance, or other sources that are excludable from gross income for tax purposes (such as employer tuition reimbursements) generally cannot be taken into account. However, tuition and fee payments made from gifts and inheritances may be considered for the credits, as may payments made from loans.

To give a simple example, consider an independent student who attends a school with tuition and fees charges of \$5,000. If the student receives a \$1,000 Pell Grant, a \$1,000 scholarship from the school, and a \$1,500 loan, qualified tuition and fees would equal \$3,000 (this is, \$5,000 minus the grant and the scholarship). Subject to limitations in the following paragraphs, the HOPE credit would be \$1,500 (that is, 100% of the first \$1,000 paid and 50% of the next \$1,000). The Lifetime Learning credit would be \$600 (20% of the \$3,000 paid).

The HOPE Scholarship and Lifetime Learning credits are phased out for taxpayers with modified adjusted gross incomes between \$40,000 and \$50,000 (\$80,000 to \$100,000 in the case of a joint return). Thus, for single filers with modified adjusted gross incomes of \$42,500 the maximum HOPE credit would be limited to \$1,125.<sup>3</sup>

The two credits are not refundable: the sum of them and other nonrefundable credits generally is limited to the taxpayer's regular income tax liability.<sup>4</sup> Thus, for taxpayers with combined nonrefundable credits of \$1,000 and a regular tax liability of \$800, the allowable credits can be no more than \$800. Under a provision in the Ticket to Work and Work Incentives Improvement Act of 1999, personal nonrefundable credits are not limited by the taxpayer's tentative minimum tax in tax years 2000 and 2001.

Taxpayers are not eligible for either the HOPE or Lifetime Learning credit if they can be claimed as dependents by other taxpayers (for example, students who can be claimed as dependents by their parents). However, in this case the taxpayers who claim the dependent are eligible for the credits (assuming the income parameters described above are met) and they make take into account tuition payments made by the dependent.

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<sup>3</sup> The maximum credit of \$1,500 x [(\$50,000 - \$42,400)/\$10,000] = \$1,125. Modified adjusted gross income is adjusted gross income (a prominent line on tax returns) increased by the foreign earned income and housing exclusion and amounts excluded for income within Puerto Rico and certain territories.

<sup>4</sup> Regular income tax liability is the product of taxable income (gross income minus deductions and personal and dependency exemptions) times the taxpayer's tax rate. The regular tax liability does not reflect any reductions due to tax credits.

The IRS Restructuring and Reform Act of 1998 modified the reporting requirements for educational institutions.

The President's FY2001 budget would increase the Lifetime Learning credit rate from 20% to 28% and also increase the income phase-out ranges to \$50,000 to \$60,000 (\$100,000 to \$120,000 for joint returns). Phase-out ranges for the HOPE Scholarship credit would not be changed. Instead of claiming the Lifetime Learning credit, taxpayers would be allowed to deduct up to \$5,000 in qualified tuition and fees (up to \$10,000 after 2002); the deduction would be taken in calculating adjusted gross income (an "above-the-line" deduction) and so would not be restricted to taxpayers who itemize.

## **Education IRAs**

The Taxpayer Relief Act of 1997 authorized new investment accounts that families can use to save for higher education. The accounts are called education individual retirement accounts (education IRAs) although they have nothing to do with retirement. Like other IRAs, however, these accounts are designated trusts that are held by banks and other financial entities. Contributions to education IRAs can be made until beneficiaries are age 18; the annual limit for all contributors combined is \$500, though this amount is reduced and then eliminated for contributors with modified adjusted gross incomes between \$95,000 and \$110,000 (\$150,000 and \$160,000 for joint returns).

Education IRA contributions are not deductible, but accounts are exempt from taxation and distributions are excluded from beneficiaries' gross income if used for qualified higher education expenses: tuition, fees, books, supplies, equipment required for enrollment or attendance, and certain room and board expenses. Qualifying expenses must be incurred at Title IV HEA institutions. Distributions for other purposes generally are taxable (that is, the part representing earnings is taxable) and a 10% penalty applies. The exclusion cannot be claimed the same year either the HOPE or the Lifetime Learning credit is claimed for the student. Remaining balances must be distributed when beneficiaries reach age 30.

The IRS Restructuring and Reform Act of 1998 included numerous technical corrections and clarifications of education IRAs regarding the taxation of distributions, rollover contributions, changes in beneficiaries, and rules for death and divorce.

Both the Senate-passed Affordable Education Act of 2000 (S. 1134) and the House-reported Education Savings and School Excellence Act of 2000 (H.R. 7) would increase the annual contribution limit from \$500 to \$2,000. They also would allow the accounts to be used for elementary and secondary education expenses, including private and home schooling.<sup>5</sup> Additional changes would include the following: (1) the accounts would be renamed "education savings accounts"; (2) contributions to accounts of beneficiaries with special needs (i.e., with disabilities)

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<sup>5</sup> For more information, see CRS Report RS20289, *Education Savings Accounts for Elementary and Secondary Education*, by Bob Lyke and James B. Stedman.

could occur after age 18 and their accounts could continue after age 30; (3) contributors other than individuals (e.g., corporations) would not be subject to income ceilings; (4) beneficiaries could exclude distributions from their accounts and claim the Hope Scholarship or Lifetime Learning tax credit the same year (though not for the same expenses); and (5) in S. 1134 only, eligibility for the credit for joint returns would phase out between \$190,000 and \$220,000, not \$150,000 to \$160,000.

## **Interest Deduction**

The Taxpayer Relief Act of 1997 authorized a new deduction for interest payments on qualified education loans. The deduction is taken in calculating adjusted gross income (an “above-the-line” deduction) and so is not restricted to taxpayers who itemize. The deduction is allowed only with respect to interest paid during the first 60 months (whether or not consecutive) in which interest payments are required; it was limited to \$1,000 in 1998 and \$1,500 in 1999, while the limit is \$2,000 in 2000 and \$2,500 in 2001 and thereafter. The maximum allowable deduction is phased out for taxpayers with modified adjusted gross incomes between \$40,000 and \$55,000 (\$60,000 to \$75,000 in the case of a joint return). Taxpayers are not eligible for the deduction if they can be claimed as a dependent by another taxpayer.

Qualified education loans are any indebtedness incurred to pay qualified expenses of taxpayers, their spouse, or their dependents at Title IV HEA institutions or at institutions of higher education, hospitals, or health care facilities conducting internship or residency programs leading to a certificate or degree. At the time the debt is incurred, students must be enrolled (or accepted for enrollment) in a degree, certificate, or other program leading to a recognized educational credential and must carry at least one-half the normal full-time work load. Qualified expenses generally equal the cost of attendance minus scholarships and other education payments excluded from taxes. Qualified loans also include indebtedness to refinance qualified education loans.

The IRS Restructuring and Reform Act of 1998 included a technical amendment regarding the interest deduction for education loans.

The President’s FY2001 budget would eliminate the 60-month limit on the deduction of interest. Both the Senate-passed Affordable Education Act of 2000 (S. 1134) and the House-reported Education Savings and School Excellence Act of 2000 (H.R. 7) would repeal the 60-month limit, which would also eliminate the restriction that nonmandatory interest payments were not deductible. The House bill would raise the income phase-out range to \$45,000 to \$60,000 (\$90,000 to \$105,000 in the case of a joint return); the Senate measure would increase the range for joint returns to \$80,000 to \$110,000.

## **Employer Education Assistance**

The Taxpayer Relief Act of 1997 extended the exclusion for employer education assistance through May 31, 2000. The exclusion, in Section 127 of the Internal Revenue Code, allows tuition reimbursements and other forms of employer education assistance to be exempt from taxes of the recipient even if the education does not



qualify as a deductible business expense (that is, even if it is not job-related). Qualifying education is not restricted to Title IV HEA schools. The extension did not apply to graduate-level courses, which had not been covered after June 30, 1996.<sup>6</sup>

The Ticket to Work and Work Incentives Improvement Act of 1999 extended the exclusion (again without covering graduate-level courses) through December 31, 2001.

The President's FY2001 budget would expand the exclusion to include graduate-level courses beginning after July 1, 2000 and before January 1, 2002. The Senate-passed Affordable Education Act of 2000 (S. 1134) would make the current-law exclusion permanent and also expand it to include graduate-level courses. The comparable reported House bill (the Education Savings and School Excellence Act of 2000, H.R. 7) has no provision regarding employer education assistance.

### **State Tuition Savings Plans**

The Small Business Job Protection Act of 1996 (P.L. 104-188) clarified the tax treatment of qualified state tuition savings plans; it generally provided that account earnings are to be included in designated beneficiaries' gross income when they receive distributions to attend school. Previously, it appeared that account earnings might be subject to annual taxation. State tuition savings plans (often called section 529 plans) are either prepaid tuition contracts or college savings accounts established by a state agency.

The Taxpayer Relief Act of 1997 expanded the definition of qualified higher education expenses for state tuition savings plans to include reasonable costs for room and board in the case of students attending at least half-time. As under prior law, qualified expenses also include tuition, fees, books, supplies, and equipment required for enrollment or attendance. The Act also expanded the definition of eligible institution to include all Title IV HEA institutions.

The IRS Restructuring and Reform Act of 1998 clarified that qualified state tuition plan distributions are taxed under the general annuity rules (unless excludable as a scholarship, etc.); thus, part of each distribution is considered to be earnings and part is considered a return of the contribution.

Both the Senate-passed Affordable Education Act of 2000 (S. 1134) and the House-reported Education Savings and School Excellence Act of 2000 (H.R. 7) generally would exempt state tuition savings plan distributions from taxation if they were used for qualified expenses. Both would also allow educational institutions to establish Section 529 savings plans, allow the new exclusion to be claimed the same year that the Hope Scholarship or Lifetime Learning tax credit is claimed (though not for the same expenses), and make modifications in the definition of family members (for making changes in beneficiaries) and qualified higher education expenses.

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<sup>6</sup> For additional information, see CRS Report 97-243, *Employer Education Assistance: Overview of Tax Status in 2000*, by Bob Lyke.

## **IRA Early Withdrawal Penalty**

The Taxpayer Relief Act of 1997 exempted IRA distributions used for qualified higher education expenses from the early withdrawal penalty. The penalty otherwise applies to distributions before age 59½, with a number of exceptions; it equals 10% of the amount of the distribution that is included in gross income. Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at Title IV HEA institutions, plus (in the case of students attending at least half-time) reasonable costs for room and board. The education must be for the taxpayer or the taxpayer's spouse or child (including stepchildren), or for a grandchild of the taxpayer or of the taxpayer's spouse.

The Act also authorized Roth IRAs. The general rule for these IRAs is that distributions are exempt from taxation and penalties if they have been held for 5 years and the account owner has attained age 59½, is disabled or has died, or is using the distribution to purchase a first home. However, no Roth IRA distribution is taxable, regardless of when it is withdrawn or how it is used, until the total of all distributions exceeds the amount of contributions. Thus, some amounts might be withdrawn before age 59½ without taxation or penalty in any case.

Technical amendments regarding distributions from Roth IRAs that had rollover contributions from other IRAs (conversions) were included in the IRS Restructuring and Reform Act of 1998.

Penalties for IRA distributions used for education expenses are not a legislative issue at the end of the 106<sup>th</sup> Congress.

## **Forgiven Student Loans**

The Taxpayer Relief Act of 1997 expanded the tax exclusion allowed student loans that are forgiven (in whole or in part) to include loans made by tax-exempt educational institutions (for example, private colleges) even if the funds originated from a private, nongovernmental source. As under prior law, the exclusion applies only if the borrower works for a certain period of time in certain professions for any of a broad class of employers (for example, teaches in an inner-city school).<sup>7</sup> There is an additional requirement for loans made by tax-exempt educational institutions from private nongovernmental sources: the loans must be issued pursuant to a program designed to encourage students to work in an occupation or area with unmet needs and provide services either for or under the direction of a tax-exempt charitable organization of governmental entity.

Technical amendments regarding this provision were included in the IRS Restructuring and Reform Act of 1998.

Forgiven student loans are not a legislative issue at the end of the 106<sup>th</sup> Congress.

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<sup>7</sup> The provision also extends the exclusion to refinancing loans issued by tax-exempt entities, provided the requirement about working in an area or occupation with unmet needs is met.

## Computer Donations by Corporations

The Taxpayer Relief Act of 1997 authorized an enhanced deduction for contributions of computer technology and equipment to elementary and secondary schools or to tax-exempt charitable organizations supporting elementary and secondary education. Contributions may be made through a private foundation. The property must be donated within two years after it was acquired or constructed, and it must be originally used by either the donor or the donee. The enhanced deduction, like others allowed under prior law, is limited to corporations other than S-corporations;<sup>8</sup> it is equal to the fair market value of the contributed property minus 50% of the ordinary income that would have been recognized had the property been sold for its fair market value. (Without this exception, the deduction would equal the corporation's basis in the property, which usually is less.) However, the enhanced deduction is limited to twice the basis of the property. Authorization for the enhanced deduction expires for taxable years beginning after December 31, 2000.

The IRS Restructuring and Reform Act of 1998 included several minor amendments to this provision.

The President's FY2001 budget would extend the enhanced deduction for computer donations to schools through July 1, 2004; in addition, it would expand eligible recipients to include certain public libraries and community technology centers.

The House-reported Education Savings and School Excellence Act of 2000 (H.R. 7) would extend the enhanced deduction for one year (December 31, 2001). In lieu of an extension, the Senate-passed Affordable Education Act of 2000 (S. 1134) would authorize a business tax credit for computer donations to schools and senior centers.

## Bonds

The Taxpayer Relief Act of 1997 authorized tax credits for a new form of obligation called **qualified zone academy bonds**.<sup>9</sup> Qualified zone academies are public schools and programs that provide education and training below the postsecondary level; they must be designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, and better prepare students for college and the workforce. The academies must either be located

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<sup>8</sup> S-corporations generally are tax-reporting rather than tax-paying entities. Their charitable contributions are divided among shareholders and reported on the latter's separate tax returns. Corporations may elect S-corporation status if they meet a number of Internal Revenue Code requirements; among other things, they cannot have more than 75 shareholders or more than one class of stock.

<sup>9</sup> For additional information, see CRS Report RS20606, *Qualified Zone Academy Bonds: A Description of Tax Credit Bonds*, by Steven Maguire.

in empowerment zones or enterprise communities<sup>10</sup> or have 35% or more of their students eligible for free or reduced price lunches. At least 95% of bond proceeds must be used for rehabilitating or repairing public school facilities, providing equipment, developing course materials, or training teachers and other school personnel. Private entities must contribute equipment, technical assistance, employee services, educational opportunities, and other property worth at least 10% of bond proceeds.

Qualified zone academy bonds are not tax-exempt; however, bondholders are allowed a nonrefundable tax credit based upon a credit rate that the Secretary of the Treasury determines would allow bonds to be issued without discount or interest cost to the issuer. Thus, unlike tax-exempt bonds, the federal government will pay all the interest costs. Qualified zone academy bondholders are limited to banks, insurance companies, and corporations actively engaged in the business of lending money.

Under the 1997 Act, state and local governments could issue qualified zone academy bonds only in 1998 and 1999, subject to a national limitation of \$400 million each year that is allocated proportionally to their share of the population in poverty.

The Ticket to Work and Work Incentives Improvement Act of 1999 authorized up to \$400 million of qualified zone academy bonds to be issued in each of 2000 and 2001. Unused authority may be carried over for several years.

The President's FY2001 budget would increase the authorization for qualified zone academy bonds by \$1 billion in 2001 and \$1.4 billion in 2002. Bond proceeds could also be used for school construction. In addition, the budget would authorize \$11 billion in new school modernization bonds in each of 2001 and 2002. The latter bonds would also be tax credit bonds.

The Taxpayer Relief Act of 1997 also expanded the **arbitrage rebate exception** that applies to small issuers of governmental bonds. The general rule has been that governmental units that do not issue more than \$5 million annually in governmental bonds do not have to refund arbitrage earnings to the federal government. The Act provided that up to \$5 million annually in school construction bonds issued after 1997 need not be counted for purposes of the \$5 million ceiling.

Both the Senate-passed Affordable Education Act of 2000 (S. 1134) and the House-reported Education Savings and School Excellence Act of 2000 (H.R. 7) would increase the small issuer arbitrage rebate exception by allowing \$10 million annually in school construction bonds not to be counted for purposes of the ceiling. In addition, the Senate bill would allow certain public education facility bonds to be treated as exempt facility bonds and permit the Federal Housing Finance Board to guarantee school construction bonds. The House measure would extend the time

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<sup>10</sup> Empowerment zones and enterprise communities are economically distressed areas that qualify for special tax incentives and other federal assistance under P.L. 103-66. See CRS Report 97-257E, *Empowerment Zones/Enterprise Communities Program: Implementation and Developments*, by Bruce Mulock.

period in which the proceeds of public school bonds must be spent in order to avoid arbitrage rebate.<sup>11</sup>

Finally, the Taxpayer Relief Act of 1997 repealed the \$150 million ceiling on the total amount of tax-exempt bonds that may be issued by 501(c)(3) **nonprofit organizations**, including private universities.

### **Provisions in Antecedent Legislation**

The Taxpayer Relief Act of 1997 did not include several education provisions that had been in the House version of the legislation (H.R. 2014) when it was first passed. One would have terminated the exclusion for qualified tuition reductions given employees (including graduate teaching assistants) of educational institutions; a second would have authorized a 50% nonrefundable credit (limited to \$150) for amounts families paid for supplementary elementary and secondary education services.

Similarly, several provisions that had been in the Senate bill (S. 949) were not included in the final legislation. One would have allowed elementary and secondary school teachers who itemize deductions to deduct professional development expenses without regard to the 2% adjusted gross income floor; a second would have allowed tax-free withdrawals from education IRAs for elementary and secondary school expenses.

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<sup>11</sup> For analysis of a similar proposal, see CRS Report 98-803, *Bonds for Public Schools: Relaxation of Arbitrage Restrictions in the Taxpayer Relief Act of 1998*, by Dennis Zimmerman.