ABSTRACT

In the 1980 election year, Congress is likely to provide taxpayers with some form of tax savings, and observers predict that legislators will begin efforts to modify the Internal Revenue Code to provide more equity, gather more revenues, and serve a number of other purposes that will affect the higher education community. Particularly, higher education institutions will seek to preserve and broaden the provision that allows charitable contributions to colleges and universities to be deducted in calculating a donor's income tax. In addition, they have a strong interest in maintaining the tax-exempt status of scholarships and fellowships (Section 117). Tuition remission, presently regarded as tax-exempt, may be vulnerable during the tax review process. The concept of tax expenditures is fundamental to the arguments on tax reform. Legislative history, cultural values, and current politics argue against any wholesale reform of the tax code, and yet piecemeal efforts to alter the code have been made and will continue. The higher education community views these efforts with concern, but has a powerful ally in other special interest groups, particularly in the nonprofit sector, that are also interested in encouragement of charitable giving. (Author/MS)
TAXATION: EQUITY AND POLITICS IN HIGHER EDUCATION

By Carol Herrnstein Shulman

In this election year, Congress is likely to provide taxpayers with some form of tax savings. In 1981, Congressional observers predicted that legislation might begin efforts to modify the Internal Revenue Code to provide more deductions, gather more revenues, and serve a number of other purposes.

These activities will affect the higher education community.

As financially-pressured organizations, higher education institutions have a considerable stake in retaining and building upon the present provisions in the tax code that work for their financial well-being. Most particularly, they seek to preserve and broaden the provision that allows charitable contributions to colleges and universities to be deducted in calculating a donor's income tax. They argue that this benefit is a major incentive for higher education philanthropy.

In addition, colleges and universities have a strong interest in maintaining the tax-exempt status of scholarships and fellowships (Section 117) Tuition remission, presently regarded as a tax-exempt, may be vulnerable during the tax review process.

Whenever Congress looks at the tax code, colleges and universities are keen observers of and active participants in the discussions and are deeply concerned about what changes are made. During the year and next, the issues raised above the fate of the charitable deduction, treatment of tuition remission, and treatment of fellowships and scholarships will go before Congress. The research community must continually raise these issues, and universities and colleges must advocate the higher education community presents to further its needs through the tax code.

Reviewing the Internal Revenue Code

Location is for most taxpayers inevitable and uncomfortable. Yet the unspoken work called on by the bulk of the federal tax system provides its own counterpart: the appealing prospect of tax relief. With substantial taxation the general rule for all society, physicians that spare particular citizens and organizations from taxation are highly prized (Kirkwood and Mundel 1979, p 142).

These provisions, so dear to the taxpayer, generate strong feelings and foster lobbying efforts whenever the prospect of changing the Internal Revenue Code occurs.

Since the late 1960s, the most significant threat to these provisions comes from a theory on taxation and the federal budget that treats income-tax deductions as tax expenditures. Developed by Wesley C. Mitchell, Assistant Secretary of the Treasury for Tax Policy, this concept underlies efforts to modify or make major reforms in the Internal Revenue Code.

Basically, the tax expenditure concept looks at the totality of revenue produced in this country for personal use. First, it postulates an ideal income-tax structure in which taxation is levied on net income, which is "the best approximate measure of ability to pay" (National Association of Independent Colleges and Universities 1978, p 3). Net income is the income remaining after certain "income-defending" deductions are subtracted from gross income. These deductions are generally limited to expenses necessary for earning or producing income, such as travel expenses or uniform purchases. Any other deductions from gross income, e.g. Social Security taxes, state and local nonbusiness taxes, and charitable gifts, represent a departure from the ideal income-tax structure. Their justification lies elsewhere, in the need to meet certain social or economic objectives.

Under the tax expenditure theory, these deductions are considered revenue lost to the federal government. Second, the tax expenditure concept holds that these departures from the ideal tax system must be accounted for in the budgetary process when total federal expenditures are considered. Since deductions sanctioned by Congress reduce federal revenues, the argument goes, they are indirect spending programs, and therefore they influence public policy and should be included in the federal budget.

Until 1968, only those expenditures directly approved by Congress through the appropriations process were included in the federal budget. But since then, the federal government has gradually adopted the tax-expenditure approach. The Department of the Treasury has published a "Tax Expenditure Budget" since 1969 (Revenue Act of 1974, Section 601). The federal budget lists certain tax expenditures and estimates of the revenue they would generate if collected.

Despite its persuasive influence, the tax expenditure concept is not without its detractors. Some commentators argue that this concept subverts the nation's fundamental belief in the right to private property.

[Not all advocates are implicitly asserting that all income covered by the general provisions of the tax laws belongs to the government. Some "treat the tax system as if what the government deciding. In a reminiscent of global equality, not to collect in taxes constitutes a subsidy" (Kirkwood 1974, p 151).] (In a world of global inequality, not to collect in taxes constitutes a subsidy) (Kirkwood 1974, p 151). (In a world of global inequality, not to collect in taxes constitutes a subsidy)

Furthermore, they contend that the tax expenditure concept is inappropriate when applied to the charitable deduction because its theory of "income definition" goes against historical tradition and cultural values.

at the core of the only definition of income that has the benefit of consensus, there is a concept of consumption (which) certainly consists of what one spends on food, shelter and clothing, what one saves to pass on to heirs. But 1,000 years of religious, philosophical, and ethical views suggest that what one gives to charity can properly be viewed differently (Kirkwood 1975, p 110)

From a practical perspective, the development and general acceptance of a "tax expenditure budget" subject the perverted deductions to continual review. In fact, current efforts to pass "sunset" legislation illustrate just how the tax expenditure concept makes vulnerable deductions that are of interest to the American Association of Higher Education and the National Institute of Education.

Research Currents is prepared by the ERIC Clearinghouse on Higher Education, The George Washington University, Washington, D.C. The material in this publication was prepared pursuant to a contract with the National Institute of Education, U.S. Department of Health, Education, and Welfare, under contract number 14-XD-813. The data and views set forth in this publication do not necessarily reflect the positions or views of the contractor. The American Asociation for Higher Education, One Dupont Court, Suite 270, Washington, D.C. 20036. Payment must be accompany all orders under $15.

Carol Herrnstein Shulman is a Research Associate at the ERIC Clearinghouse on Higher Education.
to higher education. Some legislation would require Congress to review and to decide whether to continually modify or terminate programs. If Congress failed to affirmatively reauthorize their continuance, the programs would automatically terminate or suffer other penalties. Several bills now before the House include "tax expenditures" in the same category as federal programs, thereby making them candidates for modification or termination. For example, H.R. 5888, sponsored by Congressman Gillis Long, proposes to "establish a procedure for the periodic sunset review of Federal programs and tax expenditures by the Congress" (p. 2, emphasis added). If enacted, such legislation would threaten the termination of deductions for charitable giving and scholarship. Equally important, it would create considerable problems for college and university fund-raising efforts, the possible expiration of deductions advantageous to charitable giving might slow and possibly reduce contributions because of the difficulties involved in estate planning. The testator would be uncertain about the net cost of charitable giving and the net amount of estate liability. These problems may surface several years before the end of a recognition cycle.

Section 501 (c) (3)

Most discussions on tax policy and higher education concern government-sponsored tax incentives for higher education. Section 501 (c) (3) of the Internal Revenue Code excludes from federal income tax those organizations described in Section 501 (c) (3), such as colleges and universities, that qualify as "educational, charitable, religious, scientific, literary, or other organizations primarily engaged in carrying on the activities of educational institutions." The Internal Revenue Code elevates the importance of Section 501 (c) (3) by providing that such organizations are eligible to receive gifts and bequests that are deductible in computing the income tax liabilities of the donors (Persons et al 1977).

Given the present tax structure, this system of deductions provides substantial tax advantages to those in the highest income brackets and progressively diminishes returns to others in lower classes.

For example, if a person in the 70 percent bracket gives a sum of money that is deductible from his taxable income and in effect he is only giving 50 percent, whereas when a person in the 14 percent bracket gives a sum of money, he is giving 86 percent of it (to put it differently, if $250,000 is given, 10 percent of it will come to the donor; it really costs the government $140,000 to get $60,000 out of that person $12,000 tax if one gives 10 percent of his income to charity, it costs the government $12,000 to get $60,000 from this person. The charitable deduction works just upside down (see 1975 p. 109, footnote 3).

Financial Benefits

Despite the apparent inequity in this system of charitable deductions, the higher education community supports its continuance on the basis that it provides colleges and universities with important channels of financial support. Advocates of the present system also argue that the inequities lie in the progressive tax rate rather than the system of deductions; and, second, money given to charity is not used for personal consumption, and therefore, should not be subject to taxation (File 1975). Finally, they contend that if the present system did not exist, substantial contributions to colleges and universities would be lost. They charge that the tax breaks under the present system provide a major incentive for large gifts.

Records of contributions to colleges and universities appear to bear this out. These show that a disproportionate share of gifts to institutions comes from a very small segment of the population. In 1973-74, for example, large gifts, identified as contributions over $5,000, represented 0.44 percent of all giving, but produced 70.84 percent of all voluntary support to colleges and universities (Levi and Steinbach 1975). Moreover, a substantial proportion of these gifts evidences the tax advantage provided for donations to 501 (c) (3) organizations. Taxes on estates, appreciated securities, real estate, and other property may be reduced by donating cash or these instruments to an institution in 1973-74, 98 percent of all large gifts were in the form of bequests, and 41 percent of these were in securities, real estate, and other property (Levi and Steinbach 1975).

"Above the Line" Legislation

Taxpayers who do not itemize but take the standard deduction instead cannot take advantage of deductions for charitable giving. Since 1968, this group of taxpayers has grown substantially, from 52 percent of all taxpayers in 1970 to 77 percent in 1976 (National Association of Independent Schools 1978b). Some analysts argue that this erosion of the standard deduction has reduced the incentive for charitable giving; they estimate that in 1977 alone, gifts to charity would have been $1,175 billion more under the standard deduction than had it increased since 1970 (NAIS 1978b).

Faced with this financial dilemma, charitable organizations strongly support "above the line" legislation that would provide special incentives for charitable giving. Such legislation is now pending before Congress (H.R. 1785 and S. 219) which would permit nonitemizers to deduct gifts for charitable contributions much as they are now allowed to credit such expenses as child care, alimony, and moving.

There are several objections and counterproposals to this legislation which makes taxes payable certain (1) opponents argue that this additional deduction will add the federal treasury too much between $2 to $3 billion. Whereas previously this loss will be offset by gradually increased revenues to the charitable sector, it charities will gain about $155 to $210 for each dollar lost to the Treasury (United Way 1979). Second, other groups support the general concept of enhancing charitable giving but prefer tax credit legislation, which would provide a 30 percent credit for charitable contributions. They charge that the "above the line" proposition perpetuates an already existent "incentive to deduct" system of deductions that gives greater benefits to those in higher income brackets. For example, a $200 deduction is worth $200 more to a $200,000 taxpayer than to a $20,000 taxpayer. A 30 percent credit plan would give each taxpayer the same incentive for giving (Bothwell 1978).

Advocates of the deduction approach contend that tax credits would substantially reduce the giving of those in the higher income brackets. For example, a 27 percent reduction in giving to educational institutions would result if a 30 percent credit were introduced (National Association of Independent Schools 1979).

Section 117
The Section 117 exemption has stirred continuous controversy because it does not carefully define "fellowship" and "scholarship"; that is, it does not address the many cases where an educational institution grants a fellowship to a student for rendering services to the institution. Section 117's lack of specificity leaves taxpayers and, the Internal Revenue Service in doubt over whether the payment given is a true fellowship or belongs to the excluded category, discussed above. As a result, the Internal Revenue Service, the courts, individual taxpayers, and the Congress have engaged in case-by-case decision-making over what constitutes a bona fide fellowship or scholarship.

This has proven to be an inefficient and costly process, that calls for clarification and Congressional direction. Two problem areas in particular need to be addressed:

1. Payment for services — A 1969 Supreme Court decision, Binger v. Johnson (394 U.S. 741), established the guidelines by which the Internal Revenue Service judges whether a fellowship or scholarship is excludable income. Under this decision, any "fellowship" or "scholarship" that requires "quid pro quo" is not excludable from gross income for taxation purposes "bargained for payments, given only as a quid pro quo in return for the quid of services rendered — whether past, present, or future — should not be excludable from income as "scholarship funds." (394 U.S. 741)

As a result of this decision, the Internal Revenue Service has followed a policy of treating any fellowship or scholarship that requires some work or service in return as a "quid pro quo" relationship and has followed the Section 117 exclusion, even for degree candidates (Hargreaves, 1975). There has been considerable litigation in this area, such as Sections 117(b)(1)(a) requires the service element to be discounted when determining fellowship status if the service is required of all degree candidates.

Many students have contested the applicability of Binger v. Johnson to their situations. Most often, a student who participates in a program in which he sends, takes classes, and graduate teaching fellows become involved in disputes when they seek to exclude from their income compensation received for caring for hospitalized patients for teaching undergraduate college students, or for doing research which amounts to the benefit of the grantor." (Hargreaves, 1976.)

In late 1978, there was a flurry of activity on this subject after the release of the General Accounting Office's report on tax treatment of fellowships, scholarships, and education related expenses (Hargreaves, 1978). The report proposed several changes in the tax law with which the Treasury Department disagreed. For its part, Treasury offered four recommendations: Congress has taken no action on the issue, but these proposals for changes in the tax law suggest future direction for Section 117.

Under the General Accounting Office's recommendations, Congress has taken several actions on the issue. In particular, these recommendations for changes in the tax law are considered in the following sections for Section 117.

Under the General Accounting Office's report, the purpose of the fellowship or scholarship should be excluded from gross income unless it is a full-time classmate of a graduate student, a graduate student, or a non-classmate of a graduate student. This is particularly true in cases where the fellowship or scholarship is paid in return for services rendered, whether past, present, or future.

In response to these recommendations, the Treasury Department issued regulations that are much less radical. It recognized the considerable controversy under Section 117, but suggests that the GAO's solution, while easing administrative problems, does not promote the concept of equity (Ludick and Kurtz, 1978). Instead, it offers three alternatives to the GAO plan. First, a revised Section 117 could limit excludable income to tuition and fees, books, and other education-related but non-personal expenses. The impact on most scholarship recipients would be minimal, since education-related expenses account for the bulk of most grants and the remainder is too small to be taxed. Second, Section 117 could apply to tuition, fees, and living expenses of degree candidates only. This step would eliminate a large number of cases now in question. Finally, Congress could impose a limit on excludable income similar to that presently in effect for nondegree candidates.

Tuition Remission — Tuition remission programs, tuition benefits for children of college faculty and staff, are treated as scholarships granted to students and are therefore exempt from taxation under Section 117. But since 1975, the Treasury Department has questioned the tax-exempt status of tuition-reimbursement programs as a part of its larger investigation into the tax-exempt status of many fringe benefits granted to employees. It's efforts to revise treatment of fringe benefits have drawn considerable opposition, and Congress imposed a freeze on any changes in fringe-benefit treatment until it could consider the issue. This moratorium has recently been extended until June 1, 1981.

The major issues in whether tuition-reimbursement programs are a fringe benefit to faculty or a scholarship to students. Tuition-reimbursement programs became popular during the 1970s when institutions provided tuition-free education at the home institution to employees of faculty. Eventually, the concept developed into three types of tuition-reimbursement programs, which are now widely available to faculty and staff families: (1) tuition-reimbursement scholarships at the institution where the parent teaches, (2) tuition-exchange scholarship programs, where the parent does not teach, and (3) fellowship-grant scholarship programs, in which the sponsoring institution issues a check in favor of the admission to the student. In most cases, tuition-reimbursement programs provide tuition-free education for eligible students. At some high cost institutions students may have to pay part of their tuition costs, and the tuition-grant program generally does not pay for all tuition costs (Smart, 1978-79).

The Treasury's discussion of how fringe benefits serve the employee would appear to place tuition-reimbursement programs in the fringe-benefit rather than the scholarship category. Since faculty and staff salaries are generally lower than professional salaries elsewhere, it is argued that the fringe benefit is more valuable than as fringe benefit rather than a scholarship (Hargreaves, 1978). Further, tax-exempt fringe benefits may be more valuable than cash compensation to an employee, thereby providing the employer with an incentive to provide tax-free benefits in lieu of cash. Finally, employers may use tax-free fringe benefits as a competitive advantage, that is, to use benefits as a competitive advantage, that is, to use benefits as an incentive to attract and retain employees.

The higher education community contests the concept that tuition-reimbursement programs are a fringe benefit rather than a scholarship. Advocates for the present treatment note that tuition-reimbursement programs have been regarded as scholarships since the income tax was imposed. The legislative history of Section 117 indicates that Congress intended to maintain this tradition.

If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of any such institution is remitted by any other participating in a plan attended by this child, the amount of tuition so remitted shall be considered as a scholarship under this subsection (Sasserberg, 1978, citing House Report 1147).
In addition, tuition-remission programs meet the scant criteria provided in section 117 and Internal Revenue regulations. Section 117 merely excludes from gross income any amount received as a scholarship at an educational institution. Treasury regulations define a scholarship as "an amount paid or allowed to the benefit of a student, whether an undergraduate or a graduate, to such individual in pursuance of his studies." (Treasury Regulation Section 1.117-8a) 

Most important, higher education officials argue that the primary purpose of tuition-remission programs is to promote the recipient's education, rather than an employee benefit. They note that faculty and staff salaries are not adjusted or negotiated on the basis of tuition-remission programs nor is tuition paid against a legislative increase in faculty and staff salaries. Whether they intend to promote the recipient's education, rather than an employee benefit, is the issue to be determined.

Observations

Looking at tax reform issues from an Olympian perspective, the New York Times (1972) editorialized, "The basic purpose of the income tax is to collect revenue and that motive should dominate the writing of a new tax code. The habit of using personal and corporate assets as levers for social change has become almost irresistible. Government has been taxing with one paragraph of the code, giving rebates with the next, and creating inequities with every phrase."

But legislative history, cultural values, and current political arguments against any wholesale return of the tax code, yet precedent scholars have made a case that the code is in need of reformation or, at the very least, reform. And this practice must likely well continue.

The higher education community voices these reform efforts with concern because such proposed changes may adversely affect the tax benefits available to them. Washington hadn't had the faculty and staff salaries in tax areas that affect their special interests. They have a powerful ally in other special interest groups, particularly in the non-profit sector for which are also interested in maintaining tax provisions that encourage charitable giving. Collectively, these forces may be able to bring about change in their own self-interests.

Bibliography


In order to avoid double counting, the bibliography in this report was obtained from the Library of Congress through Interlaw Microfiche. The International Tax Bulletin, "The Case for the Charitable Deduction, Not a Credit," was obtained from the Library of Congress through Interlaw Microfiche. In order to avoid double counting, the bibliography in this report was obtained from the Library of Congress through Interlaw Microfiche. In order to avoid double counting, the bibliography in this report was obtained from the Library of Congress through Interlaw Microfiche.