

The IRS Writes the Rules for the New Public Education System

by Marie Sapirie



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Treasury and the IRS recently released temporary (T.D. 10057) and proposed (REG-117199-25) regulations for the school choice tax credit program under section 25F. The new rules contain a few clarifications hailed as victories by proponents of the new system of publicly funded schools, and one notable punt.

The rules were largely met with enthusiasm from proponents of state-sponsored school choice. The American Federation for Children, which also opened a scholarship-granting organization (SGO) to accept qualified contributions from taxpayers and distribute money for qualified expenses to students' families, said that the guidance positions SGOs to "serve millions more children nationwide, with the potential to unlock up to \$75.1 billion in additional donor funding." In its examination of the Senate version of the One Big Beautiful Bill Act, the Joint Committee on Taxation estimated (JCX-35-25) that the credit would cost \$25.9 billion over the 10-year budget window.

Sen. Ted Cruz, R-Texas, recently discussed the new guidance on his podcast, where he described section 25F as "basically free money. If you write \$1,700 [to an SGO], you owe \$1,700 less to Uncle Sam. For you, it costs you nothing." Cruz added that the new program would benefit millions of kids. Taxpayers might not choose to pay the SGOs instead of Treasury for an entirely pragmatic reason, though: The payments will effectively function as a prepayment of tax. Payments to SGOs will likely need to be made by December 31 of the tax year, but taxpayers are not obligated to

pay their federal income tax bill until April 15 of the following year.

Married Filing Jointly

There was evidently disagreement between Treasury and Capitol Hill over whether married taxpayers who file a joint return are limited to a single \$1,700 qualified contribution under the text of section 25F. Cruz said he met with Treasury Secretary Scott Bessent and Treasury lawyers to explain his intent when drafting the provision that married couples be allowed to make \$3,400 of qualified contributions after Treasury officials told him the tax code typically specifies the amount of credits or deductions available to single and joint filers. The preamble nods to that conversation, seeming to chide Congress slightly for ignoring its standard drafting conventions — "Generally, the Code specifies whether a dollar limitation for a credit or deduction differs based on filing status" — but also noting that "the Code does not always provide for a dollar limitation based on filing status."

Treasury's textual interpretation in the proposed regs makes sense. Section 25F(a) refers to "an individual" and "qualified contributions made by the taxpayer." Section 25F(b) provides that "the credit allowed under subsection (a) to any taxpayer for any taxable year shall not exceed \$1,700." The preamble correctly points out that "the statutory language 'any taxpayer' without any limitation in section 25F also implies the broadest interpretation and is consistent with how the term taxpayer is defined in section 7701(a)."

Cruz made an interesting claim about the proposed rule: "The impact of this decision is massive. It's going to double the impact of this tax credit — twice as many scholarships are going to go out next year," he said. If it were clear that each spouse on a joint return was entitled to make a \$1,700 qualified contribution, then the proposed

regs wouldn't represent a doubling of the impact. Cruz might have been catering to his podcast audience in making that statement, rather than trying to accurately characterize the effect of the proposed regs.

Because section 25F is "more of a spending provision than a tax provision" and "uses taxpayers as a conduit to move general fund money to SGOs," a different analysis of the married filing jointly question is more appropriate, Andrew Gradman of the Law Office of Andrew L. Gradman APC said. "We should be asking whether the [Congressional Budget Office] and JCT made this assumption in the cost estimates which they published before Congress voted," Gradman said, adding that Treasury should strive to honor the price tag Congress voted on and all the assumptions behind it.

What's a School and Why It Matters

Treasury and the IRS are in something of a bind over section 25F's cross-reference to the definition of qualified elementary and secondary education expenses in section 530(b)(3). In the preamble to the proposed regs, they promise that they will issue guidance clarifying the meaning of qualified expenses and schools and say they "intend to issue that guidance as soon as possible so that taxpayers may rely on it." There is no difficult interpretive question at stake here; the text is clear. But following the clear meaning doesn't meet the school choice proponents' demand to have an essentially universal federal program that encompasses every possible educational choice.

Section 530(b)(3)(A) defines qualified elementary and secondary education expenses as those "incurred in connection with the enrollment or attendance of the designated beneficiary of the trust as an elementary or secondary school student at a public, private, or religious school." That definition ends up excluding certain types of educational arrangements that some families select to comply with state compulsory education statutes, most notably home education and microschools, unless they are in states where those arrangements legally qualify as private schools. The result is a dilemma for school choice advocates, who would understandably like to be able to declare victory for microschools and

homeschoolers, but it's a clean statutory interpretation question.

The evidence suggests Congress knew exactly what it was doing when it cross-referenced section 530, even if it might not have thought through the preferences of the school choice proponents. During the negotiations leading to the OBBBA, Cruz introduced a predecessor to section 25F in the Universal School Choice Act that expressly included expenses for homeschools and microschools operating under homeschool laws, but that language was removed from the final bill. It's unclear why, but the Senate ultimately chose to go with a cross-reference to section 530 instead of a definition of qualified expenses tailored to section 25F. But it is clear that Treasury's regulatory authority to carry out the purposes of section 25F doesn't extend far enough for it to read language back into the statute that Congress removed. Additional evidence that shows Congress knew how to include homeschool and microschool expenses comes from a proposal regarding section 529. The House version of the OBBBA would also have amended that section to include homeschool expenses, but that language didn't make it into the final bill either (H.R. Rep. No. 119-106 (2025)).

There has been some hand-wringing among school choice proponents about the limitation, because microschools in particular are one of the sectors lauded by the school choice movement. They tend to be small, as the term implies, and are often run by entrepreneurial educators with a knack for creating photogenic learning spaces and publicizing their efforts on social media. But while they are schools in the institutional sense, they aren't always schools as a matter of state law. Microschools often operate under the home education laws of the states they are in, although the fit is not a good one, because the salient feature of state homeschool laws is that they were designed for education that takes place outside an institution.

Treasury is also hamstrung by the legislative history of section 530. Coverdell accounts are not available for educational expenses other than those at "public, private, or religious schools," and Congress rejected an amendment to section 530 that would have added homeschooling expenses to the definition of qualified expenses in

the Affordable Education Act of 2000. Congress tried and failed again in the 401(Kids) Education Savings Account Act of 2015, which would have defined private school to include any homeschool under state law, even if it wasn't also deemed a private school under state law. It would be awkward to ignore this legislative history and that of the OBBBA in order to include microschools and homeschools for section 25F purposes while excluding them from the very statute in which the definition of qualified elementary and secondary educational expenses is written.

Perhaps the best argument for including institutions and homeschools that aren't private schools under state law may not be palatable to many of them. Section 25F and state-level school choice funding programs provide public financial support for educational choices when families opt in. As a practical matter, and in the eyes of at least one of the SGOs, that makes the microschools and homeschool families that accept state money part of the public education system, because they are publicly funded by the state and provide elementary or secondary education. If Treasury adopted that view, it could expand the population covered by section 530 to include all the microschools and homeschools in states with programs that accept school choice funding by defining the microschools and homeschools that opt in as public schools.

Semigovernmental Organizations

SGOs present novel questions because they're relatively novel entities. They are creatures of school choice laws and function within those frameworks as conduits for the redistribution of

tax money. Accordingly, they are potential targets for state lawmakers hostile to school choice programs. The new rules restrict states from imposing added requirements on SGOs beyond what is included in section 25F(c)(5) and prop. reg. section 1.25F-3(b) and (c). The rules provide examples of prohibited limitations, including limiting the type of school that scholarship recipients may attend or the types of qualified elementary or secondary education expenses for which funds may be used. But while there are limitations on state legislatures, SGOs are the de facto administrators of the new federal school choice program, and they get to create some of the rules that will apply to the families that sign up with them. "The Treasury Department and the IRS assume that SGOs will publicize their particular missions, the scope of their scholarships for eligible students, and their successes in achieving better student outcomes in order to attract more qualified contributions from taxpayers supportive of their mission," the preamble says.

The proposed rules also give the federal government oversight of the states' procedures to avoid attempts to impose additional rules. Prop. reg. section 1.25F-5(e)(3) provides that if the government discovers a pattern of irregularities or noncompliance, "the IRS, in its discretion, may require a State to modify its procedures to ensure that its determinations regarding an organization's satisfaction of the requirements in section 25F(c)(5) and (d) and section 1.25F-3(b) and (c) are being administered in accordance with the applicable statutory, regulatory, and appropriate State requirements." ■