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An Overview of Tax Benefits for Higher Education Expenses

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Summary

Government subsidies for education are available at the federal, state, and local levels. Governments employ two types of direct spending programs to help families pay for higher education: subsidies to public postsecondary institutions and need-based aid to students and families. The Higher Education Act (HEA; most recently extended by P.L. 109-150), which is scheduled to expire in the 109th Congress, authorizes many need-based student aid programs, which provide grants, loans, and work-study assistance. In addition to these direct spending programs, government subsidies for higher education are also made through the income tax system. CRS Report RL32507, *Higher Education Tax Credits: An Economic Analysis*, by Pamela J. Jackson, provides a discussion of the economic rationale for subsidizing higher education.

Tax benefits for higher education can be divided into three groups: incentives for current year higher education expenses, incentives that give preferential tax treatment of student loan expenses, and incentives for saving for college. This report discusses eight tax incentives that provide benefits to taxpayers for the expenditures they make on higher education in a given year. These provisions include two tax credits, the Hope Credit and the Lifetime Learning Credit; two deductions, an above-the-line deduction for tuition and fees, and a deduction for work-related education; three exclusions for scholarship and fellowship income, tuition reductions, and employer-provided education benefits; and a personal exemption for student dependents age 19 to 23. Tax benefits for student loan expenses allow the deduction of interest paid on student loans and provide an exclusion for student loans that have been forgiven. Five types of tax incentives promote taxpayer saving for college expenses: 1) Section 529 plans, 2) Coverdell Education Savings Accounts, 3) an education savings bond program, 4) a provision which allows early withdrawals from individual retirement accounts (IRAs) without penalty, and 5) the allowance of uniform transfers to minors.

The recipients of benefits through the tax system can be quite different from the recipients of benefits provided through spending programs. First, because none of these provisions are available to families whose incomes are too low to pay income taxes, some low income individuals (including independent students) cannot benefit from them since none provide for refundability. Even those who pay income taxes may not receive the full benefit due to limited tax liability. By contrast, direct spending programs are often particularly directed toward lower income individuals who are more likely to attend (lower cost) public institutions and to qualify for need-based aid.

This report provides an overview of the tax benefits for higher education, along with cost estimates of the revenue loss associated with these provisions. The report concludes with a discussion of the beneficiaries of education tax incentives.

This report will not be updated.

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An Overview of Tax Benefits for Higher Education Expenses

Government subsidies for education are provided at the federal, state, and local levels. Governments mainly employ two types of direct subsidies to help families pay for higher education. First, direct appropriations are made by many state and local governments to public postsecondary institutions. A majority of this funding is used to minimize tuition charges for in-state students.

A second form of direct public subsidy is need-based aid to students and families. This category represents the largest share of student financial aid. Current education subsidies provided by the federal government include student loans, grants, and work-study programs. Both of the major federal grant programs, Pell Grants and Federal Supplemental Educational Opportunity Grants (FSEOG), are need-based. There are also many specialized grants and scholarship programs offered federally for students at the graduate level. The Federal Work Study program and the Student Educational Employment programs allow students to earn money while in school.

The recipients of benefits through the tax system can be quite different from the recipients of benefits provided through spending programs. First, because none of these provisions are available to families whose incomes are too low to pay income taxes, some low income individuals (including independent students) cannot benefit from the provisions. Even those who pay some income taxes may not receive the full benefit due to limited tax liabilities. By contrast, direct spending programs are often directed toward lower income individuals who are more likely to attend public institutions and to qualify for need-based aid. This limit on the ability to benefit lower income individuals may limit the incentive effects of education tax provisions (at least with respect to college enrollment) if lower income individuals are more sensitive to price than higher income individuals (who are likely to send their children to college in any case). If so, the education tax provisions may be largely seen as incentives that provide tax reduction without altering enrollment (although perhaps altering either or both the quality and affordability of education).

In addition, the targets of these provisions may shift when other, unrelated, changes are made to the tax code. For example, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) reduced marginal income tax rates for individuals, resulting in lower tax burdens. In providing tax relief that was designed to stimulate the economy, an unintended consequence was to reduce the number of taxpayers eligible to claim education tax benefits because households experienced reductions in their income tax liability. These tax reductions may have caused them to become unable to claim education tax benefits because they either had reduced tax liability to offset the education provisions or no longer owed any tax.

Moreover, within the group of tax benefits, the method of providing the tax benefits has differential effects across types of families and students, an issue that will be addressed in the final section of the report.

An Overview of Education Tax Incentives

In addition to direct spending programs administered by the U.S. Department of Education and other executive branch agencies, government subsidies for higher education are also made through the federal income tax system. From 1954 to 1978, four tax benefits for education existed: an exclusion for scholarship and fellowship income, a parental exemption for students age 19 to 23 who were enrolled in college, a business expense deduction or adjustment to income for work-related education, and the deduction of student loan interest. In 1978 an exclusion for employer-provided education assistance was enacted, and 10 years later an exclusion for the interest earned on educational savings bonds was enacted. The deductibility of student loan interest was eliminated with the passage of the Tax Reform Act of 1986 (P.L. 99-514), which disallowed all forms of personal interest deduction. In 1996, after the enactment of an exclusion for earnings from qualified tuition savings programs, also known as Section 529 Plans, the number of tax benefits for higher education expenses rose to six.

Five new education tax benefits were enacted by The Taxpayer Relief Act of 1997 (P.L. 105-34), nearly doubling the number of subsidies available through the tax system for higher education expenses. Those tax benefits are two tax credits, reinstatement of the deduction for interest on student loans, an exclusion for earnings accruing to Education IRAs (later renamed Coverdell Education Savings Accounts), and a cancellation of the penalty for early withdrawal from individual retirement accounts (IRAs). The provisions were estimated to cost $41 billion over five years[1] and represented the largest increase in federal funding for higher education since the GI Bill.[2] Additionally, in the fall of 2001, an above-the-line deduction for higher education expenses was authorized by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). This final incentive increased the number of tax benefits for higher education expenses to 12.

This report provides an overview of the tax incentives for higher education expenses provided through the federal income tax code. The benefits can be divided into three groups: incentives for current year higher education expenses, incentives that give preferential tax treatment of student loan expenses, and incentives for saving for college. Descriptions of the tax provisions are provided in the next sections. The tax revenue loss associated with the education incentives that are listed as tax expenditures is shown in **Table 1**.

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[1] U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1998-2002*, 105th Cong., 1st sess. (Washington: GPO, 1997), p. 23.

[2] Veterans educational and training benefits are not includible in income and are thus tax-exempt.

Table 1: Estimates of Federal Tax Expenditures for Higher Education

(data shown in billions of dollars, by fiscal year)

	2004	2005	2006	2007	2008	2004 - 2008
Tax credits for postsecondary education	4.3	4.3	4.4	4.4	4.4	21.8
Deduction for higher education expenses	2.7	2.9	0.7	—	—	6.3
Exclusion of scholarship and fellowship income	1.5	1.5	1.6	1.6	1.7	7.9
Exclusion of employer-provided education assistance benefits	0.8	0.8	0.9	0.9	0.9	4.3
Parental exemption for students age 19 to 23	1.5	1.1	0.7	0.6	0.5	4.4
Deduction for interest on student loans	0.7	0.8	0.8	0.9	0.9	3.9
Exclusion of earnings of qualified tuition programs	0.5	0.6	0.7	0.8	0.9	3.4
Exclusion of earnings of Coverdell savings accounts	0.3	0.3	0.4	0.4	0.5	2.0
Exclusion of interest on savings bonds used for education	([a])	([a])	([a])	([a])	([a])	0.1

Source: U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008*; [http://www.house.gov/jct/s-8-03.pdf] website visited May 4, 2004.

a. Less than $50 million.

Tax expenditures are federal tax provisions that grant special relief designed to encourage certain kinds of behavior by taxpayers and/or to aid taxpayers in special circumstances. These provisions may be viewed as spending programs channeled through the tax system. They are, in fact, classified in the same functional categories as the U.S. budget.[3] Yet, not all education tax benefits are tax expenditures. The concept of tax expenditure refers to corporate and individual income taxes. Other parts of the tax code, such as employment taxes, excise taxes, and gift taxes, also have exceptions, exclusions, refunds, and credits that are not included as tax

[3] U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print prepared by the Congressional Research Service, Library of Congress, 107th Cong., 2nd sess., S. Prt. 107-80 (Washington: GPO, 2002), pp. 2-3.

expenditures because they are not parts of the income tax.[4] Thus, some education incentives including the business expense deduction of work-related education and tuition reduction benefits are not considered tax expenditures, and are not included in the cost estimates of tax revenue loss.

There are several tax benefits for providers of higher education. These include tax exemption for educational institutions, deductibility of charitable contributions to educational institutions, and certain tax-exempt and tax-preferred bond provisions. These benefits are not discussed in this report.

Benefits for Tuition and Other Fees

Eight tax incentives provide benefit to taxpayers for the expenditures they make on higher education in a given year. These provisions include two tax credits, two deductions, three exclusions, and one exemption.

Hope Credit

The Hope Credit may be claimed for the qualified tuition and related expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent who is enrolled at least half-time in one of the first two years of postsecondary education or vocational training. In 2003, the amount that may be claimed was generally equal to: 100% of the first $1,000 of the taxpayer's out-of-pocket expenses for each student's qualified tuition and related expenses, plus 50% of the next $1,000 of the taxpayer's out-of-pocket expenses for each student's qualified expenses. The maximum credit a taxpayer may claim for a taxable year is $1,500 multiplied by the number of students in the family who meet the enrollment criteria. The maximum amount of the Hope Credit is adjusted for inflation, although no change was projected for 2004.[5] Taxpayers cannot claim the credit if they are claimed as a dependent by another taxpayer, or if they are married and filing separate tax returns.

To qualify for the Hope Credit the student: must be enrolled in a program that leads to a degree, a certificate, or some other recognized educational credential; must take at least a half-time class load for at least one semester, quarter or other academic period in the year; may not have claimed the credit for more than two years; may not have had a felony conviction for possessing or distributing drugs or other controlled substances; and must be a freshman or a sophomore (or equivalent) in college.

The amount a taxpayer may claim as a Hope Credit is gradually reduced for higher-income taxpayers who have modified adjusted gross income between $41,000

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[4] U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print prepared by the Congressional Research Service, Library of Congress, 107th Cong., 2nd sess., S. Prt. 107-80 (Washington: GPO, 2002), pp. 2-3.

[5] CCH Editorial Staff Publication, *2004 U.S. Master Tax Guide* (Chicago: CCH Incorporated, 2002), p. 421.

($83,000 for married taxpayers filing jointly) and $51,000 ($103,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross income over $51,000 ($103,00 for married taxpayers filing jointly) may not claim the Hope Credit. The income phase-out amounts stated are for tax year 2003 and, in 2004, increased to $42,000 ($85,000 for married taxpayers filing jointly) and $52,000 ($105,000 for married taxpayers filing jointly).[6]

Lifetime Learning Tax Credit

The Lifetime Learning Credit may be claimed for the qualified tuition and related expenses of the students in the taxpayer's family who are enrolled at eligible institutions. The credit amount is equal to 20% of the taxpayer's first $10,000 of out-of-pocket qualified tuition and related expenses. The maximum credit a taxpayer may claim is $2,000 and is not indexed for inflation. If a taxpayer is claiming a Hope Credit for a particular student, none of that student's expenses may be applied to the Lifetime Learning Credit. Taxpayers cannot claim the credit if they are claimed as a dependent by another taxpayer, or if they are married and filing separate tax returns.

The amount a taxpayer may claim as a Lifetime Learning Credit is gradually reduced for taxpayers who have modified adjusted gross income between $41,000 ($83,000 for married taxpayers filing jointly) and $51,000 ($103,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross income over $51,000 ($103,000 for married taxpayers filing jointly) may not claim the Lifetime Learning Credit. The income phase-out amounts stated are for tax year 2003 and, in 2004, increased to $42,000 ($85,000 for married taxpayers filing jointly) and $52,000 ($105,000 for married taxpayers filing jointly).[7]

Education Credit Comparisons. The Hope Credit is allowable for up to $1,500 per year for each eligible student and taxpayers can claim more than one Hope Credit on a tax return, provided that more than one individual (the taxpayer, the spouse, or a dependent) meets the qualifications. In contrast, the Lifetime Learning Credit may be claimed only once on a tax return for a maximum of $2,000. The Lifetime Learning Credit can include all of the qualifying educational expenses pooled together from the taxpayer, the spouse and/or their dependent(s). Neither tax credit is refundable, meaning that taxpayers would not receive a tax refund if the amount of their allowable education credit exceeded their income tax liability.

Unlike the Hope Credit, the Lifetime Learning Credit can be used for graduate or undergraduate school, does not require the student to be in the first two years of undergraduate schooling, and requires the student to be enrolled in only one course at an eligible educational institution. The Hope Credit requires that the student not have a felony drug conviction, which is not a requirement of the Lifetime Learning Credit.

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[6] CCH, p.421.

[7] CCH, p.421.

Both credits disallow a double tax benefit for higher education expense. Taxpayers can deduct the expenses of higher education from their income tax by claiming an above-the-line tuition and fees deduction or by claiming the expenses as business related. In doing so, the taxpayer cannot also claim an education credit for those same expenses. Taxpayers cannot claim an education credit on expenses paid with tax-free scholarship, grant, or employer-provided educational assistance. Pell Grants, veterans' educational assistance, and tax-exempt scholarships are included in this category of tax-free educational assistance. Taxpayers must reduce qualified education expenses by the amount of any tax-free financial assistance before using the expenses to claim an education tax credit.[8]

Above-the-Line Tuition and Fees Deduction

In June 2001, as a part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Congress passed a new set of rules regarding the deductibility of higher education expenses. Starting in 2002, a new deduction was created for post-secondary education expenses paid by taxpayers for themselves, their spouse or dependents. This "above-the-line" deduction is for tuition and education related expenses paid for enrollment at any accredited post-secondary institution. This temporary tuition deduction, available during tax years 2002 through 2005, is available to taxpayers regardless of whether they claim the standard deduction or itemize deductions when filing their income tax return. The deduction is not restricted by the overall limitation on itemized deductions.

One of the benefits of this "above-the-line" deduction is that it reduces the taxpayer's adjusted gross income (AGI). Deductions that reduce AGI will often provide a greater tax benefit, because as AGI increases, it can cause other tax deductions and credits to be reduced or eliminated.

The "above-the-line" deduction was limited to $3,000 for 2002 and 2003. Currently, the deduction is limited to $4,000 for 2004 and 2005. It is generally available to taxpayers with adjusted gross incomes below $65,000 ($130,000 for married individuals filing jointly). For 2004 and 2005 the maximum that can be deducted is either $2,000 or $4,000 depending on adjusted gross income. If adjusted gross income is $65,000 or less ($130,000 or less for those filing a joint return), the maximum deduction is $4,000. If adjusted gross income is more than $65,000 ($130,000 for married individuals filing jointly), the deduction cannot be claimed.

Only certain higher education expenses are allowable. For example, tuition and fees required for enrollment or attendance at an eligible postsecondary educational

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[8] CRS Report RL32507, *Higher Education Tax Credits: An Economic Analysis*, by Pamela J. Jackson, provides an economic analysis of education tax credits and the effect on college enrollment and affordability, equity among taxpayers, and simplicity of the tax code. Other information about the education credits is provided in CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by Adam Stoll, James Stedman, and Linda Levine and CRS Report RL31484 *Higher Education Tax Credits: Targeting, Value, and Interaction with Other Federal Student Aid*, by Adam Stoll and James B. Stedman.

institution are allowable. However, taxpayers must subtract any scholarships, educational assistance allowances, or other nontaxable sources of income spent for educational purposes from the tuition and fees expense. This reduced amount is the qualified amount eligible for the deduction. Personal expenses and the cost of books are not allowable. Taxpayers cannot claim a course involving sports, games, or hobbies, unless such course is part of the student's degree program.

The income tax code disallows education expenses claimed for certain tax incentive programs to be claimed for the deduction as well. Any qualified education expenses deducted as a business expense, claimed for an education tax credit, or paid with earnings from either a Coverdell education savings account or U.S. education savings bonds, cannot be claimed for the "above-the-line" tuition and fees deduction.

Additionally the use of the deduction is conditional on the tax status of the student in relationship to the taxpayer. If the taxpayer claims an exemption for a dependent who is an eligible student, the taxpayer can include expenses paid for the student in determining the deduction. If the dependent pays the qualified expenses and the taxpayer claims an exemption for that student, neither the taxpayer nor the dependent can deduct the expenses.

Business Expense Deduction of Work-Related Education

An individual taxpayer is allowed to deduct education expenditures as a business expense if the education (1) maintains or improves a skill required in the taxpayer's employment or other trade or business, or (2) meets the express requirements of the taxpayer's employer, laws, or regulations, imposed as a condition to the taxpayer's retention of an established employment relationship, status, or rate of compensation. Even if one of the two tests is met, there are limits to the determination of qualifying work-related education. Such education is not qualified if it is needed to meet the minimum educational requirements of the taxpayer's present business, or if it is part of a program of study that would qualify the taxpayer for a new trade or business.

An example of qualifying work-related education is the course work that teachers or accountants are required to take to maintain their license. As long as these courses do not qualify the taxpayer for a new trade or business, they are eligible for the deduction. For teachers and accountants, though, this example applies only if they have already met the minimum requirements for their profession. If course work is being taken to become eligible to teach, it would not qualify under this provision.

Deductible expenses include tuition, books, supplies, lab fees, and similar items; certain transportation and travel costs; and other education expenses, such as costs of research and typing. Taxpayers may not deduct personal or capital expenses. The same deductible expenses may not be used to claim the above-the-line tuition and fees deduction. The deductible expenses may not be claimed if they were paid with tax-free scholarship, grant, or employer-provided educational assistance funds.

The business expense deduction of work-related education is included as a miscellaneous itemized deduction. Miscellaneous itemized deductions are allowed only to the extent that their total exceeds 2% of the taxpayer's adjusted gross income.

Exclusion of Scholarship and Fellowship Income

Scholarships and fellowships are very similar. They are both grants of money to help obtain an education. The money can be paid directly to the student or to the institution on the student's behalf. A scholarship is designed to help a student pursue undergraduate or graduate studies at a college or other educational institution. A fellowship is designed to help students pursue their studies or some form of research. These payments are tax-free only if the recipient is a candidate for a degree at a college or other educational institution, and the grant is considered a qualified scholarship or fellowship. Students are considered candidates for a degree as long as they are pursuing a degree at a college or university or attending an accredited college or other accredited educational institution that is authorized to provide a program for a bachelor's degree or a higher degree.

Scholarships and fellowships are taxable only if the taxpayer is not a candidate for a degree. Taxpayers must also pay taxes on any part of a scholarship, fellowship, or tuition reduction that can be attributed to teaching, research or other services that have been performed, are being performing, or will be performed. In effect, that income is considered payment for work. If scholarships or fellowships are received for room, board, transportation, or in return for services (such as teaching, grading papers, or answering the phone in the department offices), that income is taxable.

Many special types of scholarships receive different tax treatment. *Athletic scholarships* are tax-free only if they meet the requirements for tax-free status mentioned previously. *Fulbright grants* may be taxable depending upon the type of grant being made. If the grant is paid for lecturing or teaching, the recipient is being paid for services, so the grant is taxable. *Pell Grants* are tax-free as long as the money is used for qualifying tuition and course-related expenses during the grant period. *Supplemental Educational Opportunity Grants* and *Grants to State for State Student Incentives* are tax free as long as the money is used for qualifying tuition and course-related expenses during the grant period. *Veterans' benefits* are tax-free in accordance with the normal tax-free status accorded any payments for education, training, or subsistence by the Department of Veterans Affairs. *Cash scholarship prizes* won in contests are not considered scholarships unless the terms of the award specify that the money must be used for educational purposes. If the scholarship prize says that the money can only be used if the recipient is a degree candidate at a college and only for qualified expenses, it is a tax-free scholarship.

Tuition Reduction

If a taxpayer receives a reduction of tuition, it is tax-free as long as it meets certain requirements. The requirements depend upon the level of education being sought. Below the graduate school level, the tuition reduction is tax-free if the educational institution gives the reduction to its employees, or retirees, for their own education or that of their spouse or children. This benefit is applicable at primary

and secondary schools as well. At the graduate level, a tuition reduction is tax-free if it is given by an educational institution to a graduate student who teaches or does research for that college or university and the reduction is not given as payment for services rendered (e.g., the student receives a stipend for these services).

Exclusion of Employer-Provided Education Benefits

Employer-provided educational assistance benefits may be excluded from income when paid to individuals in amounts up to $5,250 each year. Employers do not include these benefits when reporting compensation to the IRS. If the employer pays more than $5,250 for educational benefits during the year, the taxpayer must pay tax on the amount over $5,250 and the employer must include that amount in wages reported to the IRS.

This exclusion is available only if the expenses are made in association with an educational assistance program. The Internal Revenue Code, Section 127(b), defines an educational assistance program as a separate written plan of an employer for the exclusive benefit of its employees to provide such employees with educational assistance. Educational assistance covers payments for tuition, fees, books, supplies, and equipment. The courses can be graduate or undergraduate courses and they do not have to be related to the job. Educational assistance does not include the following expenses, even if they are related to course work: meals, lodging, transportation, tools or supplies other than books that are kept after completing the course. Education expenses involving sports, games, or hobbies are not eligible unless they have a relationship to the employer's business or are required as part of the degree program. Employees of educational institutions may exclude tuition benefits they receive, either for their own education or for the education of a member of their family.[9]

Parental Personal Exemption for Dependent Students Age 19-23

A taxpayer is allowed one exemption for each person claimed as a dependent. The exemption was $3,050 in 2003 and increased to $3,100 in 2004. To claim the exemption for a dependent there are five tests that must be met. One of these tests, the gross income test, which requires that a dependent not have earned income in excess of $3,050, does not apply if the person is the child of the taxpayer and is either: under age 19 at the end of the year, or a student under age 24 at the end of the year. To qualify, the child must be a full-time student at a qualified educational institution or taking full-time, on-farm training courses which are given by either a qualified educational institution, or a state, county, or local government. The student has to have been enrolled during some part of each of five calendar months, though not necessarily consecutive months, in the calendar year. The student must meet the other tests for dependency, which are the member of household or relationship test, the citizen or resident test, the joint return test, and the support test. If the exemption

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[9] For more information see CRS Report 97-243, *The Current Tax Status of Employer Education Assistance* by Linda Levine and Bob Lyke.

for the student is claimed by the parent, that student cannot claim the personal exemption on his or her own tax return.

The parental exemption is generally available to taxpayers with adjusted gross incomes below $139,500 ($209,250 for married individuals filing jointly).

Student Loans

Taxpayers may deduct interest paid on qualified education loans. Qualified education loans, also known as student loans, are indebtedness incurred solely to pay qualified higher education expenses. The federal government operates two major student loan programs, the Federal Family Education Loan (FFEL) program and the William D. Ford Direct Loan (DL) program.[10] In addition to federally provided student loans, there are many privately provided sources of education loans as well.

Student Loan Interest Deduction

Student loan interest became deductible in tax year 1998. The interest paid is an "above-the-line" adjustment, which means that it is subtracted from taxpayer income before deductions or exemptions are claimed and lowers adjusted gross income. Student loan interest is interest paid during the year on a loan taken out to pay qualified higher education expenses which include tuition and fees, room and board, books, supplies and equipment, and other necessary expenses such as transportation. Taxpayers can deduct interest that they are required to pay as well as any interest payments made voluntarily. Taxpayers cannot take the adjustment if they are claimed as a dependent by another taxpayer, or if they are married and filing separate tax returns.

A maximum of $2,500 of the interest paid on a student loan can be deducted annually and the amount of that deduction is phased out if modified adjusted gross income is between $50,000 and $65,000 ($100,000 and $130,000 if filing a joint return). The student loan interest deduction cannot be claimed if modified adjusted gross income is $65,000 or more ($130,000 or more if the taxpayer files a joint return).[11]

Before claiming the student loan interest adjustment, taxpayers must reduce their qualified higher educational assistance benefits by any payments made from the following tax free items: employer provided educational assistance benefits; tax free withdrawals from a Coverdell Education Savings Account (formerly known as an education IRA); tax-free withdrawals from a qualified tuition program; U.S. Savings

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[10] These programs are authorized by the Higher Education Act (most recently extended by P.L. 105-244).

[11] For more detailed information regarding student loans see CRS Report RL30655, *Federal Student Loans: Terms and Conditions for Borrowers* and CRS Report RL30656, *The Administration of Federal Student Loan Programs: Background and Provisions* both by Adam Stoll.

Bond interest that is excluded from income because it was used to pay qualified higher education expenses; certain scholarships; veteran's educational assistance benefits; or any other nontaxable payments received for educational expenses.

Student Loan Forgiveness

Generally when taxpayers are responsible for making loan payments and the loan is canceled, also referred to as forgiven, the amount of the loan is to be included in the taxpayer's gross income for tax purposes. To qualify for tax-free treatment, a canceled loan must contain a provision that all or part of the debt will be canceled if the taxpayer works for a certain period of time, in a certain profession, and for any of a broad class of employers. The loan must have been made by a qualified lender to assist the borrower in attending a qualified educational institution.[12]

Incentives to Save for College Expenses

Unlike education tax credits and deductions, which are used when taxpayers are actually spending money on education for themselves, their spouse, or their dependents, education savings plans are generally used to build up college savings on a tax-free basis over a number of years. There are five types of tax incentives to promote taxpayer saving for college expenses: 1) 529 plans, 2) Coverdell Education Savings Accounts, 3) Treasury Bonds, 4) allowing early withdrawals from individual retirement accounts (IRAs), and 5) the Uniform Transfers to Minors Act.

529 Plans

These savings plans are named after the Internal Revenue Code section that describes them and are also called qualified tuition plans (QTP). Generally, QTPs fall into two types of categories: 1) prepaid plans, and 2) savings plans. Prepaid tuition plans allow individuals to purchase tuition years in advance of attendance at a discounted present day price, which is presumably less expensive. The 529 savings plans offer market-based returns based upon the type of investment selected by the plan owner from those offered by the state-sponsored plans. In both categories of plans, taxpayers contribute after-tax dollars, which are then allowed to grow on a tax-deferred basis. If funds are withdrawn to pay eligible higher education expenses, then no income tax will be due. If funds are withdrawn for other purposes, then the earnings are considered taxable income to the distributee. There are no income limits for those who contribute to the account and there are no limits on the annual amount that can be contributed. The tax-preferred treatment of 529 savings plans is scheduled to expire on December 31, 2010 and withdrawals made after January 1, 2011 will not qualify for this tax-free treatment and will be considered as taxable income to the student rather than to the funder of the plan.[13]

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[12] For more information regarding student loan forgiveness programs, see CRS Report RL32516, *Student Loan Forgiveness Programs*, by Gail McCallion.

[13] For more detailed information see CRS Report RL31214, *Saving for College through*

(continued...)

The qualified higher education expenses incurred by the beneficiary of a QTP must be reduced before the tax-free portion of the distribution can be determined. Qualified expenses must be reduced by all tax-free educational assistance, including scholarships and fellowships, veterans' educational assistance, Pell grants, and employer-provided educational assistance. Distributions from a QTP and a Coverdell cannot be allocated to the same qualified expenses and those expenses used for the QTP cannot be used to claim either of the education credits.

Coverdell Education Savings Accounts (ESAs)

Formerly known as Education Individual Retirement Accounts, Coverdell ESAs are trust or custodial accounts created or organized in the United States only for the purpose of paying qualified education expenses of the designated beneficiary of the account. Though they were previously referred to as Education IRAs, ESAs have no connection with the retirement IRA. While contributions to Coverdell accounts are not tax-deductible, the earnings on the account are tax-free as long as the funds are used for qualified education expenses. Qualified education expenses include expenses related to enrollment or attendance at an eligible postsecondary school.[14]

Taxpayers can open a Coverdell ESA at any bank in the U.S., or at any other entity that has been approved by the IRS to offer ESAs. There is no limit on the number of Coverdell accounts that can be established for any given child up to age 18 in most cases — as long as the total combined contributions do not exceed the maximum contribution amount each year. Taxpayers can contribute a maximum of $2,000 to an Education Savings Account for a specific child subject to certain income phase out limits. The contribution limit is reduced if the taxpayer's adjusted gross income (AGI) is between $95,000 and $110,000 (between $190,000 and $220,000 if married, filing a joint return). Contributions can be made up until April 15th of the next year rather than December 31st of the taxable year. If contributions exceed $2,000 in a calendar year, the beneficiary must pay a 6% excise tax.[15]

The tax-free distribution amount from a Coverdell account cannot include higher education expenses paid for by tax-free educational assistance or expenses claimed for the Hope or Lifetime Learning credits. If a designated beneficiary receives distributions from both a Coverdell and a QTP in the same year, and the total distribution is more than the beneficiary's qualified higher education expenses, the excess distribution will be taxable.

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[13] (...continued)
Qualified Tuition (Section 529) Programs, by Linda Levine.

[14] Coverdell accounts can be used for qualified elementary and secondary education expenses as well. For more information see CRS Report RL31439, *Federal Tax Benefits for Families' K-12 Education Expenses in the Context of School Choice*, by Linda Levine and David Smole.

[15] For more detailed information see CRS Report RL32155, *Tax-Favored Higher Education Savings Benefits and Their Relationship to Traditional Federal Student Aid*, by Linda Levine and James B. Stedman.

Education Savings Bond Program

In general, taxpayers must pay tax on the interest earned on U.S. Savings Bonds. If the interest is not reported in the year it is earned, it must be reported in the year the bond is redeemed. For higher education purposes, taxpayers may be able to redeem qualified U.S. Savings Bond without having to include in income some or all of the interest earned on the bonds. Taxpayers are eligible if they have paid qualified higher education expenses for themself, their spouse or a dependent for whom they claim an exemption on their tax return.

The exclusion is subject to a phase-out in the years in which the bonds are cashed. For 2004, the phase-out range began at $59,850 for single taxpayers ($89,750 for married taxpayers filing jointly) and ended at $74,850 for single taxpayers ($119,750 for married taxpayers filing jointly). The threshold amounts are inflation adjusted and may change in future tax years.

Qualified U.S. savings bonds are any series EE bond issued after 1989 or a series I bond. The owner must be at least 24 years old before the bond's issue date. The bond must be issued in either the name of the taxpayer, as sole owner, or in the name of both the taxpayer and the spouse, as co-owners. Qualified higher education expenses are tuition and required enrollment fees, contributions to a qualified tuition program, or contributions to a Coverdell ESA. Qualified higher education expenses must first be reduced by any and all of the following tax-free benefits: tax-free scholarships; expenses used to compute the tax-free portion of withdrawals from a Coverdell ESA; expenses used to compute the tax-free portion of distributions from a qualified tuition plan; any nontaxable payments received for educational expenses like employer-provided educational assistance or qualified tuition reductions; and any expenses used in figuring the Hope and Lifetime Learning Credits.

Early Withdrawals from Individual Retirement Accounts (IRAs)

Generally, if taxpayers make withdrawals from their IRA before they reach the age of 59 ½, they must pay an additional penalty of 10% on the early withdrawal. This applies to any type of IRA, traditional, SEP-IRA, SIMPLE or ROTH. When the withdrawal is made for qualified higher education expenses, the taxpayer does not incur the 10% tax on early withdrawal.

To benefit from this incentive, taxpayers must use the proceeds to pay qualified higher education expenses for themselves, their spouse, or their children or grandchildren. Qualified higher education expenses include tuition and required enrollment fees, books, supplies, equipment, and room and board if the student is attending school at least half-time. There are no income limits or phase outs, nor are there limits on the amounts withdrawn from the IRA. Qualified higher education expenses must first be reduced by any expenses paid with the following funds: tax-free withdrawals from a Coverdell ESA; tax-free scholarships; employer provided educational assistance; or any tax-free payment (other than a gift, bequest, or devise) due to enrollment at an eligible institution.

Uniform Transfers to Minors

Generally, gifts of up to $11,000[16] made by a donor during the calendar year to any donee are not included in the total amount of the donor's taxable gifts that year. This annual exclusion is available to all donors. Money given from one individual to another in excess of $11,000 during a year is typically subject to a gift tax which is imposed at graduated tax rates ranging from 18% to 35%.

In addition to this annual exclusion, an unlimited gift tax exclusion is allowed for amounts paid by a donor directly to an educational institution for tuition payments on behalf of the donee. Amounts paid for books, dormitory fees, or room and board are not eligible for the exclusion. The gift tax exclusion applies for any amount paid not only by a student's parents but also by other family members or any other individual, not necessarily related.

Beneficiaries of Education Tax Incentives

As indicated in the introduction, the beneficiaries of education tax benefits vary by type of taxpayer. Taxpayers differ by income, marital status, and number of dependents and, as a result, the same education tax incentive can affect taxpayers differently. Married individuals filing joint returns comprised 39.1% of all tax returns in 2001, while single filers were 44.6%, and heads of households were 14.4%.[17] These differences in household composition, along with differences in the number of dependents, alter the distribution of taxes among income groups, which can affect the degree of fairness in the tax code. The issue of fairness in the tax code involves two components, vertical equity and horizontal equity. Vertical equity is a concept which requires that tax burdens be distributed fairly among people with different abilities to pay. Horizontal equity states that people in equal positions should be treated equally. Education tax incentives can affect both the vertical and horizontal distributions of the tax burden.

Education tax benefits vary by type and can be categorized by the way they reduce income: as exclusions, deductions, exemptions, and credits. An exclusion is an item of income that is not included in gross income because the tax code explicitly exempts it from tax. Exclusions are deducted from gross income to obtain adjusted gross income, which serves as the base for measuring income before deductions, exemptions, and credits are taken into account. **Table 2** outlines the higher education incentives that are exclusions, exemptions, and transfers.

Personal exemptions reduce taxable income and are allowed for the taxpayer, the spouse and each dependent. In 2003, the personal exemption amount was $3,050, up from $3,000 the year before.

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[16] This amount is indexed for inflation.

[17] As reported by the IRS, [http://www.irs.gov/pub/irs-soi/01in53us.xls], visited Aug. 12, 2004.

Table 2: Higher Education Tax Incentives: Exclusions, Exemptions, and Transfers

Provision	Benefit	Annual limit	Income Phase-out Thresholds
Exclusion of scholarship and fellowship income; tuition reduction	Reduces gross income	None	None
Exclusion of employer-provided education assistance benefits	Reduces gross income	$5,250	None
Parental exemption for students age 19 to 23	Reduces adjusted gross income	$3,100	*Single: $139,500 Married: $209,250
Exclusion of earnings of qualified tuition programs	Earnings are not taxed	None	None
Exclusion of earnings of Coverdell savings accounts	Earnings are not taxed	$2,000 contribution per beneficiary	Single: $95,000 to $110,00 Married: $190,000 to $220,000
Exclusion of interest on educational savings bonds	Earnings are not taxed	Amount of qualified expenses	Single: $59,850 to $74,850 Married: $89,750 to $119,750
Exclusion of early withdrawals from IRAs	No 10% tax on early distribution	Amount of qualified expenses	None, but since 1986 IRA contributions were subject to contribution and income limits
Transfer to minors under the Uniform Transfers to Minors Act	Gift is not taxed	None, if the gift is paid by a donor directly to an educational institution for tuition payments on behalf of the donee	None, if the gift is paid by a donor directly to an educational institution for tuition payments on behalf of the donee

Notes: Table created by the Congressional Research Service and is applicable for tax year 2003.
* Households with income above these amounts may not claim the tax benefit.

Deductions from adjusted gross income are allowed for certain types of expenditures for which income taxation is deemed inappropriate or inadvisable. Deductions function like exclusions in their effect on tax liability in that they reduce a taxpayer's tax liability, but only by a percentage of the amount deducted. An individual in the 35% tax bracket would receive a reduction in taxes of $35 for each $100 deduction while an individual in the 25% tax bracket would receive a reduction in taxes of $25 for each $100 deduction. Hence, the same deduction can be worth different amounts to different taxpayers depending on their marginal tax bracket. More simply stated, the tax savings from deductions is generally equal to the taxpayer's marginal tax rate times the amount of the deduction.

Once deductions and exemptions are subtracted from adjusted gross income, taxpayers arrive at their taxable income, the base to which the income tax rates are applied to calculate income tax liability. Gross tax liability is calculated by applying the marginal tax rate and structure to taxable income; it serves as a base amount prior to subtraction of tax credits. Tax credits are subtracted from gross tax liability to arrive at a taxpayer's final tax liability. Hence, tax credits reduce tax liability directly, on a dollar for dollar basis. **Table 3** outlines the higher education tax incentives that are deductions and credits.

Table 3: Higher Education Tax Incentives: Deductions and Credits

Provision	Benefit	Annual limit	Income Phase-out Thresholds
Above-the-line deduction for tuition and required fees	Reduces gross income by the marginal tax rate multiplied by the amount claimed; can be claimed by both those who itemize and those who claim standard deduction	$3,000	*Single: $65,000 Married: $130,000
Business expense deduction of work-related education	Reduces gross income by an amount equal to the marginal tax rate multiplied by the amount claimed; can be claimed only by those who itemize	Amount of qualifying expenses, as long as miscellaneous itemized deductions exceed 2% of the individual's adjusted gross income.	May be subject to limit on miscellaneous itemized deductions
Deduction for interest on student loans	Reduces gross income	$2,500	Single: $50,000 to $65,000 Married: $100,000 to $130,000
Hope Credit and the Lifetime Learning Credit (LLC)	Reduces tax liability by 100% of amount claimed	$1,500 per student for the Hope Credit; $2,000 per household for the LLC.	Single: $41,000 to $51,000 Married: $83,000 to $103,000

Notes: Table created by the Congressional Research Service and is applicable for tax year 2003.
* Households with income above these amounts may not claim the tax benefit.

Final tax liability is the amount of federal income tax owed by the taxpayer to the federal government after taking into account allowable tax credits. When a taxpayer's final tax liability is positive, then the taxpayer has taxes due and must pay the federal government additional federal income taxes to cover the shortfall. A refund is a payment by the federal government to a taxpayer whose final tax liability is negative, such that withheld taxes exceeded the final tax liability.

An Economic Perspective

Ultimately education tax benefits for higher education can be evaluated by looking at the impact on economic efficiency, equity, and simplicity. Education tax benefits provide subsidies to encourage more investment in education than would otherwise be undertaken. Tax subsidies for education can enhance economic efficiency if they are successful in increasing investment in education. However, education tax incentives may not be effective if they subsidize activities that would have been undertaken in the absence of the tax incentive, i.e. subsidize enrollment that would have occurred anyway, or fail to increase enrollment at all. Education tax incentives can, however, be beneficial in making college costs more affordable.

As mentioned previously, vertical equity is a concept which requires that tax burdens be distributed fairly among people with different abilities to pay. Education tax incentives benefit those who have sufficient income to pay tax. Those individuals without sufficient income to pay tax do not have the opportunity to benefit from education tax provisions. The disproportionate benefit of tax expenditures to individuals with higher incomes reduces the progressivity of the tax system, which is often viewed as a reduction in equity.

The tax credits are regressive in that the more income taxpayers have, the more benefits they receive (up to the maximum phase out limits of the tax provision). As a result of the fact that the provisions are not based on need, education tax benefits move the distributional balance of federal aid away from low-income students towards middle- and upper-income students.

Higher income households are more able, and more likely, to benefit from education provisions, which some view as detracting from equity in the tax code. Yet, the incentives provide needed relief for the middle class, many of whom may not qualify for any other source of financial aid. Education tax benefits add complexity and cost to the administration of income taxes, both for individuals and the federal government, but may offer a less-complicated alternative to traditional financial aid. A closer examination of that issue is provided later in this report.

A Comparison of Households

Some families have income levels so low that they do not have tax liability, or even have a negative tax liability. In these cases, families would not be able to benefit from certain education tax incentives. For example, in 2003, a married couple with two dependent children under the age of 17 and one dependent child, attending college, after taking into account standard deductions and personal exemptions, does not begin to experience positive tax liability until their income

exceeds $26,950. A single individual in 2003, who is the head of household, with two dependent children, must have income in excess of $33,930 in order to experience positive income tax liability.[18] Families with these income levels or below may not be able to receive tax benefits from any education tax incentive programs.

Besides having low income, there are two other factors that may contribute to lower income families' inability to participate in education tax incentive programs. Lower income families may receive larger amounts of need-based aid, like Pell Grants, that cannot be claimed in conjunction with education tax benefits and lower income families typically spend less on education than other households.

The magnitude of households who may be unable to participate in education tax incentive programs (those with income below $30,000) can be approximated by using income tax data.[19] As shown in **Table 4**, a total of 130,977,219 returns were filed, and of that amount, 25,148,294 (19.2%) reported adjusted gross income of $10,000 or less; 23,493,788 (17.9%) reported adjusted gross income of $10,001 to $20,000; and 18,741,155 (14.3%) reported adjusted gross income of $20,001 to $30,000. A total of 67,383, 237 income tax returns were filed in 2001 with reported adjusted gross income of $30,000 or less, representing 51.4% of all income tax returns filed for the year.

Table 4: By Adjusted Gross Income, Income Tax Returns Filed in 2001

Adjusted Gross Income	Total Number of Returns Filed	% of Total Returns Filed
$10,000 and under	25,148,294	19.2%
$10,001 to $20,000	23,493,788	17.9%
$20,001 to $30,000	18,741,155	14.3%
$30,001 to $50,000	24,343,572	18.6%
$50,001 to $75,000	17,639,483	13.5%
$75,001 to $100,000	8,943,249	6.8%
$100,001 to $150,000	6,372,267	4.9%
$150,000 and above	4,542,690	3.5%
Total	130,977,219	

Source: CRS table created using data obtained from IRS *Statistics of Income*, [http://www.irs.gov/pub/irs-soi/01in53us.xls] visited Aug. 12, 2004. Amounts may not add up due to rounding.

[18] See CRS Report RS21841, *Federal Individual Income Tax Thresholds for 2004*, by Gregg Esenwein.

[19] This is only an approximation because the number of taxpayers who may desire to claim education tax incentives and are unable to is not distinct from other taxpayers in the same income group who may have no interest in education tax incentives.

Who Benefits From Education-Related Tax Exclusions?

Congress created tax-advantaged education savings plans out of concern that families face increasing difficulty in paying for college. The plans also reflect an intention to subsidize the education costs of families that might not qualify for need-based federal student aid. Tax provisions can be justified as a means of encouraging families to use their own resources for educational purposes and as a means of easing their education financing burdens.[20]

Exclusions reduce a taxpayer's tax liability, but only by a percentage of the amount deducted. Education tax exclusions include scholarship and fellowship income and the earnings from Coverdell ESAs, QTPs, government bonds, and IRAs. The allowance of exclusions (and deductions) diminishes the progressivity of the federal income tax system because the value of income tax exclusions increases with marginal tax rates (and income). That is to say, the tax liability of an individual in the 10% tax bracket (the lowest federal income tax rate) would be reduced $10 for each $100 of itemized deductions. In contrast, the tax liability of an individual in the 35% tax bracket (the highest federal tax bracket) would be reduced $35 for each $100 deduction.[21]

While there are no specific data to show the income levels of participants in tax-preferred education savings programs, Dynarski found that the advantages of saving for college, in particular the use of 529 and Coverdell savings vehicle, rose sharply with income.[22] The three reasons she cited are that,

> First, those with the highest marginal tax rates benefit most from sheltering income, gaining most in both absolute and relative terms. Second, the accounts are risky for families for whom college attendance of children is uncertain, since account holders are penalized if the accounts are not used for schooling. [However] the current penalty structure leaves most benefits intact for the upper [income] brackets.... Third, finally, the college financial aid system reduces aid for those families that have any financial assets, including an ESA or 529. Since the highest-income families are unaffected by this [financial] aid tax, this further intensifies the positive correlation between income and the advantages of the tax-advantaged college savings accounts.[23]

Higher income taxpayers may participate more in savings programs than lower income taxpayers because the after-tax return on savings is greater for high income

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[20] U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, committee print prepared by the Congressional Research Service, Library of Congress, 107th Cong., 2nd sess., S. Prt. 107-80 (Washington: GPO, 2002), pp. 347-360.

[21] The example assumes that the deduction does not drop the taxpayer into the next lower tax bracket.

[22] Susan M. Dynarski, "Who Benefits from the Education Savings Incentives? Income, Educational Expectations, and the Value of the 529 and Coverdell," *National Bureau of Economic Research (NBER)* Working Paper 10470, May 2004, p. 1.

[23] Ibid.

taxpayers. Given an interest rate, r, the after-tax return would be (1-t)*r, where t is the tax rate. If a household chose to move savings into tax-preferred education incentives, regardless of the interest rate, the benefits would be greater for households facing higher marginal tax rates. For instance, a household facing a 25% marginal tax rate would experience an increase in its after-tax return on savings of 33% (from (1-.25)*r to r) while a household with lower income, in the 15% bracket, would experience an after-tax return on savings increase of only 18% (from (1-.15)*r to r), almost 50% less than the higher income household.

Who Benefits From Education-Related Tax Deductions?

Taxpayers may either itemize their deductible expenses or claim the standard deduction. In 2003, the standard deduction amounts were $9,500 for a married couple filing jointly, $7,000 for heads of household, and $4,750 for single individuals. Taxpayers would need to have itemized deductions that exceed the amount of their standard deduction to make itemizing deductions worthwhile. Nationally, the percentage of taxpayers who itemize was 35% for 2002, up from 34% in 2001, and 33% in 2000.[24] Lower income taxpayers generally do not itemize and use the standard deduction amount instead.

The "above-the-line" tuition and fees deduction and the deduction for student loan interest, which is also an "above-the-line" deduction, are available to taxpayers regardless of whether they claim the standard deduction or itemize deductions when filing their income tax return. As a result, these two incentives are more available to modest income people than the business expense deduction for work-related education, which can only be claimed by those who itemize deductions. The benefits of this business expense deduction would most likely flow to higher income taxpayers who are more likely to itemize.

As mentioned previously, a deduction can be worth different amounts to different taxpayers depending on their marginal tax bracket. The higher the marginal tax rate, the more beneficial the deduction can be.

Income tax data from 2001 indicated that the student loan interest deduction incentive primarily benefitted middle and upper-middle income groups. As shown in **Table 5**, taxpayers with adjusted gross income (AGI) between $30,001 and $50,000 claimed the most deductions (36.9%) and the largest deduction amounts (42.5%) even thought they represented only 20.5% of the number of returns filed. The AGI group with the next largest participation was a higher income group, with AGI between $50,001 and $75,000. While this group represented only 14.7% of taxpayers, they claimed 24% of deductions and 20.3% of the deduction amounts.

[24] As reported in the Internal Revenue Service, *Statistics of Income Bulletin*, (Washington: Winter 2003-2004), pp. 105-107.

Table 5: By Adjusted Gross Income, the Number and Amount of Student Loan Interest Deductions Claimed in 2001

Adjusted Gross Income	Total Number of Returns Filed	% of Total Returns	Total Returns Claiming Student Loan Interest Deductions	% of Total Returns Claiming Student Loan Interest Deductions	Amount of Student Loan Interest Deduction Claimed ($ thousands)	% of Total Amount of Student Loan Interest Deduction
$10,000 and under	26,384,333	22.1%	204,159	4.8%	104,924	3.9%
$10,001 to $20,000	23,380,151	19.6%	592,876	13.8%	310,670	11.5%
$20,001 to $30,000	18,534,407	15.5%	875,728	20.5%	588,031	21.8%
$30,001 to $50,000	24,456,257	20.5%	1,580,465	36.9%	1,146,246	42.5%
$50,001 to $75,000	17,559,778	14.7%	1,028,304	24.0%	546,594	20.3%
$75,001 to $100,000	8,903,894	7.5%	0	0	0	0
Total	119,218,820		4,281,532		2,696,465	

Source: CRS table created using data obtained from IRS *Statistics of Income*, [http://www.irs.gov/pub/irs-soi/01in53us.xls] visited Aug. 10, 2004.
Note: Amounts may not add up due to rounding.

Who Benefits From Education Tax Credits?

In contrast to deductions and exemptions, tax credits are subtracted from tax liability rather than from taxable income. The value of tax credits is independent of the taxpayer's marginal tax rate and reduces tax liability by the amount of the credit. For example, a $100 credit reduces tax liability by $100 while a $100 deduction reduces taxable income by a portion of the deduction amount, dependent on the individual's marginal tax rate (e.g., at a rate of 33%, a $100 deduction reduces taxable income by $33). The only taxpayers who can benefit from education tax credits are those with positive tax liability.

An examination of education tax credit data from 2001 found that middle and upper-middle class households benefitted the most from education credits. In total, households with adjusted gross income (AGI) of $30,001 or more claimed 64% of the credits and 68% of the credit amount, even though these households comprise only 42% of all taxpayers. Households with AGI of $50,001 to $75,000 had the highest portion of returns claiming education credits (22%) and the highest portion of the total amount of education credits claimed (nearly 30%). Taxpayers with incomes $10,000 or below claimed the smallest portion of education tax credits (2.9%) and received the smallest portion (0.8%) of the amount of education tax credits, while comprising the largest portion of taxpayers (22.1%).[25]

[25] CRS Report RL32507, *Higher Education Tax Credits: An Economic Analysis*, by Pamela J. Jackson, p. 10.

Rosen discussed that the choice between deductions and credits should depend in part on the purpose of the exclusion.[26]

> If the motivation is to correct for the fact that a given expenditure reduces ability to pay, a deduction is appropriate. If the purpose is mainly to encourage certain behavior, it is not at all clear whether credits or deductions are superior. A credit reduces the effective price of the favored good by the same percentage for all individuals; a deduction decreases the price by different percentages for different people.

In part, the appropriate choice to subsidize education depends on the taxpayer's response to the incentive. This is, primarily, determined by their elasticity of demand. If taxpayers have an inelastic demand for education, they are insensitive to price and subsidies will not affect their behavior. If, on the other hand, taxpayers are sensitive to price, tax subsides may alter their education demand.

Studies of tuition price changes and enrollment response can provide some insight into expected changes in enrollment due to the price reduction that education tax benefits provide. If students and their families are sensitive to tuition price changes, the net reduction in price caused by tax benefits would positively affect enrollment. If students are relatively insensitive to price changes, the net price reduction caused by tax credits would have little impact on enrollment. Typically, students from higher income families have the resources to finance college enrollment without federal subsidies and are relatively insensitive to price changes.

Simplicity

One view of education tax incentives is that they are easier to administer relative to traditional financial aid. For families, the traditional financial aid process involves the completion of a free application for federal student aid (FAFSA), which is submitted to the U.S. Department of Education (ED). In order to complete the application, the household's income tax return must be completed for the most recent tax year. ED processes the application and sends the family a student aid report (SAR). The higher education institution receives the financial aid information from ED and uses their own methodology to determine family contribution and financial need. That determination is then communicated to the family.

The traditional financial aid process involves the taxpayer, the U.S. Department of Education, and the university's financial aid officers, while education tax incentives primarily[27] involve the taxpayer and the U.S. Department of Treasury. To receive education tax benefits, the family files an income tax return, which is processed by one agency. To receive traditional financial aid, the family files a FAFSA form, which is processed by two agencies. Both forms can involve detailed

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[26] Harvey Rosen, "The Personal Income Tax" in Public Finance (Boston: McGraw-Hill, 1999), pp.354-55.

[27] The institution of higher education is required to send forms to both the taxpayer and the U.S. Department of Treasury verifying eligible expenses that may be used in claiming education tax benefits.

calculations and multitudes of records that have to be made and kept by the taxpayer and verified and assessed by the government agencies.[28]

Unlike the education tax incentives, traditional financial aid sources are not always known or certain at the time of the student's application. While the process of completing the income tax forms may be cumbersome, the taxpayer knows their eligibility for benefits at the time of completion. As long as the taxpayer has met the eligibility criteria and has been accurate in reporting information, the tax benefit amounts are known and certain. The traditional financial aid process typically involves a degree of uncertainty about aid sources and families often have to wait months from the time of application to learn what financial aid will be made available for the student. In this respect, education tax incentives may be more advantageous than traditional financial aid.

Alternatively, education tax incentives contribute to the complexity of the tax code and raise the cost of administering the tax system. Those costs, which can be difficult to isolate and measure, are rarely included in the cost-benefit analysis of tax provisions. The complexity of the tax code adds to the cost of taxpayers in either learning how to claim incentives and doing so, or an increased direct cost of paying tax professionals to perform the service for the taxpayer. Additionally, many taxpayers do not know which of the education tax benefits may be most effective in future years. The income phase-outs are at different levels and make calculations difficult and the tax law harder to understand.

Another distinction between financial aid and tax incentives is the timing of the receipt of the assistance. The benefits of tax incentives for education are realized at the time of income tax return filing which, for most taxpayers, typically occurs in the spring by the April 15th deadline. This is in contrast to most academic tuition and fees payments that are made at the beginning of each academic year or semester, typically occurring in the prior months of August or September and December or January. This lagged difference, often up to 10 or more months, in receiving the tax benefit cannot provide assistance to anyone trying to raise enough funds to pay initial college bills. In contrast, traditional financial aid is applied to the educational account of the student at the beginning of each semester. In this respect, education tax incentives may be less advantageous than traditional financial aid.

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[28] For more information about federal financial aid simplification issues, see CRS Report RL32083, *Federal Student Aid Need Analysis: Background and Selected Simplification Issues*, by Adam Stoll and James B. Stedman.