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J. Timothy Philipps

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FEDERAL TAXATION OF PREPAID COLLEGE TUITION PLANS

J. TIMOTHY PHILIPPS*

I. INTRODUCTION

Costs of college education have escalated rapidly over the past decade-and-a-half, outstripping the general rate of inflation. For the period 1977 to 1987, charges for tuition, fees, and room and board at private colleges and universities increased by 132.2 percent, while charges at public colleges and universities increased by 109.2 percent.¹ For the same period the consumer price index for all items increased by 99.6 percent.²

If one looks only at the 1980s, the disparity between increases in costs for higher education and the general inflation rate has been even greater. In fact, the cost of tuition went up faster during the 1980s than any other

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². TAX INCENTIVES FOR EDUCATION, supra note 1, at 34. The following table details college cost increases and changes in the consumer price index for the years 1977-87.

<table>
<thead>
<tr>
<th>Year</th>
<th>Public</th>
<th>Private</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Tuition Total Costs</td>
<td>Tuition Total Costs</td>
</tr>
<tr>
<td>1977</td>
<td>7.4  4.1</td>
<td>4.0  4.0</td>
</tr>
<tr>
<td>1978</td>
<td>0.0  4.2</td>
<td>6.3  5.3</td>
</tr>
<tr>
<td>1979</td>
<td>4.8  5.1</td>
<td>6.9  6.2</td>
</tr>
<tr>
<td>1980</td>
<td>4.5  6.7</td>
<td>10.4  8.1</td>
</tr>
<tr>
<td>1981</td>
<td>3.8  4.6</td>
<td>12.2 10.1</td>
</tr>
<tr>
<td>1982</td>
<td>16.0 13.6</td>
<td>13.1 13.2</td>
</tr>
<tr>
<td>1983</td>
<td>19.5 13.3</td>
<td>8.4  8.6</td>
</tr>
<tr>
<td>1984</td>
<td>12.9  7.6</td>
<td>15.1 12.9</td>
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<tr>
<td>1985</td>
<td>1.9  3.4</td>
<td>8.4  6.9</td>
</tr>
<tr>
<td>1986</td>
<td>10.3  8.9</td>
<td>8.0  7.1</td>
</tr>
<tr>
<td>1987</td>
<td>7.6  5.5</td>
<td>6.9  5.6</td>
</tr>
<tr>
<td>1977-87</td>
<td>131.2 109.2</td>
<td>158.6 132.2</td>
</tr>
</tbody>
</table>

Id.

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good or service, including medical care. For example, the average annual rate of general inflation during the period 1982 to 1986 was approximately four percent, while the rate was almost ten percent for private colleges and was over seven percent for public colleges. The College Board estimates the increase in college costs for the 1989-90 school year to be about nine percent for private four year colleges, and eight percent for public four year colleges. This compares to a rise in the consumer price index of 5.2 percent for the 12 months ending in June, 1988. The Department of Education projects that when a child born in 1989 enters college in 2007, total costs for four years will be $200,000 at a private institution and $60,000 at a public institution. This compares to a current four year total cost of about $50,000 at a private institution and $18,000 at a public institution.

Another way to view the situation is to compare the rise in college costs to the rise in disposable income. Between 1980 and 1987, disposable income grew at an average annual rate of 6.5 percent. For the same period tuition and fees increased at a rate of 9.8 percent. This contrasts with the trend prior to the 1980s, when disposable income increased more rapidly than the cost of attending college. These large increases in costs of higher education have not brought with them comparable initiatives at the federal level for keeping the costs of college affordable. The federal government currently provides a number of grant and loan programs to help finance higher education. Among these are Pell Grants, Supplemental Educational Opportunity Grants, College Work Study, Perkins Loans, Guaranteed Student Loans, PLUS Loans for parent borrowers, and Supplemental Student Loans for student borrowers. Each of these has some disadvantages. Pell Grants and Sup-

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7. Id.


9. Id.

10. For a general explanation of the various programs, see TAX INCENTIVES FOR EDUCATION, supra note 1, at 35-37. In general these programs are self descriptive, with grant programs providing funds for college that do not have to be paid back, while loan programs may provide for below-market rate loans, deferred payment terms, government guarantees, or a combination of the foregoing. Id.
plemental Educational Opportunity Grants are reserved for the neediest students, while loan programs often saddle a student with a heavy debt burden, especially if the student goes on to graduate or professional school. Work study is simply inadequate to finance all but a small part of college education, since the students work for minimum or near minimum wages.

Furthermore, changes in the federal income tax enacted as part of the Tax Reform Act of 1986 eliminated many of the tax advantages of traditional devices used for financing college education. The Clifford Trust was eliminated, and the unearned income of children under 14 is now taxed at the parent’s marginal tax rate. Consequently, subsequent to the 1986 Act, these devices are no longer as attractive to parents planning for future college costs. In addition, the deduction for interest paid on education loans was phased out, and portions of scholarships, such as room and board grants, were made taxable for the first time.

As a result of the perceived inadequacy of federal programs and tax laws, there has been a surge of activity at the state level to find new ways to help parents and students finance college education. Two of the most prominent of these state initiatives are a special type of state bond, sometimes termed a baccalaureate bond, and prepaid tuition plans. Both of these devices share a common aim—to remedy the present inadequacy in

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11. For example, in 1984 graduating law students had incurred educational debt averaging $20,000 to $30,000. The monthly payment on a debt of $25,000 would be in excess of $300 per month. ABA, Sec. of Legal Educ. and Admissions to the Bar, Memorandum D8788-88 at 3-4 (1988). These numbers have undoubtedly increased since 1984. For a general discussion of the college debt burden, see Hansen, Student Loans: Are They Overburdening A Generation? (College Board 1987).

12. See Tax Incentives for Education, supra note 1, at 35.

13. The Clifford Trust device enabled a parent to place property in a trust for a 10 year or longer period with income payable to a child of the parent and a reversion to the parent at the termination of the trust. The income would be taxed to the child at the child’s presumably lower tax rate. I.R.C. § 671 (1982).


16. See I.R.C. § 163(h)(d). These provisions phase out the deduction for personal interest so that it is completely eliminated after 1990. For 1990, 10% of interest on education loans is deductible. Id.

17. See I.R.C. § 117(b).

18. For summaries of various college financing devices, see Kenny, Establishing a Program to Provide for College Cost Requires Careful Planning After TAMRA, Tax’n For Law. 56 (July/August 1989); Knight & Knight, New Ways to Arrange Tuition Costs, J. Acct. 46 (March 1989). Some private universities also have experimented with prepaid tuition plans. However, Duquesne University, a pioneer in the idea, recently was forced to suspend its plan. Duquesne cited a lower than projected rate of return on the bonds used to underwrite the plan and a need to raise tuition at a faster rate than originally forecast as reasons for the suspension. Duquesne University Suspends Its Tuition Prepayment Plan, N.Y. Times, March 6, 1988, at p.28, col. 1.
the saving rate for college costs. Their underlying idea is to provide incentives for parents to save for college costs on a systematic basis.

Baccalaureate bonds are simply non-recallable, tax-exempt, zero coupon bonds issued by states in such a way as to link them with saving for higher education. This is accomplished by issuing the bonds in smaller denominations than usual, making them non-recallable, and marketing them to the public as being intended for college saving. For example, the Illinois bond program issues bonds, marketed as college savings bonds, with maturity values of 5,000 and maturity terms that range between five and twenty years. An advertising brochure states that a sixteen year maturity bond can be purchased for $1400. Illinois also promises a bonus of .4 percent interest annually if the proceeds of the bonds actually are used for tuition at an in-state institution of higher education. Virginia issues bonds with maturity values of $1000 or $5000, with terms of between five and twenty years and interest rates of 6.7 to 7 percent. Virginia advertised its bonds by including in the state income tax packet a page detailing projected costs of college education and explaining its bond program. Unlike the Illinois bonds,

19. The overall United States savings rate in 1986 was 3.8%. This compares to a savings rate of 8.6% in 1975. During the 1980s the savings rate hovered in the 5% to 6% range. The following table summarizes the results of that survey:

<table>
<thead>
<tr>
<th>Percent Now Saving</th>
<th>Median Amount Saved per year</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Parents Expecting Children to Attend College</td>
<td>51%</td>
</tr>
</tbody>
</table>

By Household Income:

| Under $10,000 | 17% | $120 |
| $10,000-$19,999 | 45% | $140 |
| $20,000-$29,999 | 52% | $466 |
| $30,000 and over | 70% | $904 |

By Age of Children Expected to Attend College:

| Under 13 | 51% | $443 |
| Age 13-18 | 58% | $500 |

20. A zero coupon bond is issued at a discount (i.e., a price below its face value at maturity), and the difference between the amount paid by the investor for the bond and its value at maturity represents the interest element on the bond.


23. Id. § III.

24. Id.

25. Id.; see VA. CODE ANN. § 23-38.72 to .74 (Supp. 1989).
Virginia's bonds offer no bonus if the proceeds are used for educational purposes by the purchaser.\(^{26}\)

Interest on baccalaureate bonds is tax free to the recipient under Internal Revenue Code (IRC) section 103(a) because the receipts of the bond issue are used for general public purposes by the states issuing them.\(^{27}\) In this respect baccalaureate bonds are no different than any other general obligation bonds issued by a state and, hence, are entitled to the section 103 governmental interest exclusion. They are merely marketed as a college savings device and issued as non-recallable zero coupon bonds in smaller denominations than usual.

The tax treatment of baccalaureate bonds is, therefore, straightforward. Interest on the bonds is excluded from federal gross income and normally will be excluded from gross income for the state that issued the bonds. Several states have adopted programs to issue baccalaureate bonds because of their simplicity and tax advantages.\(^{28}\)

However, baccalaureate bonds are deficient in one important respect. There is no guarantee that income from the investment will be sufficient to fund college costs when the bonds mature. Indeed, the likelihood is that the income from the investment will be insufficient to fund future college costs of a purchaser of the bond.

The reason for this is that the historical real rate of return (return after adjustment for general inflation) on tax-exempt securities is approximately zero, while the rate of college cost inflation is projected to exceed the general inflation rate in the foreseeable future by about two percent.\(^{29}\) Therefore, a person investing in tax-exempt bonds to fund future college costs would fall further behind those costs the longer that person held the bond.\(^{30}\) The ultimate result is that baccalaureate bonds fail to protect against the risk about which parents planning for their children's college education are most concerned: college cost inflation. These bonds provide no assurance, whatsoever, that the amounts invested will be sufficient to fund future educational costs.\(^{31}\)

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26. 1989 Survey, supra note 22, at § III.
27. See I.R.C. § 103(a); Rev. Rul. 73-112, 1973-1 C.B. 47.
31. See Tax Incentives for Education Hearing, supra note 4, at 198-201 (Statement of John D. Finnerty).
Tuition prepayment plans, by contrast, address inflation risk directly. The basic idea is that in exchange for payment of a predetermined amount, the sponsor of the plan promises to provide educational services in the future, regardless of the cost of those services at the future time.

For a while prepayment plans looked like the wave of the future, as they were adopted or considered in several states. However, more recently there have been second thoughts about prepayment plans, especially with respect to their treatment under the federal income tax. Two private letter rulings indicate that the Internal Revenue Service (IRS) position with respect to tuition prepayment plans may place such onerous tax burdens on them that they simply will not be able to work as conceived. This article will examine prepaid tuition plans, using the plan adopted by the state of Michigan as a prototype, and discuss the IRS position with respect to tax treatment of such plans. The article then will discuss possible alternatives to the IRS position under present law and, finally, suggest enactment of legislation to deal with the question.

II. The Michigan Plan

Michigan was the first state to enact legislation authorizing a prepaid tuition plan, and its program has been a model for other state plans. The Service issued a letter ruling on the Michigan Plan in 1988. This article will focus on the Michigan Plan because there is more experience and information available with respect to that plan than any other.

A. Structure of the Plan

The Michigan Plan is administered by a “public body corporate and politic” designated the Michigan Education Trust (MET). MET is “within” the state Department of Treasury but exercises its “statutory powers, duties, and functions independently of the head of that department.” MET collects 

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37. Id. The state treasurer is, however, a member of MET's nine person board of directors. Id. § 390.1430(1). The other eight members are appointed by the Governor. No more than two of those eight members can be state officials or employees. Of the remaining six members, one must be appointed from a list of nominees of the Senate Majority Leader and one from a list of nominees of the House of Representatives Majority Leader, one must
funds from purchasers of prepaid tuition contracts. The MET funds then are invested by the state Department of the Treasury.

The funds can be pooled with other state investment funds for investment purposes, but they are not subject to use by the state for any other purposes but MET's. This arrangement permits MET and its contract purchasers to take advantage of the state's money management expertise and the market power of the state's investment funds. At the same time it protects MET's funds from the possibility that they may be used by the state for purposes other than fulfillment of MET's contract obligations. The plan, thereby, presents a substantial investment advantage to individual contract purchasers who normally lack the market power and expertise for sophisticated investment activity.

MET has an assortment of plans and price structures. The basic idea for each is the same. In exchange for a payment by the contract purchaser, MET agrees to provide a contracted amount of educational services to the beneficiary of the contract at an in-state institution of higher education, no matter what the cost of those services is when the beneficiary actually attends college. There is no guarantee, however, that a child will be admitted to a state institution of higher education. The admission decision remains with the individual institutions.

The MET contract also provides for a variety of payouts if the beneficiary attends an in-state private institution or an out-of-state institution, dies or becomes disabled before reaching college age, receives a scholarship, or after reaching age 18 certifies that he does not plan to attend an

be a President of a state institution of higher education, one must be a President of a community college, and one must be a representative of the interests of private in-state colleges and universities. Id. The MET board is subject to the state open meeting law and the state freedom of information act. Id. § 390.1430(5),(6). Moreover, the form of MET contracts must be approved by the state administrative board. Id. § 390.1426(2).

38. Id. § 390.1429(1-4).
40. The Full Benefits Plan provides in-state tuition at any public institution of higher education in the state. The Limited Benefits Plan provides up to 105% of the weighted average tuition costs at the state public four-year institutions. The Community College Plan provides in-district tuition at any of the state's public community and junior colleges. Mich. Dep't of Treas., Guaranteeing Tomorrow's College Tuition Costs Today Q&A 7 at 3-4 (1988). Under the most expensive Full Benefits Plan, the cost for a contract purchased for a child at birth in 1988 was $1,689 per year for a total of $6,756 for four years. Id. Q&A 8 at 4. In 1989 the cost went up to $1,916 per year for a total of $7,664 for four years. Michigan Applications Drop for Prepaid Tuition, Chicago Tribune Wire Service, Oct. 19, 1989.
42. See Mich. Laws § 390.1438, which states:

Nothing in this act or in [a Met] contract shall be construed as a promise or guarantee by [MET] or the state that a person will be admitted to a state institution of higher education or to a particular state institution of higher education.

43. In conformity with what the good nuns taught the author in grammar school, this article will use the masculine pronoun when gender is indeterminate.
institution of higher education. For the most part, in the absence of some extraordinary event, such as death or disability of the beneficiary, the funds used to purchase the contract cannot be reached by either the purchaser or the beneficiary until the beneficiary reaches college age. Moreover, the benefits of the contract are not transferable except in limited circumstances, such as when a beneficiary decides not to attend college.

The statute also provides for an annual actuarial review of the MET fund. MET will set future contract prices yearly to assure the actuarial soundness of the fund in accordance with this annual review. However, there is no guarantee that the state will rescue MET should the fund for some reason become unable to meet its obligations. Nevertheless, such a bailout is not precluded by the statute.

B. Letter Ruling 88-25-027

Under the terms of its enabling statute MET could not commence issuing prepayment contracts until it received a ruling from IRS that the contract purchaser would not be taxable on account of the prepayment contract. Accordingly, MET, in 1986, and again in 1987, requested a ruling from IRS that the plan would entail no tax consequences to the purchaser of the contract, the beneficiary, or MET. MET took the position that its contracts were similar to prepaid service contracts, such as one purchases when one buys a new car and wants more than a basic warranty. The car buyer can purchase an extended warranty whereby the seller promises to provide certain services in the future. Because these prepaid service contracts are not currently taxable, the argument went, then neither should MET contracts entail tax consequences.

When the ruling was finally issued in March 1988, the good news for MET was that IRS ruled the contract purchaser had no income tax conse-

44. Michigan Education Trust Full Benefits Plan Contract § 7. There is also provision for transferring the contract to another beneficiary where the original beneficiary dies, becomes disabled, drops out of high school, or reaches age 18 and certifies he does not plan to attend an institution of higher education. Id. § 6.

45. Id. §§ 6, 7.

46. Id. § 6. In such cases the benefits can be transferred to an "immediate family member," defined as a "spouse, child, stepchild, adopted child, grandchild, niece, nephew, or ward of the Purchaser, or the brother, sister, stepbrother, or stepsister of the beneficiary." Id. § 17.


50. Mich. Law at § 390.1433(3). The statute also provides that amounts paid over to MET are deductible for Michigan state income tax purposes, and that neither the purchaser nor the beneficiary is taxable under the Michigan income tax on account of purchasing or receiving benefits under a MET contract. See id. § 390.1435, § 390.1440.

51. See infra text accompanying notes 114-22.
quences on account of purchasing the contract. The bad news was that IRS found taxability just about everywhere else.52
The facts of the ruling are that A purchases a prepayment contract for the benefit of B, an irrevocably designated beneficiary. The educational benefits of the contract cannot be received by B until B matriculates. If certain events occur and B does not matriculate, a refund is to be paid to a secondary beneficiary, C. The refund to C may be only the amount paid for the contract or an amount determined by reference to average tuition charges at institutions covered by the contract, depending on the type of contract purchased.53 The ruling assumed that Michigan law does not impose a legal obligation on a parent to provide a child with a college education.54

1. Income Tax Treatment of Parent and Child
The ruling first considered the income tax results of purchasing the contract to the purchaser A and the beneficiaries B and C. The Service ruled that purchase of the contract is a gift by A to B and C and, therefore, not includible in B and C's gross income under IRC section 102(a), which excludes gifts from gross income.55 Neither does the purchase of the contract result in any income tax consequences to A, as A is simply making a gift.56 The basis in the contract for B would be the donor A's basis, the price A paid for the contract. If C receives a refund under the contract, C also takes A's basis.57
Although the initial purchase of the contract does not result in gross income to B or C, the receipt of benefits under the contract by B does cause B to have gross income. The Service reasoned that the income from gift property, in contrast to the gift property itself, is taxable to the donee.58 Therefore, the difference between an allocated portion of B's basis in the contract (the purchase price paid by A) and the value of the educational services received by B during B's tax year is gross income to B in that year.59
For example, if A paid $6,000 for four years of tuition and the value of one year's tuition is $2,500 when B receives the educational services, B

54. Id. For a discussion of the possibilities where such an assumption is not made, see infra text accompanying notes 130-60.
55. Ltr. Rul., supra note 52, at 54,986-87. See I.R.C. § 102(a), which provides that "gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."
56. Ltr. Rul., supra note 52, at 54,987.
57. Id. See also I.R.C. § 1015(a).
58. See Ltr. Rul., supra note 52, at 54,987; I.R.C. § 102(b).
has an income inclusion of $1,000 ($2,500 value of educational services received minus $1,500 allocated portion of B's substituted basis of $6,000) in the year that B receives the educational services.60 If C receives a refund under the contract, C, likewise, has an income inclusion in the year of receipt in the amount of the difference between the amount of the refund and C's substituted basis in the contract.61 However, the Service ruled that A, the purchaser of the contract, has no income inclusion on account of receipt of the educational services by B or receipt of a refund by C.62 The purchaser A, therefore, has no income either when the contract is purchased or when B or C receive benefits under the contract. Moreover, IRS ruled that neither A, B, nor C has constructive receipt of income between the date A purchases the contract and the date either B or C receives benefits under the contract.63

2. Gift Tax Treatment of Parent

Although the purchaser A has no income tax consequences on account of the contract, A does have gift tax consequences. The Service ruled that the purchase of the contract is a taxable gift by A for federal gift tax purposes because the payment of money by a taxpayer to a third party in consideration of the third party's rendering services to a person designated by the taxpayer is a taxable gift by the taxpayer to the designee.64 Moreover, the gift is not subject to any rule of exclusion. The gift is not excludible under the $10,000 annual gift tax exclusion because it is not a gift of a present interest.65 Nor is the gift excludible under the provision that excludes from application of the gift tax amounts paid on behalf of an individual to a qualified educational institution for the education or training of such individual. The Service concluded that this provision is inapplicable because the purchase price of the contract is paid to the Trust and not directly to the institution that provides the educational services.66

60. Id. See also Treas. Reg. § 1.61-6 (1960).
62. Id.
63. Id.
64. Id. See also I.R.C. § 2501(a); Treas. Reg. § 25.2511-1(h)(3) (as amended in 1986).
65. See I.R.C. § 2503(b). The Service concluded that there is not a gift of a present interest because the donee B's enjoyment of the educational services is delayed to some time in the future. Ltr. Rul., supra note 52, at 54,988.
66. Id. See also I.R.C. § 2503(e)(2)(A). The Service elaborated on the gift tax consequences in a later ruling, apparently addressed to the similar Indiana prepaid tuition plan. In that ruling the IRS addressed the gift tax consequences where the purchaser A retains the right to receive a refund on termination of the contract rather than giving the refund right to C, and A also makes installment payments to the trust rather than paying the purchase price in a lump sum. The Service ruled that A's retaining the right to a refund does not reduce the amount of the taxable gift, because the value of the refund right is dependent on contingencies so speculative as to make the value of that right unascertainable under generally accepted valuation principles. The Service also held that payment of the gift in installments delays completion of the taxable gift, and hence imposition of the gift tax, until the installment
3. Income Tax Treatment of MET

The most surprising aspect of the ruling was the Service’s position with respect to income tax treatment of MET. The Service concluded that MET is taxable on its investment income, despite MET’s clear relationship to the state government. The Service first held that MET is not an integral part of state government because: 1) decisions by MET’s board of directors cannot be overridden by any state agency; 2) MET’s funds are not derived from the state or any state agency; 3) MET’s funds are not subject to claims of the state’s creditors and “are not considered state money or common cash of the state”; 4) the state may not loan, transfer or use MET’s funds for any purpose; and 5) MET’s funds may only be used for the provision of educational services or refunds authorized in the trust’s enabling legislation.7 The Service then concluded that because MET is not an integral part of state government, it cannot be exempt from taxation on that ground.68

Next IRS considered whether MET is exempt from income tax under IRC section 115, which provides that gross income does not include income that accrues to a state from “the exercise of any essential governmental function.”69 The Service asserted that section 115 requires that the income not serve private interests such as designated individuals, shareholders, or organizations. Therefore, in the Service’s view, even if the income serves a public interest, “the requirements of section 115 are not satisfied if the income serves a private interest that is not incidental to the public interest.”70

The Service then addressed whether MET serves a private interest that is not incidental to a public interest. The Service explained that MET provides the beneficiary B with a direct economic benefit in the form of educational services, the value of which is expected to be substantially in excess of the initial payment for the contract. Furthermore, this benefit is available only to those persons who are beneficiaries of prepaid tuition contracts. Based on these facts, the Service determined that MET serves private interests that are not incidental to the public interest. Therefore, the Service concluded that MET’s investment income is not exempt from income tax under IRC section 115.71

The Service left the precise manner in which MET is taxable undetermined by the ruling. That is, MET taxable as a subchapter C corporation,
as a simple trust, as a complex trust, or as some other entity such as a life insurance company?

In summary, the IRS position is that the contract purchaser is subject to gift tax but not income tax on account of purchase of the contract. Moreover, the purchaser is not subject to income tax, either during the term of the contract or when a beneficiary receives the educational benefits or receives a refund. However, a beneficiary who receives educational benefits under the contract has gross income when he receives the benefits. The amount of income is the difference between the fair market value of the educational services received by the beneficiary and an allocated portion of the beneficiary's basis in the contract. The beneficiary's basis in the contract is a substituted basis from the purchaser—the price paid by the purchaser for the contract. Likewise, if either a beneficiary or the purchaser receives a refund, that person has gross income in the amount of the difference between the amount of the refund and his basis in the contract. Finally, the MET is subject to tax on its investment income in some way undefined by the ruling.

C. Competing Analyses Under Existing Law

There are currently no Internal Revenue Code provisions that deal specifically with prepaid tuition plans. The Service, in Letter Ruling 88-25-027, relied on broad code sections such as section 61, defining gross income, and general doctrines such as constructive receipt and intergovernmental immunity. Although IRS makes a plausible case for its position in the ruling, other equally or more plausible conclusions could result under existing law by using any of several competing analyses.

There are basically three potential taxpayers in a prepaid contract arrangement: 1) the purchaser of the contract (Parent); 2) the beneficiary of the contract (Child); and 3) the contract provider (MET). The first question is which, if any, of these potential taxpayers is actually subject to tax under existing law. A second question is when is the tax imposed.

1. Income Tax Treatment of Parent and Child

There are several plausible income tax outcomes under current law for Parent and Child. They all depend in some degree upon analogies with the income tax treatment of other more familiar transactions.

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72. The purchaser is, of course, taxable if a refund is paid to him and the amount of the refund exceeds the purchaser's basis in the contract. Id. at 54,987.
73. The beneficiary does not have gross income from the contract during its term. The contract's restrictive refund features prevent the beneficiary from being in constructive receipt of any income during that time. Id.
74. A parent need not be the purchaser of a prepaid tuition contract and a child of the purchaser need not be the beneficiary. However, parent/purchaser and child/beneficiary is the most common arrangement. Hence, for simplicity, the remainder of this article will refer to the purchaser as Parent and the beneficiary as Child. The analysis will also assume that Parent is entitled to any refund under the contract.
75. See Statement of Professor Leo J. Raskind, University of Minnesota Law School, in Invitational Conference, supra note 3, at 40.
a. Time-Value of Money

The transaction between Parent and MET might be subjected to economic analysis utilizing time-value of money or present value concepts. Using such an analysis, the transaction can be analogized to a loan from Parent to MET, with MET agreeing to repay the loan with interest by providing educational benefits to Child in the future. The difference between the value of the educational services furnished to Child and the amount of the "loan" would constitute economic income to Parent under familiar time-value of money principles. Concomitantly, Parent would be considered as making a gift of the value of the educational services to Child. The economic effect is the same as if Parent lent the contract price to MET at market interest, and Parent reinvested MET's interest payments in the contract. Under a strictly economic analysis, Parent has income as the unstated interest element of the contract accrues.

Three provisions in the 1984 Act, IRC section 7872 (below market interest loans), section 467 (payments for the use of property or services), and sections 1271-75 (original issue discount) conceivably could apply to prepaid tuition contracts. Nevertheless, there are strong arguments, based on both statutory analysis and legislative history, that none is applicable. Moreover, even if one or more of the time-value of money provisions were applicable, they may be overridden by the IRC section 103 state bond interest exclusion.

(1) Below Market Interest Loan

Analysis of the relevant Code provisions indicates that none of them readily applies to the prepaid tuition situation. The first IRC provision that might apply is section 7872. This section imposes the income tax when a lender lends a borrower money at no interest or at a below-market interest rate. The provision accomplishes this result by imputing a transfer of the foregone interest from the lender to the borrower and then imputing a retransfer of that amount from the borrower to the lender as an interest payment. For example, applied to the prepaid tuition case, IRC section 7872 would impute a transfer by Parent to MET of an amount equivalent to the foregone interest, and a retransfer of that same amount from MET

76. The term "time-value of money" refers to the economic fact that receipt of a dollar today has greater value than receipt of a dollar at some future time. For example, the right to receive one thousand dollars one year in the future is presently worth only about $909, assuming a 10% interest rate. That is, $909 invested today at a 10% interest rate will grow to $1,000 in one year. See A. Alchian & W. Allen, Exchange and Production: Competition, Coordination, and Control 107-31 (3d ed. 1983). The fundamental premises of the I.R.C.'s time-value of money rules are: 1) parties dealing at arm's length provide compensation for the use of money in every deferred payment transaction; 2) this compensation should normally be treated as taxable income to the creditor; and 3) this interest should be allocated to tax years on a constant interest basis.

77. See I.R.C. § 7872(a).
to Parent. The transfer by Parent to MET would be characterized as an additional tuition payment. The imputed retransfer from MET to Parent would be characterized as a payment of interest income to Parent.

The difficulty with applying IRC section 7872 in this instance is that the words of the statute simply do not fit the case. Section 7872 applies to three specific categories and to two broad residual classes of loans: 1) gift loans, e.g., loans from a parent to a child; 2) employment related loans, e.g., loans from an employer to an employee; 3) corporation-shareholder loans, e.g., loans from a corporation to a shareholder; 4) loans one of the principal purposes of which is the avoidance of any federal tax; and 5) to the extent provided in regulations, any below-market loan not included in one of the first four categories to the extent that the interest arrangements have a significant effect on the federal tax liability of the lender or borrower. 78

Of these five categories, the first three are patently inapplicable. There is no gift of foregone interest between Parent and MET; nor are Parent and MET in an employer-employee or corporation-shareholder relationship. The only categories that could possibly apply are the fourth and fifth. The fourth category—a principal purpose of the loan is tax avoidance—is obviously a fact and circumstance issue. Nevertheless, it is difficult to see how a principal purpose of MET contracts is tax avoidance. Granted, there were anticipated tax benefits when MET was created, and the MET legislation was conditioned on a favorable IRS ruling with respect to income tax consequences to Parent.79 Still, income tax consequences, though important, are incidental to the principal purposes of MET and its clients. These purposes are spelled out in the MET legislation itself as promoting state institutions of higher education and advancing the education of the state's citizenry.80

The fifth category is a catch-all provision that authorizes Treasury to issue regulations applying section 7872 to "any below-market loan . . . if the interest arrangements of such loan have a significant effect on any Federal tax liability of the lender or the borrower."81 Treasury has issued temporary regulations under this provision that exempt several classes of transactions from application of section 7872. Among the class of exempted loans are "[loans which are made available by the lender to the general public on the same terms and conditions and which are consistent with the lender's customary lending practice."82 MET makes its contracts available to the general public on equal terms and conditions in accordance with its normal business practices. Hence, MET fits within the regulations' exception. Apparently, therefore, section 7872 does not apply to MET contracts.

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78. I.R.C. § 7872(c)(1)(A),(B),(C),(D),(E). A sixth category, irrelevant to this discussion, includes certain loans to continuing care facilities. Id. § 7872(c)(1)(F).
80. Id. at § 390.1423.
(2) Payment for Use of Property or Services

A second possibly applicable Code provision is IRC section 467. That section deals mainly with proper recognition of the interest component of a payment where a lease calls for deferred payment of rent.\textsuperscript{52} However, both the legislative history and the statute itself indicate that Treasury has authority to issue regulations applying the section to advance payments and to payments for services.\textsuperscript{64} The Conference Report states, "Regulations will also deal with the treatment of front-loaded (i.e. prepaid) agreements."\textsuperscript{185} This language indicates that Treasury has authority to issue regulations applying IRC section 467 to prepaid tuition contracts because the contracts are readily characterized as advance payments for educational services. However, the actual wording of the statute is more restrictive than the broad language of the Conference Report. Section 467(f) confers upon Treasury authority to issue regulations applying section 467 "in the case of any agreement where the amount paid under the agreement for the use of property decreases during the term of the agreement."\textsuperscript{86} That is, Treasury's authority under this subsection is limited to issuance of regulations applying section 467 to prepayment of rent, not prepayment for services.

The statute does give Treasury authority in subsection (g) to issue regulations applying section 467 to payments for services.\textsuperscript{87} However, the language of subsection (g) appears to authorize only regulations applying section 467 to deferred, not prepaid, payments for services. Subsection (g) authorizes regulations applying rules "comparable to the rules of subsection (a)(2)"\textsuperscript{88} to "payments for services which meet requirements comparable to the requirements of subsection (d)."\textsuperscript{89} Subsection 467(d), in turn, applies to

\begin{itemize}
  \item \textsuperscript{83} See I.R.C. § 467(a)-(e).
  \item \textsuperscript{84} See I.R.C. § 467(f),(g); H. R. REP. No. 98-861, 98th Cong., 2d Sess. 895, \textit{reprinted in} 1984 U.S. CODE CONG. & ADMIN. NEWS 1445, 1583.
  \item \textsuperscript{86} I.R.C. § 467(f) (emphasis added).
  \item \textsuperscript{87} See I.R.C. § 467(g), which provides in relevant part:
  Under regulations prescribed by the Secretary, rules comparable to the rules of subsection (a)(2) shall also apply in the case of payments for services which meet requirements comparable to the requirements of subsection (d).
  \item \textsuperscript{88} \textit{Id.} I.R.C. § 467(a)(2) provides in relevant part as follows:
  (a) In the case of a lessor or lessee under any section 467 rental agreement, there shall be taken into account the sum of (1) . . . and (2) the sum of the interest for the year on the amounts which were taken into account under this subsection for prior taxable years and which were unpaid.
  \item \textsuperscript{89} I.R.C. § 467(g). I.R.C. § 467(d) provides in relevant part as follows:
  (1) In general-[T]he term "section 467 rental agreements" means any rental agreement for the use of tangible property under which-
  (A) there is at least one amount allocable to the use of property during a calendar year which is to be paid after the close of the calendar year following the calendar year in which such use occurs, or
  (B) there are increases in the amount to be paid as rent under the agreement.
\end{itemize}
deferred payments, not prepayments. Section 467(d)(1)(B) applies to cases where there are "increases in the amount to be paid . . . under the agreement," not to prepayments.90

In addition, section 467(d)(2) provides that the section does not apply to transactions in which the aggregate amount of payments does not exceed $250,000.91 Manifestly, aggregate payments on each prepaid tuition contract do not exceed $250,000. Hence, section 467 is inapplicable to prepaid tuition contracts by reason of this provision alone.

Finally, Treasury has not yet issued any regulations under authority of subsections 467(f) and (g). The Conference report indicates that such regulations are to be issued on a prospective basis only.92 Apparently, therefore, IRC section 467 does not apply to prepaid tuition contracts.

(3) Original Issue Discount

Conceivably, the original issue discount provisions of the Code also might apply.93 These provisions govern debt instruments issued at a discount, defined as the difference between the issue price of the instrument and the redemption price at maturity.94 If these rules apply to MET contracts, the issue price would be the price paid by Parent for the contract and the redemption price at maturity would be the value of the educational services received by Child. The redemption price at maturity would, therefore, be contingent on the value of educational services received by Child. Regulations to govern the contingent payment situation have been proposed. These regulations require that the discount element be taken into income by the owner in the year that the payments become fixed.95 Applying this analysis to MET, Parent would be taxable in the years the educational services are rendered on the difference between the purchase price (issue price) of the contract and the value of the educational services when rendered (redemption price at maturity).

The question remains, however, whether these rules apply. The operative provision, IRC section 1272, applies to "any debt instrument."96 The issue

91. I.R.C. § 467(d)(2) provides in relevant part as follows:
   This section shall not apply . . . if the sum of the following amounts does not exceed $250,000-
   (A) the aggregate amount of payments received as consideration . . . , and
   (B) the aggregate value of any other consideration to be received. . . .
   The conferees intend that the provisions relating to deferred payment services agreements and front-loaded agreements and the regulations thereunder be applied prospectively from the date of issuance of regulations.
   Id.
93. See I.R.C. §§ 1271-75.
94. See I.R.C. § 1273(a)(1).
96. I.R.C. § 1272(a)(1).
then becomes whether a prepaid tuition contract is a debt instrument. Section 1275 defines a debt instrument as a "bond, debenture, note, or certificate or other evidence of indebtedness." The proposed regulations attempt to place a broad gloss on the statute by defining debt instrument as including "all rights to deferred payments under a contract whether or not evidenced by a formal instrument." Although prepaid tuition contracts conceivably may fit under this definition by a strained reading, they do not appear to be the kind of instrument to which the original issue discount provisions are addressed. Prepaid tuition contracts are essentially agreements for provision of future services by the issuer of the contract. They are not debt instruments in any ordinary sense. In this regard it is noteworthy that IRS did not attempt to apply section 1272 in Letter Ruling 88-25-027.99

(4) Legislative History

Finally, the legislative history of the 1984 Tax Reform Act time-value of money provisions100 presents a persuasive argument that Congress did not intend for Parent to be taxed under time-value of money analysis in the prepaid tuition situation. The 1984 Act, enacted after extensive congressional consideration, created a comprehensive statutory framework for dealing with a set of income measurement problems that concerned the prior law's inadequacies in taking account of the time-value of money. The Treasury presented testimony to Congress concerning time-value of money during hearings prior to enactment of the legislation. That testimony, presented by Treasury's Acting Tax Legislative Counsel, covered a broad range of time-value of money problems and offered several examples of possible areas for congressional action. Among those examples was the following:

Rather than charging Parent tuition of $5,000 in 1985, College will accept $4,000 in 1983. Because College can earn $1,000 on the $4,000 over the two years without incurring any income tax liability, it is indifferent between $4,000 today and $5,000 in 1985. Parent

99. See supra text accompanying notes 50-73. I.R.C. § 1273(b)(5) does provide that the original issue discount provisions can apply to debt instruments issued in exchange for services, as well as debt instruments issued for property or money. Id. However, Prop. Treas. Reg. § 1.1274-1(a)(1), 51 Fed. Reg. 12069 (1986), would make the original issue discount provisions inapplicable to debt instruments issued in exchange for services and refers to I.R.C. § 467. See B. BITTKER & J. EUSTICE, FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS 4-64 n. 203 (5th ed. 1987). Moreover, I.R.C. § 1273(b)(5) pertains to the nature of the consideration that can be given in exchange for a debt instrument, not to the definition of "debt instrument," nor to the form that interest payable under a debt instrument can take. I.R.C. § 1273(b)(5) simply does not address the question whether a contract that provides for provision of educational services in the future qualifies as a debt instrument under I.R.C. § 1275(a)(1)(A).
is not indifferent, however. If he invested the $4,000 for two years, he would owe tax on the $1,000 earned. . . . In effect, the arrangement allows College to invest Parent's $4,000 and apply the tax-free earnings to Parent's tuition obligation, without subjecting Parent to tax on those earnings.101

The similarities between MET and Treasury's example are obvious. Hence, Treasury specifically had called prepaid tuition transactions to Congress' attention prior to enactment of the comprehensive 1984 time-value of money legislation.

Prepaid tuition contracts do not fit readily under any of the conceivably applicable 1984 Act provisions targeted to time-value of money problems. IRC sections 467 and 7872 are patently inapplicable,102 and the original issue discount provisions can apply only under a very strained reading of the statute.103 It is significant that Congress, in the 1984 Act, dealt with myriad time-value of money problems, but failed to address prepaid tuition contracts specifically, even though Treasury explicitly had called such transactions to Congress' attention.104 The most reasonable conclusion from this is that Congress intended that prepaid tuition contracts not be subjected to time-value of money analysis for income tax purposes.

Prior to the 1984 Act, interest-free and below-market interest loans were held not to result in taxable income to the borrower or the lender.105 The 1984 Act changed this result in certain cases. For transactions to which the provisions of the 1984 Act do not apply, the case law result of non-taxability should continue to apply.

(5) State Bond Interest Exclusion

Even assuming prepaid tuition contracts are susceptible to time-value of money analysis under present law, one might argue that the "interest" on the "loan" from Parent to MET is not taxable under IRC section 103, which generally excludes from gross income interest paid on state-owed obligations. Interest on a state obligation may be excluded under section 103, even though it is not evidenced by a formal note or bond. An obligation

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102. See supra text accompanying notes 77-92.
103. See supra text accompanying notes 93-99.
104. See supra text accompanying notes 100-01.
evidenced by an ordinary sales agreement can qualify for the exclusion.\textsuperscript{106} Under this analysis Parent would be treated for income tax purposes the same as a purchaser of a tax-exempt zero coupon state baccalaureate bond.\textsuperscript{107} Thus, Parent's "interest" income would be excluded from gross income under section 103.

Equivalent tax treatment for purchasers of tax-exempt zero coupon baccalaureate bonds and prepaid tuition contracts makes logical sense because the two are functionally similar. In both cases a taxpayer is placing money with the state in anticipation of future college expenses. Parity treatment for both transactions would be fair and would prevent the form of the transaction from controlling its taxability. However, under existing law, the arbitrage provisions\textsuperscript{108} of the IRC might, under some circumstances, prevent such treatment in the case of prepaid tuition plans like MET's.

The reason is that MET reinvests the proceeds of the contracts in securities rather than using them directly for public purposes. Generally, arbitrage bonds are bonds whose proceeds may be used to acquire investments producing a materially higher yield than the yield on the bonds themselves.\textsuperscript{109} Should MET's reinvestment run afoul of the arbitrage provisions, the "interest" would not be entitled to the section 103 exclusion.\textsuperscript{110} Whether the arbitrage provisions actually apply would depend on the relationship between the "interest" paid on the contract (presumably the difference between tuition value and price paid by Parent) and MET's investment earnings.\textsuperscript{111} If MET's investment earnings were sufficiently high in relation to the "interest" paid Parent, the section 103 exclusion would be inapplicable.\textsuperscript{112}

Finally, the exclusion would be defeated if the Service established that MET is not part of the state because the state bond interest exclusion only applies to interest on debt owed by a state or political subdivision.\textsuperscript{113}

b. Contract for Educational Services

The MET contract might be viewed as a contract between MET and Parent for future educational services.\textsuperscript{114} That is, in exchange for a payment

\textsuperscript{106} See Commissioner v. Meyer, 104 F. 2d. 155 (2d. Cir. 1939) (interest on notes given by state for purchase price of land); Rev. Rul. 60-179, 1960-1 C.B. 37. (interest paid by state in connection with purchase of house on state owned property).

\textsuperscript{107} See supra text accompanying notes 20-31.

\textsuperscript{108} See I.R.C. § 148(a)-(f).

\textsuperscript{109} See I.R.C. § 148(a),(b). A detailed discussion of arbitrage bonds is beyond the scope of this article.

\textsuperscript{110} See I.R.C. § 103(b)(2), which provides that the state bond interest exclusion shall not apply to "[a]ny arbitrage bond (within the meaning of section 148)." \textit{Id}.

\textsuperscript{111} \textit{Id}.

\textsuperscript{112} See I.R.C. §§ 103(b)(2), 148(a)-(b).

\textsuperscript{113} See I.R.C. § 103(a)(1); Treas. Reg. § 1.103-1(a),(b) (1972). See \textit{infra} text accompanying notes 175-94 for a discussion of MET's status as a part of state government.

\textsuperscript{114} The MET enabling statute is phrased in terms of a contract for services. The statute
of money by Parent, MET undertakes to provide for Child's education in the future. Viewed this way, there are no tax results to either Parent or Child upon Parent's purchase of the contract. Parent simply is making a purchase, perhaps at a bargain, and a bargain purchase normally is not a taxable event.\textsuperscript{115}

In addition, there is no taxable income during the term of the contract. First, there is no realization event.\textsuperscript{116} Second, neither Parent nor Child is in constructive receipt of the income earned on MET's investments. A taxpayer does not constructively receive income "if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."\textsuperscript{117} Access to the funds paid to MET and any earnings on those funds is severely restricted for both Parent and Child. A refund is payable only if Child dies, becomes disabled, is not admitted to a state higher education institution, or certifies after reaching college age that he does not plan to attend

requires that MET contracts provide for:

The assumption of a contractual obligation by [MET] to the qualified beneficiary on its own behalf and on behalf of the state to provide for credit hours of higher education, not to exceed the credit hours required for the granting of a baccalaureate degree, at any state institution of higher education to which the qualified beneficiary is admitted.

\textsc{Mich. Laws \textsection\textit{390.1426}(1)(h)}.

The character of the MET contract as a service contract is reinforced by statutory authorization for MET to meet its contractual obligations in any appropriate manner, not merely by making a monetary payment of an individual beneficiary's tuition bill. The statute authorizes MET to:

- make any arrangements that are necessary or appropriate with state institutions of higher education in order to fulfill its obligations under [MET] contracts, which arrangements may include, \textit{but need not be limited to}, the payment by [MET] of the then actual in-state tuition cost on behalf of a qualified beneficiary to the state institution of higher education.

\textsc{Mich. Laws \textsection\textit{390.1426}(3)} (emphasis added).

For example, MET may arrange with a state institution for payment of a lump sum discounted payment in exchange for the institution's provision of educational services to all of MET's beneficiaries attending that institution.


[T]here can be no doubt that the general rule is that the purchase of property for less than its value does not, of itself, give rise to the realization of taxable income.

25 T.C. at 309.

Although a bargain purchase does not normally result in taxable income to the purchaser, the bargain element may be taxed if the seller intends to confer some economic benefit on the purchaser by means of the transaction. For example, an employee who makes a bargain purchase from an employer will be taxed on the bargain element of the purchase (except for qualified employee discounts excludible under I.R.C. \textsection\textit{132}(a)(2)), because the transaction is a means of compensating the employee for services rendered to the employer. \textit{See Treas. Reg. 1.61-2(d)} (as amended in 1979).

\textit{116. See B. \textsc{Bittker} \& L. \textsc{Lokken}, supra note 115, at 5-15 to 5-21.}

a state higher education institution. Furthermore, in the event of a refund, Child effectively is prevented from again participating in the MET program because no refund can be granted until Child reaches college age (except for death or disablement). After a refund, MET’s rules prevent Child from further participation. These restrictions are substantial enough to prevent either Parent or Child from receiving any income during the term of the contract.

Finally, there should be no income tax consequence when Child receives educational services under the contract. The mere receipt of performance under a service contract does not constitute a taxable event, even though the services received are worth more than the price of the contract. A bargain purchase of services is no more a realization event than is a bargain purchase of property. For example, if a lawyer contracts with a client to perform legal services for a flat fee of $10,000, there is no income realization to the client if the services turn out to be worth $25,000 at the lawyer’s hourly rate. The client simply has made a good bargain.

Similar situations readily come to mind: a customer who buys a service contract in connection with purchase of an automobile does not realize gross income when the car’s engine blows up and the dealer replaces it, even though the service contract costs less than the value of the repair; a member of a health maintenance organization (HMO) does not realize gross income when the HMO performs a costly heart transplant operation on the member, even though the premium paid to the HMO is less than the value of the operation; a person who purchases a four year health club membership in year one does not realize gross income when that person uses the club’s facilities in year four, even though membership in year four may be more expensive for new members. In addition, a person who buys a four year

118. See Mich. Laws § 390.1428(1); Michigan Education Trust Full Benefits Plan Contract § 7(b).

119. See Michigan Education Trust Full Benefits Plan Contract Enrollment and Price Schedule. A qualified beneficiary must either be in school or be so young as not to have started his education. There is one conceivable way to participate in the program a second time, but it requires the beneficiary to drop out of high school before graduation, reenter school, and then reenroll in MET. This is not a likely occurrence.

120. See Cohen v. Commissioner 39 T.C. 1055 (1963); Griffith v. Commissioner, 35 T.C. 882 (1961) (taxpayer not in constructive receipt of insurance policy cash surrender value, because taxpayer would have to surrender investment in policy to receive that income); Estate of Berry v. Commissioner, 44 B.T.A. 1254 (1941); Knapp v. Commissioner, 41 B.T.A. 23 (1940) (employee’s right to withdraw amounts from employer trust account restricted because after withdrawal employee could not again participate in fund); Rev. Rul. 82-121, 1982-1 C.B. 79; Rev. Rul. 80-300, 1980-2 C.B. 165 (employee not in constructive receipt of increased value of stock appreciation rights, because to cash in on those rights employee would have to relinquish the valuable right to share in further appreciation); Rev. Rul. 58-230, 1958-1 C.B. 204 (requirement of six month suspension from employer’s profit-sharing plan as substantial restriction preventing constructive receipt).

magazine subscription does not receive taxable income because the cost of
the magazine increases during the term of the subscription over the price
he paid for the subscription. In each of these instances there is no income
realization, despite the fact that the value of the services received exceeds
the price paid for them. Similarly, when a prepaid tuition contract is viewed
as a contract for future educational services, there is no realization event
upon receipt of those services, even though the educational services are
worth more than the price of the contract.122

c. Annuity

The MET transaction is also similar to purchase of an annuity by Parent
with Child as beneficiary. Under this analogy, Parent would be considered
as making a gift to Child in the amount of the purchase price of the
contract. Consequently, neither Parent nor Child recognizes gross income
when Parent purchases the contract. Nor does either have gross income in
the interim between purchase of the contract and the time benefits are
received under the contract. When educational benefits are received by Child
(the contract “payout”), Child is taxable under the annuity rules of IRC
section 72. Under these rules, Child has gross income in the year educational
services are received under the contract in an amount equal to the difference
between the value of educational services received during the year (the return
under the contract) and a prorata portion of the contract purchase price
(investment in the contract).123

The annuity analogy produces tax results similar to the Service’s con-
cclusions in Letter Ruling 88-25-027. Moreover, there are factual similarities
between the MET contract and a traditional annuity. An annuity generally
is thought of as a contract which calls for equal periodic cash payments to
be made over a given future time period, often (but not necessarily) the
annuitant’s lifetime. These payments ordinarily are made in consideration
of an up-front premium paid in a lump sum or in installments.124 The MET
contract resembles such an arrangement in that MET promises to provide
a valuable benefit at some time in the future in exchange for an advance
payment. Still, IRS did not rely on section 72 in Letter Ruling 88-25-027.125

The Service may have disregarded section 72 because the MET contract,
despite some factual similarities to an annuity arrangement, does not seem
to fall within the requirements for section 72 to apply. The regulations
require that, in order to be taxed under section 72 as “amounts received

122. The MET contract might also be analogized to an option contract. Under this
analogy, when Child receives educational services under the contract Parent is considered as
exercising the option. Mere exercise of a non-compensatory option contract is not a taxable
123. See I.R.C. § 72(a),(b),(c).
124. See M. Chirelstein, Federal Income Taxation: A Law Student’s Guide to the
Leading Cases and Concepts 33 (5th ed. 1988); J. Warnick & B. Ellis, Private Annuities A-
125. See infra text accompanying notes 50-54.
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as an annuity,” payments: 1) must be received on or after the annuity starting date; 2) must be payable in periodic installments at regular intervals; and 3) except in the special case of a variable annuity, the total amount payable must be determinable at the annuity starting date, either directly under the terms of the contract, or indirectly by use of mortality tables or compound interest computations. It is difficult to fit the MET contract within the latter two requirements. First, although the benefits received under MET are periodic, they need not be at regular intervals. A student has the option of receiving benefits under the contract sporadically over a period of several years. Second, the total amount payable is not determinable when Child begins receiving benefits under the contract. For example, a child may transfer to a cheaper school after starting at a more expensive one, or may drop out after completing more than half the credit hours needed for a degree. Both of these contingencies affect the total amount payable under the contract.

Finally, the MET contract does not appear to come within the variable annuity exception to the requirement that the total payments under the contract be determinable. To qualify for this exception, the contract must provide that amounts are to be received for a definite or determinable period of time and that the amount of periodic payments “may vary in accordance with investment experience. . . , cost of living indices, or similar fluctuating criteria.” Benefits under MET contracts may not be received for a definite or determinable period of time, since they can be received over an extended time period of Child’s choice. Furthermore, even if a MET contract meets the determinable time period requirement, it still does not meet the second requirement. Although benefits under the MET contract can vary, they do not vary in accordance with investment experience of MET, a cost of living index, or any similar criterion. The value of benefits under the MET contract basically depends upon the cost of tuition at the school Child attends.

Therefore, the analogy of MET to an annuity, while at first blush appealing, misses the mark upon analysis of section 72’s requirements. Probably, this is the reason IRS ignored section 72 in Letter Ruling 88-25-027.129

d. Grantor Trust

The MET contract also bears similarities to a grantor trust. In a trust arrangement Parent generally transfers property to a trust with Child as income beneficiary. Parent intends that Child use the trust income to finance Child’s college education. Similarly, under a MET contract Parent transfers

127. Michigan Education Trust Full Benefits Plan Contract §§ 2(a), 4(b), 8(b).
cash to MET with the intention that the amount transferred will fund Child's future college education.

If Parent transfers property to a trust and retains no strings over the property, such as a right to revoke or a reversion, the trust income will be taxable to Child, not to Parent. However, if Parent retains certain strings over the property, the trust income will be taxable to Parent under the Code's grantor trust rules.\(^1\) There is no doubt that the MET contract precludes most of the strings that might trigger the grantor trust rules. Parent has no authority over the funds paid to MET and has no power to revoke the contract.\(^2\) However, MET undertakes to provide education to Parent's Child, and Parent can retain the right to receive a refund in the event the contract is terminated. Each of these features arguably could trigger the grantor trust rules under some circumstances.

(1) Payment of Support Obligation

The first grantor trust provision that might require an income inclusion by Parent is IRC section 677(b). This provision imposes taxability upon the grantor of a trust whose income actually is applied to meet the grantor's legal obligation of support.\(^3\) The rationale is that the grantor is essentially in constructive receipt of a trust distribution to the extent that the proceeds satisfy the grantor's obligation of support or maintenance.\(^4\) However, income is taxed only to the extent that sums actually are expended to meet the grantor's legal support obligation.\(^5\)

The applicability of IRC section 677(b) to the MET contract was not an issue in Letter Ruling 88-25-027, because the ruling assumed that Parent

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130. See I.R.C. §§ 671-679. These provisions apply to transfers in trust. This discussion will assume that the MET contract transaction qualifies as a trust arrangement covered by the grantor trust rules if the terms of those provisions are otherwise fulfilled. There is doubt, however, about whether the MET contract does in fact represent a trust arrangement for federal income tax purposes. See infra text accompanying notes 237-39.

131. Michigan Education Trust Full Benefits Plan Contract § 7. A contract can be terminated upon written request when: 1) the beneficiary has reached 18 years of age or has received a high school diploma and certifies that he will either, a) attend an independent degree granting institution of higher education and directs payment to that institution; b) will attend an out-of-state institution of higher education; or c) will attend a college or university under a scholarship; 2) the beneficiary dies or is disabled; 3) the beneficiary has reached 18 years of age or has received a high school diploma and certifies that he, a) does not plan to attend an institution of higher education; or b) will attend an independent institution of higher education, but does not direct payment to that institution; or c) will attend a community or junior college; or 4) MET approves a termination for any other reason. Id.

132. See I.R.C. § 677(b).

133. See Treas. Reg. 1.677(a)-1(c),(d) (as amended in 1971).

134. See id.; Treas. Reg. § 1.677(b)-1(a) (as amended in 1971). I.R.C. § 677(a) imposes taxability upon the grantor of a trust whose income may be applied to meet a legal obligation. This subsection is distinguished from § 677(b), because the income does not actually have to be expended for § 677(a) to apply, and the legal obligations covered by § 677(a) do not include support obligations. The grantor is taxed under § 677(a) as the owner of the trust property if the income may be applied in discharge of a legal obligation. See infra text accompanying notes 150-52.
was not under a legal support obligation to provide Child a college education.\textsuperscript{135} Nevertheless, the issue remains problematic where such an assumption is not made, and current law is far from clear on the existence and extent of a parent's obligation to provide a child with a college education. For that reason, this article includes a discussion of the possible application of IRC section 677(b) to prepaid tuition contracts such as the MET contract.

Neither the Code nor the regulations offer any guidance in determining what is a legal support obligation for purposes of IRC section 677(b). Instead, resolution of this issue depends upon state law.\textsuperscript{136} Under state law, the scope of the parental obligation to support, and more specifically to provide a college education, is often so vague that it is difficult to determine whether a certain payment fulfills a parent's legal obligation or merely provides the child with a benefit that the grantor is not legally required to provide.\textsuperscript{137} There is wide variation among the states as to who is obligated and who is a dependent.\textsuperscript{138} Moreover, it is not uncommon to find marked variations as to the extent of the obligation even within one state.\textsuperscript{139}

There have been only a few reported federal tax cases dealing with the question of the necessity of a college education.\textsuperscript{140} In \textit{Mairs v. Reynolds},\textsuperscript{141} the taxpayer created trusts for the maintenance and support of his children. The income was used to pay for the children's tuition for the years 1934 and 1935. The Eighth Circuit held that such sums were to be considered income to the grantor.\textsuperscript{142} Although the taxpayer pointed out that Minnesota law only required children to attend school between the ages of 8 and 11, and that there was no further statutory obligation to provide a higher education, the court found that "general law" and public policy required more.\textsuperscript{143} The Eighth Circuit stressed the argument that the taxpayer had carefully chosen the schools in consideration of his own financial ability as well as his children's position in life, and consequently, the money was used to discharge a legal obligation.\textsuperscript{144}

\textit{Mairs} indicates that if there is no specific statutory authority or case law on the question of purchaser liability for an education trust, then the

\textsuperscript{135} Ltr. Rul., \textit{supra} note 52, at 54,986.
\textsuperscript{136} See Treas. Reg. § 1.662(a)-4 (1960). The amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. \textit{Id}.
\textsuperscript{139} \textit{Id}.
\textsuperscript{140} See \textit{Mairs v. Reynolds}, 120 F.2d 857 (8th Cir. 1941); Morrill v. United States, 228 F.Supp. 734 (D. Me. 1964); Braun v. Commissioner, 1984-285 T.C.M. 141. 120 F.2d 857 (8th Cir. 1941).
\textsuperscript{141} \textit{Mairs}, 120 F.2d at 859-60 (8th Cir. 1941).
\textsuperscript{142} \textit{Id}.; see also Nitzburg, \textit{supra} note 138, at 108.
\textsuperscript{143} \textit{Id}.
\textsuperscript{144} \textit{Mairs}, 120 F.2d at 859-60; see also Nitzberg, \textit{supra} note 138, at 108.
so-called "general law" must be determined by examining the customs of the citizenry.\textsuperscript{145} This, of course, is quite likely to produce widely inconsistent results.

One Tax Court decision directly addresses the taxability of an education trust by determining whether a legal obligation exists according to state law. In \textit{Braun v. Commissioner}\textsuperscript{146} the tax court held that, according to New Jersey law, the income of two trusts expended for children's college tuition, room and board was used to discharge legal support obligations and, therefore, was taxable to the grantor under section 677(b). The court based its reasoning on the case of \textit{Newburgh v. Arigo}\textsuperscript{147} in which the New Jersey Supreme Court held that, while necessary education is a flexible concept that varies with circumstances, in general, financially capable parents should provide a college education for their children. \textit{Newburgh} involved a controversy between divorced parents, but the tax court in \textit{Braun} held that the support rule was not limited to the divorce context.\textsuperscript{148}

Notwithstanding the inconsistencies and variations within state law, higher education has become increasingly perceived as "necessary." The significant benefits of a college degree are obvious when examining employment prospects in virtually any field. Consequently, the obligation to provide a college education, when financially feasible, has been enforced up to the age of majority in a few states.\textsuperscript{149} More movement in this direction seems likely, as higher education has become a normal aspiration among young people, and recent increases in tuition have made it increasingly difficult for students to finance their own college education.

\textbf{(2) Contractual Obligation}

Finding that Parent is under a contractual obligation to pay for Child's tuition may also provide a basis for taxing a Parent who purchases a tuition prepayment contract. In \textit{Morrill v. United States}\textsuperscript{150} the court skirted the issue of whether or not the taxpayer was under a legal support obligation to provide a college education and held that the amount expended was taxable income under a contract theory. The court held that the taxpayer had expressly agreed to pay the tuition of two universities, and that the

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{145} See \textit{Mairs}, 120 F.2d at 859; \textit{Nitzberg, supra} note 138, at 109.
\item \textsuperscript{146} 1984-285 T.C.M.
\item \textsuperscript{147} 88 N.J. 529, 443 A.2d 1031 (1982).
\item \textsuperscript{148} \textit{Braun v. Commissioner}, 1984-285 T.C.M. The court stated that the taxpayers clearly retained an obligation to provide their children with a college education. They were willing and able, and a college education was reasonable in light of the background, values, and goals of the parents as well as the children. \textit{Id.}
\item \textsuperscript{149} See \textit{Charlton v. Charlton}, 397 Mich. 84, 243 N.W. 2d 261 (1976); \textit{Kaplan v. Wallshein}, 57 A.2d 828, 394 N.Y.S. 2d 439 (1977); H. Krause, \textit{Child Support in America} 33 (1981). There has not been much need to deal with education past majority, because college is normally completed or nearly completed by the time a student reaches 21 years of age, and graduate or professional training is rarely classified as necessary.
\item \textsuperscript{150} 228 F.Supp. 734 (D. Me. 1964).
\end{enumerate}
\end{footnotesize}
other colleges his children attended provided services in expectation that the taxpayer would pay the costs. The court relied upon IRC section 677(a), which provides that the grantor of a trust is taxable on the trust's income when that income is used to satisfy the taxpayer's express or implied contractual obligation.\footnote{151}

Although the \textit{Morrill} court avoided deciding whether the parent in that case was under a state-imposed support obligation to pay the costs of a college education, the decision could pose a threat to tuition prepayment plans. A court might find an express or implied contractual obligation on the part of Parent to pay for Child's education. It would be difficult, if not impossible, in most circumstances for Child, himself, to assume the expenses paid by the plan. Consequently, a court might hold that Parent initially assumed responsibility for the payments by express or implied contract, and was relieved of that responsibility by the plan.\footnote{152}

\section*{3) Prepaid Funeral Plans}

Another situation analogous to tuition prepayment plans involves prepaid funeral arrangements. The purchaser of a prepaid funeral plan contracts with a funeral director for funeral merchandise and services. Payments made by the purchaser are deposited into a trust and the principal, along with any interest, is used to pay for the specified goods and services deliverable upon the death of the purchaser. Under some plans the purchaser has the right to cancel the plan and receive a refund. Under other plans, the purchaser has the right to cancel the contract, but does not have a right to a refund. In the latter case, the purchaser is limited to choosing another funeral director.

Revenue ruling 87-127\footnote{153} directly addresses the federal income tax treatment of prepaid funeral plans. The ruling first holds that where the purchaser is entitled to cancel the plan and receive a refund, the purchaser is taxable on the income, because the plan is revocable under IRC section 676(a).\footnote{154} This part of the ruling should not affect prepaid tuition plans, such as MET’s, under which the purchaser does not retain the right to cancel the contract and thereby receive a refund.

\begin{footnotes}
\footnotenumbers
\footnotetext[151]{151. \textit{Morrill v. United States}, 228 F. Supp. 734 (D. Me. 1964); see also Treas. Reg. § 1.677(a)-1(d) (as amended in 1971), which provides in relevant part: Under section 677 a grantor is, in general treated as the owner . . . of a trust whose income is, or in the discretion of the grantor . . . may be applied in discharge of a legal obligation of the grantor.}
\footnotetext[152]{Id.}
\footnotetext[153]{152. \textit{See Nitzburg, supra} note 138, at 110.}
\footnotetext[154]{154. \textit{Id.} at 158. I.R.C. § 676(a) provides in relevant part: The grantor shall be treated as the owner of any portion of a trust . . . where at any time the power to revest in the grantor title to such portion is exercisable by the grantor. . . .}
\end{footnotes}
However, the ruling went on to hold that the purchaser is taxable on the income, even under those plans that do not give the purchaser the right to cancel the contract and receive a refund. The Service based this holding on IRC section 677(a). The ruling held that in those states in which the purchaser's spouse has a legal obligation to pay for a funeral, the income earned on the money deposited into the trust may be applied to discharge an obligation of the grantor or the grantor's spouse within the ambit of IRC section 677(a). Therefore, under IRC section 677(a), the purchaser is treated as the owner of the entire trust and the income of the trust is includible in the purchaser's gross income in the year in which the income is earned by the trust.

A tuition prepayment plan could fall under section 677(a) by analogy to prepaid funeral arrangements. However, this will occur only if Parent, by state law or by implied contract, is under some legal obligation to pay Child's tuition. This remains a matter of local law.

(4) Reversionary Interest

IRC section 673 provides that a trust grantor is taxable on income from any portion of a trust in which he has a reversionary interest in either the corpus or income if, as of the inception of that portion, the value of such interest exceeds five percent of the value of such portion. The purchaser of a prepaid tuition contract would retain a reversionary interest if he designates himself as the recipient of any refund under the contract. However, in the case of the MET contract, the value of the reversionary interest is very difficult to compute because the reversion can be triggered only by an unpredictable occurrence, such as the beneficiary's death, his failure to be admitted to college or his own decision not to attend college even if accepted. The mechanical method of using actuarial tables to compute the value of the reversionary interest is inadequate to deal with such unpredictable occurrences.

156. Id.
157. Id. The ruling also held that the grantor is taxable under I.R.C. § 673(a) (retention by grantor of reversionary interest) if the grantor's estate has an obligation under state law to pay for the funeral expenses. It is not likely that IRC § 673(a) will apply to require an income inclusion by the purchaser of a prepaid tuition plan. See infra text accompanying notes 159-64.
158. See infra text accompanying notes 132-52.
159. I.R.C. § 673(a) provides in relevant part:
   The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest . . . if, as of the inception of that portion, . . . the value of such interest exceeds 5 percent of the value of such portion.
   I.R.C. § 673(a).
160. See Michigan Education Trust Full Benefits Plan Contract § 7, which permits Parent to retain the right to a refund under certain limited contingencies.
161. Id. §§ 6, 7. See also B. BITTKER & M. McMAHON, FEDERAL INCOME TAXATION OF INDIVIDUALS 35-12 (1988).
Private Letter Ruling 89-01-027, in dealing with application of the gift tax to a prepaid tuition contract, provides guidance on valuation of a reversionary interest retained by Parent under the contract. The Service stated that if the prepaid tuition contract designates the purchaser as recipient of any refund, the reversionary interest is contingent and incapable of valuation. Consequently, the value of the gift at the time of the contract purchase is the entire amount paid by the purchaser for the contract and is not reduced on account of the reversionary interest. This line of reasoning suggests that the purchaser of a prepaid tuition contract is not liable for income tax under IRC section 673 on account of the reversionary interest represented by the refund right. The value of such a reversionary interest is incalculable and should be disregarded. Therefore, the requirement that the value of the reversionary interest exceed five percent of the value of the property in which the reversion is retained is not met. Hence, the purchaser should not be taxed under IRC section 673(a).

2. Gift Tax Treatment of Parent

When Parent purchases the MET contract it appears that under the federal gift tax Parent has made an indirect transfer to Child. Letter Ruling 88-25-027 properly found that such a purchase was an indirect transfer to Child. Nevertheless, there remains a question as to whether
the transfer should be subject to gift tax. Two possible exclusion provisions might apply.

First, the transfer might come within the $10,000 annual gift tax exclusion. This exclusion applies only to gifts of present interests in property.1 An interest is a present interest only if the beneficiary is entitled to an unrestricted right to the immediate use, possession, or enjoyment of the property.16 In the case of the MET contract, Child generally is not entitled to the educational benefits under the contract or to a refund under the contract until he reaches college age.169 Therefore, apparently the IRS correctly concluded in Letter Ruling 88-25-027 that Parent is not entitled to the $10,000 annual exclusion.170

The second possible exclusion provision is more problematic. IRC section 2503(e)(2) affords an exclusion for "any amount paid on behalf of an individual... as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual..."171 There is no doubt the MET contract price paid by Parent qualifies as an "amount paid on behalf of an individual... as tuition." The question is whether the payment is "to an educational organization described in section 170(b)(1)(A)(ii)."

Section 170(b)(1)(A)(ii) is applicable to:

an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.172

Clearly, MET does not fall within this description. The only argument that can be made is that somehow MET is acting on behalf of a qualified organization when it takes payment of the contract price. For example, one might argue that MET is acting as an agent for state higher education institutions when it takes payment of the contract price. Certainly, the spirit, if not the letter, of the section 2503(e) exclusion encompasses MET reversionary interest in the amount paid. The Service concluded that retention of such a reversionary interest does not prevent gift taxation of the full purchase price, because the events entitling Parent to a refund under the terms of the contract are so contingent and speculative (at least where a lump sum payment is made) as to make Parent's reversionary interest incapable of valuation. Id. See supra text accompanying notes 159-61.

167. See I.R.C. § 2503(b), which provides in relevant part:
In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not... be included in the total amount of gifts made during such year.

I.R.C. § 2503(b).


169. See Mich. Laws § 390.1428; Michigan Education Trust Full Benefits Plan Contract § 7. A refund may also be payable if a child dies or becomes disabled. Id.

170. Ltr. Rul. supra note 52 at 54,988.

171. I.R.C. § 2503(e)(2).

contract payments. Congress clearly intended to exclude from gift tax amounts paid on behalf of an individual for tuition. Undoubtedly, the typical situation Congress envisioned was payment of a child's tuition by a parent or grandparent. There is no good reason why the policy behind the exclusion should be so limited as to treat payment of tuition through an intermediary worse than direct payment to an institution. Nevertheless, it is difficult to fit the MET transaction into the literal wording of the statute. Consequently, it seems that IRS was at least technically correct in imposing gift tax liability on Parent when Parent purchases a MET contract.

3. Income Tax Treatment of MET

The most surprising aspect of Letter Ruling 88-25-027 was its holding that MET itself is liable for income tax on its investment income. Prior to the ruling there was respectable opinion among those familiar with prepaid tuition plans that MET would be exempt from tax as either: 1) an integral part of state government; or 2) an entity performing an essential governmental function whose income accrues to the state. Moreover, if MET is not tax-exempt for either of the foregoing two reasons, it may be tax-exempt under IRC section 501(c)(3) as an educational organization. Finally, even if MET is not tax-exempt, a question remains as to the appropriate application of the income tax to an entity such as MET.

a. Integral Part of State Government

The Internal Revenue Service has long taken the position that an integral part of state government is not subject to income tax. For example, in Revenue Rulings 71-131 and 71-132, the Service held that the profits from state-owned liquor stores are not subject to the income tax, because the stores are operated as an integral part of the state. These rulings superseded and adopted the reasoning of G.C.M. 14407, which likewise exempted state-owned liquor stores from income tax. The Service pointed out that it never has attempted to tax the direct income of a state. The Service said:

Not only has the Bureau failed to tax the direct income of any state or municipality but it has throughout this period of 22 years made no effort to obtain income returns from states or municipalities, or to determine by any other means whether any State or municipality has had income of this nature. This persistent non-enforcement of the tax against States may be reasonably explained

173. See Statement of Professor Leo J. Raskind, University of Minnesota Law School, in INVITATIONAL CONFERENCE, supra note 3, at 41; Statement of Lawrence D. Owen, Partner, Miller, Canfield, Paddock, and Stone, id. at 42.
only as indicating a tacit construction by the Bureau in accordance with the interpretation that has just been suggested.\textsuperscript{177}

The IRS bases its position on the notion that a state or subdivision of a state is not taxable in the absence of a specific statutory provision imposing tax. Because the income tax statute imposes a tax generally on individuals, estates, trusts, and corporations, but not on states, it follows that states generally are not subject to income tax.\textsuperscript{178} There is a plausible argument that MET is not subject to income tax, because it is an integral part of the state. MET is created by statute as a "body corporate and politic" within the State Department of Treasury.\textsuperscript{179} Its funds can be pooled with other state funds for investment purposes.\textsuperscript{180} The statute mandates the priority in which MET may expend its funds,\textsuperscript{181} and MET must make an annual accounting to the governor, the Majority and Minority Leaders of the State Senate, and the Majority and Minority Leaders of the State House of Representatives.\textsuperscript{182} The statute dictates the membership on the Board of Directors that governs MET and state officials comprise most of the Board's membership.\textsuperscript{183} The statute also mandates both the substance and form of MET contracts,\textsuperscript{184} and authorizes MET to

\textsuperscript{177} Id. at 105.5

\textsuperscript{178} See Rev. Rul. 87-2, 1987-1 C.B. 18 (Lawyer Trust Account fund created and controlled by State Supreme Court not subject to income tax because integral part of state government). The Service position is based on the income tax statute itself, and not on any constitutional limitation on the power of the federal government to tax the states under the doctrine of intergovernmental immunity.

The precise constitutional limits on the power of the federal government to tax the state remain unclear. See Wells & Hellerstein, \textit{The Governmental-Proprietary Distinction in Constitutional Law}, 66 VA. L. REV. 1073, 1080-85 (1980); Tucker & Rombro, \textit{State Immunity from Federal Taxation: The Need for Reexamination}, 43 GEO. WASH. L. REV. 501, 503-512 (1975). In New York v. United States, 326 U.S. 572, 582 (1946), which upheld a federal excise tax on mineral water bottled by the state of New York, Justice Frankfurter, announcing the judgment without plurality, stated that the constitutional test should be whether "Congress generally taps a source of revenue by whomsoever earned and not uniquely capable of being earned by a state. . . ." Chief Justice Stone in a concurring opinion joined by Justices Reed, Murphy, and Burton, stated:

Only when and because the subject of taxation is State property or a State activity must we consider whether such a non-discriminatory tax unduly interferes with the performance of the State's functions of government. If it does, then the fact that the tax is non-discriminatory does not save it.

\textit{Id.} at 588.

From this, it appears that Congress constitutionally can impose the income tax on at least some state income. Moreover, it has imposed an income tax on the unrelated business income of state universities. See I.R.C. § 511(a)(2)(B). Even so, it might be argued, under the Stone formulation, that a tax on MET unduly interferes with the state's function of providing higher education to its citizenry. See \textit{infra} text accompanying notes 195-209.

\textsuperscript{179} Mich. Laws § 390.1425.

\textsuperscript{180} Id. § 390.1429(4).

\textsuperscript{181} Id. § 390.1429(3).

\textsuperscript{182} Id. § 390.1432.

\textsuperscript{183} Id. § 390.1430(1). See also supra note 37.

\textsuperscript{184} Mich. Laws § 390.1426(1); § 390.1427.
contract on behalf of itself and the state. Finally, the statute subjects MET to the state Open Meeting Law and to the state Freedom of Information Act.

All of the foregoing indicates a legislative intent that MET be an integral part of the state. Nevertheless, the legislature also intended that MET would not depend on the state for funding. Accordingly, the statute contemplates that MET will be self-supporting. This conforms with the purpose of the legislation to further higher education. Purchasers of MET contracts want to be assured of the financial soundness of the fund and that MET’s performance of its obligations not be subject to the vagaries of the state appropriations process.

In keeping with the financial soundness concept the statute further provides that:

Assets of [MET] shall not be considered state money, common cash of the state, revenue for the purposes of sections 26 to 34 of article IX of the state constitution of 1963, nor state money for purposes of Act No. 259 of the Public Acts of 1982.

The state constitutional provisions to which the statute refers concern limitations on state taxes and expenditures. The obvious purpose of the statute is to exclude MET from these limitations because MET is self-financing. The statute also exempts MET from the operation of Act No. 259 of the Public Acts of 1982 for a similar reason. Act No. 259 makes all “state money” subject to the claims of holders of general state obligations. Again, the self-financing character of MET makes application of this law to MET inappropriate. One of the primary goals of MET is to assure purchasers of MET contracts that MET can and will fulfill its obligations to provide educational services. That is the reason the legislature designed MET to be self-financing. Both of the foregoing exemptions from general state financial management laws are basically additional means to assure that MET can and will meet its obligations to contract purchasers.

Nevertheless, the Service found that MET is not an integral part of state government. The Service stressed the statutory phraseology that MET funds are “not state money” or “common cash” of the state. Perhaps the Service misconstrued the limited function of this phraseology, which...
was to exempt MET from certain provisions of state fiscal management law. At the least, it is dubious whether this exemption should cause MET to be precluded from treatment as an integral part of state government.

The Service also cited in support of its conclusion the point that MET funds are exempt from claims of general state creditors.192 However, this exemption is an essential feature of the state's strategy in creating MET because it furthers the primary function of assuring purchasers of MET contracts that the educational services promised in fact will be provided.

It is certainly plausible to assert that MET is an integral part of state government given MET's creation by the state, its intimate relationships with the state, and its furtherance of the vital state function of higher education. The Service's conclusion that MET is not an integral part of state government is ironic in view of prior IRS holdings that legislative creatures, such as state liquor stores, are integral parts of state government.193 Under the IRS position it appears that to achieve status as an integral part of state government, a state-sponsored tuition prepayment plan would, at the least, have to make plan funds subject to the general claims of state creditors and provide that plan funds are part of general state funds.194 Of course, to the extent that plan funds are put at risk by such provisions, the state's goal of guaranteeing contract purchasers that the educational services promised actually will be provided is pro tanto curtailed.

b. IRC Section 115

IRC section 115 excludes from gross income, "income derived from any public utility or the exercise of any essential governmental function and accruing to a State..." 195 Section 115 applies when the potentially taxable entity is not an integral part of state government.196 Hence, even if MET

192. Id.
194. The Florida statute attempts to make the Florida prepaid education fund an integral part of state government by providing that:
There is created within the State Treasury the Prepaid Postsecondary Education Expense Trust Fund.
FLA. STAT. ANN. § 240.551(4) (West 1989). The Florida statute further provides that:
The Florida Postsecondary Education Expense Program shall be administered by the Prepaid Postsecondary Education Expense Board as an agency of the state.

Id. § 240.551(5).
However, Florida may not have accomplished its objective because its statute also contains provisions that appear to shield the fund from the claims of state creditors. See id. § 240.551(4)(10). FLA. STAT. ANN. § 240.551(10) provides in relevant part:
The assets of the fund shall be maintained, invested, and expended solely for the purposes of this section and shall not be loaned, transferred, or otherwise used by the state for any purpose other than the purposes of this section.

Id. § 240.551(10).
195. I.R.C. § 115(1). This section dates as far back as the income tax originally enacted in 1913. Tariff Act of 1913, ch. 16, § II G(a)[3], 38 Stat. 166 (1913).
is not an integral part of state government, it may still come within this exclusion from gross income. To qualify for exclusion under IRC section 115 MET must establish that 1) its income is derived from the exercise of an essential governmental function; and 2) its income accrues to the state.197

(1) Essential Governmental Function

Consequently, the first question is whether MET's income derives from the exercise of an essential governmental function. Neither the Code nor the regulations specifically defines the term "essential governmental function." Moreover, there has been little judicial interpretation of the term.198 Nevertheless, there can be no doubt that provision and facilitation of education, including higher education, to its citizens long has been one of the essential functions of state government.199

The State of Michigan recognizes this essential function by including an article pertaining to education in its Constitution.200 The first section of that article provides that: "[r]eligion, morality and knowledge being necessary to good government and the happiness of mankind, schools and the means of education shall be forever encouraged."201 Furthermore, the Michigan Constitution explicitly provides for creation and maintenance by the state of higher education institutions.202 Finally, the MET enabling statute acknowledges the essential state function of higher education in its preamble by expressly stating:

(b) It is a responsibility of state government to maintain state institutions of higher education as provided by section 4 of article VIII of the state constitution of 1963.

C.B. 45. If the entity is an integral part of state government section 115 is inapplicable. In that case the Service agrees that, in the absence of a specific provision imposing tax (such as I.R.C. section 511(a)(2)(B) imposing unrelated business income tax on state colleges and universities), the income tax statute simply does not reach the entity. See supra text accompanying notes 175-78.

197. See I.R.C. § 115(1); Tucker & Rombro, supra note 178, at 525.
198. See Tucker & Rombro, supra note 178, at 527-46.

The preamble in the ancient act, Watkins' Digest, p. 299, is an unanswerable argument for higher education as a function of democratic government. It reads in part: 'As it is the distinguishing happiness of free government that civil order should be the result of choice and not necessity, and the common wishes of the people becomes the law of the land, their public prosperity and even existence very much depends upon suitably forming the minds and morals of their citizens * * * This is an influence beyond the sketch of laws and punishments, and can be claimed only by religion and education.'

Id.

201. Id. art. VIII, § 1 (emphasis added).
202. Id. art. VIII, §§ 4-7.
(c) It is an essential function of state government to encourage attendance at state institutions of higher education.\(^2\)03

Given all the above, it is indisputable that the Michigan legislature, at least, regards MET as performing an essential governmental function by facilitating and encouraging state citizens to obtain the benefits of higher education.

The Service ruled that MET's income is not derived from exercise of an essential governmental function, because in the Service's view, MET primarily serves private interests that are not incidental to a public interest.\(^2\)04 As support for this view IRS stated:

[MET] provides [Child] with a direct economic benefit in the form of education the value of which is expected to be substantially in excess of the up-front payment. Moreover, this benefit is available only to those persons such as [Child] who are beneficiaries of a contract.\(^2\)05

Assuming the foregoing to be true, that is not sufficient reason to deny application of section 115.

The very nature of education requires that the primary beneficiaries be the recipients of the education. It is impossible to accomplish the essential state function of education without directly benefiting those educated. It is necessary for private citizens to benefit directly from their individual educations in order to achieve the public good flowing from an educated populace. For example, state financial support permits public institutions of higher education to charge tuition below the actual cost of providing education. The state, thereby, confers a direct benefit on students attending those institutions in the form of a subsidized tuition rate.\(^2\)06 But few would argue that this means the state is not carrying on an essential governmental function. By the same token, the fact that some individuals benefit directly from MET should not, of itself, disqualify MET from the status of performing an essential governmental function for purposes of section 115.\(^2\)07

\(^2\)03. MICH. LAWS § 390.1422(b),(c).

\(^2\)04. See Ltr. Rul., supra note 52, at 54,987. The Service interpreted the "essential governmental function" requirement as follows:

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

Id.

\(^2\)05. Id.

\(^2\)06. See Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 HARV. L. REV. 925, 935-37 (1967).

\(^2\)07. There are other instances of the same principle. For example, should a public marina be taxable because the boat owners who rent dock space benefit from its operation? What
Although MET does not dispense education directly, it does provide a means by which higher education is made more readily available to the public.

Finally, the apparent purpose of section 115 is to avoid the overburdening of state government by federal taxation. The IRS position imposing tax liability on MET has precisely such an overburdening effect.

(2) Income Accruing to State

The Service did not reach the second requirement for application of section 115, that the income accrue to the state. However, fulfillment of the second requirement is closely connected with satisfaction of the first. By holding that MET is not an integral part of state government, and that MET’s income is not derived from performance of an essential governmental function, IRS implicitly found that MET’s income does not accrue to the state. If either of these holdings were reversed, it seems to follow that MET’s income would accrue to the state by reason of the fact that the income is being used for state purposes, and thereby the second requirement of section 115 would be satisfied.

c. Section 501(c)(3) Status

If MET is not exempt from income tax by reason of being an integral part of state government or by operation of IRC section 115, it still might qualify for tax-exempt status as a section 501(c)(3) organization. MET can argue that it comes within the section 501(c)(3) language by being “organized and operated exclusively for ... charitable ... or educational purposes.”

about a public airport that rents hangar space to plane owners? A public park that rents campsites to campers? Moreover, the fact that MET is designed to be financially independent should not disqualify it from exclusion under § 115. Two cases, Maryland Savings-Share Ins. Corp. v. United States, 308 F. Supp. 761 (D. Md. 1970), rev’d on other grounds, 400 U.S. 4 (1970), and Jamestown & Newport Ferry Co. v. Commissioner, 16 B.T.A. 638 (1929), have intimated that state financing is a requirement for qualification under the essential governmental function test. However, such a requirement would essentially negate the test, because it would permit a state to satisfy the test or not by the expedient of either providing or not providing some state financing. See Tucker & Rombro, supra note 178, at 536.

208. See Maryland Savings, 308 F. Supp. 761; Tucker & Rombro, supra note 178, at 536-37.

209. See infra text accompanying notes 247-57.

210. I.R.C. § 501(c)(3) provides in relevant part for tax exempt status of the following kinds of organization:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, ... no part of the net earnings of which inure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, ... and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

I.R.C. § 501(c)(3).
Its argument would be that it is organized and operated for the exempt purpose of promoting higher education.

MET applied for section 501(c)(3) status following issuance of Letter Ruling 88-25-027. The Service denied MET 501(c)(3) status in April 1989, on the ground that MET serves a private rather than public interest. The similarity of this determination to the IRS position on application of IRC section 115 in Letter Ruling 88-25-027 is obvious. Essentially, the Service has taken the position that the benefits received by participants in the MET program preclude MET from tax exempt status under either IRC section 115 or section 501(c)(3).

It is undeniable that MET serves an educational purpose by providing a mechanism to facilitate and encourage parents (or others) to pay for their children’s college education. The question is whether the private benefits MET provides its participants are so substantial in relation to the public benefits derived from MET as to prevent section 501(c)(3) status. The arguments in favor of a negative answer to this question are much the same as the arguments for tax exemption under IRC section 115.

The primary argument is that educational purposes, by their very nature, cannot be accomplished without conferring a private benefit on the persons being educated. Hence, the fact that private individuals benefit under MET should not preclude section 501(c)(3) status.

An analogous issue was raised in Sound Health Association v. Commissioner. That case involved the application of a health maintenance organization (HMO) for exempt status. An HMO provides health services to its members in return for a flat fee. This resembles the MET arrangement. In both cases the organization offers services to participants in its program in exchange for payment of a fee. Both organizations have an exempt purpose, advancement of health for the HMO and advancement of education for MET.

The Service denied exempt status to the HMO, stating:

Although you will provide some health services to the general public, it is clear that preferential treatment will be accorded your member-subscribers. This characteristic is incompatible with the requirement of section 1.501.(c)(3)-1(d)(1)(ii) of the Income Tax Regulations that an organization must serve a public rather than a private interest in order to qualify under section 501(c)(3) of the Code.

211. Telephone interview with Lawrence D. Owen, Esq., Partner in Miller, Canfield, Paddock, and Stone (July 13, 1989) [hereinafter Owen interview]. Mr. Owen and his firm were principal drafters of the MET legislation.
212. Id.
213. See supra text accompanying notes 195-209.
214. See supra text accompanying notes 206-07.
The Tax Court rejected the Service's contentions and ruled that the HMO was a charitable organization entitled to section 501(c)(3) tax-exempt status. The fact that the HMO charged fees to its members did not preclude tax-exempt status. The court declared that, "[t]he term 'charitable' is thus capable of a definition far broader than merely the relief of the poor." 218

The court also found that the HMO satisfied both the organizational and operational tests for exempt status. The key factors were that the HMO made its services available for treatment of the indigent and that its membership was open to the entire community. 219 The court said:

The most important feature of the Association's membership form of organization is that the class of person's eligible for membership, and hence eligible to benefit from the Association's activities, is practically unlimited. The class of possible members of the Association is for all practical purposes, the class of members of the community itself. 220

The court also pointed out that the basic criteria for determining whether an organization qualifies for exemption have been derived from the law of charitable trusts. 221 In this regard, the court declared that an organization will qualify for exempt status "if the class served is not so small that its relief is not of benefit to the community." 222 The court quoted a leading treatise, Scott on Trusts, to the effect that:

A trust is not a charitable trust if the persons who are to benefit are not of a sufficiently large or indefinite class so that the community is interested in the enforcement of the trust. 223

The negative implication is that an organization should qualify if the class served is sufficiently large.

Finally, the court asserted that, in order for an organization to be operated for exempt purposes (the operational test),

the purposes toward which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization's right to be classified as a section 501(c)(3) organization under section 501(a). * * * Rather, the critical inquiry is whether petitioner's primary purpose for engaging in its sole activity is an exempt purpose, or whether its primary purpose

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217. Id. at 178-80.
218. Id. at 178 (quoting Eastern Kentucky Welfare Rights Org. v. Simon, 506 F.2d 1278, 1287, vacated on other grounds, 426 U.S. 26 (1975)).
219. Id. at 178-86.
220. Id. at 185.
221. Id. at 177.
222. Id. at 181.
223. Id. (quoting 4 A. Scott, Trusts § 372.2 at 2897 (3d ed. 1967)).
is the nonexempt one of operating a commercial business producing net profits for petitioner.224

Hence, to determine exempt status one must look to the ultimate purpose of the organization.

The principles articulated in Sound Health indicate that MET should be entitled to tax exempt status. Eligibility for participation in the MET program is wide open. Virtually anyone can purchase a contract and a beneficiary need only be a resident of the state.225 MET has enhanced the availability of its benefits by arranging with financial institutions for purchasers to acquire MET contracts on the installment plan.226 Thus, MET meets the open membership standard enunciated in Sound Health. In addition, MET plans to provide scholarships to needy students who cannot afford MET contracts, thereby meeting the second Sound Health standard of making services available to the indigent.227 This appears to meet the condition, set out in Scott on Trusts, that the class benefited be sufficiently large to make the community interested in enforcement of the exempt purpose.228

Finally, although MET does not engage directly in educational activity, its fundamental purposes all involve the advancement of education.229 This complies with the operational test that the purpose of an organization's activities, not the nature of the activities themselves, determines the organization's entitlement to tax exempt status.230 Therefore, based on the foregoing, MET seems entitled to section 501(c)(3) tax-exempt status.

224. Id. at 190 (quoting B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352, 356-57 (1978)).


228. See supra note 223.

229. See Mich. Laws § 390.1423, which states MET's purposes to be as follows:
(a) To encourage education and the means of education.
(b) To maintain state institutions of higher education by helping to provide a stable financial base to these institutions.
(c) To provide wide and affordable access to state institutions of higher education for the residents of [Michigan].
(d) To encourage attendance at state institutions of higher education.
(e) To provide students and their parents economic protection against rising tuition costs.
(f) To provide students and their parents financing assistance for postsecondary education at a Michigan institution of higher education of their choice.
(g) To help provide the benefits of higher education to the people of [Michigan].
(h) To encourage elementary and secondary students in [Michigan] to achieve high standards of performance.

Id.

230. See supra text accompanying note 224.
d. MET as a Taxable Entity

Although there are good reasons why MET should be accorded exempt treatment under the income tax, the question remains as to the proper tax treatment of MET if IRS ultimately prevails in its contention that MET is a taxable entity. The Service did not address this issue in Letter Ruling 88-25-027. The Service simply said that MET was taxable on its investment income, but did not elaborate.21

This article takes the position that MET should be tax-exempt, because either: 1) it is an integral part of state government; 2) it derives its income from an essential governmental activity under IRC section 115; or 3) it qualifies for tax-exempt status under IRC section 501(c)(3). Hence, a detailed discussion of the myriad issues that arise if MET is a taxable entity are beyond the scope of this article. Nevertheless, it is appropriate to summarize these issues here because their resolution bears on the practical consequences to prepaid tuition plans should the IRS position ultimately prevail.

The fundamental question concerns the appropriate tax classification of MET. Should it be considered a simple trust, a complex trust, or a corporation for tax purposes? The ultimate tax effects to MET will, of course, differ depending on its tax classification.22 For example, if MET is classified as a trust, the net tax liability to MET might be zero because a simple trust can take a deduction for income to which the trust beneficiaries have a current right.23 However, it is doubtful that MET qualifies as a simple trust. Not only is MET's income not required to be distributed currently, but rather its income may not be distributed until certain events occur, such as Child attending a state college.24

A complex trust is any trust other than a simple trust. Thus, a complex trust can accumulate its income for future distribution.25 If MET is a complex trust it would pay tax at a marginal rate of twenty-eight percent of taxable income during the time it accumulates income. When educational services are provided, Child would pay tax on the accumulated income

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231. See L-tr. Rul., supra note 52, at 54,987-88. Neither did the Service address the issue in Priv. L-tr. Rul. 89-01-027 (Jan. 6, 1989), the only other letter ruling so far published with respect to tuition prepayment plans.
233. See Tax Implications, supra note 232, at 677; I.R.C. § 651(a), which provides in relevant part:
   a) DEDUCTION.- In the case of any trust the terms of which-
      (1) provide that all of its income is required to be distributed currently, and
      (2) do not provide that any amounts are to be paid, permanently set aside, or used
      for the purposes specified in section 642(c) (relating to deduction for charitable, etc.,
      purposes), there shall be allowed as a deduction in computing the taxable income
      of the trust the amount of the income which is required to be distributed currently.
   Id. § 651(a).
234. See supra text accompanying notes 43-46.
235. See I.R.C. §§ 661-64; 3 B. Bittker, FEDERAL TAXATION OF INCOME, GIFTS, AND
minus any tax paid by MET under the intricate "throwback rules."\(^{226}\)

Despite its name (Michigan Education Trust), MET may not be a trust for income tax purposes. Treasury regulation section 301.7701-4(c)(1) provides that an investment trust will be taxed as a corporation "if there is a power under the trust agreement to vary the investments of the certificate holders."\(^{227}\) In Revenue Ruling 77-261 IRS held that an investment fund similar to MET was an investment trust.\(^{228}\) MET has the authority to vary its investments.\(^{229}\) The Service, by characterizing purchasers of MET contracts as "certificate holders," might contend that this authority satisfies the regulation.

If IRS were successful in this contention, MET would be classified as a corporation for federal tax purposes. However, that characterization only raises more questions. For example, if MET is a corporation, who are the shareholders? Are they the contract purchasers? The beneficiaries? The state of Michigan? Or is MET a corporation without any shareholders? Moreover, what kind of a corporation would MET be?

On the last question, MET can make a plausible argument that it should be classified as an insurance company. The Code defines a life insurance company as a "company which is engaged in the business of issuing life insurance and annuity contracts . . ." if more than half of its business during the taxable year is the issuing of such contracts.\(^{230}\) In Letter Ruling 88-25-027 the Service basically treated Parent and Child in the same way as if Parent had bought an annuity contract with Child as beneficiary.\(^{231}\) Consequently, it would be consistent to treat MET as a seller of annuity contracts and, accordingly, a life insurance company under the Code's definition because more than half of MET's business would be the issuance of annuity contracts.\(^{232}\)

If MET is treated as a life insurance company, it should be allowed to take a deduction for additions to reserves in anticipation of future payouts on its contracts. Although income tax law normally denies deductions on account of reserves for anticipated expenses,\(^{233}\) the Code explicitly permits

\(^{226}\) See I.R.C. §§ 665-68; 3 B. Bittker, supra note 235, at ¶ 81-5 to 81-53; Tax Implications, supra note 232, at 677.

\(^{227}\) Treas. Reg. § 301.7701-4(c)(1) (1986).

\(^{228}\) Rev. Rul. 77-261, 1977-2 C.B. 45. An investment trust enables a number of investors to acquire an interest in an array of securities. This permits them to participate in a relatively widespread investment thereby diversifying their own investment. See Commissioner v. Chase Nat'l Bank, 122 F.2d 540, 541 (2d Cir. 1941); Rev. Rul. 75-192, 1975-1 C.B. 384; B. Bittker & J. Eustice, Federal Taxation of Corporations and Shareholders ¶ 2.03 (5th ed. 1987).

\(^{229}\) See supra text accompanying notes 123-29.

\(^{230}\) In this connection it is noteworthy that IRS itself raised the possibility of MET being classified as a life insurance company in its determination letter denying MET section 501(c)(3) status. Determination Letter to Michigan Education Trust from Chief, IRS Exempt Organizations Rulings Branch 1, p.9 (April 26, 1989).

\(^{231}\) See I.R.C. § 816(a) (emphasis added).

\(^{232}\) See supra text accompanying notes 123-29.

\(^{233}\) See I.R.C. § 461(h) (deduction not normally allowable until economic performance
such a deduction in the case of life insurance companies. In this case, MET's deductions might well fully offset its gross income, which would leave it with no taxable income because MET is established to break even actuarially. MET is designed to pay out over time, in the form of educational benefits, as much as it takes in after administrative expenses. Hence, its deductions on account of additions to reserves for anticipated payouts should equal its investment income over time. Such treatment would make sense from an accounting standpoint because, as previously stated, MET is designed to break even, not make a profit.

III. POLICY CONSIDERATIONS

The preceding discussion demonstrates that, at best, existing law is murky with respect to the income tax treatment of prepaid tuition contracts. This is not surprising because prepaid tuition contracts are a relatively new idea. The law has not yet caught up with the concept. For purposes of the IRC, therefore, prepaid tuition plans appear to be sui generis. Consequently, current law is inadequate, and legislation specifically pertaining to federal taxation of prepaid tuition plans is needed.

A. Practical Effects of Existing Law

There are two adverse effects on prepaid tuition plans under existing law. First, if the IRS position enunciated in Letter Rulings 88-25-027 and 89-01-027 is upheld, the adverse tax consequences of that position will make the economic viability of prepaid tuition plans much more difficult to sustain. Second, the uncertainty surrounding existing law acts as a deterrent to further implementation of prepaid tuition plans.

1. Adverse Tax Consequences

The IRS position is that Parent is subject to gift tax on purchase of a MET contract, MET is subject to tax on its investment income during the

occurs); Treas. Reg. 1.461-1(a)(2) (as amended in 1967) (no deduction allowable for accrual method taxpayer until "all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."); Brown v. Helvering, 291 U.S. 193 (1934) (deduction denied insurance agent for addition to reserve in anticipation of policy cancellations); Sebring v. Commissioner, 93 T.C. 20 (1989) (payments of cash to fund characterized as reserve for future liabilities not currently deductible); Simplified Tax Records, Inc. v. Commissioner, 41 T.C. 75 (1963) (addition to reserve for estimated future cost of preparing clients' tax returns not deductible); Rev. Rul. 76-345, 1972-2 C.B. 134; B. BITTKER, FEDERAL TAXATION OF INCOME ESTATES AND GIFTS ¶ 105.3.6 (1981).


term of the contract, and Child is subject to income tax when Child receives educational services under the contract. Potential imposition of gift tax on contract purchasers is likely to have little practical impact because of the $10,000 per donee annual gift tax exclusion and the unified gift tax credit, which has the effect of excluding lifetime gifts up to a total of $600,000. However, imposition of income tax liability on MET and Child will have significant practical consequences.

With respect to Child, the tax impact is not catastrophic, but it can produce some pain, especially to a cash-poor student. Assume that Parent paid $6,000 for a four year MET contract, and in the year Child receives educational services under the contract, the services are worth $5,000. Assume also that Parent rightfully claims Child as a dependent on Parent's income tax return, Child earns $2,500 at a summer job, and Child does not itemize deductions.

Under these facts, Child would include $3,500 in gross income on account of receiving the educational services ($5,000 value of services minus $1,500, one-fourth of Child's substituted basis in the contract) plus the $2,500 in wages. The standard deduction would completely offset the $2,500 in wage income. However, Child's standard deduction would be limited to $2,500, the amount of earned income, because he can be claimed as a dependent by Parent. Moreover, Child may not claim a personal exemption on Child's own return. As a result, Child will pay tax on the entire amount included in gross income on account of receiving the educational services. At a fifteen percent tax rate, the amount of tax would be $525. Over a four year period, the income taxes paid by Child would total $2,100.

247. See supra text accompanying notes 50-73.
248. See I.R.C. § 2503(b) (annual exclusion); § 2505 (unified credit).
249. See I.R.C. § 63(c)(2)(C), (5).
250. I.R.C. § 63(c)(5) provides in relevant part as follows:
   In the case of an individual with respect to whom a deduction under section 151 is allowable to another taxpayer . . . the basic standard deduction . . . shall not exceed
   (A) $500, or
   (B) such individual's earned income.

251. See I.R.C. § 151(d)(2), which provides in relevant part as follows:
   In the case of an individual with respect to whom a deduction under this section is allowable to another taxpayer . . ., the exemption amount . . . shall be zero.
252. I.R.C. § 1(i). Child would be taxed at his own rate, not Parent's rate, because Child is over 14 years of age. See I.R.C. § (1)(i)(2).
While this does not constitute an insurmountable barrier to Child's educational goals, it is certainly no encouragement.253

The effect of imposing tax on MET's investment income could be drastic. Economists project the long-range college cost inflation rate to be about two percentage points above the general inflation rate.254 Consequently, if general inflation runs between five and six percent a year, a prepaid tuition fund would need a net rate of return of at least eight percent a year to keep pace with college inflation. The fund probably would aim to achieve a higher rate of return than eight percent as an actuarial hedge against unanticipated college cost inflation. Suppose the fund aims for a ten percent rate of return. If the fund is taxed on its income at the thirty-four percent corporate rate, it would have to achieve a before-tax rate of return of over fifteen percent to achieve a ten percent after-tax return.255 Manifestly, a fifteen percent sustained rate of return is difficult to achieve for even the best investment managers.

The alternative to striving for a higher rate of return is to increase the initial price charged for a prepaid tuition contract. For example, assume the fund aims for an eight percent rate of return and projects that four years' tuition eighteen years hence will be $25,000. If the fund pays no income tax it needs to charge about $6,200 for a four year contract. However, if the fund pays tax at the thirty-four percent corporate rate it would have to charge $9,900 for the contract to achieve the same eight percent rate of return after taxes.256 The higher purchase price obviously makes the contract less attractive. Furthermore, the higher price may preclude entirely many lower-middle income purchasers from participating in the plan. Such a result would be most unfortunate because middle income parents appear to have an especially pressing need for the benefits of prepaid tuition plans.257

2. Uncertainty

The uncertainty of how existing law applies to prepaid tuition plans is, in itself, a hindrance to their implementation. The only guidance from IRS thus far has been in the form of two private letter rulings.258 These, of course, have no binding precedential value, although they do offer an

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253. In addition, Child presumably would pay FICA taxes on the $2,500 wage income. At currently scheduled rates this would amount to $191.25 (7.65% times $2,500) payable by Child and $191.25 payable by Child's employer.


255. The 10% after tax figure is computed as follows: 15% before-tax rate of return minus 5.1% tax (34% times 15%) equals 9.9% after-tax rate of return.

256. See Tax Implications, supra note 232, at 678.

257. See infra text accompanying notes 311-14.

indication of IRS thinking on the subject. Prepaid tuition contracts are a relatively new idea. They are plausibly analogous to a variety of situations. Conceivably, any of these analogies might prevail ultimately.

However, potential plan sponsors need certainty, not abstract legal speculation. Currently, it is not at all certain how plans set up differently than MET might be taxed. For example, officials connected with the Florida prepaid tuition plan disagree as to whether their investment fund will be subject to a tax on its investment income. This has discouraged states from going forward with prepaid tuition plans. Their only choices seem to be: 1) request a letter ruling, which is likely to be unfavorable in light of the IRS ruling on the MET plan; (2) plunge ahead in the face of uncertainty and be prepared to litigate; (3) wait for further developments; or 4) abandon the idea of a prepaid tuition plan. Several states apparently have opted for the third or fourth alternative. Only Michigan, Wyoming, and Florida actually have put prepaid tuition plans into operation.

The conclusion is that application of the current IRS position with respect to taxation of prepaid tuition plans may not necessarily result in their failure. However, the IRS position, along with the uncertainty of existing law, assuredly makes successful implementation of such plans considerably more difficult.

B. Desirability of Prepaid Tuition Plans

Prepaid tuition plans have distinct advantages over other means of financing college education. Although existing plans also have disadvantages, most notably that they tend to restrict college choice, these problems can be overcome by changes in the structure of the plans. Moreover, even as presently constituted, prepaid tuition plans are a step forward in college financing alternatives.

1. Undersaving for College Costs

Families basically can pay for college costs out of three sources: savings, current income, and loans. Many families are likely to use a combination

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259. See I.R.C. § 6110(j)(3), which provides:

Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent.

The term "written determination" includes letter rulings. See I.R.C. § 6110(b)(1).

260. See supra text accompanying notes 74-246.

261. Florida's plan is established in such a way that some believe it has a stronger argument for tax exemption as an integral part of the state. See TAX IMPLICATIONS, supra note 232, at 678-79. But see supra note 194.


263. 1989 SURVEY, supra note 22, at § II; Blumenstyk, supra note 262, at A23.
of the three. However, families appear to be undersaving for college costs. A widely quoted 1984 study found that only about half of the families who plan to have a child attend college currently were saving anything for that purpose. Moreover, the overall-median level of saving was only $517 (about $625 in current dollars) per year, and families tended to wait until the child was within five or six years of college to begin saving.

There are several reasons why families undersave for college costs. First, the available savings options for families may appear to be inadequate for them in light of anticipated college costs. For a small saver the common alternatives for cash saving are savings accounts, series EE bonds, municipal bonds, life insurance policies, common stocks, and annuities. Except for common stocks, the rate of return on these investments historically has been below the rate of college inflation. Interest income on Series EE bonds purchased after December 31, 1989 will be excludible by taxpayers below certain income levels to the extent proceeds of the bonds are used for payment of college tuition and related fees. Therefore, the after-tax return on these Series EE bonds will increase for eligible taxpayers. Nevertheless, even with the benefit of tax exclusion, the return on Series EE bonds (eighty-five percent of a three year moving average of five year treasury bonds, with a six percent floor) is likely to be less than college cost inflation.

More importantly, prevailing public policies, including tax policy, make saving for college relatively unattractive. People save in order to meet unanticipated emergencies, such as extraordinary medical expenses, and to meet certain planned needs, such as retirement. Government benefits, in the form of Medicare, Medicaid, Social Security, and similar programs provide for many of these needs. Furthermore, the tax system affords substantial incentives for private sector employers to join in satisfying these needs by providing employees with medical coverage, pension plans, and other fringe benefits. Finally, the tax system includes strong incentives for

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264. STATE SAVING AND PREPAID TUITION PLANS, supra note 8, at 11.

265. Statement of John H. Finnerty in Tax Incentives for Education Hearing, supra note 4, at 194, 203 id. 1-2, citing ROPER ORGANIZATION, A NATIONAL STUDY ON PARENTAL SAVINGS FOR CHILDREN’S HIGHER EDUCATION EXPENSES 5 (National Institute of Independent Colleges and Universities 1984). The study indicated that 70% of families with 1984 incomes in excess of $30,000 saved for college. Their median savings level was $904 in 1984. Adjusted for subsequent inflation, the current median yearly saving amount for these families would be about $1,100. Id.

266. Most people, when asked, overestimate rather than underestimate the cost of attending college. STATE SAVING AND PREPAID TUITION PLANS, supra note 8, at 11.


268. See I.R.C. § 135. The exclusion is phased out between modified adjusted gross income levels of $60,000 and $90,000 for married couples filing joint returns (between $40,000 and $55,000 for single taxpayers and heads of household). Id. § 135(b)(2). Bond purchasers who were under age 24 on the date of the bond’s issuance and married taxpayers filing separate returns are not eligible for the exclusion. Id. § 135(c)(1)(B), (d)(2).


270. Id. at 3-4.
individuals to funnel what savings they do undertake into the form of home equity. Thus, the home mortgage interest deduction, the tax-free rollover of gain on sale of a principal residence, the exclusion of gain on sale of a principal residence by a person age fifty-five or older, the step-up in basis of an asset at death, and the exclusion from gross income of unrealized asset appreciation all afford powerful incentives for saving to take the form of build-up in home equity.

In contrast, powerful governmental incentives to save for higher education do not exist. The initiatives of states with baccalaureate bonds and the federal government with tax exempt Series EE bonds thus far have been fairly limited. Furthermore, the federal government actually has removed several incentives for college saving that previously existed. As a leading commentator on financing college costs has said:

Higher education, particularly the independent sector, is conspicuously alone in creating a need for savings for which there is an acknowledged public value yet no public inducements for private capital accumulation.

The result has been that families generally depend too much on loans and not enough on saving to finance college costs.

2. Advantages of Prepaid Tuition Plans

An ideal college saving plan would possess the following features: 1) adequate return on investment to pay for college costs; 2) minimization of college cost inflation risk; 3) adequate security for invested funds; 4) low entry cost; and 5) flexibility of college choice. Prepayment plans do as well or better than other college saving vehicles under the first four criteria. Existing plans do not do as well under the last criterion—flexibility of college choice. However, it is possible to refine the prepayment idea so that plans can offer adequate flexibility in college choice.

Prepayment plans, such as MET, can offer a superior alternative to the investments usually available to college savers, who normally must operate in the retail investment market. Small investors normally operate under substantial handicaps. First, they are unable to diversify their investments

273. See I.R.C. § 121.
274. See I.R.C. § 1014.
276. See supra text accompanying notes 20-31.
277. See supra text accompanying notes 13-17.
sufficiently to protect against changing market conditions and risk. Even a mutual fund does not solve the problem because the investor still must choose a fund of which there will always be some winners and some losers.\textsuperscript{281} Second, small investors usually have insufficient access to relevant knowledge of the market and insufficient time and resources to obtain that knowledge.\textsuperscript{282} 

Finally, college savers will be hampered by a short time horizon for their investment. The need for college funds arises within the time between when the saver begins to save and when the children reach college age. Therefore, college savers cannot depend on spanning cyclical markets. Their investments do not span that long a time frame.\textsuperscript{283} They need access to their savings when their children are ready to matriculate. For safety, they need to keep their savings in stable investments that tend to be low-yield.\textsuperscript{284} Therefore, prepaid tuition plans promise to allow families to benefit from more aggressive long-term investment strategies than they would otherwise be able to do without taking on too much risk. Plan beneficiaries will attend college over many years, not just the limited amount of time appropriate for any one family. Plan managers can spread their investment risks over time, paying less attention to investment volatility than individual investors must do.\textsuperscript{285} 

Prepaid tuition plans also minimize college cost inflation risk for the purchaser, because they basically shift that risk to the sponsor of the plan. For example, if college costs go up faster than anticipated when Parent purchases a MET contract, MET must adjust its price for future contract purchasers to compensate for the unexpected costs.\textsuperscript{286} This may be the single most important advantage of prepayment plans, because other available forms of saving do not shift the risk of college cost inflation. Thus, the purchaser of a baccalaureate bond assumes the risk that college costs will increase at a faster pace than the return on the bond. This is likewise true of most other investment alternatives, such as Series EE bonds, savings accounts, stocks, and mutual funds.\textsuperscript{287} 

A prepayment plan, such as MET's, also offers the college saver a high degree of investment security, because its funds are pooled with other state funds for investment purposes. Moreover, from a political standpoint, it is

\textsuperscript{281} See Prepaying for Higher Education, supra note 29, at 9-11.

\textsuperscript{282} Id.

\textsuperscript{283} Id.


\textsuperscript{285} Id.

\textsuperscript{286} This is not an absolute guarantee, however, because the whole plan can simply terminate if it becomes actuarially unsound. See Mich Laws § 390.1433(2). In this event, the plan would distribute its assets prorata to holders of existing contracts. Id.

\textsuperscript{287} One financial institution, College Savings Bank of Princeton, N.J., does offer a certificate of deposit indexed to the rate of college cost inflation, which it advertises as a guarantee against college cost inflation risk. See RESEARCH DIVISION, COLLEGE SAV. BANK, COLLEGESURE PLUS CD: HIGHER RETURN AND LOWER RISK (1988).
unlikely that a state would allow its prepayment plan to default on obligations. In a worst-case scenario in which the fund was terminated because of actuarial unsoundness, the investors still would get their initial investment back, plus in all likelihood at least some return on that investment.

Finally, prepayment plans can provide a low entry cost by authorizing purchase of contracts on an installment basis. For example, MET has arranged with financial institutions to make loans to MET contract purchasers. The financial institution lends the purchaser the contract price, which is paid over to a MET escrow account. The purchaser repays the financial institution in installments. The unpaid balance on the loan is secured by the funds transferred to MET, thereby affording the financial institution a high degree of security for repayment of the loan. This permits the financial institution to charge the purchaser a favorable interest rate. If the purchaser defaults, MET pays off the loan, and credits any remaining balance to the contract.

The installment plan aspect may be the most important impetus for participation by lower and middle income families. It is quite difficult for many people to save enough cash in a lump sum to make large purchases or investments. For example, few persons save enough to purchase a new automobile with cash, and almost no one purchases a personal residence with cash. However, many people find it possible to "save" for purchase of an automobile or home by paying for it in installments.

The outside discipline exercised by the payment book or mortgage schedule provides sufficient motivation to pay the installments. When the person has paid off the balance due, the person is likely to have substantial equity remaining in the car or house and will have, in effect, "saved" that equity. Paradoxically, the person has saved by borrowing. The installment plan has proven popular with MET contract purchasers, as a substantial number of purchasers have chosen to pay in this manner. Presumably, this popularity comes from the convenience and discipline of the installment arrangement, along with the favorable interest rates available by reason of the fact that the loans are fully secured.

3. Disadvantages of Prepaid Tuition Plans

The most notable criticism of prepaid tuition plans is that they fail to provide sufficient flexibility of college choice. This is a valid criticism,

288. The possibility of such a state bail-out has been raised as an argument against states' instituting prepaid tuition plans on the ground that it is improvident for a state to take on the risk of a bail-out. See College Savings and Prepayment Plans, supra note 30, at 11.
290. Id. § 5(b).
291. Installment payment for prepaid tuition plans could be made even more convenient for purchasers by use of devices such as payroll deductions.
292. Owen Interview, supra note 211.
293. See, e.g., State Saving Incentive and Tuition Plans, supra note 8, at 50-53; College
especially for plans sponsored by a single or small number of institutions. The MET plan provides a tuition guarantee at every publicly supported institution of higher education in the state. Moreover, the plan contains liberal refund provisions for beneficiaries who choose to attend independent or out-of-state institutions, or who choose not to attend college at all. Therefore, the MET plan, and others like it, do provide considerable flexibility in college choice. Still, there is no denying that these plans afford considerably less than absolute choice. They definitely tend to favor attendance at state-supported institutions.

There are two answers to this criticism. The first is that something is better than nothing. Prepaid plan beneficiaries may well find themselves with a wider array of college choices than if the plan did not exist. Second, there is nothing in the nature of prepaid plans that requires them to limit college choice. It is possible to devise a plan that provides considerable flexibility in college choice. To provide flexibility, more institutions must participate in the plan. The National Association of Independent Colleges and Universities has suggested the broad outlines of such a plan. Two private companies, Hemar Corp. and College Prepayment Fund, Inc., also are initiating plans that would provide a wide variety of college choice. The problem lies not in the inherent nature of the idea, but rather in its current implementation.

C. Legislative Proposals

The adverse impact of the IRS position enunciated in Letter Ruling 88-25-027 on prepaid tuition plans, along with the uncertainty of how existing law should apply to these plans, make clarifying legislation particularly appropriate. The question of proper federal tax treatment for these plans should be confronted directly, not approached by analogy to other situations.

Savings and Prepayment Plans, supra note 30, at 11; Statement of William J. Moore, President, National Association of Independent Colleges and Universities, in INVITATIONAL CONFERENCE, supra note 3, at 16; Statement of John D. Finnerty, in Tax Incentives for Higher Education Hearing, supra note 4, at 199.

294. See supra text accompanying notes 40-46.
295. Id.
297. See Wilson, National Prepaid-Tuition Program is Started by Company Representing 14 Private Colleges, Chronicle of Higher Education, Oct. 25, 1981, p. A34; Putka, Group of Colleges Endorses Tuition-Prepayment Plan, Wall St. J., July 18, 1989, p. B1, col. 3. Under such plans, a Parent would purchase a contract from a participating institution for a price set by that institution. The educational benefits of the contract could be used at another participating institution at a value proportionate to the prices set by the respective institutions for their contracts. Id. For example, assume the price of institution A’s contract is $8,000 for one year’s tuition and the price for institution B is $10,000. Parent purchases a contract from Institution A for $8,000. Child decides to attend institution B when the cost of one year’s tuition is $15,000. Child would be entitled to $12,000 ($8,000/$10,000 times $15,000) of educational benefit under the contract.
The question is should prepaid tuition plans be tax-favored. If so, what form should tax-favored treatment take? A strong argument exists for some form of treatment more favorable than the current IRS position. The current IRS position, if sustained, would make the economic viability of prepaid tuition plans quite doubtful. At the same time, there is a real need for new ways for families to finance college education. Prepaid tuition plans represent an innovative attempt to meet this need. This initiative should not be abruptly forestalled by a shortsighted tax policy.

A few Congressmen have introduced proposed legislation according favorable tax treatment to prepaid tuition plans. These bills generally would exempt the prepayment fund, the purchaser, and the beneficiary of a prepayment contract from income tax, but would not permit an income tax deduction for the purchase price of a contract. However, these proposals have made no legislative progress to date.

1. Tax Neutrality

The treatment proposed by this legislation would afford tax neutrality between the decision to save for college and the decision to consume, whereas the current IRS treatment is biased against the decision to save and in favor of the decision to consume. The IRS position is biased against the saving decision, because the current income tax law in general is biased against saving. This bias results from the fact that both saved income and the investment return that saved income generates are taxed.

A simple example illustrates the idea. First assume that $X$ earns $1,000 and there are no taxes. Assume also that $X$ can earn a ten percent return on saved income. $X$ has the choice of spending the $1,000 on consumption or saving it and earning an additional $100 income. The price of each dollar of additional income is $10 in foregone consumption.

Next, assume that there is a twenty-five percent income tax similar in structure to the current income tax. After tax there would be $750 left of the original $1,000 earned. If $X$ invests this $750 at 10 percent $X$ will receive $75 additional income. This $75 income will in turn be subject to the twenty-five percent tax, leaving an after-tax return of $56.25. The twenty-five percent tax raises the cost in foregone consumption of each additional dollar.

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298. See supra text accompanying notes 247-63.
301. Id. at 15.
302. Id. This discussion assumes that investment is a substitute good for current consumption, because investment is equivalent to deferred consumption. See J. DODGE, THE LOGIC OF TAX 326 (1989).
of income from $10 to $13.33 ($750 foregone consumption returns $56.25 additional income). Hence, the twenty-five percent tax raises the foregone income cost of saving by thirty-three percent.\textsuperscript{303}

Exempting the investment income from income tax accomplishes tax neutrality between the consumption and saving decisions. Assume the same facts and twenty-five percent tax rate as above, except that the additional income is exempted from tax. The $750 after-tax income when saved produces $75 additional income on which no tax is paid. Consequently, the cost of one dollar additional income is $10, the same as in the no-tax situation, and tax neutrality exists between the consumption and saving decisions.\textsuperscript{304}

2. Tax Expenditure

Aside from tax-neutrality, there is a question concerning the fiscal soundness of exempting the income generated by a prepayment plan from tax. Some may argue that such an exemption would be an unwise “tax expenditure.” There are two responses to this argument.

First, the tax expenditure concept, itself, is not without flaws. The idea is based on the notion that in an ideal income tax all economic income—defined as personal consumption plus wealth accumulation—should be taxed.\textsuperscript{305} The next step is to assert that deviations from this ideal income tax base represent indirect subsidies or tax expenditures for those who pay less tax because of the deviation.\textsuperscript{306}

The tax expenditure is measured by the revenue foregone by the government on account of deviation from the ideal. However, as presently formulated, the measurement of foregone revenue is inaccurate because it fails to take into account changes in taxpayer behavior that will occur if a

\textsuperscript{303} J. Dodge, supra note 302, at 16.

\textsuperscript{304} Id. at 17.

\textsuperscript{305} This is the well-known Haig-Simons definition of income. See R.M. Haig, The Federal Income Tax 7 (1921), reprinted in Readings in the Economics of Taxation 54 (R. Musgrave & C. Shoup eds. 1959); H. Simons, Personal Income Taxation 50-55 (1938). In Simons' formal presentation of the income concept, personal income is defined as:

[T]he algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question.


deviation from the ideal income tax base is eliminated. For example, it is incorrect to assert that exempting income of prepaid tuition plans will decrease government revenue by an amount equivalent to the product of the exempted income times the applicable tax rate. The existence of the exemption will affect the amount of foregone revenue.

The tax expenditure concept also fails to take a long view. Granting tax exemption to prepaid tuition plans may result in short-term revenue loss, but long-term revenue will increase if the tax exemption fosters a better educated and, hence, higher earning work-force. Furthermore, the tax expenditure concept assumes that income, broadly defined, is the proper tax base. But this assumption begs the question. Viewed from the perspective of saving/consumption neutrality, a tax that exempts the income derived from saving may be more appropriate. Finally, in a common sense vein, the proponents of the concept seem to have an underlying premise that the government has a preeminent right to a taxpayer’s income, so that whatever the government does not take from a taxpayer in the form of taxes becomes, mirabile dictu, a “tax expenditure.”

A second response to the tax expenditure objection is that even if everything that proponents of the tax expenditure concept claim for it is true, the societal gains to be derived from prepaid tuition plans are worth the cost. Opponents of tax exemption for prepaid tuition plans are likely to argue that these plans will benefit mainly the well-off; that “tax expenditures” and direct government aid are better directed to lower income groups. The answer to this is that direct government aid in the form of

308. A recently published book aptly expresses the long range need for a highly educated work-force as follows:

As the economies of developed nations move further into the post-industrial era, human capital plays an ever more important role in their progress. As the society becomes more complex, the amount of education and knowledge needed to make a productive contribution to the economy becomes greater. A century ago, a high school education was thought to be superfluous for factory workers and a college degree was the mark of an academic or lawyer. Between now and the year 2000, for the first time in history, a majority of all new jobs will require post-secondary education. Many professions will require nearly a decade of study following high school, and even the least skilled jobs will require a command of reading and thinking that was once necessary only for the professions.

Education and training are the primary systems by which the human capital of a nation is preserved and increased. The speed and efficiency with which these education systems transmit knowledge govern the rate at which human capital can be developed. Even more than such closely-watched indicators as the rate of investment in plant and equipment, human capital formation plays a direct role in how fast the economy can grow.

309. See supra text accompanying notes 300-04.
310. The author realizes this is anathema in an academic article.
guaranteed loans and Pell grants currently is directed at lower income students. The middle income group, by contrast, has come up short on government aid over the past decade. This was forcefully expressed by a participant at a recent conference on prepayment plans, who said:

Middle-income squeeze—this is what it’s called, I guess—is a fact across the nation. Families that don’t qualify for financial aid, yet don’t have the big bucks to afford the big institutions, are the ones that are basically being squeezed out of higher education. So a prepayment plan may really attract them.311

Thus far, MET’s experience bears this out. An analysis of MET contract purchasers in MET’s initial year found that more than half of contract purchasers had family income of less than $50,000.312 The average income of a working family of four in Michigan is about $46,000.313 Average working families are precisely the group prepaid tuition plans aim to help. Whatever “tax expenditures” may be involved in granting favorable treatment to these plans will be money well “spent” in the long run.314

IV. CONCLUSION

Prepaid tuition plans offer middle income taxpayers a sound opportunity for self-help in financing their children’s education. Their development ought not to be frustrated by the short-sighted tax policy enunciated in Letter Ruling 88-25-027. Legislation granting prepaid tuition plans favorable tax status should be enacted. Such legislation will pay dividends far into the future.

311. Statement of Shari Caprara, Legislative Director, Florida Student Association, in INVITATIONAL CONFERENCE, supra note 3, at 14.
312. Jones, Study of Prepaid Tuition Plan Finds Mid-Income Acceptance, Detroit Free Press, March 18, 1989, p. 3A. Contract purchasers broke down by income group as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>Percentage Purchasing Contracts</th>
<th>Cumulative Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $20,000</td>
<td>17%</td>
<td>17%</td>
</tr>
<tr>
<td>$20,000 to $39,999</td>
<td>18%</td>
<td>35%</td>
</tr>
<tr>
<td>$40,000 to $59,999</td>
<td>26%</td>
<td>61%</td>
</tr>
<tr>
<td>$60,000 to $79,999</td>
<td>20%</td>
<td>81%</td>
</tr>
<tr>
<td>Over $80,000</td>
<td>19%</td>
<td>100%</td>
</tr>
</tbody>
</table>

313. Id.
314. The pressure for more government aid in financing college education may increase in the next five to ten years as the children of the baby boom generation come of college age. Currently, child-care for these children is a pressing issue. When the baby-boomers’ children are ready for college it will not be surprising to see college financing come to the forefront as a political issue.