F I N A L R E P O R T

EDUCATION TRUST FUND STUDY COMMITTEE

January, 1988

BACKGROUND INFORMATION

The Education Trust Fund Study Committee was established by the Legislative Council to consider the state's role in developing alternative financial aid programs for Iowa students in public and private institutions of higher education, and opportunities and incentives to address the costs of higher education prior to college enrollment. The Study Committee was directed to consider various savings and investment plans being developed in other states, including the "education Trust" concept adopted in Michigan.

Members of the Study Committee were:
Senator Richard J Varn, Solon, Co-chairperson
Representative Linda Beatty, Co-chairperson
Senator Bill Dieleman, Pella
Senator Wally E Horn, Cedar Rapids
Senator Wilmer Rensink, Sioux Center
Representative Dennis Cohoon, Burlington
Representative Russell Eddie, Storm Lake
Representative Charles Poncy, Ottumwa
Representative George Swearingen, Sigourney

The issue of helping parents to pay for future college costs of their children has been considered in many states throughout the United States. The issue has arisen partly because the costs of tuition and other college related costs are increasing at faster rates than the rate of inflation and partly because of the actions of the federal government to reduce its commitment for assisting with college costs.

The Education Commission of the States, a nationwide interstate organization formed to help the development of policies to improve the quality of education at all levels, gathered information about the activities of the 50 states in this area and the Study Committee used this information in developing its recommendations.

Michigan was the first state to enact legislation in this area. The Michigan Plan provides that parents may buy tuition certificates from a state authority that will enable parents to guarantee the costs of four years of undergraduate tuition for their children at a Michigan public college or university. The costs of these certificates and the earned income are exempt from state taxation. An Internal Revenue Service ruling has been requested to determine whether the earnings are taxable to the parent or the student and whether the earnings are taxable at the time they are earned or when they are withdrawn for college tuition. At least five other states have enacted some form of tuition prepayment plan. Some other states are considering an approach that would provide for setting aside a portion of the state's general obligation bond sales for zero coupon bonds for parents who could purchase the bonds for the purpose of saving for their children's college education. There would be no guarantee that the amount saved with interest earned would actually pay for tuition and other associated college costs. However, the interest earnings on state general obligations bonds are already exempt from federal and state taxation. Under a plan passed by Illinois, but item vetoed by the Governor, the state would pay an additional one-half percent of interest on bonds purchased and used for college costs of Illinois residents for in-state colleges and universities.

These approaches assume that a parent has some additional income that could be set aside each year to pay for future college costs. They will not help low income parents. The State of New York has developed a proposal that would provide state matching funds for low income parents who set aside small amounts of money for future college costs.

MEETINGS

The Study Committee was authorized two meetings by the Legislative Council and held them on October 1 and November 19.

At the October 1 meeting, the Study Committee received historical information about college costs and information about the various kinds of scholarships, grants, and loans presently available to Iowa residents from Mr. Gary Nichols, Executive Director of the Iowa College Aid Commission.

Mr. Paul Hayes, a partner in the McGladrey, Hendricksen and Pullen Public Accounting Firm, described some avenues available in the private sector that would allow parents to shelter some of their income from taxation to be used for college costs of their children. It was noted that with the enactment of the Federal Tax Laws of 1986 these avenues are more limited than they were under the old tax laws.

Mr. Scott Brown, United Students of Iowa; Mr. Mike Reck, National Collegians Association at the University of Iowa; and Mr. Earl Dowling, Financial Aid Officer from Iowa State University, discussed the rapid increase in college costs and the difficulties students have paying for college.

Dr. John Hartung, Executive Director of Iowa Association of Independent Colleges and Universities, stressed the importance of parental planning and responsible saving for the payment of future college costs. He also stressed that any program recommended by the Study Committee not be limited to students enrolled in public colleges and universities, but be available to students at any North Central Association accredited not-for-profit institution in Iowa.

Dr. Hartung described several bills that have been introduced in Congress that would reduce or eliminate the taxes on money saved for college purposes.

Representatives from the Department of Revenue analyzed several of the approaches being considered by state legislatures to determine whether the income earned on investments would be taxable. Mr. Benjamin Brown stated that under current Iowa law there is no provision for an exemption or deduction for the principal payments that might be made to a college prepayment fund. It was also noted that the interest rates paid on tax exempt bonds are lower than those paid on fully taxable bonds.

The staff was directed to develop a listing of factors that could be considered by the Committee in developing its recommendations.

At the November 19 meeting the Study Committee heard a presentation from Mr. Joe Young, an independent financial planner. He suggested the following:

1. Inform young parents concerning the importance of early planning for future college costs.

2. Create an approach for saving for college costs that is deductible from earnings.

3. Provide for the purchase of bonds that would be tax exempt at both the state and federal levels.

Mr. Doug True from the State Board of Regents commented to the Committee that the State Board of Regents is considering, but has not acted upon, a proposal that would recommend a change in the law to allow a certain percent of its bonds to be issued as zero coupon bonds. The State Board of Regents would make this recommendation for the purpose of evening out its tuition replacement costs, but the proposal could also be used by individuals as a means of reducing tax liability on income set aside to pay for future college costs.

Mr. Steve Roberts, Bond Counsel for the Iowa Finance Authority, discussed the procedures that would be necessary if state general obligation bonds were issued as zero coupon bonds with proceeds to be used for future college costs. He suggested that a negotiated sale rather than a bid sale would be necessary, that the minimum denomination would have to be set at $500 or $1000, and that the additional procedures required might be assigned to an existing bond authority.

COMMITTEE RECOMMENDATIONS

The Committee considered a list of questions developed by the staff and the information it received from the various individuals who presented information to the Committee. It makes the following recommendations:

1. The state should adopt a program to encourage parents to preplan financing for future college costs. This program should include some state appropriations to provide funding for money to match the savings of lower income Iowans. Because of the difficulty in predicting future college costs, the state guarantee should be limited to the matching funds and any interest earnings on such funds. The income levels for state assistance should not be as restrictive as the income guidelines at the federal level. College costs should include tuition, room and board, books, and other college-related expenses. The program should be available for payment of college costs at Iowa colleges and universities possessing North Central Association accreditation.

2. The state should establish a state trust fund for future college costs and provide for annual appropriations to the trust fund. Earnings from the trust fund should be used to enhance programs that provide financial assistance to low income individuals for payment of college costs and to provide moneys to match savings of low income parents for payment of future college costs. The moneys available will depend on the interest earned on the moneys in the fund.

3. The Department of Revenue and Finance should be directed to analyze the comparative state tax advantages for different income levels of using existing tax sheltered investment programs and using a program that would provide that a certain portion of the general obligation bonds of the State Board of Regents would be issued as zero coupon bonds for purchase by individual taxpayers and used only for education-related expenditures. If there are advantages to the bond approach, then legislation should be drafted to allow the issuance of zero coupon bonds. The Internal Revenue Service should perform a similar comparison for federal tax purposes.

4. Legislation should also be drafted as a third approach to saving for future college costs that would allow parents to invest up to $2,000 per year in an Individual Education Account (IEA). The principal and interest earnings would be exempt from state taxation. If the principal and interest are not used for the payment of college costs, the principal would be subject to taxation and a penalty on interest earned would be assessed that is similar to the penalty charged for early withdrawal of moneys from an Individual Retirement Account under the federal program. However, a parent could donate the money in an account to an Iowa college or university without incurring the penalty if the money

in the account is used by the Iowa institution for academic purposes.

Payments made from an Individual Education Account would be made jointly to the educational institution and the parent, similar to the guaranteed student loan program.

5. The IEA program should be available to Iowa residents and it should allow for the payment of college costs at any higher education institution in the United States.

6. The money available to a student under the IEA program should not affect the student's eligibility for other types of financial aid, except that a student should not be eligible for more money than is needed to pay college costs.

7. A letter should be written by the Committee to the members of Iowa's Congressional delegation encouraging them to introduce and support legislation at the federal level that would mirror the tax and financial aid eligibility recommendations for the proposed Iowa programs.

In addition, a concurrent resolution should be introduced in each house of the General Assembly that would urge the members of the Congressional delegation to meet the requests included in the letter.

8. The College Aid Commission should be directed to prepare a brochure for parents of kindergarten and lower grade elementary school students stressing the importance of planned savings for future college costs and outlining how this savings might be accomplished.

The Committee requested additional information from staff listing the number of Iowa students in college in Iowa during a fiscal year, the number entering college each year, the estimated cost of exempting income invested for future education costs from the state income tax, and the cost of meeting 100% of the financial aid needs in Iowa.