Executive Memorandum

RUSH!

The Heritage Foundation 214 Massachusetts Avenue, N.E. • Washington, D.C. 20002-4999 • (202) 546-4400 • http://www.heritage.org

2/4/98 Number 507

PRIVATE PREPAID HIGHER EDUCATION PLANS GAIN MOMENTUM

John S. Barry
Policy Analyst

The rapidly increasing cost of higher education in the United States received much attention in 1997. To address this concern, Congress established the National Commission on the Cost of Higher Education, which is expected to issue its final report shortly. In addition, President Bill Clinton made the skyrocketing costs of college education a top priority last year.

Worries about the cost of college also led to provisions in the Taxpayers' Relief Act of 1997 (Public Law 105–34) to help students and families afford college education. Many of the measure's provisions—HOPE (Hope and Opportunity for Postsecondary Education) and lifetime-learning scholarships, in particular—will encourage colleges to raise tuition and increase the cost of higher education even further. Congress, however, did include several provisions to aid families who work hard and save for their children's education. Families now are able to establish Education Individual Retirement Accounts (education IRAs) and deposit up to $500 annually for use later to pay for education expenses without having taxes levied on the accrued interest. In addition, Congress established "Roth" IRAs. These are similar savings accounts that effectively allow retired Americans to establish a special savings account for their grandchildren, with the proceeds able to be withdrawn tax-free for college and other large expenses.

Much remains to be done, however, to assist families who save for impending higher education costs. Specifically, the new law's provisions are very limited in their impact, and several provisions serve to help only parents planning to send their children to public institutions but not those planning on private college.

To deal with this, Congress and the President should:

1. **Remove the $500 annual contribution limit currently set on education IRAs.** The average annual cost of attending a private college increased some 220 percent between 1980 and 1997; the cost of attending public institutions increased 234 percent over the same period. Although saving $500 per year, even over 18 years, would be helpful, it is not enough to keep up with these skyrocketing costs. Families should be able to save for the entire cost of either a private or public college education tax-free.

2. **Extend to all private prepaid tuition plans the same tax treatment public plans receive.** Currently, 16 states have established prepaid tuition plans that allow resident families to lock in today's tuition rates for tomorrow's education. Income taxes on the accrued interest in these accounts are deferred until the account is

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

cashed in to pay for college. Taxes are paid at the student's rate, which is typically lower than that of the parents. As valuable as these plans are, however, there are drawbacks. Specifically, the plans typically cover only in-state public universities. If a student decides to attend an out-of-state school or even an in-state private school, then the savings accrued in the prepaid plan are less valuable because states typically redeem only the principal and some nominal interest to account for inflation. This places private schools at a distinct disadvantage vis-à-vis their public counterparts. To correct for this distortion, Congress and the President, at the very least, should extend deferred income tax treatment to all prepaid plans, including those established by private schools and private investment companies. This will place all savings plans and all schools on an equal playing field.

3. **Include within the definition of education IRAs any contributions made to prepaid tuition plans.** Not only should all tuition prepaid plans receive equal treatment, they also should be extended the same tax treatment as regular education IRAs. In other words, accrued interest on prepaid plans should be tax-free when the student redeems it to pay for college costs. This would eliminate the double taxation on interest earnings that currently exists within the tax code. It also would eliminate one of the penalties in the current system of higher education financing imposed on families who work hard and save for college.

4. **Ensure that families can transfer financial assets—including prepaid tuition contracts—into and out of education IRAs.** Education IRAs should be flexible enough to accommodate a family's changing needs. For example, families that move from state to state, or that are unhappy with their current method of saving for college expenses, should be allowed to trade an asset in their education IRAs, including a state or private prepaid tuition contract, for an asset or contract that better suits their circumstances. Conventional IRAs currently benefit from this treatment; an individual unhappy with the performance of a specific mutual fund within an IRA can sell the holdings in that fund and purchase another. The key is that the increase in value of the account would be realized tax-free, no matter how the money in the account is invested.

Positive steps toward realizing these goals have been taken in two separate bills introduced in Congress after passage of the Taxpayers' Relief Act of 1997. Representative Kay Granger (R–TX) and nine cosponsors have introduced H.R. 2847, the Higher Education Affordability and Availability Act. The Granger bill would extend the favorable tax treatment now enjoyed by state plans to prepaid plans established by private colleges and universities. Moreover, this bill would make interest earnings on all of these accounts (including regular education IRAs) free of federal income taxes, subject to a $5,000 annual contribution limit. Although this is not ideal, it is a tremendous improvement over the limit on regular education IRAs currently set at $500.

Senators William Roth (R–DE) and Paul Coverdell (R–GA) have introduced S. 1116, the Affordable Education Act, which, among other things, would raise the contribution limit for education IRAs to $2,000 per year. Like the Granger bill, the Roth–Coverdell bill would place private prepaid plans on an equal playing field with state plans, and extend tax-free status to interest earnings in all cases. Again, although the $2,000 contribution limit is not high enough to allow families to save the full amount to pay for college, it is a good step toward the goals outlined above.

American families accrued more college debt in the 1990s than the previous three decades combined. Recognizing that this trend cannot continue, several states established prepaid savings plans. Now, a group of more than 20 private schools located throughout the country, with nearly 700,000 alumni, has begun to investigate the possibility of establishing a similar plan for private schools. In every case, the plans are extremely popular with parents, students, and alumni. It is time for Congress and the President to recognize the value of these plans and eliminate the double taxation that exists on interest earned through such prepaid accounts. Even though the groundwork was set last year to accomplish this, much work remains to be done. H.R. 2847 and S. 1116 would be solid steps in the right direction and, with minor changes to eliminate the contribution limits and strengthen transferability language, would reach the goal of helping families afford college.