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BAD DRAFTING –
A CASE STUDY OF THE DESIGN AND
IMPLEMENTATION OF THE
INCOME TAX SUBSIDIES FOR EDUCATION

Glenn E. Coven*

For decades the writers of tax legislation steadfastly ignored the burden on the
typical American family due to the skyrocketing costs of higher education. In
1997, however, the dam suddenly burst and out tumbled a ragtag collection of
provisions designed to give the appearance, if not the reality, of tax relief for
students and their families. These rules included the somewhat deceptively named
Hope Scholarship Credit and the Lifetime Learning Credit, both provided by
Code section 25A; the resurrection of the ability to deduct interest on educa­
tional loans under section 221; the misnamed Educational Individual Retirement
Accounts (EIRAs) created by section 530; and a mishmash of other rules, in­
cluding the favorable treatment of certain prepaid tuition plans. These new rules
are poorly designed and poorly drafted. While they add a measure of needed tax
relief for the costs of education, they also add an infuriating measure of com­
plexity to the preparation of income tax returns for a broad range of taxpayers
whose returns otherwise tend to be relatively uncomplicated.

What went wrong? Unfortunately for students and their families, the attempt
to subsidize the costs of higher education finally bore fruit during an era in
which the ability of Congress and its tax writing staff to produce coherent
legislation had reached an all time low. A devil’s brew of political conflict and
constraint, inexperience, and perhaps downright contempt for the history and
purposes of the law being amended has left Congress all too frequently unable to
transform the simplest ideas into workable statutory language.1 While the educa­
tional assistance provisions may not be the most glaring example of the qualita­
tive erosion of the Internal Revenue Code,2 they are some of the most instruc­
tive to examine. The adverse consequences of the prevailing drafting practices
are plainly visible in these new provisions.

The new rules governing the principal education assistance provisions, EIRAs,
and tuition tax credits are examined in the following pages with particular refer­

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research assistant, for his assistance in preparing this article.

1There is a limited yet growing amount of literature detailing the poor quality of the drafting of
tax legislation during the late 1990s. See John Bogdanski, Section 357(d)-Old Can, New Worms, 27
J. Corp. Tax’n. 17 (2000); Toni Robinson & Mary Ferrari, Protecting the Innocent: Tax Court and
Service “One-Up” Congress, 88 Tax Notes (TA) 1507 (Sept. 18, 2000); see also Daniel Q. Posin &
Charles Davenport, The Big Bear II: Applying the New Capital Gains Rules, 77 Tax Notes (TA)
1370 (Dec. 22, 1997).

2The revision of the rate of tax on the capital gains of an individual imposed by §1(h) takes that
honor.
ence to the failures of design and drafting that permeate these provisions. The purpose of this undertaking is to do more than merely explain these new rules and occasionally grumble about their drafting inadequacies. To the contrary, the premise of this article is that these provisions are really poorly drafted and the resulting deterioration in the quality of the taxation statute results in unacceptable costs. If any improvement in the drafting of tax legislation is possible, it will require far more than the private grousing that is currently popular. Rather, it will require some very public grousing accompanied by some very specific objections, which will be the task undertaken here.

I. DRAFTING AND ITS ENVIRONMENT

Design and drafting, in the sense used here, mean more than the ministerial task of choosing the grammar and sentence structure to be used to convey tax rules. Rather, they encompasses the whole range of decision-making that is responsible for producing a taxation statute that is either simple or complex, intelligible or unintelligible. Thus, while the drafting that is of concern here certainly does include such seemingly mundane but ultimately important tasks as sentence structure, section structure, and the manner in which the thoughts within a section are organized, it also includes the more discretionary decisions involved in tax law design such as whether to use a cross-reference and, if so, to what. Drafting also requires making decisions concerning coverage. When making choices one must consider to what extent elaboration should be left to others and to what extent Congress and its employees should embellish the details of the statutory language.

The decisions that result in an acceptably workable law, however, involve even more discretionary issues of design that blend with the policy decisions that underlie the statutory material. The making of the fundamental decision to extend tax relief to students and their families would not normally be thought of as a drafting decision. Nevertheless, if it proved impractical to implement that policy in a rational manner through the tax laws, the decision to follow that path rather than craft programs to be administered by a different agency as a part of our national education laws would, in the sense of the term used here, be a drafting decision, albeit one of the highest order. While that fundamental decision is not in fact addressed here, lesser policy-implementing decisions are. Some examples include: the decisions to use two credits rather than one; to phase out programs as a function of income and at different income levels; and to allow the transfer of tax benefits are policy laden decisions that directly influence the ultimate rationality of the statutory provision. One of the factors that bears upon whether a policy choice is sensible is whether it can be implemented through workable and comprehensible statutory language. If it cannot be, then that policy choice becomes a source of poorly drafted legislation.

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3The deduction for interest on education loans is more briefly examined.
The quality of the design and drafting of the tax law, as understood, is attributable to a wide range of quite distinct causes, some more difficult to address than others. It will help in evaluating the scope of the drafting problem to identify a few of the more obvious causes of the poor drafting of the education assistance provisions.

A. The Political Context

As the United States approached the end of the turbulent Twentieth Century, a host of historical and social forces led to an erosion of the tolerance that its citizens had held for a strong federal government and the high, progressive taxes that had supported it. The rates of income taxation of both individuals and corporations fell swiftly and greatly.4 The principal beneficiaries of this mini-revolution were the very rich, setting the stage for future social conflict. This is only thinly papered over by the unprecedented strength of the current economy. As social and economic philosophies clashed, Congress worked out odd compromises as it crept through its legislative agenda. The adoption of new tax reducing provisions, such as the education assistance provisions, tended to be accompanied by a shift in the relative tax burden in incremental steps up the income scale. But that restoration of progressivity occurred only in the most opaque of ways—certainly not by raising the maximum rate of tax above its current nominal level of 39.6 percent. These conflicting forces produced needlessly complex legislation as Congress sought to redistribute the tax burden through provisions that had no logical relationship to tax incidence.

The most visible consequence of these pressures has been the frequent use of limitations attached to both new and old tax allowances that target the tax relief on the lower end of the income tax spectrum and “phase-out” relief for higher income taxpayers. These so-called phase-outs have significantly complicated the tax system, reduced its horizontal equity,5 and produced bizarre effective marginal rates of tax.6

B. The Legislative Process

Badly drafted legislation is a natural by-product of a flawed legislative process, and the process by which tax legislation is produced is badly flawed indeed.7 As will be demonstrated in the following pages, of the provisions

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5Individuals above the phase-out range who are denied a tax concession attributable to a particular expenditure are taxed identically to their equal income neighbors who did not incur that particular expenditure. That result is inequitable because upper income taxpayers are as entitled to horizontal equity as are low income taxpayers.
7See Martin A. Sullivan, Dare We Ask: Is It Time to Reform the Taxwriting Committees?, 89 Tax Notes (TA) 708 (Nov. 6, 2000).
considered here, the Hope credit portion of the tuition credits is the most fully
and skillfully drafted. However, the Lifetime credit portion of the package is
vague and incomplete, and the EIRA was poorly designed and given inadequate
consideration. Also, the scope and operation of the education loan interest de-
duction is sharply inconsistent with the features of the other provisions. All of
these differences become understandable when viewed in light of the process in
which they were created.

The Hope credit, which seems to have originated with the executive branch,8
was contained in 1997 versions of both the legislation that was passed by the
House9 and the version passed by the Senate.10 By contrast and much to the
amazement of those who thought they understood how the legislative process
was supposed to work, the Lifetime credit was not contained in either version of
the legislation; it was added in conference.11 That process, or lack thereof,
explains many of the deficiencies of the Lifetime credit provision. The EIRA
seems to have originated in the House bill as a savings account, the income of
which was not taxed until it was distributed.12 It was downsized and converted
to a Roth IRA-type vehicle in the Senate,13 but the conversion was not entirely
successful. The deduction for interest on an education loan, on the other hand,
originated in the Senate—obviously crafted by different hands.14 The unsurprising
consequence of this historical evolution is a chaotic series of uncoordinated and
occasionally inconsistent provisions.

C. Micro-Management

Almost by definition, a principal source of the complexity of the current
income tax is the extraordinary desire of Congress to fine-tune the application of
the tax laws. This activist approach to drafting results in part from political
conflict and in part, perhaps, from congressional overconfidence in itself, coupled
with distrust of the administration. In any event, a striking feature of the text of
the current Code is the extraordinary detail that encumbers so many provisions
enacted towards the end of the last century. In large measure, that detail does not
provide rational development of the principal theme of a section which other­
wise would have to be added by regulations. Quite to the contrary, the details
contributed by Congress tend to be arbitrary, policy-based rules that could not
be added by regulation because they do not derive from the main theme of the
provision but rather alter that theme. Accordingly, such congressional micro­
management greatly adds to the complexity of the law.

It may well be that in most, if not all, instances, the detail added by Congress

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[hereinafter Conference Report].

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reflects meritorious national policy. Nevertheless, overwhelming complexity in
the federal income taxation statutes is understood to be harmful from every
perspective and thus is contrary to our national interest. The issue becomes
whether the benefits to be achieved from the addition of further detail to the
Code exceed the burdens of complexity and arbitrariness. Too often Congress
has failed to exercise the restraint that such balancing requires.

D. To Copy or Not to Copy

Most income tax questions and issues first arose decades ago and were re­solved at that time. In general, the resolutions reached were logical and work­able and remain so today. When those issues arise again in the context of new
legislation, one might expect the adoption of the time-honored solution, absent a
persuasive justification for the adoption of a different rule. The failure of Con­gress to follow it is an added, and entirely needless, source of complexity and
irrationality in the Code. Obviously, time and experience can demonstrate that
the solutions used in the past were inadequate and require change. Change can
indeed be beneficial. However, the adoption of new solutions to old problems
without revising the approaches taken under prior law is rarely beneficial.

On the other hand, copying the language of a previously enacted provision,
either expressly or by way of a cross-reference, is not always a good idea.
Obviously, approaches taken in one context may not be fully applicable to the
case at hand. In that situation, an unwitting adoption of a prior solution may not
produce a sensible rule; it may not produce anything meaningful at all.

E. Simple Sloppiness

Often it is impossible to identify a broad and consistently encountered cause
of poor drafting. All too frequently it just seems that the drafter simply fell
asleep at the switch, or lacked sufficient experience and supervision. While it
may be difficult to make much headway against the irrational policies that flow
from political conflict, the solutions to simple sloppiness have long been under­stood.

II. THE ASSISTANCE TO EDUCATION PROVISIONS

A. The Education IRA

The Education Individual Retirement Account (EIRA) created by section 530
has nothing to do with retirement and very little to do with education. As its
name suggests, the EIRA is modeled after the Roth IRA which, in turn, is a
variation of the traditional IRA. The apparent purpose of the EIRA is to provide
a tax incentive for individual savings which are, more or less, committed to the
payment of the higher educational expenses of a designated beneficiary. The
assumption presumably is that those savings will assist students in defraying the
costs of attending college and thus will make it possible for more students to
attend college without incurring a crushing financial obligation.

In general, an EIRA account is a trust of which a bank is the trustee and a
single individual is the beneficiary.\textsuperscript{15} The trust purpose must be limited to the payment of the qualified higher education expenses (QHEE) of the beneficiary. If the trust funds are not used by the time the beneficiary becomes thirty or dies, the trust assets must be distributed.\textsuperscript{16} However, the beneficiary of the EIRA may be changed to a member of the family of the initial beneficiary (including children, nieces and nephews), thus avoiding the required distribution.\textsuperscript{17} At present, EIRAs are intended to be small; the trust instrument must provide that a contribution will not be accepted if such contribution would result in aggregate contributions for the taxable year exceeding $500. Moreover, contributions may not be made to the account after the beneficiary becomes eighteen years old.\textsuperscript{18}

At the same time Congress adopted the educational assistance provisions, it invented and adopted a new approach to retirement income assistance. Rather than extend a deduction for contributions to a retirement account coupled with taxation of both the principal and income element of all distributions, under the unfortunately named “Roth IRA,” no tax benefit attaches to contributions to the account, but distributions from the account are entirely free from tax.\textsuperscript{19} The new EIRA was constructed along the Roth pattern. Thus, making a contribution to the account has no income tax consequence and receiving distributions of principal from the account has none as well.\textsuperscript{20} In addition, there are no income tax consequences of receiving distributions of accumulated income from the account that are used to discharge the qualified higher education expenses of the beneficiary. Since the EIRA itself is not subject to tax,\textsuperscript{21} the general effect of the EIRA is to exempt permanently the income from gifts set aside to fund education from tax.

To understand where the EIRA fits in the overall scheme of things, compare the consequences of an anticipatory funding of education in the absence of the new rules. Wholly aside from section 530, annual transfers of $500 to a minor or to his or her custodian would normally be treated as gifts and would neither be deductible by the transferor nor result in income to the transferee. While the income from the transferred property would remain subject to tax, the income would be taxable to the child as long as the gift was bona fide and complete. During most of the history of the income tax that would have meant that the income would have been subject to the lowest tax rate or, most likely, zero.\textsuperscript{22}

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{15}] I.R.C. \textsection 530(b)(1).\textsuperscript{16}
\item[\textsuperscript{16}] I.R.C. \textsection 530(b)(1)(E).
\item[\textsuperscript{17}] I.R.C. \textsection 530(d)(6); see text accompanying infra notes 74-78.
\item[\textsuperscript{18}] I.R.C. \textsection 530(b)(1)(A).
\item[\textsuperscript{19}] I.R.C. \textsection 408A. This variation of the theme was of obvious interest to Congress because it deferred the budgetary impact of the provision. It should be of interest to taxpayers who expect their tax bracket to be higher at the time of their retirement than during their working years!
\item[\textsuperscript{20}] See text accompanying infra notes 45-50.
\item[\textsuperscript{21}] I.R.C. \textsection 530(a).
\item[\textsuperscript{22}] Unless, of course, the child was wealthy in his or her own right, the income from quite a number of $500 gifts would be offset by the deduction for the personal exemption and the standard deduction.
\end{itemize}
\end{footnotesize}
Today, however, the rules governing the taxation of the unearned income of minors have been tightened considerably. As long as the child can be claimed as a dependent by another, the child may not claim a deduction for the personal exemption or claim the standard deduction against more than a trivial amount of unearned income. Moreover, until the child reaches the age of fourteen, his or her unearned income will normally be subject to tax at the rates applicable to his or her parents. Thus, for transfers outside the EIRA provisions, the income from the gift would almost surely be taxable and, until the child is fourteen, taxable at the parent’s applicable tax rates. The EIRA, therefore, constitutes an exception to these reforms and is best understood as retreat from the eminently sound policy of taxing the investment income of a child as if the income had been earned by the child’s parents.

While the objective of the EIRA is thus quite simple and straightforward, its implementation has not been as easy. The problem lies in the drafting choices made or not made by policy-makers.

1. General Tax Consequences

Section 530(a) makes clear that the EIRA account itself is exempt from tax. The section should have contained a similarly clear statement that neither the contributor nor the beneficiary of the trust account would be subject to current tax on the income in the account, but such a statement is lacking. Indeed, while section 530 incorporates the gift and estate tax rules of paragraphs (2), (4), and (5) of section 529(c), it rather oddly does not incorporate the general exemption from tax of the beneficiary provided by paragraph (1) of that subsection! Nevertheless, a footnote to the conference agreement asserts that “the conference agreement clarifies that no amount is includable in the gross income of a beneficiary.” However, it is not evident where that clarification occurs. Nevertheless, there is no serious substantive question concerning the exemption of the income of an EIRA from current tax; the issue is one of drafting expertise. The apparent reason for this omission is characteristic of poor drafting. In the initial House version of this provision, distributions from the accounts were subject to tax and thus the omission of a cross-reference to paragraph (1) of section 529(c) was understandable. However, when the Senate revised the concept to excuse the tax, the drafters evidently forgot to correct the cross-reference or otherwise document that result.

By virtue of a cross-reference to section 408(e)(2), which in turn cross-references section 4975, the tax exemption of the EIRA account can be lost if

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23 I.R.C. § 151(d)(2).
24 I.R.C. § 63(c)(5).
25 I.R.C. § 1(g).
26 This policy is supported by other relatively recent reforms such as the compression of the tax brackets applicable to trusts. See I.R.C. § 1(e).
27 Conference Report, supra note 11, at 363 n.40.
29 I.R.C. § 530(e).

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the beneficiary engages in a prohibited transaction with the account. The excessive and sometimes seemingly unthinking cross-references and double cross-references such as this are a common feature of the education assistance provisions. Here, for example, there was little reason to reach the provisions of section 4975 through section 408(e) rather than directly, and good reason to avoid section 408(e). That provision, which applies to retirement accounts, contains language that has no relevance to education accounts.\(^\text{30}\)

2. Permissible Contributors

While one might suppose that the first question to be addressed in designing these rules would be to define the permissible contributors to an EIRA, the Code does not address this issue at all. The omission is mildly surprising; it is not entirely clear whether the omission reflects an admirable economy of language or poor drafting. Perhaps the failure to define the term “contributors” stems from the lack of tax consequences associated with the making of a contribution to the account and thus no occasion to describe the persons who do not have any tax consequences. The effect of the failure to restrict contributors is merely that any individual,\(^\text{31}\) even a complete stranger, should they so desire, may make a contribution to the EIRA of a particular beneficiary and that liberality certainly does not offend any principle of tax policy.

a. Phase-outs. While Congress did not limit who could contribute to an EIRA, it did specify who could not contribute. Consistent with its current general practice, Congress undertook to limit the benefits of this new provision to relatively low income taxpayers. Accordingly, the EIRA contains a phase-out of its tax benefit. While the propriety of phase-outs in general is subject to serious question, the phase-out of the EIRA appears utterly misguided.

In designing a phase-out for the EIRA, one should obviously ask the threshold question, to whose income should the phase-out be related—the contributor or the beneficiary? One might expect that the limitation would be related to the individual who obtained the tax benefits of the provision being limited. That individual is not the contributor to the EIRA for the contributor does not obtain any tax benefit from the making of a contribution. While it is true that the income from the contributed property will be exempt from tax, after the transfer to the EIRA the property no longer belongs to the contributor; the equitable interest in the property has passed to the beneficiary. Thus the “benefit” to the contributor is merely that of not being taxed on the income from property that is no longer owned! Under section 530(c), however, the phase-out of the EIRA benefits is related to the income of the contributor. The ability of an individual filing a joint return to make a contribution to an EIRA is reduced if the contributor’s adjusted gross income (AGI) exceeds $150,000 and entirely disap-


\(^{31}\)The question of entity contributors is considered below.
pears if his or her AGI exceeds $160,000. 32

In a provision considered below, the Code contains a second restraint on the scope of EIRA benefits in the $500 annual ceiling on contributions. That limitation is applied to beneficiaries on an aggregate basis, 33 but is not applied to contributors. Contributors are free to make any number of $500 contributions for the benefit of any number of different beneficiaries. It is not at all obvious why the $500 ceiling should apply to beneficiaries, but not contributors, while the phase-out should apply to contributors, but not beneficiaries.

Because the benefit of the revenue loss, if any, from the EIRA redounds to the benefit of the individual who is responsible for funding the education of the beneficiary of the account and whose burden is lessened by the EIRA provisions, the phase-out, if there is to be one, should be related to the income of the beneficiary (or the individual financially responsible for the beneficiary, presumably the beneficiary’s parents). Relating the phase-out to the income of the contributor thus will make sense only where the contributor is in fact the beneficiary or the beneficiary’s parents. While that may often be the case, it certainly will not always be the case. Because there are no limitations on the identity of contributors, other family members, particularly grandparents, the proverbial rich uncle, or even charitably motivated strangers, will be contributors to EIRAs. Indeed, unless the omission of any definition of a permissible contributor is entirely attributable to poor drafting, Congress must have anticipated such a range of contributors. Phasing out the benefits of EIRAs for children and their low income parents because the contribution is being made by a wealthy distant relative seems inconsistent, at best, with the fundamental purposes of the educational assistance provisions.

Tying the phase-out of this benefit to the AGI of the contributor rather than the AGI of the beneficiary or his or her parents or both seems particularly misguided in light of the role the EIRA provisions play in the Code as a whole. The EIRA is only needed because of the presence of the more fundamental rule that the unearned income of minor children should be taxed as if it were derived by their parents. Where the income from a traditional gift to a child would be taxed at a low rate because the child’s parents are in a low tax bracket, it seems bizarre to deny that child the benefits of an EIRA for a reason related to the income level of the contributor.

For a number of reasons, the tax bill facing a dual income household will often be higher than the tax bill that the couple would pay if they were not married. That so-called marriage penalty has had a checkered career and is currently under heated attack. 34 One of the more dramatic causes of the penalty is the effect of the progressive rate structure but that effect has its defenders and may in fact be appropriate. A second, and far less defensible, cause of the

32 I.R.C. § 530(c)(1)(A).
marriage penalty is the large number of tax allowances that are phased out or otherwise lost more quickly by a married couple than by two single taxpayers. It is surprising to find that Congress enacted such a penalty since a consensus seems to have emerged that this excess burden on married couples should be eliminated from the law. Yet, that is exactly what Congress did in the EIRA phase-out. While the ability to contribute to an EIRA begins to phase out at an income level of $150,000 on a joint return, for a single taxpayer the ability phases out over an income range of $95,000 to $110,000. That means that two single parents earning, say, $95,000 and $65,000, may each make full contributions to the EIRAs of their respective children. However, should they marry, their combined income of $160,000 would bar both of them from making any further contributions to anyone’s EIRA.

b. Indirect Contributions. Aside from the propriety of the EIRA phase-out, the ability of the Service to enforce this restriction on contributions is subject to serious question. Phase-outs, whether sensible or not, seem to work effectively when they function to bar the claim of a tax allowance. It is far harder to see how a phase-out will work when there is no tax allowance to phase out! In the context of EIRAs, the problem is compounded by the lack of any limitation on the identity of contributors.

An EIRA contributor obtains nothing but the pleasure of knowing that he or she has contributed to the funding of the beneficiary’s costs of higher education and has done so in a manner that may be especially beneficial to the beneficiary because of the tax subsidy extended by Congress to EIRAs. Accordingly, the contributor may be completely indifferent to whether he or she makes a direct transfer to the EIRA or makes a conventional gift, because he or she is secure in the knowledge that another person can make a contemporaneous transfer to the EIRA in question. Accordingly, a taxpayer who desires to make a contribution to an EIRA but is blocked from doing so by the phase-out provisions can fully and easily accomplish his or her objectives by making a conventional gift to another person whose income does not exceed $150,000, provided that the transferee in turn funds the EIRA. The individual who is most likely to fit that need will be the child who is the intended beneficiary of the account.

Of course, the Service could challenge such a transparent avoidance of the phase-out rules under the traditional step transaction doctrine.35 When the income of the parents of the student exceeds the phase-out range so that avoiding these rules requires making a gift to the child to fund his or her own EIRA, the avoidance may not work. However, commonly it may be that the income of the grandparents or other wealthy relatives exceeds the $160,000 ceiling, not

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the income of the parents. Treating gifts to the parents that are retransferred to an EIRA as direct contributions from the grandparents to the EIRA will be extremely difficult for several reasons. For example, small gifts are not even reportable, family conversations do not really amount to preconditions, amounts and times of transfers can differ, and transfers often become entangled with other transactions. Accordingly, this phase-out, misdirected as it may be, often will be of no consequence.36

c. Penalized Contributions. If it is established that an individual whose income exceeded the phase-out ceiling made a contribution to an EIRA, the amount of the contribution becomes an "excess contribution" subject to a penalty under section 4973(e). In that event, the Service imposes an annual tax equal to six percent of the amount of the excess contribution. If the entire $500 contribution constituted an "excess," the penalty would be $30. Oddly, however, the penalty is to be paid, not out of the assets of the EIRA, but by the beneficiary.37 The Code is quite clear on the point. So, what Congress decreed is this: if grandparents improperly make a $500 contribution to the EIRA of their two-year-old grandchild, an annual penalty tax of $30 is imposed on the two-year-old. The tax is payable, not out of the assets of the EIRA, but out of the child's lunch money. It is simply impossible to imagine that in today's Service-bashing environment there is even a single revenue agent who so longs for unemployment that he or she would consider trying to collect that tax. Indeed, it is so inconceivable that anyone would do so that it is tempting to wonder whether, in enacting section 4973(e), Congress was deliberately trying to set the Service up for another splashy media event!

While the collection of the $30 penalty may be problematic, it could happen. If it does happen, the penalty, while small, is large enough so that in the normal case it will eliminate the benefit of the tax exemption for the financial return earned on the EIRA assets. Accordingly, the parties may collectively wish to unwind the transaction and either return the excess contribution to the contributor or distribute it to the beneficiary. While that will probably be possible, at least if the parties act promptly, the path leading to that result is unusually murky.

The Code does require that the governing instrument of the EIRA bar the receipt of contributions that would result in aggregate contributions exceeding $500 in any year38 and for this purpose, "aggregate" would include the contributions of others to other accounts for the same beneficiary. However, the Code does not address what is to happen if such a contribution is in fact accepted because the existence of earlier contributions was not known at the time. In

36See also Morris, supra note 8, at 906.
37I.R.C. § 4973(a) "[T]he tax imposed by this subsection shall be paid by such individual," (referring to the individual who possesses an EIRA); see also 46 Fed. Reg. 36198 (July 14, 1981) (to be codified at 26 C.F.R. pts. 1, 25, 31, 54, and 301).
particular, it is unclear whether the excess contribution is to be returned to the contributor because it should not have been accepted in the first place or whether it is to be distributed to the beneficiary because the funds have been given to the beneficiary even though they cannot remain in the EIRA. The provision that was intended to govern in this situation is section 530(d)(4)(C).

As discussed below, distributions from an EIRA that are not used for the prescribed purposes are subject to a penalty tax. However, that penalty is excused by section 530(d)(4)(C) if contributions are unwound in the prescribed manner. The problem lies with how to determine what constitutes the manner prescribed. The provision in question, which is caption titled "contributions returned before due date of return" (emphasis added), provides that the penalty will not apply to "the distribution of any contribution" by the time for filing the beneficiary's return. At this point the misdrafting of the provision is so complete that it is unclear whether it governs the return of the contribution to the contributor, the distribution of the contribution to the beneficiary, or both. Notice 97-60 ducks the issue completely by providing that the six-percent penalty will apply to excess contributions unless they are "withdrawn" from the account—a perfect ambiguity.

Section 530(d)(4)(C) is poorly drafted in other ways. The provision, by its terms, applies to the distribution of any contribution, not just to the distribution of an excess contribution, and thus would seem to apply anytime the contributor changed his or her mind. However, the subparagraph continues to provide that the distribution must be accompanied by any income attributable to "such excess contribution." This internal inconsistency suggests, of course, that the subparagraph was only intended to apply to the return/distribution of excess contributions. Notice 97-60 ducks that issue as well; it discusses the "withdrawal" of excess contributions but does not mention the withdrawal of non-excessive contributions.

d. Entity Contributors? The absence of any description of permissible contributors also creates at least one more ambiguity. Section 530 does not expressly address whether entities, that is, corporations, partnerships, or charitable organizations, may make contributions to the EIRA of a child. The general purpose of the section would obviously be furthered if either businesses or exempt organizations could assist in the funding of education. On the other hand, because the EIRA phase-out is related to the income of the contributor rather than the income of the beneficiary, the effect of the phase-out could be evaded by channeling contributions through entities. While this could be barred

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39See text accompanying infra note 45.
40I.R.S. Notice 97-60, 1997-2 C.B. 310. The Treasury is effectively barred from issuing interpretative guidance through temporary regulations. See I.R.C. § 7805(e). Thus, such guidance is issued in "Notices" which closely resemble temporary regulations. To complete the silliness, for some purposes Congress treats notices like temporary regulations. See I.R.C. § 7805(b)(1)(C) (regulations may be retroactive to the date of any notice containing the rule).
by a set of complex attribution rules, no such rules are contained in section 530.

While section 530 does not address the issue of permissible contributors, it is at least likely that the drafters of the section assumed that only individuals could contribute to an EIRA. The phase-out of the right to fund an EIRA is a function of adjusted gross income, relevant only to individuals. Without acknowledging the absence of a clear statutory rule, in Notice 97-60 the Service assumed that only individuals may contribute to an EIRA. Regardless of whether the rule is well-considered or sensible, it is likely to prevail.

On the other hand, it is not clear what would happen if an entity did make a contribution to an EIRA, since such a contribution is neither permitted nor barred. At worst, such a contribution would be an excess contribution under section 4973(e), subjecting the minor beneficiary to another annual $30 tax. Alternatively, with considerable effort, the regulation writers may treat entity contributions as indirect contributions from the individuals in control of the entity. All in all, it would have been better if Congress had addressed this rather obvious issue.

e. Multiple EIRAs. While the Code is characteristically vague on this point, Notice 97-60 takes the position that multiple EIRAs may be established by multiple contributors for the benefit of a single beneficiary. That possibility raises serious issues of how the various limitations on EIRAs are to be applied to multiple accounts, created independently by different persons with different banks. The application of the $500 per year limitation, for example, is particularly tricky.

Section 530(b)(1)(A)(iii) provides that the aggregate contributions to a particular EIRA may not exceed $500 in any year. That statement simply does not address the question of whether all EIRAs of a given beneficiary must be aggregated for the purpose of applying that ceiling. Significantly, the analogous provision applicable to Roth IRAs applies the annual contribution limit "to all Roth IRAs maintained for the benefit of an individual . . . ." The absence of such language in the EIRA rules would naturally lead to the conclusion that each such account has a $500 limit and that a single beneficiary might benefit from a series of $500 contributions to different accounts in a single year. While a textual approach to statutory interpretation would lead to that conclusion, commonsense suggests that such an interpretation could not be correct. Reading the $500 ceiling as a per EIRA ceiling would effectively eliminate any practical ceiling at all for EIRA contributions, a result that Congress plainly did not intend. Presumably for that reason, Notice 97-60 takes the position that the EIRA rule is identical to the Roth IRA rule, notwithstanding Congress' omission

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\footnote{\textsuperscript{41}I.R.S. Notice 97-60, 1997-2 C.B. 310. The notice repeatedly refers to "individuals" opening EIRAs.}

\footnote{\textsuperscript{42}See Reg. § 25.2511-1(h)(1).}

\footnote{\textsuperscript{43}I.R.S. Notice 97-60, 1997-2 C.B. 310.}

\footnote{\textsuperscript{44}I.R.C. § 408A(c)(2).}

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of the pertinent language from section 530. The linguistic differences merely reflect poor drafting by Congress.

The Service's position, however, creates a series of problems of its own. What is supposed to happen, for example, when the second set of grandparents creates a fully funded EIRA as a Christmas present for their new grandson, unaware of the fully funded EIRA created earlier in the year by the other grandparents? Of course, the second contribution constitutes an excess contribution which should not have been accepted by the trust and thus should be returned, distributed, or subject to an annual penalty tax of up to $30. But, this assumes that the beneficiary or his or her parents learn of both the first and second contributions, realize that an excess contribution has occurred, and notify the second set of grandparents that their gift, while welcome, must nonetheless be rescinded. All of that may, on rare occasion, occur.

f. The $500 Ceiling. While Congress plainly intended a $500 ceiling to apply to each EIRA, it also seems to have created an easy method for avoiding that limitation, although it may be of limited usefulness. Under section 530(b)(1)(A)(iii), the $500 limitation does not apply to rollover contributions. As explained below, the assets of one EIRA can be transferred without tax consequences to the EIRA of a family member, provided only that the transferee beneficiary has not attained the age of thirty. Accordingly, the ceiling can be avoided if it is possible to create an EIRA for an under eighteen member of the beneficiary's family who will have no need for the account with a view to rolling those funds into the EIRA of the intended beneficiary.

3. Distributions From EIRAs

The basic pattern for taxing distributions from an EIRA is reasonably straightforward. Distributions of principal are not taxed and neither are distributions of income, provided the income is used to pay the higher education expenses of the beneficiary. Distributions of income not so used are taxed to the beneficiary. Moreover, unless there is a good reason for the diversion of funds, the tax is at a rate ten percentage points higher than the otherwise applicable tax rate. The simplicity of the system did not, however, translate into simple statutory expression.

a. The General Rule. The treatment of distributions under section 530(d) begins with a general rule that is not intended to be the overarching rule. Reflecting the worst Code drafting techniques, the structure of section 530(d) is reversed. The general rule set forth in paragraph (1) states that distributions of income are taxed, although this is only intended to apply when the income of the EIRA is used in impermissible ways. This sort of reverse structure is highly confusing to even fairly sophisticated readers of the section, as the drafters discovered themselves. The reversed structure of the section required treating distributions for education as the exception. That treatment was so counterintuitive that, in the version of the section actually passed by Congress, distributions used for educational purposes ended up being taxed while distributions not so used
However, the error was deemed editorial and was corrected when the law was published.46

As originally enacted, the general rule provided by section 530(d) stated that distributions are includable in the income of the distributee “in the manner as provided in section 72(b).”47 Section 72 governs the taxation of annuities and subsection (b) is the heart of that rule. Unfortunately, EIRAs are not annuities and the cross-reference to section 72(b) is meaningless. While the statute thus failed to prescribe an intelligible rule governing the taxation of distributions, the congressional intent, at least, was disclosed by a remarkably clear statement of a quite logical rule contained in the committee reports: the proportion of a distribution that consists of principal equals the fraction of the distribution equal to the total contributions to the EIRA divided by the value of the EIRA at the time the distribution is made.48 In 1998, Congress changed the cross-reference from section 72(b) to section 72.49 According to the Senate Report accompanying the bill, this change “clarifies” that EIRA distributions contain a pro rata share of principal and income.50 It does no such thing, of course. What it does is make the cross-reference sufficiently broad, or vague, to allow the drafting of regulations that could provide for nearly anything (but will provide a rule based on the statement in the committee reports).

For those willing to allow legislation to be fleshed out by committee report, the opacity of the general rule can be clarified—but only to a certain degree. Because no one involved in the legislative process seemed to anticipate the question of multiple EIRAs, the application of the pro rating rule under these circumstances is unclear. The principal issue is whether the income and principal of all of the EIRAs of a single beneficiary must be aggregated in computing the ratio to be used in the taxation of a distribution from one of these accounts. While the pointless complexity of such an aggregation rule would argue against this approach, it seems required by a literal reading of the committee reports. In describing the ratio, the Senate Report compares the “aggregate amount of contributions” to the total value of the account.51 As previously stated, the $500 annual ceiling applies to the “aggregate contributions” and that, Notice 97-60

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46Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 815. The confusion in code section 530 concerning the taxation of distributions seems to be attributable to drafting errors made in the Senate. The Senate Report seems to acknowledge that H.R. 2014 as passed by the Senate imposes a tax on all EIRA distributions (which it did) but asserts that the bill further provides that if a Hope credit is not claimed by the taxpayer, then distributions for educational purposes would not be taxed. S. REP. No. 105-33, at 16 n.12 (1997). If the bill does so provide, the provision well hidden. The present language, which does so provide, was added in conference.
48Conference Report, supra note 11, at 357.
says, means the total of all contributions to all EIRAs of a single beneficiary. Of course, the aggregate contributions referred to in a committee report can be different from the aggregate contributions referred to in the Code.

b. Distributions for Qualified Higher Education Expenses. Subsection (d) provides that as long as the "qualified higher education expenses" (QHEE) of the beneficiary for the taxable year "are not less than" the amount of the EIRA distributions, none of the distributed income will be subject to tax. The specification that "no amount" will be taxable if the QHEE are "not less than" the EIRA distribution makes this provision needlessly difficult to read and therefore to apply. A more natural use of the language would have extended the tax exemption if the expenses "exceeded" the distributions. But, with a little interpretive effort, the rule provided becomes clear.

Although nothing very clearly addresses the issue, it does not appear necessary to trace the EIRA distributions to specific educational expenses. Rather, the exemption appears to be available so long as the requisite amount of expenses is incurred during the year in question. Thus, for example, it would seem permissible to make a distribution in December which would be sheltered from tax by QHEE incurred and paid from other sources throughout the taxable year.

While the nature of the expenses that will support this tax exempt treatment is sharply defined, that definition is generally quite expansive. QHEE are defined by a series of cross-references to include: the expenses described in section 529(e)(3), which governs the state tuition programs, reduced as provided in section 25A(g)(2) (the educational tax credit section), which are incurred at an "eligible educational institution" as defined in section 529(e)(5) (basically a cross-reference to section 481 of the Higher Education Act of 1965). While the heavy use of cross-references is one of the leading causes of textual complexity throughout the Code and accompanying regulations, the offsetting benefit of this drafting technique is the resulting uniformity. Here that benefit seems to justify the complexity although cross-references to legislation codified outside of Title 26 complicates research and is an added source of potential error. The section 529(e)(3) enumeration of expenses is rather broad and includes: tuition, fees, books, and supplies. As long as the student is carrying at least a one-half load, room and board costs are included but not in an amount in excess of the minimum cost of room and board used by the institution in computing the cost of attendance for the purpose of federal financial aid programs. Travel to and from the institution and, apparently, while in attendance, is not included. This definition of expenses is to be compared to the far narrower definition of expenses for which a tax credit may be claimed.

\[\text{I.R.S. Notice 97-60, 1997-2 C.B. 310.}\]
\[\text{1997 Senate Report, supra note 51, at 17.}\]
\[\text{Deferring the reimbursement in this manner would have the advantage of maximizing the receipt of tax-exempt income in the EIRA account.}\]

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The expenses must be incurred at an institution "described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on the date of the enactment of this paragraph." Section 1088 was basically an expansion of section 1141 of the same Title (i.e., another cross-reference). However, in the following year, both sections of Title 20 were repealed, and their substance was reenacted in other sections. While it is possible figure out what a recodified item of non-tax legislation said on a particular day in history, the task is not easy. Moreover, the regulations are no help at all. While regulations to the EIRA provisions have not yet been proposed, the same definition is used for the purposes of the educational tax credits. Those current proposed regulations simply restate the statutory cross-reference, noting that the reference generally includes all accredited postsecondary institutions.

The reduction in qualified expenses required by the cross-reference to section 25A is somewhat more troublesome and will be examined more closely in connection with the credit itself. In general, that provision requires reducing the amount of the education expenses that will support a tax-free distribution by the amount of all other educational assistance payments that are not includable in the income of the student, other than gifts or bequests.

c. Partially Non-qualified Distributions. When the distributions from an EIRA exceed the amount of qualified expenses for the year, a portion of the distribution becomes taxable to the distributee. Since the initial contributions to the account were not deductible, distributions of the principal amount of those contributions will never be subject to tax regardless of how they are later used. However, a distribution of the previously untaxed return on those contributions will be subject to tax to the extent the distribution is not used to pay qualified educational expenses. These rules require two allocations. The pro rata allocation between principal and income required by the legislative history to section 530(d)(1) has already been described. In addition, the distribution of income must be allocated between qualified and non-qualified uses. For that purpose, section 530(d)(2)(B) provides that the proportion of the income distributed that will be exempt from tax equals the ratio of qualified expenses to total distributions.

Following the language of section 530(d)(2)(B), assume that an EIRA, which had received aggregate contributions of $6,000, now has a value of $10,000. In a year in which the beneficiary has qualified educational expenses of $750, the account makes a distribution of $1,000. Of that distribution, 6,000/10,000 or $600 is treated as principal and is not subject to tax. Accordingly, the $400 that

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57 Of course, the documents creating the EIRA must dedicate the contributions to paying the educational expenses of the beneficiary unless the beneficiary dies or fails to use the funds prior to the age of thirty. That contractual requirement limits the ability to obtain the EIRA assets for other uses.
is deemed to be income would (by virtue of section 530(d)(1)) "otherwise" be taxable to the beneficiary. However, that inclusion is reduced by an amount equal to the ratio of the qualified expenses, or $750, to the total distribution, or $1,000. Thus, the inclusion in income is reduced by $750/1000 or $300 and only $100 of the total distribution of $1,000 will be subject to tax, notwithstanding the fact that $250 of the distribution has been spent on non-qualified items. That result reflects a middle ground. The taxpayer is neither forced to allocate income first to the non-qualified item nor allowed to allocate principal first to that item.

d. **Coordination with Educational Credits.** Section 530(d)(2)(C) allows a distributee of an EIRA to waive the tax exemption for amounts used to discharge QHEEs and thus become subject to tax on the entire amount of distributed accumulated income. This somewhat surprising rule, which is likely to assume considerable importance in the administration of an EIRA, is Congress' attempt to coordinate the benefits of the EIRA and the tuition tax credit. Because taxpayers cannot benefit from both the EIRA provisions and the tuition tax credit in the same year, the waiver allows the taxpayer to select more favorable benefits. This provision is examined below.

e. **Additional Tax on Distributions.** If a distribution from an EIRA is subject to tax, under section 530(d)(4), the tax rate is increased by ten percentage points. Thus, assuming the beneficiary would normally be subject to tax in the fifteen percent bracket, the tax on income not used to pay QHEE is increased to twenty-five percent. The point of this penalty is presumably to discourage the deliberate abuse of the EIRA tax exemption. Even though none of the income earned by an EIRA account was used to discharge QHEE and thus the entire amount of the income was taxed to the beneficiary, taxpayers might still obtain a significant and unintended benefit from the creation of an EIRA. The tax on distributions is imposed at the time of distribution, not at the time that the income is earned. Thus, even if the beneficiary is taxed at the time of distribution, he or she will have benefit from the deferral of tax for a period that can be as long as thirty years. The ten percent additional tax is designed to offset this deferral benefit somewhat.

The section, as passed in 1997, contains three specific exceptions to the imposition of this additional tax. First, the tax will be waived if the distribution is made following the death or disability of the initial beneficiary. Second, the addition is waived if the distribution from the EIRA is "made on account of a scholarship, allowance, or payment described in section 25A(g)(2)" received by the beneficiary to the extent the distribution does not exceed the amount of the scholarship. Finally, under a provision discussed above, the additional tax is

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59 I.R.C. § 25A(e)(2).
60 I.R.C. § 530(d)(4)(B)(i), (ii).
not imposed upon the distribution of an excess contribution if the distribution occurs before a specified time. As originally enacted, the additional tax was not waived if the distribution was taxed because the beneficiary deliberately waived the tax exemption. This omission was undoubtedly attributable to the fact that the additional tax provision was copied from section 529, which did not contain such a waiver. The omission was corrected in the 1998 revision.

There is a disconcerting lack of coordination between the definition of an EIRA and the enumeration of the kinds of distributions contemplated by section 530(d) that is aggravated by these exemptions from the penalty tax. Under section 530(b)(1), the governing instrument of an EIRA must provide that the funds in the account are dedicated exclusively to the payment of the qualified higher education expenses of the named beneficiary, although the account balance must be distributed when the beneficiary reaches the age of thirty or dies. Nothing authorizes distributions for any other purpose. Nevertheless, section 530(d) contains an elaborate system for taxing distributions that are made for other purposes. Indeed, the exceptions to the ten percent penalty tax specifically include distributions “attributable to the designated beneficiary’s being disabled” although nothing permits such a distribution. Apparently Congress intended to allow distributions under a wider set of circumstances than those actually set forth in section 530.

The exception from the penalty for expenses paid by a scholarship raises a number of complex issues. As a drafting matter, this provision makes little sense. It is difficult to conceive of a distribution “made on account of a scholarship.” This awkward language is present because the entire exception from the additional tax was copied from section 529(b)(3), which similarly provides that a penalty must be imposed on the refund of amounts contributed to a state tuition plan unless the refund is “made on account of a scholarship.” Given that history, section 530(d)(4) would appear to contemplate the making of a distribution by an EIRA to a beneficiary who does not have QHEE because those expenses were defrayed by a scholarship, an armed forces educational assistance allowance, or any of the other forms of tax-exempt payments for education described in section 25A(g)(2). Such a distribution would be subject to tax in the hands of the beneficiary but would not be subject to the additional tax.

As a policy matter, this treatment seems inappropriate. Because by definition the beneficiary will not have any unreimbursed education expenses, the EIRA distributions in question will be used for the personal, non-education related expenses of the beneficiary. Allowing the beneficiary to retain the full benefit of

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65 The account itself may be transferred upon death or divorce. I.R.C. § 530(d)(7).

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the prolonged deferral of income tax provided by the EIRA for funds used in this manner is certainly of debatable wisdom.

In addition, this favorable treatment of distributions “on account of a scholarship” does not mesh well with the statutory requirements for EIRAs. Section 530 requires that the assets of an EIRA be dedicated exclusively to the payment of the qualified higher education expenses of the beneficiary, defined by section 530(b)(2)(A) as educational expenses reduced “as provided in section 25A(g)(2).” It would seem, therefore, that an EIRA is not permitted to make distributions with respect to education expenses that in fact have been discharged by a scholarship or similar grant. Indeed, it seems that what section 530(d)(4)(B)(iii) treats so favorably is barred by section 530(b)(2)(A)!

It may be, however, that Congress was drawing a somewhat unsatisfactory distinction. While it seems clear that a beneficiary cannot receive an EIRA distribution after having received the proceeds of a scholarship, a beneficiary could receive a distribution before the receipt of those proceeds. While it is not easy to view such a distribution as occurring “on account of a scholarship,” it would appear that this is the manner of distribution that section 530(d)(4)(B)(iii) addresses. While the distribution would be taxable, it would not be subject to the penalty tax. It is unfortunate that such a premium is attached to the timing of an EIRA distribution. Rather than allow a factor that is largely within the control of the beneficiary to have such importance, it would have been preferable to require such an unneeded EIRA distribution to be returned to the EIRA. Such treatment would also be consistent with the treatment of tuition tax credits. The different, and far more favorable, rule contained in section 530 is attributable to the fact that this portion of section 530 was copied from a similar feature of the state tuition programs without sufficient reflection upon the differences between the state prepayment programs and EIRAs. While returning funds to a state program might not be desirable, requiring that return to an EIRA might be preferable to the solution adopted in section 530. Whether the regulations will seek to rewrite this aspect of the EIRA rules remains to be seen.

f. Rollover Contributions and Changing Beneficiaries. As discussed further below, it is quite likely that the assets of an EIRA will not be used to pay the QHEE of the initial beneficiary of the account. This might be the case, for example, because the beneficiary dies, simply does not attend college, or attends on a full scholarship, or because of the manner in which the EIRA rules interact with the educational tax credit rules. When this occurs, there are a number of options available, but one must be exercised before the initial beneficiary becomes thirty years old.

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68I.R.C. § 529(b)(3)(C) (allowing a refund from a state tuition program without penalty if made on account of a scholarship).
69See text accompanying infra notes 81-82.

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The age thirty rule is worth a special note. In the conference agreement to the original 1997 legislation it apparently was determined that any assets remaining in an EIRA when the beneficiary became thirty years old must be distributed at that time. Unfortunately, while that decision made its way into the committee reports, it did not make its way into the statute. For a time, this led to the kind of question that is amusing to academics but not at all amusing to practitioners: which controlled? Did an EIRA account agreement have to provide for a termina distribution at age thirty or did it not? In 1998, the provision was amended to add the age thirty rule. Thus, section 530(b)(1)(E) now provides that the EIRA agreement must require that if the beneficiary becomes thirty, or dies before attaining that age, the balance in the account must be distributed. Since all of the 1998 amendments to the EIRA rules were regarded as technical amendments to the 1997 legislation, all of these changes were made retroactive to the effective date of the 1997 act. Presumably, therefore, EIRA agreements drafted in reliance on the Code rather than on the committee report fail to conform to the statutory requirements and are threatened with invalidity, all because of a sloppy drafting error by the tax-writing staff.

If a terminal distribution is triggered because the beneficiary reaches the age of thirty, the distribution presumably must be to that beneficiary. Section 530(d)(8) only vaguely provides that the balance in the account will be "deemed distributed" but the committee reports assume as much. Since a terminal distribution will not be used to pay education expenses, it would seem to follow that the accumulated income portion of the distribution will be subject to tax and to the additional ten percent tax. However, this result may be avoided in two ways. The beneficiary of an EIRA may be changed or the assets in the account may be rolled-over into an EIRA for another person. As long as the new beneficiary is a member of the family of the old beneficiary, neither the substitution of a beneficiary nor the rollover will be treated as a taxable distribution. Rather, the account continues with the new beneficiary.

For purposes of avoiding a taxable distribution, Congress adopted the expansive section 529(e)(2) definition of family. Under this provision, family includes all of the persons who might qualify as dependents under section 152(a)(1) to (8), and their spouses. Those persons not only include all direct descendants (and their spouses, although the descendants of a thirty-year-old will usually not have spouses), and siblings, but also the descendants of siblings and their spouses.

70Conference Report, supra note 11, at 363.
72See id. § 6001(b).
73Conference Report, supra note 11 at 363.
74I.R.C. § 530(d)(6).
75I.R.C. § 530(d)(5).
76Although not addressed, the implication of these provisions is that a rollover or beneficiary change that benefits a non-family member can occur but will be treated as a taxable distribution. It is not clear, however, to whom the distribution should be taxed.

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The section 592(e)(2) definition of family includes lots of folks. As a result, there is no tax reason why an EIRA must ever terminate. If its beneficiaries change periodically, the account can retain its tax-exempt life forever. The only constraint contained in the Code is that tax-free rollovers of EIRA accounts cannot occur more frequently than once per year. No such limitation applies to a change in beneficiaries. Whether this would prove to be a good use of savings, however, is a different question.

Although section 530(b) requires that the EIRA trust agreement provide that no contribution will be accepted after the date on which the beneficiary attains the age of eighteen, the 1998 amendments allow the benefits of any existing EIRA to be transferred to an individual who has not attained the age of thirty. Thus, section 530(d)(6) allows the substitution of a beneficiary who has not attained the age of thirty and section 530(d)(5) allows the rollover of an account to the EIRA of an individual who has not attained the age of thirty. While the 1998 age limits are not directly in conflict with the 1997 age limits, the necessary effect of the new rules is to substantially undermine the age eighteen limitation. After 1998, if one desires to make additional contributions to the EIRA of an individual over the age of eighteen, one merely is required to establish and fund the EIRA of a member of the family of the intended beneficiary and subsequently roll over those amounts or change beneficiaries. None of this is rational. While barring further funding after an individual first attains college age is certainly not logically required, undermining that limitation one year later is hardly an improvement.

Although nothing in section 530(d)(6) limits beneficiary changes to family members, its apparent purpose is to treat only a change of beneficiaries to a family member as not being a taxable distribution. Annoyingly, no provision of section 530 treats a change of beneficiary to a non-family member as a distribution, which literally renders section 530(d)(6) meaningless. Nevertheless, the implication is clear that, if a non-family member becomes a beneficiary under section (d)(6), the assets of the account will be deemed to be distributed to that individual and thus will be subject both to normal taxation and to the ten percent penalty tax. The failure of Congress to state this is the kind of sloppiness that is routinely overlooked.

In addition to the rules governing changes in beneficiaries and rollover contributions, section 530(d)(7) incorporates the rule of section 220(f)(7) in the event of a divorce. This cross-reference to section 220 is discussed further in the following section. Here it need only be noted that section 220(d)(7) basically allows a change in the beneficiary of an account to a spouse or former spouse. Given that the rules in section 530 generally allow a change in beneficiaries, it is

77 Code section 530(d)(6) allows changing the beneficiary to a "member of the family (as so defined) of the old beneficiary" although family is not defined in that paragraph. Presumably the "so" refers to the definition in paragraph (5), which is the cross-reference to section 529. That would make the expression in paragraph (6) the most casual cross-reference in the Code.
hard to understand what useful purpose is served by this provision. Unfortunately, the presence of this redundant provision creates an irritating ambiguity. This cross-reference was included in the original 1997 version of section 530. That version unintentionally omitted the requirement that the assets of the account be distributed when the beneficiary became thirty years old. When that rule was added the following year, the changes in beneficiary rules were conformed to bar transferring the account to an individual over thirty. However, the cross-reference to section 220 was not similarly amended. Accordingly, the Code on its face permits a transfer of an EIRA account to a spouse over thirty, a drafting error that is paralleled by the provisions governing transfers on death.

g. Death of a Beneficiary. Section 530(b)(1)(E) requires that the balance in an EIRA account be distributed within thirty days following the death of the beneficiary, subject to the provisions of subsection (d)(7). It does not address the question of to whom the balance must be distributed, presumably leaving that issue to be resolved by state law. While the income element of the distribution would be taxable to the distributee, section 530(d)(4)(B)(I) provides that a distribution to the estate of the deceased beneficiary or to a successor beneficiary is not to be subject to the ten percent penalty tax.

This terminal distribution rule will not commonly apply, however, because it is subject to an exception that consumes the rule. Section 530(d)(7) incorporates the rules governing the death of a beneficiary under section 220(f)(8), the section creating medical savings accounts. However, for the purposes of section 530, all of the members of the family of the beneficiary are treated in the same manner as the spouse is treated under section 220(f)(8). Accordingly, applying the facts of an EIRA to the concept contained in section 220(f)(8)(A), the tax exempt status of an EIRA continues after the death of the initial beneficiary and no amount will be treated as distributed, so long as the account agreement specifies a secondary beneficiary who is a member of the broadly defined “family” of the initial beneficiary.

As with the related divorce cross-reference to section 220(f)(7), it is not clear what purpose section 530(d)(7) is intended to serve. The provision is merely a change in beneficiary rule having the same consequence as section 530(d)(6). Indeed, aside from the confusion created by the presence of section 530(d)(7), it would appear that a change in beneficiary pursuant to the terms of the account agreement following the death of the initial beneficiary would be a change in beneficiary governed by section 530(d)(6). Thus, this aspect of section 530(d)(7), like the aspect related to divorce, seems cumulative and unnecessary. Similar to the divorce cross-reference, section 530(d)(7) does not require that the successor beneficiary be under the age of thirty as does section 530(d)(6), thus creating a confusing inconsistency between these two provisions. Whether this omission was deliberate or simply overlooked when the section was corrected in 1998 is

78 I.R.C. § 530(d)(7) (second sentence).
unclear.

As drafted, it appears that an EIRA may be transferred to an individual over the age of thirty upon the divorce or death of the beneficiary. The significance of this ability will be somewhat limited if the EIRA remains subject to the requirement that it be terminated and its assets distributed when its beneficiary becomes thirty years old. However, it simply is not clear whether that provision applies to a successor beneficiary over age thirty. Section 530(b)(1)(E), which requires that the assets be distributed within thirty days of the beneficiary attaining the age of thirty, plainly does not contemplate the possibility of a successor beneficiary over the age of thirty. Moreover, the distribution requirement only applies to the "designated beneficiary" of an EIRA. While that term is not specially defined within section 530, it is only used to apply to the initial beneficiary of the EIRA. Arguably, the distribution-at-age-thirty rule does not apply to successor beneficiaries.

Of course, common sense suggests that Congress could not possibly have intended to allow successor beneficiaries arising under section 530(d)(7) to maintain tax-exempt EIRAs until their deaths while requiring all other beneficiaries, including successor beneficiaries arising under section 530(d)(6), to be under thirty years old. All of this must be just a sloppy failure to amend section 530(d)(7) in 1998. But, can the regulations validly insert a prohibition against over thirty successor beneficiaries under section 530(d)(7)? Or, can they provide that an over-thirty successor beneficiary is permissible but maintain that the EIRA immediately terminates under section 530(b)(1)(E)?

Under the special rule of section (d)(7) governing transfers of the account following the death of the beneficiary, the transferee does not have to be a family member. However, the consequences of transferring the account to a non-family member are not totally clear. The cross-referenced section 220(f)(8) also contains a subparagraph (B) which is included in the cross-reference from section 530. In the case of the death of the holder of a medical expense account, if subparagraph (A) does not apply because the transfer is not to the spouse of the account holder, then the account loses its special status and an amount equal to the value of the assets in the account is includable in the income of the person inheriting the account or, if there is no such person, the final return of the account holder. Plainly that full inclusion rule should have no application to EIRAs. Contributions to medical savings accounts are deductible and thus distributions from these accounts have no basis and are appropriately taxed in full. EIRA contributions are not deductible and for that reason section 530 (d)(1) provides that distributions are taxed only to the extent they consist of accumulated income. Without much doubt, this general rule of section 530(d) applies when EIRA assets are transferred upon the death of the initial beneficiary, and the inclusion of subparagraph (B) was in error. On the other hand, the more general notion in section 220(f)(8)(B) that the transfer of the account to a non-family member of the deceased beneficiary will be treated as a taxable distribution should apply. The cross-reference is faulty but the intended result is fairly clear up to a point.
While the transfer to a non-family member under section (d)(7) must be treated as a taxable distribution, it is not clear whether the distribution is subject to the ten percent penalty. Under section 530(d)(4)(B)(I), distributions are excused from the penalty if they are "made to a beneficiary . . . on or after the death of the designated beneficiary." Nothing in the exception requires that the beneficiary be a member of the family of the designated beneficiary. While it plainly seems wrong to waive the ten percent penalty upon a transfer of the account to a non-family member following the death of the initial beneficiary, this is the literal effect of the exception.79

There is one final reason why a cross-reference to section 220 was ill-advised. The section is a highly restricted, experimental provision80 and there is an excellent chance that it will be repealed sooner rather than later. (Of course, much the same can be said for section 530.) When that occurs, the cross-references to that section will be even harder to follow.

4. Coordination with the Tuition Tax Credits

As noted above, if a student receives a non-taxable distribution from an EIRA in any amount and for any purpose, no tuition tax credits may be claimed with respect to that student either by the student or the student’s parents. To allow an escape from that staggeringly harsh rule, section 530(d)(2)(C) generously allows the student to waive the tax exemption for the EIRA distribution. As long as students include the income portion of the distribution in their gross income, the ability to claim the tuition credits will not be affected. Whether it will be more beneficial for the student to claim the credits or the exemption for the EIRA distribution can only be determined in the year in which the tuition charges are incurred and will depend upon numerous factors as well as current tax law. As a result, at the time that the decision must be made to fund or not fund an EIRA—presumably when the prospective student is an infant, the donor must not only confront the uncertainty that the child will in fact survive and attend college but also face the very considerable uncertainty that it will ever be desirable to elect the tax-free treatment that the EIRA provisions promise. Indeed, even when it will be preferable to take a tax-free EIRA distribution, the value of that benefit will be trivial since it must be offset by the cost of the loss of the tuition tax credits.

To illustrate, it would be optimistic but reasonable to project that, at the time it was needed, an EIRA would have grown to $23,000,81 consisting of contributions of $9,000 and accumulated income of $14,000. For a student in the fifteen

79 The casual cross-reference to section 220 creates other, lesser, interpretive questions. For example, under that section, rollovers can only be to one person—the spouse. Under section 530, all members of the family are eligible transferees. May the assets of an EIRA thus be divided and transferred to multiple successor beneficiaries?
81 One author has calculated that investing $500 per year for eighteen years at ten percent interest would produce a fund equal to $22,800. See Morris, supra note 8, at 900 n.129.
percent federal tax bracket, the maximum tax payable on the distribution of that entire amount, should the section 530 exemption be waived, would be $2,100 (and could be far less). That $2,100, therefore, is the maximum amount of the benefit a student could obtain by using EIRA funds to pay education expenses. However, to obtain that benefit, the student must give up the Hope credit worth $1,500 or a Lifetime credit worth (after 2003) $2,000. Thus, the net benefit from using the EIRA for its intended purpose will generally be $100 or less.

Accordingly, for most families it would not be rational to view the EIRA as a vehicle for accumulating funds that can be passed to a child or grandchild free of tax for the purpose of financing education. This use and treatment of the funds is simply too unlikely to come to pass. Rather, the EIRA rationally can only be viewed as a vehicle for making a tax deferred investment that is to pass to the next generation. From this perspective, it is not very useful but it certainly is odd.

B. The Tuition Tax Credits

While section 530 was intended to encourage the accumulation of savings that would facilitate paying the costs of higher education, the tax credits extended by section 25A were intended to reduce the costs of that education by passing a portion of its cost along to the federal treasury. Because political posturing prevailed over rational drafting, section 25A actually consists of two different credits having significantly different benefits and conditions. The Hope credit is a very high percentage credit but is only available to apply against a relatively small amount of expense incurred within the first two years of higher education. For this reason it is thought to be directed at students attending relatively inexpensive two year junior colleges. The Lifetime credit is a lower percentage credit but is available against much larger expenses and can be claimed annually. The Lifetime credit is thus thought to be aimed at students attending private, four-year colleges.

On January 6, 1999, the Treasury issued proposed regulations under section 25A. As a result, the opportunity exists to examine the effect of poor statutory drafting upon the regulatory process. In the case of the tuition tax credit regulations, the effect was fairly dramatic. The burden of a badly constructed statutory provision falls first on those charged with drafting the regulations that explain and interpret those provisions. One might suppose that an irritated Treasury Department would be sorely tempted to issue regulations that apply the statute quite literally, thereby granting taxpayers an unfiltered glimpse of the legislative process. Generally, that has not occurred. Rather, the Treasury seems to have attempted to convert even the most ill-conceived statutory language into a workable pattern. Aggressive regulation drafting, however, carries with it significant risks that are well illustrated by the tuition tax credit regulations.

82 Of course, if other children exhaust the credit ceilings, the EIRA may be of value but, again, all of that must be predicted when the student is an infant.
The presence of two distinct credits in section 25A is a monument to the ineptitude of the congressional leadership at the time they were enacted. The existence of two credits having different eligibility requirements and benefits that are available only in the alternative not only complicates the Code but also greatly complicates tax planning to maximize the benefit of these credits, as the following examination illustrates.83

1. Election

One of the very worst of all drafting techniques is to make a Code section elective when virtually all taxpayers would want the section to apply but quite a number will lack the assistance of sophisticated tax counsel. Such a provision creates a trap not just for the unwary, and is calculated to deny the tax benefit to multitudes of deserving taxpayers. We have plenty of experience in this regard84 so it is quite amazing to find that section 25A is elective. Subsection (e)(1) quite simply but most regrettably provides that no credit shall be allowed unless the taxpayer elects to have the section apply.

Unfortunately, sloppy drafting of the provisions granting the individual credits creates an utterly needless ambiguity with respect to this election. The grant of the Hope Credit under subsection (b) properly (given subsection (e)) limits the credit to students “for whom an election is in effect.” The grant of the Lifetime Credit under subsection (c), however, makes no reference to the election at all. Consistently with other credits granted under the Code, the Lifetime credit simply is granted in an amount equal to a fraction of the eligible expenses. As a result, subsection (c) is inconsistent with subsections (b) and (e) and that inconsistency unavoidably raises the question of whether an election is in fact required in order to obtain the Lifetime credit. The lack of parallelism in the drafting of these sections is inexcusable.

The proposed regulations assume that the requirement of an election applies to both credits. However, presumably in recognition of the pointlessness of the election, the regulations also essentially eliminate the requirement. In practice neither credit could be claimed without the preparation of the appropriate form and, under Proposed Regulation section 1.25A-1(d), the filing of Form 8863 is treated as the making of whatever election is required. The form itself avoids unnecessary confusion by not mentioning elections at all.

As a result of this proposed regulation, the only effect that the election requirement might have would be to bar the claiming of the credit through the

83A joint report of the American Bar Association, the Tax Executives Institute and the American Institute of CPAs listed ending the multiplicity of tax benefits for education as one of the ten best ways to simplify the Code. See Ryan, J. Donmayer, Tax Professionals Unite in Urging Congress to Simplify Code, 86 TAX NOTES (T A) 1185 (Feb. 28, 2000).

84Perhaps the most extreme example of the pointless election was contained in section 1244 which treats certain losses on dispositions of stock as ordinary rather than capital. Prior to 1978, countless taxpayers lost the benefits of this section because of the failure to make the then-required advance election.

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filing of an amended return on the ground that the credit had not been properly
elected. Given the complexity of the tax credits, that interpretation would be
both unnecessary and unfortunate. The Service, however, has a longstanding
institutional aversion to the possibility of retroactive tax planning and thus tends
to resist the making of elections on amended returns. Accordingly, the proposed
regulations require that Form 8863 be filed along with a timely income tax
return for the year for which the credits are claimed. Because the claiming of
tuition tax credits hardly constitutes retroactive tax planning, the rule was need­
lessly harsh and misguided. Fortunately, it did not survive for long; in a notice
issued just six months after the regulations were proposed, the Service an­
nounced that the final regulations would permit the claiming of the credits by an
amended return.85 With that announcement, no significance remains in the elec­
tion requirement of subsection (e)(1). None of this would be necessary, of course,
if the election requirement had not been foolishly inserted in section 25A.

2. Availability.

a. The Hope Credit. The availability of the Hope credit is limited by a fairly
lengthy and complex set of restrictions that are vague, redundant, and probably
misdrafted. Under the structure of the Code, the student must be an “eligible
student" and must also meet an additional series of requirements that do not
all fit together. The regulations rework this structure by treating most of the
conditions for obtaining the Hope credit as part of the definition of an “eligible
student." The difference appears to be largely semantic rather than substantive
but does somewhat confuse the discussion. The inconsistency between the stat­
ute and the regulations also creates confusion when other sections, like section
221, cross-reference the section 25A definition of an eligible student. Is the
reference to the statutory or the regulatory version of the eligible student defini­
tion?

“Eligible student” is defined by section 25A(b)(3) as one who meets the
requirements of section 1091(a)(1) of U.S.C. Title 20 and carries at least one­
half the normal course load. There are two aspects of the cross-reference to Title
20. The regulations accurately translate the first aspect into a so-called “degree
requirement” that an eligible student must be enrolled in a program that leads to
a “recognized post-secondary educational credential,” which they quite under­
standably do not further define.89 The second aspect of the cross-reference is
that the enrolling institution must be an “eligible” institution within the meaning
of section 1094 of Title 20. At first glance, this might seem to be, at worst, an
unnecessary duplication of the requirement contained in section 25A(f) that
creditable expenses be incurred at an “eligible” educational institution. Unfortu-

87I.R.C. § 25A(b)(2).
nately, however, the subsection (f) eligible institution is defined by a cross-reference to 20 U.S.C. section 1088, not section 1094. To make matters worse, section 1088 has been repealed but its substance has been reenacted in sections 1001 and 1002! Unraveling these complex cross-references further is not profitable here for the point is made. Without a doubt, cross-references to non-tax law, which seem to strain the abilities of the policy-makers, greatly complicate the task of tax advisors and ought to be avoided whenever possible. At the very least, the cross-references should be to the same provisions of the non-tax law!90

Congress’ general intent with respect to the availability of the Hope credit was quite clearly expressed in the committee reports. The credit was to be made applicable to the tuition and related expenses “incurred during a student’s first two years of attendance (on at least a half-time basis) at a college . . . .”91 While that simple objective should have been easy to translate into statutory language, it did not quite work out that way. The difficulty apparently stems from the combination of the unfortunate decision to use two distinct credits and the fact that academic years do not correspond to taxable (i.e., calendar) years.

To execute its general intent, Congress adopted the following three rules, in addition to the requirement that the student be “eligible:”

1. The credit may only be claimed in two taxable years. I.R.C. 25A(b)(2)(A).
2. The student must be an eligible student during one academic period which begins during the year for which a credit is claimed. I.R.C. 25A(b)(2)(B).
3. The credit may not be claimed if the student had completed “the first 2 years of post-secondary education” before the beginning of the year. I.R.C. 25A(b)(2)(C).

Because the first two years of either a two-year or a four-year college normally fall within three taxable years, rule number one would seem to bar claiming a Hope credit for the spring semester of the second academic year if the credit had been claimed for the first semester of the first year and again for the spring and fall semesters of the following year. A student might consider pre-paying the costs of the spring semester but that avenue of tax manipulation would seem to be barred by the basic rule of section 25A(b)(1)(A), that the credit is extended for the costs of education “paid . . . during the taxable year (for education furnished . . . during any academic period beginning in such taxable year) . . . .” This language would seem to plainly block any attempt to manipulate the system through prepayments. Unfortunately, it produces the undesirable result of barring the Hope credit for the fourth semester of college. However, section 25A(g)(4), somewhat astonishingly in light of the quoted language, provides that if an academic period begins before the end of March, then

90Here the cross-reference seems oddly appropriate. Section 25A is fundamentally a part of our national educational policy and ought to have been brought to life as a grant program administered by a wholly different branch of government and should not be cluttering up Title 26 at all.
it is treated as if it began during the prior year! As a result, if the student is willing and able to prepay the costs of the spring semester of the second academic year during the fall semester of that academic year, the Hope credit can be claimed for those costs. Ultimately the Code seems to achieve the right answer, but the section is so poorly structured that it requires a rather silly legal fiction to produce the correct result.

Using the prepayment device might accomplish little if it brought the costs of three college semesters into a single taxable year. At most colleges, the eligible costs for just two semesters would exceed the $2000 of expenses that can be taken into account for the Hope credit and the prepayment would accomplish nothing. To counter this result and maximize the claimable credit, the student must prepay the costs of the spring semester of the first academic year during the fall semester of the first year. In other words, students must learn to manipulate their financial affairs in order to minimize their income tax liabilities during their first semester in college. Evidently it is never too early to teach tax avoidance planning. From the students' perspectives, the benefit of that manipulation will be offset by the cost of needlessly (except for tax purposes) accelerating the payment of educational expenses.

Contrary to what might be expected, the Hope credit can be claimed for expenses incurred while the student is not "eligible" (i.e., carrying a one-half load and pursuing a recognized credential). Rule two only requires that a student be an eligible student during one quarter or semester during the year. If that test is met, a credit may be claimed for all eligible expenses paid during that year—including expenses paid for other academic periods during that taxable year when the student was not "eligible." Thus, as long as a student is carrying a one-half load towards a recognized credential during one academic period, the Hope credit may be claimed for tuition or related expenses incurred in other academic periods during that taxable year even though the student is not carrying a one-half load or is not enrolled in any program.

Similarly contrary to expectations, a Hope credit may be claimed for expenses incurred during the third academic year. Under rule three the credit is no longer available only if the student had completed the first two years of college education before the beginning of the taxable year. Normally a student will not have completed two years of college by January 1st of the second academic year. In that event, if the student can claim a Hope credit for any tuition during that year, all tuition incurred during that year, including tuition for the first semester of the third academic year, is creditable. However, this reach of the credit is not discussed in the committee reports and it is hard to know whether it is a calculated or accidental consequence of the statutory design. Of course, it will commonly be the case that, in this third taxable year, the student will not be able to claim any Hope credit at all because the credit will have been claimed and thus ex-
hausted during the two preceding taxable years.

The drafting of this relatively simple limitation not only produces surprising and possibly unintended results, but also requires a distressing amount of tax planning by persons who should not be required to engage in tax planning at all. To illustrate the planning complexity these rules create, assume that Student A enters college in August 2001, and proceeds to carry a full course load. For the year 2001, the student may claim a Hope credit for just the fall semester of 2001 or, by engaging in a prepayment, for two semesters. Or, the student may fail to claim the Hope credit in 2001 and claim instead the Lifetime credit. While the Lifetime credit for 2001 would likely be less than the Hope credit for that year, this approach would preserve the availability of the Hope credit for expenses paid in 2003. This might be desirable, for example, if the Lifetime credit, while available in 2001, would be consumed by the expenses of other siblings in 2003.

The more attractive option normally will be to prepay the expenses of the spring 2002 semester and claim a credit in the year 2001 for the expenses of two semesters. This approach accelerates the benefit of the credits. However, pursuing this approach entails a real economic cost. It requires the student to accelerate the payment of tuition, not only for the spring semester of 2002 but also for the spring semester of 2003. In many cases, that in turn will require the acceleration of the need to borrow money to finance those accelerated payments. All of this decision-making is completely inappropriate for a tax credit that has an objective as simple as does the Hope credit.

Because the requirements directed at the student who may claim a credit are separate from the requirements that are directed at the courses for which a credit may be claimed, the connection, if any, between these sets of requirements is left unclear in both the statute and the proposed regulations. Thus, while it is clear that the student must be enrolled in a program leading to a credential, there does not seem to be any requirement that the classes for which such a student claims a credit must be taken in that program. While the classes must be taken at an eligible institution, there does not appear to be any required connection between those classes and the student’s program. For example, a student enrolled in a degree program with a major in history at State College A might take a class in computer programming at the local Community College B just for fun. State College A does not give the student any academic credit for the course. May the cost nevertheless be credited? Nothing appears to bar that result and, in fact, section 25A(f)(1)(C), which bars a credit for courses involving sports or hobbies unless the course is part of the student’s degree program, implies that the credit may be claimed. The rule seems to assume that the cost of courses that are not a part of the student’s degree program, like the cost of the computer programming course, are creditable subject only to the exception the rule creates. It might have made more sense to limit the Hope credit to the costs of courses that are creditable toward the credential that makes the student “eligible.”

b. The Lifetime Credit. In contrast to the detailed limitations on eligibility for
the Hope credit, section 25A contains virtually nothing that describes eligibility for the Lifetime credit and this omission creates substantial ambiguity. One omission, however, was quite deliberate. The Lifetime credit lacks all of the time constraints of the Hope credit and may be claimed in any year in which the taxpayer has eligible expenses without any limit on the number of years in which the credit can be claimed.

On the other hand, the Lifetime credit is not limited to "eligible students" and does not impose any other similar requirement. Accordingly, it appears from the face of the statute that the student does not have to carry any minimum course load and does not have to be enrolled in a program leading to a recognized "credential." While it is quite clear that the statute does not limit the Lifetime credit to "eligible students," doubt concerning the scope of eligibility for that credit is created by section 25A(c)(2)(B). Subparagraph B expressly provides that for the purposes of the Lifetime credit, creditable tuition expenses include the cost of courses taken "to acquire or improve job skills." Because no part of the definition of the Lifetime credit would exclude those expenses, it is somewhat unclear why Congress thought it necessary to insert this provision.

Language in the Conference Committee report suggests, however, that Congress had in mind more limitations on the availability of the Lifetime credit than are present in the statutory language. Thus, at one point the report suggests that the credit would only be available to an "eligible student" while at another point the report indicates that the credit is limited to the expenses of either "a student who attends classes on at least a half-time basis as part of a degree or certificate program" or a student seeking to improve job skills.

While none of this is reflected in the statute, the statements in the committee reports might be regarded as providing a sufficient basis for a regulation extending the eligible student requirement of the Hope credit to the Lifetime credit. Unpredictably, however, the regulations take a different approach. The proposed regulations do not seek to apply the "eligible student" requirements to the Lifetime credit. However, Proposed Regulation section 1.25A-4(c) does provide that the Lifetime credit is available either for courses taken as "part of a post-secondary degree program" or for courses that improve job skills—but not otherwise.

For present purposes, there are two significant aspects of this regulation. First, one obvious inference from the very existence of this regulation is that the Treasury concluded that the statute as written and enacted either did not make sense or plainly did not reflect the intention of its congressional drafters. Accordingly, the Treasury searched for some basis for imposing a limitation on the unconstrained statutory language and found that basis in the language of the committee reports.

Secondly, in adopting a limitation, the Treasury chose not to follow either the statute or the committee report but rather created a new, and probably indefe-

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90 Conference Report, supra note 11, at 346.
91 Id. at 347.
sible, limitation. The proposed regulations do not contain the requirement mentioned in the committee reports, that the student be at least a one-half time student. The regulations do, however, pick up from the reports the requirement that the course be “part of a post-secondary degree program” although the committee reports used the broader reference to “degree or certificate programs.” Presumably, the requirement in the regulations is intended to be markedly narrower than the very liberal requirement for the Hope credit that the classes be in a program leading to a “recognized credential.” While it is possible that this regulation was simply misdrafted and will be corrected in the final version to parallel the eligible student requirement, the regulation also reflects one consequence of an inconsistency between the statute and the committee report. While the report may undermine the authority of the statute, the report contributes little, if any, authority of its own. Thus, the inconsistent report (or, more precisely, the poorly drafted statute) broadens the scope of the discretion of the Treasury to adopt requirements of its own choosing.

While the proposed regulations under the Lifetime credit are thus more restrictive than either the statute or the committee reports would justify, they are also irritatingly vague. While the Hope credit clearly requires that the student be enrolled in a program leading towards degree or other credential, the regulations under the Lifetime credit only require that the course be part of a degree program.\footnote{Prop. Reg. § 1.25A-4(c)(1), 64 Fed. Reg. 794 (1999).} They do not seem to require that the student be enrolled in that program; only that the course be offered in such a program.

c. Drug Use. A Hope credit may not be claimed for a student who has been convicted of a felony under either state or federal law involving the possession or distribution of a controlled substance prior to the end of the year for which the credit is claimed.\footnote{I.R.C. § 25A(b)(2)(D).} Oddly, no such requirement applies to the Lifetime credit. Needless to say, Congress did not explain why it had adopted a strict “no drugs” policy for a credit targeted at community college students but not for a credit targeted at the Ivy Leagues. In fact, it did not explain why facilitating the education of an individual with a history of drug abuse would be a bad policy. Nor, in fact, did it explain why serial murderers remained free to claim the credit. For purposes of this discussion, the point is that this sort of random micro-management just complicates and undermines the rationality of the Code without really furthering any legitimate goal.

3. Maximum Allowable Credit.

a. Nature of the Credit. Several different rules affect the maximum amount of the tuition tax credit that may be claimed. Initially, the Hope credit is a per student credit while the Lifetime credit is a per taxpayer credit. When the student is self-supporting, and claiming a credit for his or her own expenses, this distinction is of no significance. However, when the student is a dependent child...
and the taxpayer claiming the credit is the parent, the distinction is quite significant. The Hope credit operates in the familiar way—much like the personal exemption. The taxpayer is entitled to claim the full credit allowable for each student supported. Thus, the proud but tired parents of seven college freshmen would be entitled to seven Hope credits. Under this traditional approach to tax allowances, the amount of the credit allowable is not affected by the identity of the taxpayer claiming the credit. The same credit is available whether the student is entitled to claim the credit or the student’s parents claim the credit. Similarly, it does not matter when the children decide to attend college; the same credit is available whether all seven children attend college in the same year or one at a time over seven years. As a result, this traditional form of credit does not lend itself to manipulation nor require sophisticated tax planning to maximize its benefits.

The Lifetime credit is different. It is a per taxpayer credit, although it might be better described as a per family credit. Under this approach, on a given Form 1040, a taxpayer cannot claim more than the maximum allowable credit regardless of the number of students that generate eligible expenditures. Moreover, excess credits generated in one year do not carry over and thus may not be claimed in any other year. Unlike the structure of the Hope credit, this limitation on claiming the Lifetime credit plainly encourages and rewards tax planning that may run counter to the purpose of the section.

Quite plainly, the total amount of credits available may be sharply reduced if all children in the family attend college in the same year. Thus, families who have children close together in age will not fare as well under this credit as families that are more spread out—unless the timing of their education can be altered. If, for example, the second child can be induced to delay education until the first child graduates (normally an undesirable result for both the individual and the economy), the credit will be maximized. Second, since the Lifetime credit has a relatively low annual ceiling but can be claimed in an unlimited number of years, the amount of the credit can be maximized by spreading education over a larger number of years by pursuing a degree on a part-time rather than a full-time basis. In short, the design of the Lifetime credit has the effect of discouraging, rather than encouraging, education!

Third, the Lifetime credit can be maximized by increasing the number of families entitled to claim the credit. Thus, if the Lifetime credit available to the parent is exhausted by other children, a credit can nevertheless be claimed if an older child with some income to absorb the credit were to “become” self-supporting and thus entitled to claim the credit on his or her own Form 1040. This complex issue of who is entitled to claim these credits is considered below.97

Here, the point is simply that the manner in which a ceiling was imposed upon the Lifetime credit brings with it a number of negative consequences. The credit can be maximized through tax planning that is often inconsistent with sound educational decisions. Taxpayers who are unable or unwilling to engage in this

97See text accompanying infra notes 112-29.
tax planning may not obtain the same credit as their more tax-conscious neighbors, although their educational expenses may be identical. Thus, the operation of the credit will tend to undermine the horizontal equity of the tax system.

b. **Dollar Limitation.** The drafting of the dollar ceiling on the Hope credit is an extraordinary exercise in gobbledygook. Under section 25A(b)(1)(A), the Hope credit is the sum of (a) a generous one hundred percent of the qualifying expenses up to $1,000, plus (b) fifty percent of qualifying expenses in excess of $1,000 but less than "the applicable limit." Under section 25A(b)(4), the applicable limit is twice the amount in effect under paragraph (1)(A). That amount, of course, is $1,000. Twice that amount is $2,000, which is the applicable limit. That "limit" exceeds $1,000 by $1,000. Fifty percent of that amount is $500. This is a particularly convoluted way of expressing the dollar ceiling on the Hope credit. In any event, after tracing through this truly absurd language, the maximum allowable credit turns out to be $1,500 and that is available if the student has eligible expenses of at least $2,000 for the year. Thus, every student with annual higher education expenses of at least $2,000 will be entitled to a total of two $1,500 Hope credits for a total of $3,000.

The Lifetime credit is equal to twenty percent of the eligible expenses, up to an annual maximum of $5,000. Because the resulting maximum credit of $1,000 is less than the amount of the Hope credit, taxpayers will assume that, whenever possible, the Hope credit should be claimed in preference to the Lifetime. However, that strategy may not maximize the credit if the eligible expenses in the first year of higher education are less than $2,000. Beginning in 2003, the maximum expense eligible for the Lifetime credit is scheduled to increase to $10,000, thus increasing the maximum credit to $2,000. Should this change come into effect, the relationship between the Hope and Lifetime credits becomes even more complex. For a single student, the Lifetime credit potentially would be larger than the Hope credit but only if the student had education expenses of at least $7,500 (20 percent of $7,500, or $1,500). For a taxpayer supporting two or more students, the Lifetime credit with its annual credit limitation of $2,000 would never be as favorable as claiming multiple Hope credits, each of which could equal $1,500. However, the overall credit may be maximized if the Hope credit is claimed for some children and the Lifetime credit is claimed for others. While under section 25A(c)(2)(A) a Hope credit and a Lifetime credit cannot be claimed in the same year for the same student, the provision does not bar a taxpayer from claiming both the Hope and Lifetime credits so long as the credits are claimed for different students.

Since the Hope credit reimburses a generous one hundred percent of a portion of the education costs, the credit is referred to as the "Hope Scholarship" credit, but this is misleading. Like most credits, neither of the tuition tax credits are refundable. In the case of the Hope Scholarship, the limitation means that,

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98 I.R.C. § 25A(c)(1).
unless in the year in which the education expenses are paid the taxpayer has an income tax liability of at least $1,500, the student will not be able to claim the full amount of the credit, and he or she will have lost his or her scholarship. The ultimate fairness and rationality of this approach is obviously debatable but parallels the normal consequence of pursuing non-tax social policies through the income tax laws.

4. Eligible Expenses

Both credits allow a credit for the “qualified tuition and related expenses” defined in section 25A(f)(1). Like the EIRA rules, these expenses must be incurred at an eligible educational institution, which is defined by the same cross-reference to an obsolete section of Title 20.100 However, unlike the EIRA rules, the definition of creditable expenses in section 25A is not all-inclusive. In fact, it is annoyingly narrow; but just how narrow it is remains to be seen. Here, again, the apparent statutory requirement is simply unsound and is not followed in the proposed regulations.

Under section 25A(f)(1)(A), only the costs of tuition and “fees required for the enrollment or attendance” of the student are eligible for the credit. The committee reports make clear that the cost of books is not creditable.101 Supplies and equipment are not mentioned but presumably are to be treated in the same manner as books. The costs of room and board are clearly excluded. The drafter of the proposed regulations, however, felt otherwise. Under section 1.25A-2(d) of the proposed regulations, a credit is allowable for “fees” for “books, supplies and equipment,” provided the “fee” is paid to the educational institution. The examples under this regulation make clear that if the educational institution monopolizes the provision of books and supplies by requiring that they be purchased from the institution, the costs are creditable.102 However, if the source of supplies is opened to competition and does not require that purchases be made from the institution, the cost of the books and supplies is not creditable. Although the examples are infuriatingly unclear, presumably purchases from a college bookstore are treated as purchases from the educational institution and are creditable if required.103 It is difficult to believe that a Republican Congress intended this result, but it is only marginally less rational than the complete disallowance of any credit for the costs of required books, which it did seem to intend.

Under section 25A(f)(1)(A), creditable expenses include tuition and fees required for enrollment or attendance. However, under subparagraph (C), the term “does not include . . . student activities fees . . . unrelated to an individual’s

110 Conference Report, supra note 11, at 346.

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academic course of instruction." This limitation is designed only to limit the availability of the credit to students attending less expensive schools. For students attending the more expensive schools in which the cost of tuition alone will exceed the limitations on the amount of the expenses that are creditable, such limitations are of no significance.

This limitation again illustrates the increasing congressional tendency to unduly complicate tax law provisions through micro-management. This tendency becomes particularly obnoxious when the micro-management takes the form of the insertion of ill-considered, hair-splitting and generally pointless provisions, as seen here. The fees in question are not voluntary. From the perspective of the student they are indistinguishable from tuition: if they are not paid, one is no longer enrolled. Moreover, there is often no meaningful distinction between academic and non-academic fees. Like banks and telephone companies, colleges have discovered that their charges appear smaller if they are broken down into relatively arbitrary components. Treating those components differently, however, is foolish. Where the treatment of these fees is relevant to the student (i.e., at low cost institutions), the only thing that this legislation would accomplish would be to require a re-bundling of educational charges. Presumably, as long as all required charges are billed under the single heading "tuition," all are creditable.

Interestingly, the drafters of the proposed regulations seem to agree that the subparagraph (C) exception is both pointless and unenforceable because the regulations generally ignore it. Under section 25A-2(d)(2)(iii) and (6) (example 3), the payment of all fees, even separately stated student activities and athletic fees, is creditable if the payment is required for enrollment. That is, fees for non-academic purposes are not creditable only if they are voluntary. Since voluntary fees would not be creditable under the general rule of section 25A(f)(1)(A), the regulations effectively ignore the subparagraph (C) exception. Without a doubt, the rule contained within the proposed regulations is far more rational than the rule adopted by Congress. Nevertheless, it is difficult to see how a regulation so inconsistent with a statute might be thought valid.

5. Third Party Payments

Creditable expenses are reduced by the amount of the various types of tax-free receipts enumerated in section 25A(g)(2), namely: (a) tax-exempt scholarships, (b) educational assistance provided to present or past members of the armed forces, and (c) any other payment for the student's education that is not taxable to the student, other than payments that constitute gifts or bequests. The regulations specifically identify only employer-provided assistance under section 127 as falling with the scope of subsection (c). The philosophy resting behind these exclusions is not entirely clear. However, elsewhere in the structure of these educational assistance provisions Congress has adopted the principle

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that a student is limited to a single tax benefit: the Hope credit or the Lifetime credit or an EIRA distribution. Section 25A(g)(2) is perhaps best viewed as extending that concept to the section 117 exemption for scholarships and related tax-exempt receipts.

While in theory this exclusion from the credit seems sensible, the very generosity of the credits creates an unhappy clash with the various exclusions listed in subsection (g)(2). The problem is that the tax benefit from the credits may be more valuable than the tax benefit of these other exclusions from income. As a result, a student might very well be worse off if he or she received a tax-free scholarship than if he or she received a taxable receipt which was used to pay the educational expense. For the tax system to penalize the receipt of a scholarship through the application of a provision designed to defray the costs of education would be truly absurd. Consider, for example, the extreme case of a first-year college student with a tuition bill of $1,000. If she accepts a $1,000 scholarship from the local Rotary Club, she will have no income but no tax credit. On the other hand, if the receipt were taxable and the student were in the fifteen percent bracket, she might owe a tax of $150. However, she would now be entitled to a tax credit of $1,000 which would offset her income tax liability on the entire $5,667 she earned over the summer. Put differently, she would be $850 better off if she had received taxable income rather than a tax-exempt scholarship. That, unquestionably, is a heavy price to pay for being the most likely to succeed in her high school class! This problem is not unique to the education credits; it occurs whenever the credit rate is higher than the taxpayer's marginal income tax rate. However, the one-hundred percent Hope credit is by far the most generous credit in the Code and is the most extreme example of the phenomenon.

The adverse, and apparently unanticipated, impact of section 25A(g)(2) upon the receipt of a scholarship was immediately recognized by taxpayers who responded by somewhat bizarrely requesting permission from the Treasury to include the amount of an otherwise tax-exempt scholarship in income. This request created a conundrum. Section 117, which exempts certain scholarships from tax, is not on its face elective and neither are any of the other exemption sections of the Code. It would be extremely unwise for the Treasury to start down the road of allowing taxpayers to treat mandatory tax rules as if they were elective. That caution would seem particularly relevant to an exemption from tax. The only reason that a taxpayer would prefer to waive an exemption is because the taxpayer has found a way to be better off than he or she would be with a taxable receipt—a situation sufficiently suspicious to require close, case-by-case scrutiny.105

105 For example, should a taxpayer be entitled to report as income otherwise nontaxable receipts such as employee discounts in order to obtain an increased earned income tax credit? See Powers v. Commissioner, 79 T.C.M. (CCH) 1287, T.C.M. (RIA) 2000-005, affirmed, 2000-2 U.S.T.C. ¶ 50,838, 86 A.F.T.R.2d 6809 (6th Cir. 2000).
The principle argument for including a scholarship in income turned on the requirement in section 117(b) that the student "establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses."\(^{106}\) It was suggested that if the student declined to make the required demonstration, the exclusion would not apply and the scholarship would become taxable, and the credit would thus not be reduced. This argument, however, had the effect of converting a shield designed to retard taxpayer abuse into a sword that allowed taxpayers to elect out of section 117 should it serve their interests. It would be more consistent with the purpose of section 117(b) to view the required demonstration as waivable by the Service than to view the general rule of section 117 as waivable by taxpayers.

On the other hand, the foolishness of the result adopted by Congress cried out for relief. Penalizing scholarship recipients did not seem acceptable. In the regulations proposed to date, the Treasury has attempted to resolve this conflict by developing techniques for causing what otherwise would be treated as scholarship to become taxable without expressly treating section 117 as elective. Section 1.25A-5(c)(3) of the proposed regulations walks this tightrope in two different ways. The first approach, while apparently rejecting the elective argument based upon section 117(b), provides a roadmap to a comparable result. Under section 117, only amounts used for the payment of tuition and certain specified related expenses are exempt from tax. The proposed regulations under section 25A provide that if a third party payment "must be applied, by its terms, to the discharge of expenses other than tuition or related expenses, the payment will not be regarded as a tax exempt scholarship and thus will not reduce the amount of expenses for which the credit may be claimed."\(^{107}\)

The written statement required by the regulations, however, carries with it a significant burden. While the grant requirement may preserve the credit, it also serves to convert what would have been a tax-free scholarship into a taxable receipt. This conversion will not always be beneficial to the taxpayer. Accordingly, in practice this condition will not be inserted into a scholarship grant in the absence of the agreement of the grantee to the proviso. That is, the regulation requires the grantors of scholarships to collude with grantees to manipulate the tax consequences of the grant.

Second, and more interestingly, the proposed regulations provide that the creditable amount of education expenses does not have to be reduced if "the student reports the grant as income on the student’s federal income tax return."\(^{108}\) That sentence in the regulations is not further explained although its meaning is obviously obscure. While the quoted language might be read as referring only to amounts included in income as the taxpayer is required to do under the Code, it can also be read as suggesting that a student might elect to

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\(^{106}\)I.R.C. § 117(b)(1).
report an otherwise excludable scholarship in income. The latter reading, of course, would require treating the section 117 exclusion as if it were fully elective, although nothing in the proposed regulations or in section 117 itself suggests that the Treasury has reached that problematic conclusion.

Allowing students to omit reducing the amount of creditable expenses by the amount of a scholarship that has been electively included in income is inconsistent with the spirit, if not the letter, of section 25A(g)(2). This provision requires reducing the amount eligible for the credit, not by the amount of any scholarship that is actually excluded from income, but by the amount of any scholarship that is excludable from gross income. What that means is that, if a scholarship could have been excluded from income, it causes a reduction in creditable expenses regardless of whether the taxpayer elected to exclude the award. In other words, even if section 117 is treated as elective, this should not have the effect given by the proposed regulations.

If the proposed regulations were read as treating section 117 as elective, the Treasury will have created a series of headaches for itself. The first problem will be defining the scope of the elective treatment of section 117. In circumstances outside section 25A, deriving taxable income can be more valuable than deriving tax-exempt income. Taxable income allows the claiming of losses and increases entitlement to certain credits such as the earned income credit. Could the scholarship exclusion be waived by taxpayers for those purposes as well? Similarly, section 25A(g)(2) is applied by cross-reference from each of the other education assistance provisions, the EIRA and the deduction of interest on education loans. If section 117 is elective for the purposes of the tuition credits, is it also elective for the purposes of these related provisions?

In addition, allowing scholarships to be brought into taxable income will require the Treasury to address one of the stickier questions in taxation: the difference between gaining income and incurring less of a loss. When the educational institution itself grants a scholarship, from the perspective of the student it appears as a reduction of the charge for tuition. If section 117 is elective, can the amount of that tuition remission be treated as income as well? Creating a context in which such a question must arise seems most unwise.

One of the kinds of tax-exempt receipts that presumably would reduce creditable education expenses would be a distribution from an EIRA. However, to underscore the fact that Congress did not intend to allow a tax credit for educational expenses paid by an EIRA, section 25A(e)(2) provides that the election to claim a section 25A credit for a student shall not be effective if any portion of an EIRA distribution to that student is excluded from income. While the policy underlying this provision of barring duplicate tax benefits is similar to that of section 25A(g)(2), the EIRA rule is indefensibly excessive and may also reflect a poor policy decision.

At this point, let us recall two aspects of the EIRA rules. First, the maximum portion of an EIRA distribution that can be included in income is the portion attributable to the accumulated income of the EIRA account. This proportion may be large or it may be a very small fraction of the distribution. Second, the
range of expenses that may be paid by an EIRA without loss of the tax exemption is far broader than the expenses for which a section 25A credit may be claimed. To illustrate the irrational harshness of the combination of these rules and section 25A(e)(2), imagine an EIRA with an unsuccessful investment policy: its assets of $10,000 include contributions of $9,000 and accumulated income of $1,000. The EIRA makes a distribution of $100 to its beneficiary to help pay the cost of a room in the college dormitory. The student pays all other costs of this first year of college from his personal savings, including tuition of $2,000. The EIRA distribution is deemed to include income of $10, the tax on which in the 15 percent bracket would have been $1.50. Because of that tax savings, however, no one may claim an education tax credit for the student for this year. Thus the $1,500 tax savings benefit of the Hope credit is lost because of a $1.50 tax benefit from an EIRA. This surprising result is not at all affected by the fact that the EIRA distribution is used entirely to pay expenses for which a tuition credit cannot be claimed. There is no justification for this extreme result. By contrast, the entitlement to a deduction for interest on an education loan is reduced by the amount of any EIRA distribution but is not lost by the receipt of a tax-free distribution.

Even in the original legislation Congress recognized that section 25A(e)(2) was too crude and provided an alternative approach to coordinating the EIRA with the tuition tax credit. As considered above, under section 530(d)(2)(C) the beneficiary of an EIRA may waive the tax exemption provided by that section and include the amount of distributed income in taxable income. In this event, the claiming of a section 25A credit will not be barred by the EIRA distribution. This alternative solution would satisfactorily resolve the problem in the example—so long as the student was sufficiently well-advised to know that he must give up the tax benefit from the EIRA that his parents established for him fifteen years earlier!

6. Phase-outs

Like the EIRA, the education credits are subject to a phase-out that limits their benefit to relatively low-income taxpayers. The phase-out range of the EIRA on a joint return, it will be recalled, is a relatively generous (and relatively unenforceable) $150,000 to $160,000 with a significant marriage penalty. For the tax credits, the phase-out is strikingly and inexplicably different. The phase-out commences at a much lower income level, $80,000 on a joint return, and proceeds somewhat more gradually. The credit is not entirely lost until income reaches $100,000. There is no marriage penalty built into the tax credit. On single returns, the phase-out range is exactly one-half the joint return range, from $40,000 to $50,000.

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110 I.R.C. § 221(e)(2)(A); see text accompanying infra notes 151-52.
The phase-out is, of course, applied to the taxpayers upon whose tax return the credit is claimed. For most students, that will be the parent who is financing the major portion of the education. When this is the case, this phase-out will have a real sting. A substantial number of taxpayers old enough to have one or more children in college will encounter the $40,000 or $80,000 threshold and will lose all or part of the credit. The loss of the credit can be avoided if the credit can be passed from the parent to the student, who will be far less likely to have a level of income that places him or her within the phase-out range. In some circumstances, it will indeed be possible to shift the credit to the student and that possibility, of course, further complicates the tax planning for the use of credits. However, the question of who can claim the education credits raises one of the least satisfactory features of section 25A.

7. Who Can Claim Credits?

The question of who is entitled to claim the education tax credits seems particularly ill-considered. The initial complicating factor is that in most cases, both the parents and the student make some contribution to the costs of higher education so that both would have a claim of entitlement to the credit. There are several aspects to the rather odd solution apparently adopted by Congress and its unappetizing modification in the proposed regulations.

a. Relationship. One of the more odd, but not terribly significant, features of the EIRA provisions is the absence of any required relationship between the contributor and the beneficiary. This omission creates a number of ambiguities explored above. In contrast, the tax credit rules do contain such a limitation, but one that creates its own ambiguities and peculiarities. Under section 25A(f)(1)(A), a taxpayer may claim a credit for the education expenses he or she pays for his or her education or that of his or her spouse, or of any dependent for which the taxpayer "is allowed" a deduction for the personal exemption under section 151. However, in a provision that creates a great deal more trouble than appears on its face, a taxpayer may not claim a credit for his or her own expenses if the deduction for the taxpayer's personal exemption "is allowed" to another.

The statutory language plainly limits a taxpayer's ability to claim tuition tax credits for educational expenses incurred for persons for whom the taxpayer is in fact entitled to claim the personal exemption. The dependents for which such a deduction may be claimed are expansively defined in section 152 to include most of the relatives for whom one would consider paying educational expenses, including grandchildren, nieces and nephews, and sons- and daughters-in-law. Moreover, under section 152(a)(9), the list is expanded to include wholly unrelated individuals who are members of the taxpayer's household, a category that at least includes live-in partners and their children. With one important exception, however, dependency requires that the taxpayer provide over one-half of the individual's support, a requirement that imposes a real limitation on the scope of the definition of a dependent. In addition, for the personal exemption to be allowed to the taxpayer, unless the dependent is the taxpayer's child, the
dependent may not derive gross income in excess of the amount of the deduction which, in 1998, was $2,700. In the case of a child, the exemption is allowed without regard to the income of the child so long as the child has not reached the age of nineteen or has not reached the age of twenty-four and is a student as defined in section 151(c)(4).

The definition of a student in section 151 is not as expansive as the definition of an eligible student in section 25A. For purposes of section 151, the child generally must be a “full-time student” at an educational organization described in section 170(b)(1)(A)(ii). Under the regulations, the first branch of this definition expressly excludes night students while the second branch excludes nights schools and correspondence schools. Both the Hope and Lifetime credits, however, are available to half-time students and to students at a broader range of educational institutions than are described in section 151. These definitional differences may be annoying but do not appear to create special difficulties. Obviously, a child may be a student for the purposes of the education credit but not a student for the purposes of the personal exemption. In that event, and assuming that the child earns over $2,700, the child is simply not a dependent.

The education credits may not be claimed by the parent regardless of the extent of their financial contribution to those expenses, but the expenses actually paid by the child may be claimed on his or her own return.

When a child's parents are divorced or live apart, the support test for dependency is effectively replaced by a rule contained in section 152(e), which grants the deduction to the parent having custody of the child unless that parent expressly agrees that the deduction may be claimed by the non-custodial parent. Because the ability to claim the education credit follows the entitlement to claim the personal exemption, the application of this rule means that in general the custodial parent will be entitled to claim the credits for expenses paid by him or her. However, the non-custodial parent will not be able to claim credits for the education expenses of a child paid by that parent, even where the payment of those expenses is required by a separation agreement or divorce decree. (In fact, under a rule contained in the regulations and described below, the custodial parent may be able to claim a credit for the education expenses paid by the non-custodial parent!) However, if the custodial parent has agreed pursuant to section 152(e)(2) that the personal exemption may be claimed by the non-custodial parent, the ability to claim the education credits also passes to the non-custodial parent, which may come as quite a surprise to the custodial parent. Nevertheless, if such an agreement has been made, the non-custodial parent may claim the education credits but the custodial parent may not.

As drafted, this statutory rule creates harsh and unfair results. The education expenses of a child of divorced or separated parents will commonly be shared

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\(^{112}\)Reg. § 1.151-3.

\(^{113}\)Many agreements in effect today to shift the personal exemption would have been entered into prior to the enactment of the tuition tax credits.

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between the parents, and the loss of a credit for the expenses paid by one parent is not appropriate. The proposed regulations apparently seek to ameliorate this result through the use of the constructive payment rule, which is examined below.

Under section 151(d)(3), the ability to claim a personal deduction for anyone is phased out as a function of adjusted gross income. By limiting the ability to claim the education credits to taxpayers entitled to claim the personal exemption, the statute creates an ambiguity concerning whether the credits may be claimed if the taxpayer would be entitled to claim the personal exemption except that it has been entirely phased out by this provision. This ambiguity does not appear to have any current importance because of the phase out of the credits. The ability to claim education costs currently phases out before the ability to claim the personal exemption phases out and thus the issue does not arise.

b. Dependent of Another. In many families, some portion of the expenses of education are paid by both the parent and the child. This basic fact raises the question of how the tuition credits are to be allocated between the two payors. The traditional and entirely logical approach to this situation would be to allow each taxpayer, parent and child, to claim a credit for expenses actually incurred by each of them. In section 25A, however, Congress provided that in any one year only one taxpayer can claim a credit for any given student. If the student can be claimed as a dependent by another, the student is barred from claiming any education credit and the credit can be claimed by the person entitled to the dependency exemption. On the other hand, if the student cannot be claimed as a dependent by another, no one but the student may claim the credit.

It is not clear why Congress chose to abandon the traditional approach to dependents’ expenses in favor of the all-or-nothing rule of section 25A. Perhaps because the education credits contain fairly restrictive ceilings and limitations, Congress wanted to prevent efforts to evade those limitations by dividing the expenses between parent and child. If that is the objective, it is substantially undermined by the proposed regulations discussed below. Alternatively, the drafters of this provision may have been under the misimpression that other Code sections had previously adopted a similar all-or-nothing rule that was merely followed in section 25A. That, however, is not the case. No other section of the

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114 Portions of the following material are based upon Glenn E. Coven, Who Should Be Entitled To Claim the New Education Credits?, 84 TAX NOTES (TA) 1643 (Sept. 20, 1999).
115 In general, children are taxpayers and are entitled to deduct their own expenses. See Boris I. Bitker & Martin J. McMahon, Federal Income Taxation of Individuals ¶34.5(3) (2d ed. Supp. 2000); see also Tax Rules for Children and Dependents (I.R.S. Pub. 929), p. 4; I.R.C. § 73(b). Parents may deduct payments made on behalf of their children when the Code so permits. See, e.g., I.R.C. § 213(a) (permitting medical expenses for dependent).
118 That problem could have been addressed in a less oppressive way by requiring related taxpayers to share a single ceiling.
Code disallows a tax benefit for an out-of-pocket expenditure to a taxpayer simply because that taxpayer could be claimed as a dependent on another’s tax return.\textsuperscript{119}

The all-or-nothing rule in section 25A is thus a new feature of the Code and one that has two highly undesirable consequences. Denying a student who is also a dependent the tuition tax credits for the payments that he or she makes towards education from his or her own funds is extraordinarily harsh and will undoubtedly be viewed by the legions of affected students as fundamentally unfair. Second, this new approach to the taxation of the family does not supplant the preexisting rule in the analogous areas (such as the payment of medical expenses) where it applies. The existence of two entirely different solutions to a single tax issue is an entirely unnecessary source of complexity and confusion.\textsuperscript{120}

Wrongly or not, section 25A(g)(3) denies an education credit to a student if the deduction for the personal exemption attributable to the student “is allowed” to another. Just what Congress means by “is allowed” is an interesting question that, more than any other issue, illustrates the inadequate thought that was devoted to crafting these rules. Under the antecedent sections 151(d) and 63(c), the respective allowances are barred to an individual if the personal exemption for that individual is “allowable” to another. Under these sections, it is well established that “allowable” means “entitled to claim the benefit whether or not it is

\textsuperscript{119}Section 151(d)(2) does bar an individual from deducting his or her own personal exemption if another taxpayer may also deduct a personal exemption attributable to that individual. The personal exemption, however, does not reflect a specific disbursement. In fact, the exemption is really an aspect of the rate structure and functionally imposes a zero rate of tax on the first slice of income. Section 151(d)(2) quite appropriately bars a second exemption for a child when an exemption has already been claimed by the parent.

Similarly, section 63(c)(5) limits the use of the standard deduction to offset tax on the investment income of an individual who can be claimed as a dependent on the return of another. Again, this provision does not limit the tax benefit for a specific expenditure. Taxpayers, both parent and child, remain free to deduct any expenditures actually incurred and which are properly deductible by them. The standard deduction of today is designed to provide a measure of tax relief to low income taxpayers who lack specific personal deductions. Section 63(c)(5) reflects the entirely reasonable decision that this tax relief should not be extended to the investment income of minors.

A similar disallowance is contained in section 220. That section, added in 1996, allows on an experimental basis a deduction for amounts contributed to medical savings accounts and is cross-referenced by the EIRA provisions. The funds accumulated in such an account may be used to pay the medical expenses of the taxpayer and his or her dependents. Under section 220(b)(6), dependent children are barred from creating their own accounts. That decision, while perhaps not entirely beyond criticism, still does not bar a child from deducting an out-of-pocket expenditure. Rather, section 220 bars dependent children from making an expenditure by denying them the opportunity to establish a medical savings account. Significantly, if such a dependent child does have a medical expense which the child in fact pays out of his or her own funds, the child would be entitled to a deduction under section 213.

\textsuperscript{120}Were the question one of first impression, a case might be made for including all of the income and expenses of a dependent minor on the return of his or her parents. Aggregating family income has been a topic of interest to tax scholars for decades. However, as a general proposition, Congress has not adopted that approach and children generally are required to report their own income and to deduct their own expenditures.

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in fact claimed and whether or not it does the taxpayer any good.”121 Thus, if the family members decide that it would be preferable if the child were not a dependent and were entitled to claim his or her own personal exemption, the family cannot implement that decision by causing the parent to forego the deduction for the personal exemption for the child. Because the personal exemption was “allowable” to the parent, although not in fact claimed, the child remains barred from claiming his or her own personal exemption. That approach is entirely justifiable. Tax rules should not be and generally are not elective. The decision embodied in section 151(d) is that the personal exemption for dependent children belongs to their parents—not that the exemption belongs to whomsoever the parties select. In barring that election under section 151, Congress was on solid ground.

In paragraph (g)(3) of section 25A, however, Congress used different language. The credits are not barred to a child if a deduction for the child’s personal exemption is “allowable” to another; rather, they are barred if the deduction “is allowed” to another. Did the different choice of language signal a different meaning? If so, what meaning? In the portions of the Code that address depreciation and the resulting adjustments to basis, the words “allowed” and “allowable” are given distinct meanings. “Allowable” means the proper amount of depreciation prescribed by law, while “allowed” means the amount of depreciation actually taken on the income tax return, which may be more or less than the amount properly allowable.122 If this meaning (i.e., the section 1016 meaning) of “allowed” applied to the use of that word in section 25A, it might suggest that the education credits are barred to a child only if the parent actually claimed the personal exemption for the child—regardless of whether the deduction was “allowable.”

On the other hand, elsewhere in the Code the word “allowed” does not seem to have been given such a specialized meaning but rather is used in its conventional sense, meaning permitted. Illustrations occur in many sections of the Code. For example, in section 32 (which provides the earned income credit) subsection (a), which is caption-titled “allowance of credit,” provides in paragraph (1) that “there shall be allowed as a credit . . .” while paragraph (2) provides that the “amount of the credit allowable” under paragraph (1) is subject to limitation. Section 32(a)(1) plainly does not refer to an amount actually claimed on a return but rather to any amount permitted to be claimed.123 If section 25A is using “allowed” in this sense to mean permitted, education credits are barred to a child if the parents are entitled to claim the child as a personal exemption.

The legislative history is no help, unless meaning can be attributed to this

122See I.R.C. §§ 1016(a)(2) and 1245(a)(2).
123Compare I.R.C. § 32(a)(2) (“allowable”) with I.R.C. § 221(b)(1) (“the deduction allowed by subsection (a)”).
very silence. In describing section 25A(g)(3), the reports shift to the use of the word “claim.” Whether the parent or the child can claim the tuition credits depends upon whether the parent “claims” the student as a dependent. The use of that word certainly could be read as supporting the section 1016 meaning of “allowed”. However, section 24, which extends the child tax credit, was enacted along with section 25A. Like section 25A, section 24 conditions its relief upon whether the taxpayer is “allowed” a deduction for the child’s personal exemption. In describing that provision, the reports refer to whether the taxpayer “can claim” the deduction! All that one can really conclude from the committee reports is that they were rather casually drafted and do not expressly reveal the meaning of the word “allowed” in section 25A. Since Congress has never previously permitted a taxpayer to shift the entitlement to a tax allowance like the tuition credits by electing to forego a different allowance to which they otherwise were entitled, one would expect a reasonably clear explanation of the new rule. Indeed, it would be highly inappropriate for Congress to create a novel and significant rule but to communicate its existence only through a subtle and ambiguous wording. The absence of an explanation suggests that either the new rule was not intended or that Congress really did not know what it was doing.

While it would indeed be objectionable for Congress effectively to convert the deduction for the personal exemption, for the purposes of section 25A, into an elective provision without warning or due consideration, given the unfortunate decision to allow only one person to claim the tuition credits for a given student, it is not clear which approach is superior. Treating the claim of the personal exemption for dependents as not elective is correct as a matter of principle and is consistent with the traditional approach of the income tax laws, but has the unsatisfactory consequence of denying the credit to dependent children. Conversely, treating the deduction as elective is improper in principle, but avoids that harshness and thus produces a preferable result.

In the relative vacuum created by a vague statute and an ambiguous legislative history, the Treasury has great freedom to adopt its own interpretation and it has done precisely that. In general, the proposed regulations under section 25A(g)(3) adopt the section 1016 meaning of “allowed.” Under section 1.25A-1(g) of the proposed regulations, if a taxpayer is eligible to claim a student as a dependent but does not do so, the personal exemption is not treated as “allowed” to the taxpayer. Accordingly, paragraph (g)(3) does not apply and the student can claim the education credit for the costs of his or her own education.

In the process of creating this new rule, the Treasury evidently concluded that it was necessary to create a new taxpayer category and thus the proposed regulations invent the new concept of a “claimed dependent.” A claimed dependent

125 I.R.C. § 24(c)(1)(A).
126 See Staff of Joint Comm. on Taxation, supra note 124.
is said to be a dependent for whom a deduction for the personal exemption "is allowed" on the taxpayer's return. By defining a claimed dependent using the statutory language, the regulations create a circular and essentially meaningless definition. Nevertheless, elsewhere the proposed regulations make clear that a claimed dependent is an individual for whom the taxpayer in fact claimed the personal exemption. Presumably an individual for whom the deduction could be taken but is not is an "unclaimed dependent" although the regulations refrain from using that slightly unsavory term. As will be explored shortly, the adoption of the section 1016 meaning of "allowed" has the highly regrettable consequence of permitting section 25A to be manipulated in a manner that produces manifestly improper and presumably unintended results.

Having created this new category of taxpayer, the proposed regulations then drop the issue without attempting to create the set of rules needed to develop the concept fully. For example, it may be assumed that taxpayers are permitted to switch the status of their dependents back and forth from claimed to unclaimed at will and may do so annually without limitation. However, the proposed regulations are silent on the point. Similarly, the proposed regulations do not address the obvious issue of the interaction between the concept of a claimed dependent and the phase-out of the deduction for the personal exemption. Without a doubt, a child will remain a claimed dependent notwithstanding the fact that the deduction for the child's personal exemption has been reduced, say, to $54 by the phase-out of that allowance. However, reading the proposed regulation literally, if the deduction is reduced to zero the child automatically becomes an unclaimed dependent. That interpretation of the proposed regulations, of course, is at least doubtful.

c. Expenses Paid. There is one further rule, or set of rules, that may affect who is entitled to the benefit of the tuition tax credits. As might normally be expected, the credit is generally available for the education expenses paid by the taxpayer for the education of the taxpayer or his or her dependents. However, under the all-or-nothing approach to the expenses of dependent children, taxpayers who can be claimed as dependents on the returns of another are barred from claiming any education credits—even for their own education expenses paid out of their own funds. In order to prevent this peculiar rule from resulting in the complete loss of credits attributable to those expenses, section 25A(g)(3)(B) provides a second unusual rule: the expenses paid by a dependent barred from claiming the credit are to be treated as if they were paid by the person who can claim the personal exemption. Accordingly, it is the parent of a dependent child who is entitled to claim the credit for the education expenses of a child, regard-

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129It might be said that a taxpayer who may no longer deduct any amount for the personal exemption because of the phase out is not "eligible" to claim the dependent. See Prop. Reg. § 1.25A-1(g), 64 Fed. Reg. 794 (1999).
Bad drafting

less of whether it is the parent or the child who actually pays those expenses. Although a rule allocating the tax benefit from an education expense paid by the child to the parent is superior to a rule that results in the total loss of any credits for education expenses paid by a dependent child, the rule of paragraph (3)(B) is highly objectionable.

While this solution to the problem of the loss of credits caused by the all-or-nothing rule must have appeared quite clever to the drafters of section 25A, the significance of the provision may have been overlooked. Section 25A(g)(3) both disallows a tax benefit to the individual who quite properly bore an expense and allows another taxpayer who did not bear such an expense nevertheless to claim the tax benefit from the payment by another. That result under the tax law is extraordinary and flatly inconsistent with fundamental income tax rules concerning the assignment of income and expense among taxpayers. Since the very inception of the income tax, these foundational rules have barred the shifting of tax benefits among related taxpayers. Indeed, should an attempt be made to shift a loss among family members, the typical Code solution is to deny the loss to anyone! 131

Section 25A(f)(3) thus creates an anomaly of the type that is corrosive to the integrity of the income tax. The assignment of income rules contribute importantly to deterring manipulative transactions that lack economic substance but that avoid tax liability. It is essential to the administration of the tax law that taxpayers generally respect these fundamental anti-tax avoidance rules. It is difficult to sustain that respect when Congress itself ignores those rules in an off-hand manner merely to avoid a modest drafting hurdle. The provision, therefore, reflects the ultimate in bad drafting—it mandates behavior that always ought to be prohibited.

Oddly, the Code does not address the reversal of these facts. That is, when it is the child who is entitled to the credits but some of the expenses are paid by the parents, nothing in the Code attributes the payment of such expenses to the child. On the Code’s face, at least, the credit for these expenses would be lost; this is not a very satisfactory result. One reason for this omission may be that under the structure of the Code itself, if the credits may be claimed by the child, it will normally be because the child is over the age of twenty-three. In that event, Congress may have assumed, parents commonly will not make significant contributions to the education expenses of the child. However, the proposed regulations greatly expand the circumstances in which a minor dependent may claim tuition credits by developing (if not inventing) the concept of an unclaimed dependent. For these dependents, the parents quite commonly will contribute substantially to the cost of education. Thus, the solution that the Treasury created to address the inability of dependent children to claim a credit for their own education expenses results in the potential loss of credits to their parents.

131See, e.g., I.R.C. §§ 267(a)(1) and 1015.
To prevent the solution from having such a consequence, the proposed regulations create one additional rule. According to section 1.25A-5(a)(1) and “solely for purposes of section 25A,” if a third party pays an education expense of a student, the funds are treated as passing through the hands of the student. Thus, the student is treated as receiving the amount of the payment and using that amount to pay the education expenses directly. The regulation defines a third party as “someone other than the taxpayer, the taxpayer’s spouse, or a claimed dependent” which, of course, includes the parent (or another relative) of an unclaimed dependent. The net effect of this deemed payment rule is to attribute the payment of education expenses by a parent to the child who can claim the tuition credits. Thus, the proposed regulations supply precisely the rule that is notably missing from the statutory provision. Obviously, the regulatory rule, if not inconsistent with the statute, is utterly devoid of statutory support.

Under some circumstances, the long established step transaction doctrine will treat a payment directly between two taxpayers, for example, parent and institution, as if it passed through the hands of a third, the student. However, the bounds of this doctrine, and the nature of its theoretical underpinnings, are unusually opaque and hotly disputed as recent litigation has confirmed. In spite of this lack of clarity, there is no support in the step transaction doctrine for attributing a payment that discharges an obligation of the paying taxpayer to another. Thus, when the payment by the parent discharges the parent’s obligation of support, or discharges a contractual obligation, such as one imposed by a separation agreement, there is no justification for attributing that payment to another, such as the student—notwithstanding the incidental benefit obtained by the student from the payment. Therefore, the regulatory rule is neither supported by nor consistent with the judicial step transaction doctrine.

This inconsistency is underscored by looking at the transaction in reverse. If taxpayer A wishes to make a payment to X but the tax consequences of the payment would be improved if it were made by taxpayer B, A might arrange to pay B who in turn would pay X. For example, a grandparent too wealthy to fund an EIRA might pass funds to the parent who would fund the account, or a parent barred from claiming tuition credits might pay the child who would then pay the college. In either case, the Service could be expected to invoke the step transaction doctrine, ignore the circuitous flow of cash, and treat the payment as passing directly from the actual payor to the ultimate payee. The regulations proposed under section 25A surprisingly mandate the result that the step transaction doctrine normally would be used to attack. The undermining of an important

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136 The Treasury admits as much by limiting the rule to section 25A.
anti-abuse rule occurs because the regulations needed to prevent unfavorable consequences from the unclaimed dependent rule, which was created to prevent unfavorable consequences from Congress’ all-or-nothing rule.

The scope and consequences of the generous but unprincipl ed deemed payment rule are not fully clear. It obviously was intended to shift the entitlement to the tuition credits from a parent (who could not use them) to an unclaimed dependent child (who could use them). However, the application of the rule is far broader than this and seems to produce results that might be thought to be bizarre. For example, it was noted above that a divorced parent (say, a father) who is not entitled to the personal exemption for a child but who is bearing the economic costs of the child through child support payments is not entitled to the tuition credits for payments toward the child’s education. However, under the deemed payment rule, the father’s payment of the tuition bill is deemed to be a payment to the child who in turn is deemed to pay the bill. If the mother claims the child as a personal exemption, then under section 25A(g)(3)(B) the payment of education expenses by the child, including these deemed-paid expenses, are attributed to the mother who can claim the credits.137 Fortunately, as a result of this cumbersome procedure, no tuition credits are wasted due to Congress’ unfortunate all-or-nothing rule. Unfortunately, at least for the father, the tax benefit for a payment in after-tax dollars by one taxpayer is doubly shifted to an unrelated taxpayer who does not in any sense bear the economic burden of the payment. This solution by the Treasury violates the most fundamental principles of income taxation.

The proposed regulations also fail to answer whether the deemed payment rule can apply to payments by institutions as well as payments by individuals. At least, nothing in the expansive proposed regulation bars this result. Accordingly, when a portion of a student’s education costs are discharged by a direct payment from an institution such as a charity (whether or not affiliated with the educational institution) or the federal government, the payment will be treated as passing through the hands of the student. Since the payment normally will be exempt from tax, this constructive passage normally will not have any income tax consequences. However, if the regulations are indeed interpreted to allow the elective inclusion of scholarships and similar payments in income, the deemed payment rule will allow the student to include these constructive payments in his or her income as well. Thus, the deemed payment rule could allow students to claim tuition credits with respect to payments from, say, the law school foundation directly to the law school. It certainly seems unlikely that Congress intended such a result, but these unintended consequences are the natural result of the bad drafting.

Although this feature of the regulations lacks statutory or judicial support and is contrary to principle, when applied to payments by parents, at least, it does

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reflect a certain practical reality. If the regulations merely reflected the statutory requirement that a taxpayer is only entitled to a credit for "expenses paid by the taxpayer," parents wishing to shift the credit to their children would be required to make gifts, presumably unrestricted gifts, to the children in the hope that the child would use the funds to pay college tuition. Well-advised taxpayers would go to some length to avoid a step transaction challenge to the credits by the Service; less well-advised taxpayers would ignore the issue and generally would go unchallenged anyway. What the regulations do, therefore, is waive the application of the step transaction doctrine to this category of payments. While commonsense practicality in the Service is a virtue to be applauded, waiving the application of sound anti-tax avoidance doctrines is nevertheless unwise. If even the Service agrees that the step transaction doctrine does not have to apply to the most transparent of step transactions, why should taxpayers not aggressively assert that the doctrine has no application in other contexts?

d. Consequences of the Claimed Dependent Rule. The conclusion that "allowed" means "actually claimed" permits the parent to shift the education credits to the student-child by failing to claim the personal exemption for the child on his or her (the parent's) own return. However, the deduction for the personal exemption itself cannot similarly be shifted. Rather, if the parent does forgo the deduction for the personal exemption in order to shift the benefits of the tuition credits, the child cannot claim that allowance—it is permanently lost to all. Accordingly, the implication of the argument that "allowed" means "actually claimed" is that, in the context of legislation designed to assist families and particularly to assist in paying the costs of education, Congress allowed the education credits to be claimed by the student but only at the price of forfeiting the personal exemption.

The consequences of the rule are quite substantial. At the twenty-eight percent bracket, which is the bracket in which many parents of college-aged students find themselves, a deduction for the 1999 personal exemption available of $2,750 results in a tax savings of $770. For such a taxpayer, forfeiting the personal exemption means increasing one's tax liability by that amount. On the other hand, the maximum Hope credit that can be claimed for a single child is only $1,500, while the maximum Lifetime credit is currently only $1,000. Accordingly, the forfeiture of the deduction for the personal exemption would have the effect of more than halving the net tax benefit from claiming the tuition credits. That result is simply too ridiculous and counterproductive to have been intended. If Congress did intend such a rule, it was certainly (and understand-

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138 The result of this elective shifting of the credit is not at all similar to the mandatory shifting of the credit to the child that will occur when the child is no longer a dependent. At that point, the parent loses the deduction for the child's personal exemption and is no longer able to claim education credits attributable to the child. However, in this circumstance, the child becomes entitled to claim both the tuition credits and the deduction for the personal exemption. It is the forfeiture of the personal exemption to all that makes the regulatory interpretation of section 25A(g)(3) distinctly unfair.

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ably) secretive about it. There is no hint in the committee reports of any intent to halve the benefit of the credit. Either the drafters of section 25A did not intend that the parent should be able to shift the credits to their dependent children or they forgot that the deduction for the personal exemption may not be shifted.

There would seem to be two reasons why a parent might wish to shift the credit to the child. One reason is the non-tax factor of family harmony. Family members might agree that it is unfair that the tuition credits should belong to the parents when the child is making a major contribution to the costs of his or her own education. Family members might want to correct that perceived injustice. For those taxpayers, the forfeiture of the personal exemption is a heavy price to extract.

The second reason to desire a shift of the credit is that it is worth more to the children than it is to the parents. There are several reasons why this might be so, but the most likely are that either the parent’s ability to claim the credit is limited by the $5,000 (or $10,000) ceiling on the Lifetime credit, or, in the hands of the parent, the credit is subject to a phase-out. Shifting the credit to the child, therefore, will often be a tax planning device that avoids the specific and deliberate limitations on the use of the credit that were inserted in section 25A. Thus the ability to “unclaim” a dependent will generally constitute a tax planning device for avoiding one of the relatively strict limitations on the availability of the credit that were deliberately imposed by Congress. If Congress did intend that the benefits of the credit could be shifted, it also seems to have intended that those limitations could be avoided by well-advised taxpayers willing to pay a toll charge in the nature of relinquishing the personal exemption for the student (and hiring a tax advisor). This would be an odd policy choice.

The interaction between the unclaimed dependent rule and the phase-out of the deduction for the personal exemption results in the addition of a highly inappropriate element to the ability to shift the tuition credits. Forfeiting the deduction for the personal exemption is an offsetting cost only if a taxpayer has the deduction to lose. Because the deduction for personal exemptions is subject to one of the ever-present phase-outs, moderately high income taxpayers do not have a deduction to lose. Accordingly, these taxpayers can shift the education credits to their children without incurring any cost.

Regardless of whether it was intended, this scheme greatly complicates the tax planning required to maximize the use of the tuition credits. Consider, for example, the simple case of a family whose children include twenty-two year old twins who are both juniors in college. The parents are entitled to two personal exemptions with respect to those children, each producing a tax reduction of $770, and a Lifetime credit (in 2003) for educational expenses of $10,000, resulting in a credit of $2,000. However, each child has eligible expenses of $8,000 and therefore education expenses of $6,000 are not creditable. Under the solution contained in the regulations, the parent may give up the personal exemption for one twin, in which event the parent will also lose a credit of $400 on the expenses of $2,000 attributable to that child. However, the child may now take a credit on all $8,000 of her expenses which would be worth $1,600, provided that the child has a sufficient income tax liability to absorb such a credit. If that income exists, the $1,600 credit available to the child will likely be worth more than the $1,170 ($400 plus $770) tax savings lost by the parent.
On a joint return, the education credits are completely phased-out for taxpayers having an adjusted gross income of $100,000. Thus, the only way that upper-middle-income taxpayers can obtain any benefit from these provisions is by shifting the credits to their children. While that shifting requires a forfeiture of the personal exemption for the child, the deduction for the personal exemption begins to phase-out on a joint return for the taxable year 2000 when adjusted gross income reaches $193,400 and is entirely phased out when AGI rises to $315,900. Accordingly, as income increases over this range, shifting the education credits to the child “costs” a decreasing amount. Ultimately, when the deduction has been completely phased-out, the resulting loss of the personal exemption costs nothing at all. As a result, shifting the credits to the child of the taxpayer does not result in a halving of the value of the credits; it does not result in any reduction in their value at all. Stated differently, as income rises, the value of the tuition tax credits that have been shifted to dependent children also rises, an effect that is plainly contrary to the policy embodied in the phase-out of the credits for high income taxpayers. Indeed, the ability of the quite wealthy to shift the tuition credits to their children without cost permits the complete avoidance of the income limitation on the ability to claim credits.

C. Interest on Education Loans

Generally speaking, personal interest, which previously had been deductible, was made nondeductible in 1986, unless secured by a personal residence. What is left of the deduction for non-business interest is contained in section 163. Another of the education assistance provisions adopted in 1997, not considered here in detail, retreated from this policy by allowing a very limited deduction for interest on loans incurred to finance higher education. Confusingly, however, this provision was not added to section 163 but rather is contained in new section 221. The provisions of this section so resemble the definition and limitations of the EIRA and tuition credits that a close examination of its features would be repetitive and unnecessary. However, the inconsistencies between this provision and the similar sections 25A and 530 deserve attention.

In general, section 221 allows a deduction of up to $2,500 (beginning in 2001) for interest paid on a “qualified education loan” incurred to pay the “qualified higher education expenses” of the taxpayer, the taxpayer’s spouse, or “any dependent of the taxpayer as of the time the indebtedness was incurred.” The deduction is only allowed for interest paid during the first five years in

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140 The same need to shift the credits can occur at lower income levels if the taxpayer encounters the ceiling on the Lifetime credit or one of the other limitations of the ability to benefit from the credits.
143 I.R.C. § 221(e)(1)(A).
which interest payments are required on the loan.\textsuperscript{144} This benefit, however, phases out at relatively low income levels, beginning at an adjusted gross income of $60,000 on a joint return,\textsuperscript{145} and is completed at an adjusted gross income of $75,000.

The benefits of the section are available to finance the education of an "eligible student" as defined in section 25A(b)(3).\textsuperscript{146} This statutory provision has little content beyond providing that the student must carry at least a one-half load. However, section 25A attaches a series of other conditions to its relief and the proposed regulations under this section treat many of these additional requirements as a part of the definition of an eligible student.\textsuperscript{147} Obviously it is not clear whether the cross-reference in section 221 is to section 25A(b)(3) or to section 25A(b)(3) as embellished by the regulations to that provision. The fault here lies not in the section 221 cross-reference but in the loosely constructed proposed regulations under section 25A.

The expenses for which the proceeds of such a loan must be used are defined only by a cross-reference to the education law.\textsuperscript{148} As the proposed regulations explain, however, this definition of expenses is vastly broader than the definition of the expenses for which a tax-free distribution from an EIRA may be made which, in turn, is vastly broader than the definition of the expenses for which a tuition tax credit may be claimed. Under section 221, education expenses include not only tuition, related costs, room, and board, but also "transportation and miscellaneous expenses of the student."\textsuperscript{149}

As with the other education assistance provisions, the eligible expenses under section 221 must be reduced by the amounts described in section 25A(g)(2).\textsuperscript{150} That means, for example, that the amount of a loan, the interest on which is deductible, must be reduced by the amount of any scholarship received by the student that is excluded from income under section 117. However, it will be recalled that, under the proposed regulations under section 25A, it appears that, in one way or another, students are to be given an ability to waive the section 117 exclusion, either in form or effect, and may include a scholarship in income for the purpose of increasing the amount of tuition credits that may be claimed. This waiver presumably will be effective for the purposes of section 221 as well. Thus, the amount of the expenses for which an education loan may be obtained do not have to be reduced to reflect the fact that a portion of those expenses were paid by a scholarship so long as the amount of the scholarship is brought into taxable income. That rule creates an added benefit if a scholarship is treated as taxable. That treatment not only allows the taxpayer to claim tax credits worth

\textsuperscript{144}I.R.C. § 221(d).
\textsuperscript{145}I.R.C. § 221(b)(2)(B). The section contains a significant marriage penalty; the phase-out for unmarried taxpayers does not begin until adjusted gross income reaches $40,000.
\textsuperscript{146}I.R.C. § 221(e)(3).
\textsuperscript{148}I.R.C. § 221(e)(2).
\textsuperscript{150}I.R.C. § 221(e)(2)(B).
more than the tax due as a result of waiving the benefits of section 117, but also permits the deduction of interest on a loan the proceeds of which are used for non-educational purposes (because the costs of education were in fact paid by the proceeds of the taxable scholarship)! This may not have been intended.

In coordinating the EIRA with the tuition credits, Congress adopted a very strict one-benefit rule: if any tax free distribution is received from an EIRA, even for an expense for which the credit is not available, no tuition tax credit may be claimed for the year.\footnote{I.R.C. § 25A(e)(2).} In coordinating section 221 with the other education assistance provisions, Congress took a radically different approach. There is no coordination at all between section 221 and section 25A. Accordingly, taxpayers are free both to claim a tuition credit for expenses, including the 100 percent Hope credit, and to deduct the interest paid on a loan obtained to pay those expenses. While section 221 is coordinated with the EIRA provisions, the coordination is far more favorable than the coordination between the EIRA and the tuition credits. Under section 221(e)(2)(A), the amount of the eligible education expenses must be reduced by “the amount excluded from gross income under section . . . 530 by reason of such expenses.” Thus, the student can benefit from both the EIRA provisions and the section 221 interest deduction (although not with respect to the same expenses), a coordination that is far more rational than the coordination of the EIRA provisions with the tuition credits.

Unfortunately, it is not entirely clear what amount of a distribution from an EIRA is excluded from income by section 530, and the proposed regulations under section 221 do not address the issue.\footnote{See Prop. Reg. § 1.221-1(f)(2)(ii)(F), 64 Fed. Reg. 3257 (1999).} It will be recalled that a portion of any EIRA distribution consists of principal and is not subject to tax because it is a return of capital. Only the distribution of the accumulated income of the EIRA would be subject to tax if it were not used to pay qualified education expenses. Whether the amount of the expenses that may be taken into account under section 221 must be reduced by the entire EIRA distribution or only by the accumulated income portion of the distribution is simply not addressed by section 221 and is unclear.

Much like education expenses, which can be paid by either the student or the student’s parents, a qualified education loan may be obtained by either the student or the parents. If the loan is obtained by the parents to finance the education of their child, the loan will qualify if the child is a dependent within the meaning of section 152 at the time the loan is obtained.\footnote{I.R.C. § 221(e)(1)(A), (e)(4).} Unlike the similar provision in section 25A, there is no requirement that the parent actually claim a deduction for the personal exemption attributable to that child under section 151; thus, the claimed dependency concept has no relevance. The requirement is simply that the student be a dependent. Moreover, there is no requirement that the student remain a dependent for the loan to remain qualified.
While interest on a qualified loan is normally deductible, the section contains
the same ambiguous prohibition against claiming its benefits by an individual if
the deduction for that individual's personal exemption "is allowed" to another
taxpayer. The proposed regulations under the section adopt the same "claimed
dependent" concept that is contained in the regulations proposed under section
25A. Accordingly, just as only the parent of an actually claimed dependent
can claim the tuition credit, only the parent may claim a deduction for interest
on an education loan incurred for the benefit of a child who is a claimed depen­
dent. Thus, if a dependent child obtains an education loan for himself or herself,
the child cannot deduct the interest on that loan. Under section 25A the harsh­
ness of the all-or-nothing rule is mitigated by attributing the payment of educa­
tion expenses by the child to the parent. No such rule appears in section 221. To
the contrary, the proposed regulations under the section stress that no deduction
is allowable under section 221 unless the taxpayer claiming the deduction is
legally obligated to make the interest payments on the loan. Accordingly, if a
child who is claimed as a dependent by his or her parents obtains an education
loan, the interest will not be deductible by either the child or the parents.

If the parents fail to claim the deduction for the child's personal exemption,
the child can deduct the interest on a loan that he or she obtained. This circum­
stance, of course, creates the same series of problems and improprieties that
were explored in connection with the tuition credits. Failing to claim the deduc­
tion for the personal exemption in order to shift the entitlement to the interest
deduction to the child means forfeiting the deduction for the child's personal
exemption. That, of course, is a serious cost to middle income taxpayers but is
not a cost to high income taxpayers for whom the deduction has been phased­
out.

While section 221 bars a deduction to a claimed dependent, it does not quite
adopt the all-or-nothing approach of section 25A; however, this difference may
not have been intended. The parent's entitlement to an interest deduction turns
on whether the student-child is a dependent, not on whether a personal exemp­
tion for that child is claimed, while the child's entitlement to an interest deduc­
tion turns on whether the child is a claimed dependent. Thus, if a parent obtains
a loan to finance the education of a child who is a dependent (even an unclaimed
dependent) at the time the loan was obtained, the parent may deduct the interest
on that loan. At the same time, the child can always obtain an education loan to
finance his or her own education and can deduct the interest on that loan so long

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154 I.R.C. § 221(c).
obtained by students are often co-signed by their parents. In that event, the parents should receive a

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as he or she is not a claimed dependent of another. Thus, it appears possible for both a parent and an unclaimed dependent child to deduct interest on education loans incurred to finance the education of the child. All that is required is that the parent and the child each be legally obligated to pay the interest on their respective borrowings.

If the parent and child are each able to deduct the interest on an education loan, they can effectively double the amount of interest that is deductible since the $2,500 ceiling would apply separately to each taxpayer. Accordingly, the concept of an unclaimed dependent plays the same role under section 221 as it does under section 25A: it allows taxpayers to avoid the provisions that Congress inserted for the purpose of limiting the benefits of the section. On the other hand, under section 221 it is far more difficult to avoid those limitations than under section 25A. The interest deduction can be shifted to the child only by causing the child to become legally obligated to pay that interest at the time the loan is obtained.

III. THE REPORT CARD

The picture painted in the preceding pages is not an attractive one. These three sections of the Code cannot be read without concluding that Congress and its staff are not properly executing their primary job of designing and drafting the laws by which we are to live. The deficiencies are serious, costly, and unforgivable. In this very tiny sample of the Code we have identified at least the following significant deficiencies:

A. Inadequate Structural Design

One of the least excusable faults in the reviewed sections is the recurring presence of serious flaws in the design of the provisions. These are the kinds of errors that result from a lack of skill and experience on the part of those whose job in the federal government is to write legislation. Basically, these errors reflect what, in other parts of the economy, would be considered inadequate job performance. These errors are analogous to the error of an architect in designing a sports stadium seating 100,000 with the only restroom two floors away from the refreshment stands.

Examples of poorly structured provisions abound, but the worst example may be the casual creation of the new rule, contained in the tuition tax credits, that bars taxpayers from claiming a tax benefit for their own out-of-pocket expenditures, incurred for their own benefit, while shifting that tax benefit to another. That rule is both fundamentally unfair and conflicts with basic principles of our tax system that are nearly ninety years old. The related rule that allows taxpayers to elect whether to claim a deduction for a dependent’s personal exemption is equally unprincipled and creates a totally unsound precedent.

Some of the other more obvious examples include the following:

• The reversed structure of the taxation of distributions from an EIRA.
• Making the tuition credits elective.
• Creating two tuition credits with different eligibility requirements.
• The penalty on excess contributions to an EIRA that must be paid by the infant who is the beneficiary of the account.
• Not addressing multiple EIRAs.

B. Inadequate Development

Many aspects of these sections are incomplete in the sense that the designer simply did not think through the significance of the provisions he or she drafted and did not complete their design. This problem is related to the structural defects. To continue the architectural analogy, it is like perfectly designing a building except that the walkway connecting the two wings adjoins the second floor of the east wing to the third floor of the west wing.

Again, examples are plentiful but two stand out from the others. Congress created a tuition tax credit that is so much more valuable than the alternative tax exemption that it has caused millions of students to regret receiving scholarships and other tax-exempt allowances, none of which was apparently intended. Second, Congress created a potentially beneficial EIRA but then rendered it nearly useless for funding education, first by imposing unrealistic size limitations, and second, by barring tuition credits to anyone using the EIRA for its intended purpose.

Other examples include the following:
• Not defining eligible contributors to EIRAs and, in failing to do so, not addressing entity contributors.
• Imposing a $500 ceiling on beneficiaries of EIRAs but not on contributors.
• Phasing out the ability to make transfers to EIRAs although the transfers do not have income tax consequences.
• Allowing EIRA rollovers to avoid the age eighteen limitation and not coordinating transfers on death with the age thirty limitation.
• Failing to define the nature of the programs for which Lifetime credits may be claimed.
• Creating overlapping and inconsistent change-in-beneficiary rules for EIRAs.

C. Simple Sloppiness

At a lower level, the failure to think through the provisions being drafted results in simple sloppiness. As has become the custom, the most notorious instances of sloppiness in the drafting of the education assistance provisions were rectified a year later in a technical corrections act, but these corrections do not eliminate the costs of the initial mistakes. For example, the omission of the age thirty termination rule from those provisions was promptly corrected but that correction left in doubt the validity of EIRAs created in conformity to the law as initially enacted. A host of these minor irritants are described throughout the preceding pages.

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D. Poor Use of Cross-References.

One of the most common criticisms of the Code and the regulations issued under the Code is the heavy use of cross-references that seriously interfere with the reader's ability to understand what is being read. From the perspective of the drafter, however, cross-references can serve obvious and desirable purposes. A cross-reference is an economical way of providing consistent content to a recurring statutory issue. In these sections, there is a heavy reliance on cross-referencing. The EIRA provision, for example, refers to twelve other subsections of the Code. While many of these references are helpful and appropriate, several others are not. Also, some were used poorly, tending to create far more confusion than they eliminate.

Some cross-references are entirely unnecessary. The most regrettable is the EIRA provision's reference to the section governing the taxation of annuities for a rule governing the taxation of distributions that consist of both principal and income. On the one hand, the pro rata rule desired was easily expressed and adequately expressed in the committee reports; there was no need for a cross-reference. On the other hand, the reference was virtually meaningless; section 72 does not really contain the contemplated prorating rule. Similarly, the references in the same provision to the medical savings account section for a rule concerning the transfer of the account in the event of divorce or death were entirely unnecessary because the beneficiary of an EIRA can be changed for any reason.

Other cross-references are so casual that it is hard to be sure what is being cross-referenced. For example, the references in the EIRA provisions to the "family (as so defined)" may be the most casual in the Code.

Some cross-references are simply wrong. The initial cross-reference from the EIRA provisions to section 72(b) was plainly wrong and has since been corrected (and rendered meaningless) by the creation of a cross-reference to all of section 72. Similarly, the cross-reference from the same section to section 220(f)(b)(B) must be wrong, although the error has not yet been addressed.

Other cross-references are plainly accidents waiting to happen. Cross-references are designed to promote consistency and stability and thus should only be made to foundational provisions in the law. Nothing undermines the positive benefits of a cross-reference more quickly than the amendment or disappearance of the cross-referenced provision. That, of course, is precisely what has happened and is likely to happen again. Only a year after the adoption of these tax provisions, the cross-referenced provisions of the Education Law were repealed and reenacted elsewhere, rendering that cross-reference almost untraceable. Similarly, for no important reason, the EIRA provisions cross-reference the new and probably temporary section prescribing medical savings accounts. It is likely that this experimental provision will be repealed before the EIRA provisions are repealed.

E. Bad Policy

Analysis of the policies that these provisions implement is beyond the scope of the present inquiry. Nevertheless, some of the policy-tinged decisions that
entered into the design of the education assistance provisions contribute to their unnecessary complexity and awkwardness. The inconsistent resolution of identical issues among these three provisions is particularly deserving of criticism. The increasingly common but largely unprincipled phasing out of tax benefits is regrettable enough, but the inconsistent manner in which phase-outs are used in these provisions aggravates the problem. The tuition credits are phased out over an income range of $80,000 to $100,000 on a joint return while the ability to deduct interest on an education loan phases out over an income range of $60,000 to $75,000. Also, the ability to contribute to an EIRA phases out over an income range of $150,000 to $160,000.158

Similarly, for purposes of the interest deduction, the expenses of education that may be financed are broadly and vaguely defined to include all such expenses. The expenses that may be paid by an EIRA, however, are more sharply and narrowly defined to exclude travel and miscellaneous expenses and may exclude a portion of room and board. The tax credit excludes all room and broad and, depending upon how the regulations finally evolve, some or all books and supplies and some fees. Because all of these allowances are subject to relatively strict dollar ceilings, these definitional differences add little but complexity to the law. Indeed, for both the phase-outs and the definitions, whatever minor policy-based rationale may be embodied in these differences is far outweighed by the resulting complexity.

F. Micro-Management

One of the less commonly considered causes of complexity in the tax law, but one of the most important, is the increasing tendency of Congress to legislate in too much detail. If this detail constituted a logical development of the statutory provision that provided clarification and minimized ambiguity, the detail would be as welcome as interpretative regulations. However, much of the detail added by Congress is not added because it is a logical extension of the statutory provision. Instead, it alters the application of the statute in a manner that is inconsistent with its general tenor. This sort of detail clutters the Code with incomprehensible exceptions and confusing permutations.

One favorable conclusion from this review of the education assistance provisions is that the quantity of such harmful detail is relatively small. Perhaps because the amounts involved in these allowances are not great and thus did not attract the attention of the lobbying community, Congress generally confined the legislation to rules germane to the issue at hand. The exceptions, however, generally contained in the tuition tax credits, are flagrant. Congress simply could not resist denying the Hope, but not the Lifetime, credit to persons convicted of drug related felonies and also childishly (and ineffectively) barring both credits for the payment of student activity fees.

158Oddly, the more generous of the phase-outs are also the ones that are more readily avoidable, at least by the relatively rich.
IV. THE COSTS OF BAD DRAFTING

The cost of the bad drafting produced by Congress, while essentially unquantifiable, is fairly obvious and surely enormous. Legislation, if it is to serve any purpose, must be understood. Admittedly, it is not always necessary that legislation be understandable by the average member of the general public. Indeed, it might not even be necessary that legislation be fully understood by the practicing bar if it were understood, digested, and promptly interpreted by the Treasury—although it might not always be reasonable to rely on that interpretation. Nevertheless, legislation must be understood by someone and, normally, by many people.

There is a cost to acquiring an understanding of legislation. The primary cost of knowledge is time, an expensive commodity that could be spent on more profitable pursuits. When legislation is clear and logical, that cost should be small and acceptable. However, as the clarity of the legislation fades and its complexity and irrationality increase, this cost rises. When the quality of the legislation deteriorates to the point reached by the sections considered here, the cost becomes unacceptable. In the first instance, the cost of gaining an understanding of tax legislation must be paid by the Treasury as it seeks to prepare interpretive materials ranging from forms to regulations. That added cost of government, of course, will ultimately be borne by the taxpaying general public.

To the extent that the Treasury is unable to create clarity from the legislative fog, the cost of learning what the law provides and how it operates is passed on to tax practitioners and ultimately their clients, the taxpaying public. Bad drafting thus has the effect of imposing a new tax, a charge for using the new legislation that directly offsets whatever benefits the legislation may provide. When the tax benefits of Code amendments are relatively small, as in the case of the education assistance provisions, and the obscurity of the legislation substantial, this user charge may obliterate the intended tax relief for too many taxpayers.

In spite of the best efforts of the administrators, the requirements of a badly drafted law often remain unclear. This opacity will affect taxpayer behavior in a variety of undesirable ways. Lack of clarity in the law can affect the form of the transaction to be taxed and whether the transaction is undertaken at all. If a taxing provision intended as a tax incentive designed to affect taxpayer behavior cannot be understood, taxpayers may not respond to the incentive. In the context of the education assistance provisions, Congress intended to mitigate the cost of obtaining post-secondary education, thereby enabling more citizens to attend college or otherwise obtain an education. If taxpayers cannot understand that incentive, they will be far less likely to respond to the incentive and the legislation will fail to achieve its objectives as fully as would more clearly drafted legislation. In other contexts, unclear legislation may retard business transactions and thus negatively impact economic growth.

On the other hand, when the requirements of the law remain unclear but the transaction proceeds, the proportion of taxpayers that will misreport their tax liabilities, either accidentally or purposefully, must necessarily increase. Those
inaccuracies, whether of under-reporting or over-reporting, not only increase the cost of unclear legislation but also shift those costs in inappropriate ways. In the first instance, the increased misreporting of tax liabilities requires an increased audit effort by the Service, an unwelcome cost to both taxpayers and the government. To the extent that these reporting errors are not uncovered and corrected, the relative burden of the income tax is shifted, either to or from the mistaken taxpayer depending upon the nature of the error.

Finally, a residual lack of clarity in the tax rules will unavoidably affect taxpayer attitudes towards the income tax laws in general. Opacity in the law cannot help but result in frustration and general hostility towards the source of that discomfort. Unfortunately, taxpayers may incorrectly identify the income tax law, rather than Congress, as that source. The resulting taxpayer hostility to income taxation can interfere with, and thus increase the cost of, the administration of the income tax through increased rates of non-compliance and general recalcitrance.

Examination of the education assistance provisions, however, discloses more subtle costs. Bad drafting has a tendency to corrupt the law. Ill-designed, ill-fitting legislation has a tendency to cause a general deterioration in the quality of the rules that interact with that legislation, and the damage to the integrity of the law spreads in ever widening circles.159 The adoption of the all-or-nothing rule for the claiming of tuition credits provides a classic illustration of this phenomenon. The highly questionable decision to restrict the claiming of the tuition credits for a given student to one individual required the adoption of a statutory rule attributing a tax loss incurred by one taxpayer to a related taxpayer, an attribution that flatly violates the firmly established assignment of income principle. The initial design flaw, not surprisingly, required the support of equally flawed ancillary statutory provisions.

More surprisingly, however, bad statutory drafting tends to produce bad regulatory drafting, as evidenced by the Treasury’s attempt to minimize the damage caused by the Congressional failure. In an attempt to reduce the grosser instances of unfairness flowing from the all-or-nothing rule for claiming tuition credits, the Treasury embraced and extended the suspension of the assignment of income rules and ignored the step transaction doctrine in the process. Similarly, when Congress designed a credit that made the receipt of a tax-exempt scholarship burdensome, the proposed regulations responded to the manifest unfairness by dictating rules that would allow taxpayers to treat mandatory tax rules as elective, an extraordinarily unwise move. Here, bad legislation plainly forced the promulgation of bad regulations.

In other contexts, the Treasury sought to ignore statutory rules that it evidently deemed both ill-considered and unenforceable. Thus, for example, at two points the regulations seem to ignore statutory limitations on the expenses eli-

gible for the tuition credits and to dictate a broader (and fairer) rule. Blatant inconsistencies between statutory and regulatory rules inevitably confuse taxpayers and produce litigation, the results of which are highly unpredictable.\(^{160}\)

V. CONCLUSION

Americans, particularly American politicians, love to hate the Code. In truth, however, the income tax has been a source of both pride and strength for the country. Americans actually pay the income tax, and it has generated the revenues required to overcome the economic and military challenges of the Twentieth Century while still allowing the economy to flourish. The United States has never come close to needing the sixteen to twenty percent national turnover tax that burdens most of the rest of the world. But that particular source of national pride is losing its glow. There cannot be any question that United States tax laws have become too long, too complex, and too indecipherable. In large measure, these faults are not inherent in income taxation but are the result of bad design and drafting. The attempt has been made here to document this failure as the first step toward recovery.

\(^{160}\)See generally Deborah A. Geier, Some Meandering Thoughts on Plaintiffs and Their Attorneys’ Fees and Costs, 88 TAX NOTES (TA) 531 (July 24, 2000) (arguing, among other things, that the courts were developing erroneous doctrines to avoid the consequences of bad legislation).