# Tax-Favored Higher Education Savings Benefits and Their Relationship to Traditional Federal Student Aid

**Linda Levine**
Specialist in Labor Economics

**Charmaine Mercer**

January 18, 2008

**Congressional Research Service**
7-5700
www.crs.gov
RL32155

**CRS Report for Congress**
*Prepared for Members and Committees of Congress*

# Summary

Reflecting the desire among Members of Congress to help middle-income families pay for the escalating cost of higher education, the Congress has passed and enhanced a variety of tax benefits since 1990. These federal income tax benefits may be categorized in two ways: (1) those intended to encourage taxpayers to save for future postsecondary education expenses, and (2) those meant to help taxpayers meet current higher education expenses. The first group, on which this report focuses, is composed of Education Savings Bonds, Section 529 (prepaid tuition and college savings) Programs, and Coverdell Education Savings Accounts (formerly, Education IRAs). The second group (e.g., the Hope Scholarship Credit, Lifetime Learning Credit, and the Higher Education Deduction) and its relationship to eligibility for traditional federal student aid is the subject of CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*.

An Education Savings Bond is a series EE bond issued after December 31, 1989 or a Series I bond owned by an individual who was at least 24 years old on the date the bond was issued; the bond must be registered in the name of the taxpayer and/or spouse who claim the student as a dependent on their tax return. Taxpayers, depending on their income at the time of school enrollment, may be able to exclude from income the interest earned on bonds redeemed to pay tuition and required fees. The bonds are little utilized for educational purposes. The very popular Section 529 Programs are sponsored principally by states and enable virtually anyone to make contributions toward the future higher education expenses of designated beneficiaries. Section 529 prepaid tuition plans, which operate as a hedge against tuition inflation, typically cover tuition and fees. Section 529 college savings plans, which function much like mutual funds, cover the cost of attendance. Each 529 prepaid tuition and college savings plan is controlled by its account owners, who may change beneficiaries and have the account balances refunded to them if they desire. A Coverdell Education Savings Account is a trust or custodial account that similarly allows money to be saved for a beneficiary's cost of attendance. Unlike 529 Programs, however, the "responsible individual" who manages a Coverdell Account cannot have the contributions to and tax-exempt earnings accumulated in Coverdell Accounts refunded to him/her. Typically, the balances in Coverdell Accounts must be given to the beneficiaries shortly after they reach 30 years of age.

These tax benefits may affect students' eligibility for traditional federal financial aid. For most aid applicants, this impact is felt to the extent that the net worth of these savings vehicles and income from them are expected to be contributed toward postsecondary education expenses under the traditional system; a greater expected family contribution (EFC) can lead to reduced financial need and decreased eligibility for need-based aid. The treatment of each of these tax benefits in the determination of the EFC can differ sharply. Further, applicants for federal financial aid often do not receive clear guidance from the Department of Education as to whose assets or income these are, and how they are to be reported on their applications. Congress has addressed some aspects of the relationship between traditional student aid and education savings benefits in the College Cost Reduction and Access Act of 2007. This report will be updated as warranted.

# Contents



## Tables



## Contacts

Policymakers have been concerned that a college education is becoming less affordable for middle-income families because the rise in tuition has outpaced the increase in average household income for the past two decades.[1] As a reflection of the desire among Members of Congress to keep postsecondary education broadly available to the U.S. population, the Congress has passed and enhanced a variety of tax benefits toward that end since 1990.

This report examines three tax-favored savings incentives for higher education, namely, Coverdell Education Savings Accounts, Section 529 or Qualified Tuition Programs, and Education Savings Bonds. It omits discussion of some other forms of tax-advantaged savings that were created primarily for other purposes (e.g., Individual Retirement Accounts)[2] and for which higher education is just one of many possible uses (e.g., Uniform Gift or Transfers to Minors Accounts).[3] It then explains the interaction between the three postsecondary education tax benefits and the process of determining student eligibility for traditional federal financial aid, consisting of grants, loans, or work-study income.

# Introduction

The federal income tax measures specifically intended to assist individuals meet higher education costs may be categorized in two ways: (1) those provisions intended to encourage taxpayers to save for future postsecondary education expenses, and (2) those provisions meant to help taxpayers meet current postsecondary education expenses. The first group is composed of Education Savings Bonds, Section 529 or Qualified Tuition Programs, and Coverdell Education Savings Accounts (formerly known as Education IRAs). To take advantage of these incentives, taxpayers must be financially able to set aside money from current income for educational costs they or others (e.g., their children) may incur in years to come. The second group includes the Hope Scholarship Credit, the Lifetime Learning Credit, and the Higher Education Deduction.[4]

All education tax benefits share two characteristics. First, individuals must have a federal income tax liability for the measures to be of value to them. Second, these provisions, like others in the Internal Revenue Code (IRC), are paid for through revenue losses to the government rather than through appropriations by the government.

The IRC sets forth how the tax incentives dedicated to assisting individuals finance a postsecondary education are coordinated with one another. They interact not only with each other, but also with the traditional student aid system. That is to say, the use of these tax provisions may affect the government's calculation of student eligibility for need-based federal financial

---

[1] For more information see CRS Report RL34224, *College Costs and Prices: Issues for Reauthorization of the Higher Education Act*, by Rebecca R. Skinner and Blake Alan Naughton.

[2] Funds withdrawn from an Individual Retirement Account (IRA) to pay for qualified higher education expenses are exempt from the 10% tax penalty on distributions taken before age 59½. The earnings portion of withdrawals remains subject to taxation. The IRA's owner must be the student, their spouse, or either of their children or grandchildren.

[3] These accounts are irrevocable gifts to minors. Parents typically act as custodians of the accounts. The custodians control the accounts until minors reach age 18 or 21, depending upon the state. The beneficiaries then can use the funds for any purpose. Custodial accounts, which are subject to taxation annually, allow families to minimize their tax bills.

[4] For information on these measures, see CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by Linda Levine and Charmaine Mercer. Other higher education tax benefits that are not broadly available are not addressed in this report (e.g., employer educational assistance and the miscellaneous business expense deduction).

assistance, such as Pell Grants. The relationship between the federal income tax system and the traditional federal student aid system, for which Congress appropriates funds, generally is determined by how certain items reported on tax returns (e.g., unearned income including interest and dividends) are treated on the Free Application for Federal Student Aid (FAFSA). The FAFSA is administered by the U.S. Department of Education (ED).

Although the Committee on Ways and Means in the House and the Committee on Finance in the Senate have jurisdiction over tax matters, the Education and Labor Committee in the House and the Health, Education, Labor, and Pensions Committee in the Senate have jurisdiction over education issues. The 110th Congress continues to work on the reauthorization of the Higher Education Act (HEA, P.L. 89-329, as amended by P.L. 105-244). During the first session of the 110th Congress, two major HEA reauthorization proposals were introduced: Higher Education Amendments of 2007 (S. 1642) and the College Opportunity and Affordability Act of 2007 (H.R. 4137). Neither of the two proposals contain provisions that would affect college savings plans. This is in part because reauthorization of the HEA is heavily intertwined with the budget reconciliation process. The passage of the College Cost Reduction and Access Act (CCRAA) of 2007 (P.L. 110-84) on September 27, 2007, made significant changes to the student loan programs, the Pell Grant program, and the federal need analysis formula. Notably, the CCRAA included provisions that will change how disbursements from the education savings plans are treated in the need analysis formula and clarified the issue of ownership of these accounts, specifically for dependent students. These changes have been viewed as important particularly in an era of heightened concern about the ability of families to afford postsecondary education in the face of rising college prices.

# Tax-Advantaged Higher Education Savings Provisions

## Education Savings Bonds

The first college savings tax benefit Congress enacted is the Education Savings Bond (ESB). The program became effective in 1990 pursuant to Section 6009 of the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647), which created a new Section 135 in the IRC. It applies to otherwise eligible owners of Series EE bonds issued after December 31, 1989 and Series I bonds. Bond owners are not required to indicate at the time the bond is purchased that the proceeds will be used for educational purposes.

Taxpayers who apply the principal and interest of the bonds toward qualified higher education expenses (QHEEs) in the same year in which the bonds are redeemed may be eligible to exclude all or part of the interest earned from their income for federal tax purposes. Ordinarily, the interest would be subject to federal income tax at the applicable marginal tax rate for individuals with tax liabilities not fully offset by their personal/dependency exemptions, deductions, and credits. For example, families with income tax liabilities who are in the 15% tax bracket would pay $75 in taxes on interest of $500 (0.15 x $500) when the bond is redeemed, while a family in the 25% tax bracket would pay $125 (0.25 x $500).[5] Generally then, the higher a taxpayer's marginal tax rate, the more valuable an exclusion from income.

In order for the interest of a bond used to pay QHEEs to be excluded from gross income, it must have been registered in the taxpayer's name and/or the spouse's name—*not* in the dependent child's name alone or as co-owner.[6] Bond owners also must have reached age 24 before the issue date of the bonds,[7] which limits the utility of the program to students under 29 years old who file tax returns separately from their parents.[8] Consequently, the program may be more useful to persons who expect to take courses during their working lives. Further, grandparents can only obtain federal tax savings from Series EE or I bonds used to pay their grandchildren's QHEEs if the students are dependents on the grandparents' income tax return.

Taxpayers with students for whom they take exemptions (e.g., themselves, their spouses, and their children) must meet income requirements *in the year in which bond proceeds are used toward QHEEs* to claim the tax benefit. Persons whose modified adjusted gross income (MAGI) is $80,600 or more ($128,400 or more for filers of joint returns) in tax year 2007 may not take the exclusion.[9] The amount that can be subtracted from income is gradually reduced for taxpayers whose MAGI is above $65,600 ($98,400 for married couples filing jointly).[10] These income levels are adjusted annually for inflation. If a family at the time of bond purchase underestimates their future income, they may be unable to take the income exclusion and also may have to pay more tax on the interest than if the bond had been purchased in the child's name.[11] But, if the bonds are in the student's name, it could be more disadvantageous to the student's eligibility for traditional federal aid than if the bonds were in the parents' name. (The effect on aid eligibility of who is considered an asset's owner will be examined later in the report.)

---

[5] U.S. savings bonds confer a tax benefit whether or not they are applied toward QHEEs. They, like other U.S. government obligations, are exempt from state and local income taxes.

[6] Otherwise eligible bonds that were bought to qualify for the ESB program but were registered in the child's name may be reissued in the taxpayer's and/or their spouse's name provided the bonds were not purchased with money belonging to the child. The purchaser must complete a form, have their signature guaranteed or certified, and submit the form along with the bonds to the appropriate regional Federal Reserve Bank.

[7] Before enactment of the ESB benefit, taxpayers could claim the dependency exemption for children of any age attending postsecondary school full-time. The revenue cost of the benefit was paid for by allowing taxpayers to claim as dependents only those children enrolled in postsecondary school full-time who are under age 24.

[8] Independent students who purchase bonds at age 24 would not be able to redeem them for five years if they want earnings to accumulate at the variable market rate. Bonds held less than five years earn a lower fixed rate so the tax savings these students could obtain by redeeming the bonds in that period to pay QHEEs might not outweigh the lower return.

[9] MAGI usually is the same as adjusted gross income (AGI). In the case of ESBs, MAGI is AGI *before* taking into account the bond interest exclusion, the higher education deduction and the student loan interest deduction, the exclusion for adoption benefits received under an employer's adoption assistance program, the foreign income exclusion, and the exclusion for income from sources in U.S. territories and Puerto Rico; and *after* applying the partial exclusion of social security and tier 1 railroad retirement benefits, amounts deducted for contributions to individual retirement arrangements, and adjustments for limitations on passive activity losses and credits.

[10] Married couples who own bonds must file joint returns to take the exclusion.

[11] Taxpayers who own series EE and I bonds can choose to defer recognition of interest until the bond is redeemed or they can pay tax on the interest annually as it accrues. If a bond is purchased in a child's name and interest is recognized annually, it can be offset by the child's standard deduction. Other taxpayers with children whose income exceeds the child's standard deduction might be better off deferring recognition of unearned income (e.g., bond interest) until the children attain age 14.

As in the case of Section 529 Programs and Coverdell Education Savings Accounts, ESBs may be used to pay the QHEEs of eligible students taking courses at the undergraduate and graduate degree level. Similarly, to be eligible for the three tax benefits, a student must be enrolled in or attend a college, university, vocational school or other postsecondary institution that participates in an ED-administered student aid program. (**Table 1** provides a side-by-side comparison of the major features of ESBs, 529 Programs, and Coverdell Accounts.)

Qualified expenses are defined as tuition and related fees. Contributions of ESB proceeds to 529 Programs and Coverdell Accounts also are considered QHEEs (i.e., interest may be excluded from income if the bond's redeemed value is contributed to the other education savings programs). Taxpayers may wish to contribute ESBs to the other savings vehicles if their MAGI were to exceed the threshold for tax-free treatment of bond interest when their dependents attend postsecondary school.

The bond's redeemed value is applied against *adjusted* qualified expenses, that is, QHEEs must be reduced by any tax-free educational assistance (e.g., Pell Grants, scholarships, veterans' educational assistance, and employer-provided educational benefits). If the proceeds from a bond are more than the student's adjusted QHEEs, the taxpayer can exclude from income only a pro rata share of the interest. For example, assume that (1) a dependent child attends a college charging the 2007-2008 average tuition and fees of $6,185 at four-year public institutions,[12] and receives a Pell Grant of $2,400 as well as a tax-free scholarship of $1,100 and that (2) an ESB with a total value of $4,000, including $2,000 in interest, is redeemed. Under these circumstances, the taxpayer could exclude 67% of the bond's interest or $1,340 from income ($2,685 in adjusted QHEEs—$6,185 less $3,500 in tax-free educational assistance—divided by the bond's total value). Whether a family has tax savings from the ESB program will thus depend upon whether the student receives traditional aid, the composition of any aid received (e.g., aid provided through loans does not reduce the value of QHEEs against which the exclusion can be taken), the amount of tuition and fees actually incurred and, as previously mentioned, the family's income level.

The ESB interest exclusion is coordinated with other IRC provisions to avoid "double-dipping." Higher education expenses paid with bond interest excluded from income cannot be used to calculate other tax benefits, including the Hope Scholarship Credit, Lifetime Learning Credit and Higher Education Deduction, as well as the tax-free portion of withdrawals from 529 Programs and Coverdell Accounts.

Uncertainty about the level of future family income, the kind of traditional financial aid a student will receive, and the amount of tuition and fees charged by the institution a student will attend likely has restrained participation in the ESB program. Factors specific to the program also could have dampened its usage (e.g., only bond owners who claim students as dependents on tax returns can utilize it and the rate of return on government bonds historically has been comparatively low). The Joint Committee on Taxation (JCT) estimates that revenue losses associated with the ESB program typically are below $50 million annually.

[12] The College Board, *Trends in College Pricing 2007*.

## Section 529 or Qualified Tuition Programs

Few states sponsored Section 529 or Qualified Tuition Programs before their federal tax treatment was clarified by the Small Business Job Protection Act of 1996 (P.L. 104-188) in Section 529 of the IRC.[13] The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) more recently promoted interest in 529 Programs by making earnings tax-exempt when withdrawn to pay QHEEs through December 31, 2010. Subsequently, the Pension Protection Act of 2006 (P.L. 109-280) made EGTRRA's changes to Section 529 plans permanent. Due in part to the program enhancements, every state and the District of Columbia is the sponsor of at least one of the two types of 529 Programs and new enrollments have driven much of the growth in their value.[14] As of December 31, 2006, there were 9.3 million accounts;[15] their total asset value was $105.7 billion.[16]

If projections of assets totaling in the hundreds of billions of dollars by the end of the decade prove correct,[17] the 529 Program could become quite costly to the government in terms of revenue forgone (i.e., tax expenditures) and a considerable source of federal support for higher education beyond appropriated funds. Although the value excluded from income due to the Section 529 Program is not available from the IRS, the JCT estimates that the income exclusion could produce tax expenditures that double between FY2007 and FY2011, from $600 million to $1.2 billion.[18]

The two types of 529 Programs are the following:

- *Prepaid tuition plans* operate as a hedge against tuition inflation. Contributors (e.g., parents, grandparents, and non-relatives) purchase tuition credits or certificates, on behalf of beneficiaries, for future QHEEs in state-sponsored programs or programs sponsored by eligible institutions of higher education (including private institutions). Contributions to prepaid tuition plans are pooled and then invested by, or on behalf of, the state or institutional sponsor with the aim of at least matching the anticipated increase in tuition. Similar to ESBs, the balances in prepaid tuition plans typically can be used for tuition and required fees.
- *College savings plans*, in contrast, function much like a mutual fund by offering account owners a choice among a variety of investments that financial services firms typically manage for the state sponsors. The value of each beneficiary's account is based upon the performance of the selected investment option, which

[13] It had previously appeared that earnings might be subject to taxation while they were building up inside the program. The legislation clarified that the earnings would grow on a tax-deferred basis.

[14] Peter Schmidt, "Prepaid-Tuition Plans Feel the Pinch," *Chronicle of Higher Education*, September 12, 2003. (Hereafter cited as Schmidt, *Prepaid-Tuition Plans Feel the Pinch*.)

[15] The number of accounts exceeds the number of beneficiaries because there is no limit to the number of accounts that can be established on behalf of a beneficiary.

[16] Quarterly data on value of assets in each state-sponsored 529 Program and number of accounts/contracts by type of plan are available at http://www.collegesavings.org.

[17] Schmidt, *Prepaid-Tuition Plans Feel the Pinch*.

[18] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011*, JCS-3-07, September 24, 2007. (Hereafter cited as JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011*.)

> the account owner may change subject to certain limitations.[19] Similar to Coverdell Accounts, the balances in college savings plans can be used to cover the cost of attendance (i.e., tuition, fees, books, supplies, and equipment required for enrollment or attendance; room and board expenses for students enrolled on at least a half-time basis; and expenses for special needs beneficiaries).

The majority of 529 Program assets were in prepaid tuition plans through 2000.[20] The value of investments in college savings plans has increased greatly, to the point that today they account for the vast majority of 529 Program assets.

There is no annual limit on contributions to a beneficiary's 529 plan(s).[21] Although contributions are not deductible from income for federal tax purposes, many states offer a deduction for state tax purposes.[22] There also are no income-related restrictions for 529 Program savers, unlike the case with those who save through ESBs and Coverdells, which likely makes the program particularly attractive to more affluent families.

Federal income tax on earnings that accumulate in the plans is deferred until withdrawn. In addition, the earnings that have built up inside the program are exempt from tax if they are withdrawn to pay QHEEs. Both the deferral and exemption confer greater tax savings on more affluent families because of their higher marginal income tax rates.

If plan distributions are not used to pay the beneficiary's QHEEs or distributions exceed QHEEs, the earnings are taxable income to the distributee (account owner or beneficiary). In addition, a 10% tax penalty on the earnings portion of nonqualified distributions is assessed the distributee, unless the beneficiary dies, becomes disabled, or receives a tax-free scholarship or educational allowance.

The Taxpayer Relief Act of 1997 (P.L. 105-34) declared that donations to 529 Programs are completed gifts from contributors to beneficiaries even though account owners maintain control of the accounts (e.g., they can change the beneficiary or have the money refunded to them). Contributors can give up to $12,000 in 2007 as a tax-free gift per beneficiary, with the amount adjusted annually for inflation. Taxpayers with substantial resources who want to assist students can gain from a special gifting provision that allows them to donate up to $60,000 per beneficiary in a single year (or $120,000 in the case of two grandparents, for example) by treating the payment as if it were made over five years.

---

[19] Account owners are restricted to the specific investment options offered by the college savings programs they have selected. However, account owners are able to transfer funds between the investment options of a state's program, without tax consequences and without changing beneficiaries, once every 12 months. Similarly, they may make nontaxable transfers of funds between a program's investment options if they change accounts' beneficiaries to close relatives of the original beneficiaries (i.e., the original beneficiary's spouse; children, grandchildren, and stepchildren; brothers, sisters, and stepsiblings; parents, stepparents, and grandparents; aunts and uncles; nieces and nephews; sons-in-law, daughters-in-law, fathers-in-law, mothers-in-law, brothers-in-law, and sisters-in-law; spouses of the aforementioned individuals; and first cousins of the original beneficiary). Account owners also may annually make same-beneficiary, nontaxable rollovers into the program of another state such as one with different investment strategies.

[20] Schmidt, *Prepaid-Tuition Plans Feel the Pinch*.

[21] Programs have set high and varying limits on the total value that a college savings account can reach.

[22] For information about how different states tax contributions to 529 Programs and for a more in-depth discussion of them see CRS Report RL31214, *Saving for College Through Qualified Tuition (Section 529) Programs*, by Linda Levine.

Like the two other higher education savings provisions, withdrawals from 529 Programs must be applied against adjusted qualified expenses of students taking courses at the undergraduate and graduate degree level who are enrolled in colleges, universities, vocational schools or other postsecondary institutions that participate in an ED-administered student aid program. That is to say, QHEEs must be reduced by any tax-free educational assistance (e.g., Pell Grants, scholarships, and veterans' educational assistance).

Qualified withdrawals from Section 529 plans also must be coordinated with the other education tax benefits in order to obtain favorable income tax treatment. Although withdrawals can be taken from a beneficiary's 529 plan and Coverdell Account in the same year, the withdrawals will be taxable to the extent they exceed adjusted QHEEs. Further, if 529 Program withdrawals are used to pay the qualified expenses against which a Hope Scholarship Credit, Lifetime Learning Credit, or Higher Education Deduction is taken, they will be subject to taxation.

## Coverdell Education Savings Accounts

The most recently enacted higher education tax provision to encourage savings is the Coverdell Education Savings Account. Originated in the Taxpayer Relief Act of 1997 (P.L. 105-34) as the Education Individual Retirement Account at Section 530 of the IRC, it first became available in 1998. It was renamed in P.L. 107-22 effective July 2001, and substantially enhanced in P.L. 107-16 effective January 2002.

A Coverdell Account is a trust or custodial account that enables money to be saved toward the QHEEs of a designated beneficiary who takes undergraduate or graduate courses at any college, university, vocational school, or other postsecondary institution eligible to participate in an ED-administered student aid program. The trustee or custodian must be a bank or another IRS-approved entity. A parent or guardian typically is the "responsible individual," "authorized person," or "manager" named when the account is opened because the beneficiary is a minor at that time. The trustee or custodian generally has policies concerning the nature of the responsible individual's decision-making authority. For example, unlike a 529 Program account owner, the responsible individual cannot have a Coverdell Account's balance refunded to them. However, a trust or custodial agreement may allow the manager of a Coverdell Account to change the beneficiary.[23]

Among other things, the document establishing and governing a Coverdell Account must specify that the trustee or custodian can only accept contributions in cash (like a 529 Program), that contributions be made before the beneficiary attains age 18 (except for special needs beneficiaries), and that contributions to the account will not cause total contributions per beneficiary for the year to exceed the legal limit. Further, the account's funds cannot be invested in life insurance contracts and cannot be combined with other property except in a common trust fund or common investment fund. (Other than these restrictions, contributions can be invested in any options available through the trustee, such as stocks, bonds, mutual funds, and certificates of deposit.) The agreement also must state that any balance in the account will be distributed to the

[23] The new beneficiary must be one of the following family members of the original beneficiary: the original beneficiary's spouse; children, grandchildren, and stepchildren; brothers, sisters, stepbrothers, stepsisters; parents, stepparents, and grandparents; aunts and uncles; nieces and nephews; sons-in-law, daughters-in-law, fathers-in-law, mothers-in-law, brothers-in-law, and sisters-in-law; spouses of the aforementioned individuals; and first cousins of the original beneficiary.

beneficiary within 30 days after the beneficiary reaches age 30 (other than a special needs beneficiary) or dies, whichever is earlier.

Earnings in Coverdell Accounts generally grow on a tax-deferred basis, which as previously noted, provides greater tax savings to more affluent families because their income is subject to higher marginal tax rates. In addition, withdrawals from the accounts that are applied toward qualified expenses at the elementary, secondary, and postsecondary levels are exempt from federal income tax.[24]

Because information on qualified withdrawals from Coverdell Accounts does not have to be reported on federal income tax returns, the value excluded from income is not available from the IRS. (As previously noted, this also is true for the 529 Program.) The JCT estimates that the earnings exclusion of Coverdell Accounts could produce tax expenditures of $100 million annually during FY2007-FY2011.[25] Of the three education savings provisions, then, the 529 Program appears to be the most costly to the Treasury (i.e., provide the greatest benefit to taxpayers) and the ESB Program, the least costly (i.e., provide the smallest benefit).

Any individual taxpayer whose income is below specified levels may make after-tax contributions to Coverdell Accounts of up to $2,000 annually per beneficiary through December 31, 2010. The annual per-beneficiary contribution limit—which was quadrupled in P.L. 107-16—is not adjusted for inflation and will revert to $500 in 2011, absent congressional action. Tax-free rollovers of funds from one Coverdell Account to another of the same beneficiary or to certain family members of a beneficiary do not count against the annual limit.[26] Contributions receive favorable gift and estate tax treatment, although not the "5-in-1-year" provision allowed 529 Program contributors as noted above. Also unlike the 529 Program, the beneficiary must pay a 6% tax on excess contributions.

The MAGI of individual taxpayers who contribute to Coverdell Accounts in tax year 2007 must be below $110,000 ($220,000 for joint return filers).[27] The annual limit on contributions is gradually reduced for individual taxpayers with incomes of more than $95,000 but less than $110,000 (more than $190,000 but less than $220,000 for joint return filers). However, parents whose incomes are above the thresholds could give a tax-free gift of up to $2,000 to their child who could deposit the entire amount in his/her account. The income ceilings are not adjusted for inflation and will (under the sunset provisions of P.L. 107-16) revert to $95,000 and $150,000, respectively, after December 31, 2010.

Contributions from corporations and tax-exempt organizations (e.g., a foundation, charity, or union) are not contingent upon income. They thus may donate the maximum annual contribution to accounts of children in families with incomes in the phase-out ranges.

Like 529 college savings plans, qualified withdrawals from Coverdells may pay for tuition, fees, books, supplies, and equipment required for enrollment or attendance; room and board expenses

---

[24] Effective after December 31, 2001 and through December 31, 2010, funds invested in Coverdells may be used toward certain expenses incurred in connection with attending public or private elementary and secondary schools.

[25] JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011*.

[26] Eligible family members are the same as those previously described for the Section 529 Program.

[27] In the case of Coverdells, MAGI is equal to AGI plus the exclusions for foreign earned income, foreign housing costs, and income from sources in U.S. territories and Puerto Rico.

for students enrolled on at least a half-time basis; and special needs services required by a special needs beneficiary. QHEEs also include withdrawals from a beneficiary's Coverdell Account that are contributed to the beneficiary's 529 plan.

With some exceptions, the earnings portion of withdrawals that go toward purposes other than QHEEs or that exceed them is included in the taxable income of the distributee. These nonqualified distributions also are subject to a 10% penalty, unless they are made to a beneficiary or to the beneficiary's estate on or after the beneficiary's death, due to a beneficiary becoming disabled, or due to a beneficiary receiving a tax-free scholarship or educational allowance. In order to determine whether any portion of earnings withdrawn from a Coverdell Account is taxable, the beneficiary's QHEEs must be reduced by any tax-free educational assistance received and be coordinated with other education tax benefits as shown in **Table 1**.

**Table 1. Major Features of Education Savings Bonds, Section 529 or Qualified Tuition Programs, and Coverdell Education Savings Accounts**

| Characteristics | Education Savings Bonds | Section 529 or Qualified Tuition Programs | Coverdell Education Savings Account |
|---|---|---|---|
| Nature of the savings vehicle | The bond must be a Series EE bond issued after 1989, or a series I bond. It must be issued in the taxpayer's name (if sole owner) or the name of the taxpayer and spouse (if co-owners). | A program that enables funds to accumulate for the purpose of paying the QHEEs of designated beneficiaries. There are two kinds of Section 529 Programs: prepaid tuition plans and college savings plans. The former, which can be sponsored by states and higher education institutions, provides a hedge against inflation by enabling contributors to pay tuition for future courses at today's prices; contributions are pooled and invested by the plan sponsor. The latter, which can only be sponsored by states, allows individuals to contribute to one of several investment options predetermined by the plan's sponsor. | A custodial or trust account established expressly to pay the QHEEs of designated beneficiaries. Accounts may be established for beneficiaries at any bank or other IRS-approved entity. Contributions can be invested in any options (except life insurance contracts) available through the trustee, such as stocks, bonds, mutual funds, and certificates of deposit. As the beneficiaries typically are minors when the accounts are opened, parents or guardians generally act as the responsible individual who is accorded decision-making authority according to the trustee's policies. |
| Nature of the tax benefit | Interest may be excluded from bond owner's income if both principal and interest are used to pay QHEEs of eligible students. | Earnings on non-deductible cash contributions to 529 Programs grow tax-deferred until withdrawn. | Same as 529 Programs. |
| | | Earnings withdrawn from a state-sponsored 529 Program to pay the QHEEs of the plan's beneficiary are tax-free. If withdrawals are not used to pay QHEEs or exceed their value, the earnings portion is taxable and generally subject to a 10% additional tax penalty. | Same as 529 Programs. |
| | | Amounts in a 529 Program can be rolled over tax-free once a year to another 529 plan of the same beneficiary or to a 529 plan of a member of the beneficiary's family. The account owner can change a 529 plan's beneficiary without tax consequences, but the new beneficiary must be a family member of the original beneficiary.[a] | Same as 529 Programs. |
| For whom can the savings be used? | The student must be someone for whom the bond owner takes a federal income tax exemption (e.g., children, spouse, or themselves). | Beneficiaries and contributors do not have to be family members. | Same as 529 Programs. |

| Characteristics | Education Savings Bonds | Section 529 or Qualified Tuition Programs | Coverdell Education Savings Account |
|---|---|---|---|
| | The bond owner must be at least 24 years old before the bond's issue date. | No age limit on contributors or on beneficiaries. | Accounts can be established for persons under age 18, or for special needs beneficiaries regardless of age. When the beneficiary (other than special needs beneficiary) reaches age 30 or upon the death of the beneficiary, the account generally must be closed and the earnings included in the beneficiary's or estate's income. |
| Income eligibility limits | Individuals whose MAGI is $80,600 or more ($128,400 or more for joint filers) in tax year 2007 cannot claim the tax benefit for bonds redeemed to pay QHEEs. The amount of the benefit is gradually reduced for taxpayers whose MAGI is above $65,600 (above $98,400 for married couples filing joint returns and for qualifying widower(s)). The income ranges are adjusted annually for inflation. | No income eligibility limits or phase-out of the value of contributions contingent on income. | Through December 31, 2010, individuals may contribute if their MAGI is below $110,000 ($220,000 for those filing joint returns). The contribution amount is gradually reduced for individuals whose MAGI is between $95,000 and $110,000 ($190,000 and $220,000 for those filing joint returns). Contributions of organizations (e.g., corporations, unions, and trusts) are not income-limited. |
| Annual contribution limits | The standard yearly purchase limit on bonds applies ($30,000 face value for an individual and $60,000 face value for a married couple owning bonds jointly in the case of Series EE bonds and $30,000 face value in the case of Series I bonds). | None | Contributors may make a total of $2,000 in nondeductible cash contributions annually per beneficiary (excluding rolled over amounts) through December 31, 2010. The contribution limit is not indexed for inflation. The beneficiary must pay a 6% tax on excess contributions. |
| Level of postsecondary education and eligible institutions | Any college, university, vocational school, or other postsecondary institution eligible to participate in an ED-administered student aid program. For courses at the undergraduate and graduate degree level. | Same | Same |
| Qualified expenses | Tuition and required fees. Bond proceeds also may be rolled into Section 529 Programs and Coverdell Accounts. | In practice, prepaid tuition plans generally are limited to coverage of tuition and required fees. College savings plans can cover the cost of attendance (i.e., tuition, fees, books, supplies, and equipment required for enrollment; room and board for students enrolled at least half-time; and expenses for special needs beneficiaries). | Cost of attendance (see Section 529 Program column for definition). Withdrawals from Coverdell accounts also may be used to make contributions to 529 plans on behalf of the Coverdell accounts' beneficiaries. |
| | These expenses must be reduced by any tax-free educational assistance (e.g., Pell Grants, scholarships, veterans' educational assistance, and employer-provided educational benefits). | Same | Same |

| Characteristics | Education Savings Bonds | Section 529 or Qualified Tuition Programs | Coverdell Education Savings Account |
|---|---|---|---|
| Coordination of benefits (i.e., no double benefit allowed) | The interest exclusion cannot be taken for the same QHEEs used to compute an education tax credit and higher education deduction, paid with any tax-free educational assistance, or paid with expenses used to calculate the tax-free portion of withdrawals from a 529 Program or Coverdell Account. | Section 529 plan withdrawals will not be tax-free if used to pay the same QHEEs used to compute an education tax credit and higher education deduction, paid with any tax-free educational assistance, or paid with ESBs. A beneficiary may receive withdrawals from a Coverdell Account and a 529 plan in the same year, but the withdrawals will be taxable to the extent they exceed adjusted QHEEs. | Same as 529 Programs. |

**Source:** The tax information was derived from Internal Revenue Service, Tax Benefits for Education, Publication 970; provisions of the Internal Revenue Code; and commentary.

**Note:** MAGI may be defined differently depending on the tax benefit. It is equal to AGI for most taxpayers.

a. Amounts in 529 Programs and Coverdell Accounts may be transferred to the designated beneficiary's spouse; their son or daughter or descendant of son or daughter; stepson or stepdaughter; brother, sister, stepbrother, or stepsister; father or mother or ancestor of either; stepfather or stepmother; son or daughter of a brother or sister; brother or sister of father or mother; son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; the spouse of any individual previously mentioned; and first cousin.

# Relationship to Eligibility for Traditional Federal Student Aid

Higher education savings benefits and federal student aid, specifically the federal need analysis system, are closely interrelated. A change in the treatment of higher education savings benefits can impact the need analysis calculation, by affecting the amount determined to be available from income and assets—also known as the expected family contribution (EFC)—to contribute toward postsecondary education expenses.[28] To the extent that the balances in these savings vehicles (assets) and the withdrawals from them (income) are expected to be contributed toward postsecondary expenses, an aid recipient would be determined to have a higher EFC and less financial need for federal student aid.

Although the relationship between higher education savings benefits and federal student aid is interrelated, over the years the treatment of the various types of plans in the federal need analysis calculation has differed or lacked clarity. Both the Deficit Reduction Act of 2005 (DRA) (P.L. 109-171) and the College Cost Reduction and Access Act of 2007 (CCRAA) (P.L. 110-84) attempted to clarify some of the confusion surrounding the treatment of the different education savings benefits. Specifically, the DRA enacted the following changes:

- A qualified education benefit is defined as a qualified tuition plan under Section 529 of the IRC or other prepaid tuition plan offered by a state, and Coverdell Accounts;
- a qualified education benefit shall *not* be considered an asset of the dependent student for the purposes of determining need for federal financial aid; and
- the value of a qualified education benefit shall be the refund value of any tuition credits or certificates purchased for prepaid tuition plans, and the current balance of the account for college savings plans.

Additionally, the following provisions enacted by the CCRAA will become effective July 1, 2009:

- individuals who were in foster care at age 13 or older will be considered independent students for the purpose of applying for and receiving federal student aid;[29]
- distributions from the education savings benefits will not be considered as income in the need analysis formula; and

[28] For additional information regarding the calculation of the EFC, see CRS Report RL33266, *Federal Student Aid Need Analysis System: Background, Description, and Legislative Action*, by Charmaine Mercer.

[29] There are three separate dependency classifications for individual applicants: dependent student, independent student with dependents, and independent student without dependents. Parental financial information is not considered if the applicant meets the statutory definition of an independent student. To be classified as statutorily independent [Title IV, Section 480(d)], an applicant must meet one of the following conditions: be 24 years of age or older by December 31 of the award year; married; enrolled in a graduate or professional program; have a dependent other than a spouse; be an orphan or ward of the court; or be a military veteran or active duty service member.

- qualified education benefits were further clarified as being considered the asset of the student in the case of independent students and the asset of the parent in the case of dependent students, no matter who the account owner is.

This section analyzes how education savings benefits are treated in the calculation of the EFC, focusing specifically on the calculation for dependent students because many of the difficult issues associated with the treatment of education savings benefits in need analysis are likely to be experienced by dependent students.

This section begins with an overview of the federal need analysis system, including a brief description of the key steps for calculating the EFC for dependent students. It is followed by an analysis of the EFC treatment of each of the education savings benefits separately. It concludes with a discussion of selected issues relating to need analysis and education savings benefits.

## Federal Student Aid and the EFC

The federal need analysis system underlies the annual allocation of billions of dollars (more than $94 billion in 2005-2006) in student financial aid supported by Title IV (grants, loans, work-study) of the Higher Education Act (HEA) (P.L. 89-329, as amended). It entails gathering financial data, which are provided by the student via the free application for federal student aid (FAFSA); calculating the EFC; and packaging of the applicant's financial aid award by the postsecondary institution's financial aid administrator (FAA).

### EFC

The EFC is the amount that the federal need analysis system determines a family has available to contribute toward postsecondary education expenses. In calculating the EFC, consideration is given to available income (a combination of taxable and untaxed income and benefits), and for some families, available assets. In addition, living expenses, retirement needs, and federal and state tax liabilities are considered. The income contribution is calculated by determining the total income of a student and his or her family (where applicable), and determining available income by subtracting a series of allowances from total income; a percentage of that available income is considered as an income contribution toward postsecondary education costs. A contribution from assets is similarly calculated. The combination of the available income contribution and asset contribution divided by the number of individuals in the family enrolled in college constitutes the EFC. The EFC process looks back a year for its income data and federal income tax liability. That is, for award year 2007-2008,[30] 2006 income and federal income tax data were used.

#### *EFC and Packaging*

FAFSA data are submitted to a Central Processor (an entity working under contract for the U.S. Department of Education) that calculates the aid applicant's EFC based on statutorily defined rules. From the Central Processor, the EFC and other summary data are reported to FAAs and to the FAFSA filer. The FAA determines the student's need for federal student aid and other sources of aid, based primarily upon the EFC and cost of attendance (COA). This is true for all federal student aid programs (e.g., loans, campus-based programs) except for the Pell Grant program. For

[30] The 2007-2008 award year began July 1, 2007, and ends on June 30, 2008.

nearly all Pell recipients, the award is calculated by subtracting the EFC from the maximum appropriated Pell Grant for the year (i.e., without regard to the COA). The FAA determines need in conjunction with each program's award rules and puts together the financial aid award or package, which consists of the specific sources and amounts of student aid the applicant will receive to help pay for his or her education-related expenses.

### *EFC Calculation for Dependent Recipients*

The EFC is influenced by the inclusion of income and assets, such as the net worth or the distribution from an education savings benefit. The EFC is further impacted by the reported ownership of the education savings benefit. The need analysis calculation assesses parental income and assets at a lower rate than the income and assets of dependent students (discussed below).

Parents' income is afforded a more generous income protection allowance (IPA) than is a dependent student's income. For example, for the 2007-2008 award year, the lowest parental IPA is $12,430 (this amount varies by family size and the number of students in college), whereas the IPA for dependent students is a fixed $3,000. Further, parental available income (total income minus various allowances including the income protection allowance) is taxed within the EFC process on a progressive schedule with an assessment rate ranging from 22% to 47%; in contrast, a dependent student's available income is assessed at a fixed 50%.

Parental assets are reduced by an education savings and asset protection allowance (i.e., the amount of assets that is shielded from the expected family contribution) that varies depending upon the age of the older parent; in contrast, no portion of a dependent student's own assets is similarly sheltered from consideration. More critically, the discretionary net worth of parental assets (net worth minus the education savings and asset protection allowance) is taxed within the EFC calculation at a much lower rate than are the assets of a dependent student—not more than 5.64% for parental assets,[31] and a fixed 20% for a dependent student's assets.

As a result of these assessments, for nearly all dependent students, it is more advantageous for the net worth of savings and income derived from those savings to be considered those of their parents in the EFC calculation.[32] To illustrate, consider the different amounts a hypothetical dependent student will be expected to contribute toward postsecondary expenses if $10,000 in savings is treated as a parental asset or as his/her own. Based on the 2007-2008 rules for determining the EFC, for a dependent student from a family of four (including two parents, the oldest parent being 45 years of age, and a younger sibling) with total parental income (TI)[33] of

[31] The EFC rules provide that the discretionary net worth of parental assets is first taxed at a 12% rate; this determines the so-called "contribution from assets." That asset contribution is added to parental available income yielding "adjusted available income." Adjusted available income is then taxed under a progressive contribution table, with 47% being the highest tax rate in this table. As a result, the maximum possible contribution from the discretionary net worth of parental assets is equal to 47% of 12%, or 5.64%.

[32] There are two conditions under which the process described above is greatly modified, particularly rendering differences in the treatment of assets inconsequential. Under the simplified needs test, no assets are considered in calculating the EFC for a dependent student if his or her parents' AGI is less than $50,000 and the student and parents meet certain conditions applied to their federal income tax returns. Further, there is an automatic zero EFC applicable when the parents of a dependent student have AGI that is not greater than $20,000 (the threshold for 2007-2008 award year) and meet the same conditions regarding federal tax returns as apply for the simplified needs test.

[33] Total income (TI) includes the adjusted gross income (taxable income from all sources) amount that is calculated for federal tax filing purposes, income earned from work, and untaxed income and benefits claimed for federal income tax.

$50,000, student AGI of $1,000, and parental assets of $50,000,[34] that includes the $10,000 education savings benefit, the estimated EFC is approximately $3,000.[35] If, in contrast, the additional $10,000 in savings is treated as the student's asset, the EFC rises to an estimated $5,000. Depending upon the student's postsecondary expenses, this difference may have a substantial negative effect on his/her eligibility for federal need-based aid.

## EFC Treatment of Each Savings Benefit

To delineate the impact of each savings benefit on the EFC and students' financial need, CRS considered the following questions for each:

- What does the HEA specify as the EFC treatment of the benefit?
- What is ED's intended policy regarding the reporting on the FAFSA of the benefit and its EFC treatment?
- What guidance do FAFSA filers generally have regarding how to report the benefit on the FAFSA?

It is this last question that is perhaps the most telling. Regardless of what the HEA requires and ED intends, it is FAFSA filers' understanding of what they are to do on the FAFSA that will determine for many students the impact these tax benefits have on their EFC and financial need. As will be delineated below, it is likely that many individuals, including even those paying close attention to the instructions they receive in print or on the Web, will find limited or confusing guidance or, at times, no guidance.

The text of the HEA is the source for consideration of the first question. The *2007-2008 Federal Student Aid Handbook* is the primary source consulted for the second.[36] In addition to the *Handbook*, over the years ED has issued several letters intended to provide policy guidance on this issue for financial aid administrators. For example, on January 22, 2004, in an effort to clarify its intended treatment of Coverdell Accounts, Section 529 programs (prepaid tuition and college savings), and ESBs in calculating the EFC, ED published a *Dear Colleague* letter to institutions participating in the student aid programs.[37] Additionally, following the enactment of the DRA, two *Dear Colleague* letters were released in April and June of 2006 to provide guidance in the calculation of the EFC and COA adjustment.[38] It should be noted that *Dear Colleague* letters are

---

[34] These total assets are $6,900 more than the $43,100 asset protection allowance provided in the EFC rules to a family whose older parent is 45 years of age. Thus, a portion of the $6,900 will be expected to be contributed toward education expenses.

[35] This estimate is based on the following allowances for parent's income: only one parent having earned income; 2006 taxable income being assessed at 15%; 5% of total income being reserved for state and other taxes, and 7.65% of income for Social Security taxes.

[36] This a multi-volume document of which the part entitled *Application and Verification Guide* is the source for the citations in this CRS report. For convenience, CRS refers simply to the *Handbook* in all subsequent references. All volumes of the 2007-2008 *Federal Student Aid Handbook* can be found at http://www.ifap.ed.gov/IFAPWebApp/currentSFAHandbooksYearPag.jsp?p1=2007-2008&p2=c. The discussion in this report reflects the version of the *Handbook* posted on the Web as of January 14, 2008.

[37] The letter is identified as DCL ID: GEN-04-02, and referred to subsequently in this report as the 2004 *Dear Colleague* letter. The letter is available at http://ifap.ed.gov/dpcletters/GEN0402.html.

[38] The April 2006 letter is identified as DCL ID: GEN-06-05, and is referred to subsequently in this report as the April *Dear Colleague* letter. The June 2006 letter is identified as DCL ID: GEN-06-10, and is referred to subsequently in this report as the June *Dear Colleague* letter. The April 2006 letter is available at http://www.ifap.ed.gov/dpcletters/ (continued...)

intended to provide FAAs with ED's interpretation of the legislation regarding the treatment of education savings benefits for the purposes of calculating the EFC, although there is no guarantee that all FAAs will receive or read the letters.

In terms of guidance for FAFSA filers, the focus is on the resources that individuals filing the paper or web forms are most likely to have access to. These are the instructions accompanying the form itself for 2007-2008[39]—individuals filling out either the paper or web versions receive relatively similar instructions—and an online set of instructions *separate* from the Web FAFSA that is available to all FAFSA filers.[40] The former are referred to subsequently in this report as the "FAFSA-accompanying instructions." The latter are referred to as the "online instructions."

## Education Savings Bonds: Asset Treatment

HEA Section 480(f) defines "assets" for purposes of calculating the EFC as including bonds, among other financial resources. The HEA does not address ESBs per se. The *Handbook* is silent regarding the asset treatment of ESBs. ED, in the 2004 *Dear Colleague* letter, identifies ESBs as assets of the bond owner.

FAFSA filers are informed through all of the sets of instructions, that investments to be reported include bonds, though ESBs are not identified specifically. In fact, there is no guidance as to whose asset the bonds should be considered. If filers understand "bonds" to include ESBs, their inclusion among assets may increase the EFC. Filers reporting ESBs as assets are likely to report them as their parents' since the bonds, to be used toward tuition and fees, must be in the taxpayers' (typically, the parents') names. As described earlier, a much smaller portion of parental assets are expected to be contributed compared to student assets.

## Education Savings Bonds: Income Treatment

HEA Section 480(a)(1) provides that total income for purposes of determining the EFC includes "untaxed income." Untaxed income is defined in Section 480(b)(5) as including "interest on tax-free bonds" but there is no reference to ESBs. The *Handbook* provides no guidance regarding treatment of ESB untaxed income.

The FAFSA-accompanying instructions are silent regarding whether and how aid filers are to report untaxed ESB income specifically. Worksheet B, one of three worksheets that filers complete in order to calculate amounts of income, assets, or tax benefits to be reported on the FAFSA, is used to determine the amount of untaxed income and benefits to be included in determining total income. While not asking about ESB interest directly, it does include two questions which may lead to the inclusion of untaxed ESB income in the EFC calculation.

---

(...continued)

attachments/GEN0605.pdf. The June 2006 letter is available at http://www.ifap.ed.gov/dpcletters/attachments/GEN0610.pdf.

[39] The 2007-2008 paper form and instructions can be accessed at http://www.ifap.ed.gov/fafsa/attachments/0708FAFSAFinal.pdf.

[40] The separate online instructions for 2007-2008 can be found at http://www.ifap.ed.gov/fafsa/attachments/0708FOTWWorksheetColor.pdf. The discussion in this report reflects the version of these online instructions posted on the Web as of January 14, 2008. The *Handbook* is available on the Web as well, but because FAFSA filers are not directed to it, it is likely that very few filers would consult the *Handbook* as they complete their application.

Worksheet B asks filers to report any tax-exempt interest income which they have reported on line 8b of their 1040 or 1040A federal income tax return. Line 8b is used to report any "tax-exempt interest" received (untaxed ESB income is not explicitly identified for inclusion by the instructions for the federal income tax return). In addition, Worksheet B has an open-ended request that filers provide the amount of "Other untaxed income not reported elsewhere on Worksheets A and B." All of the instructions list a number of examples of untaxed income and benefits, such as workers' compensation benefits, without mentioning ESBs. For this question, all instructions also direct the filer *not* to include student aid.

Thus, it is unclear whether most FAFSA filers with untaxed ESB income would report it on their aid application. It would appear to depend in part on whether they report ESB interest on line 8b of either the 1040 or 1040A federal income tax return.[41] As to whom the income should be credited, none of the instructions offer guidance, although, similar to the ESB asset treatment, it is likely filers would assume this is the parents' income.

## Section 529 Prepaid Tuition Plans: Asset Treatment

The HEA, as amended by the DRA, delineates how Section 529 prepaid tuition plans are to be treated in determining a student's eligibility for federal student aid. Previously, the asset value of prepaid tuition plans did not have an impact on the calculation of the EFC and was not reported on the FAFSA. Rather, payment of qualified expenses from a prepaid tuition plan reduced a student's cost of attendance on a dollar-for-dollar basis. As a consequence, a student's financial need for federal need-based aid was decreased by the amount of any qualified withdrawal made from a prepaid tuition plan—effectively applying a 100% tax rate to the distribution when determining financial need. The DRA amended this provision so that prepaid tuition plans are considered assets in calculating the EFC. Furthermore, the HEA specifies that the value of these plans is to be determined by ascertaining the refund value of any tuition credits of certificates purchased.

HEA Section 480(f)(3) states, "A qualified education benefit shall not be considered an asset of a student for purposes of Section 475 [EFC calculation for dependent students]." In addition, the FAFSA-accompanying instructions, released in January 2007, state that prepaid tuition plans should be reported as an asset of the parent if the account is owned by the parent. ED's April and June 2006 *Dear Colleague* letters state that the plan's value shall be included in the EFC calculation *only* if the account is owned by the parent. The *Handbook* further maintains that if the account is owned by the dependent student, the value of the account is to be excluded from both the student's and parent's assets.

## Section 529 Prepaid Tuition Plans: Income Treatment

As has been described, withdrawals from Section 529 plans (both prepaid tuition plans and states' college savings plans) to pay QHEEs are excluded from income for federal tax purposes. The HEA does not explicitly address the treatment of income from these plans, though Section 480(b)(14) describes the untaxed income to be considered in determining the EFC as including "any other untaxed income and benefits...."

[41] Tax filers calculate the exclusion of interest from ESBs on IRS form 8815 and report the "excludable interest" on Schedule B. Instructions for these forms do not direct the tax filer to also include this interest income on line 8b.

The FAFSA-accompanying instructions and the online instructions are silent with regard to the treatment of qualified withdrawals from Section 529 prepaid tuition plans. As noted, FAFSA Worksheet B does ask for information on "other untaxed income and benefits," although the second sentence in the instructions for this open-ended question ("Don't include student aid,...") may suggest that they not report withdrawn earnings.

Effective July 1, 2009, withdrawals from prepaid tuition plans to pay QHEEs will no longer be considered income for the purposes of determining need for federal student aid.[42]

## Section 529 College Savings Plans: Asset Treatment

Section 480(f) of the HEA defines assets for purposes of the EFC calculation as including such savings vehicles as stocks, mutual funds, and qualified education benefits. The *Handbook* not only states that college savings plans are to be included as assets, but also that "The value of the account is considered an asset of the owner of the account, unless the owner is a dependent student." Both Section 529 college savings plans and prepaid tuition plans are, according to ED's guidance, to be treated as parental assets *only* if the parents are the owners. Because there are several instances whereby a dependent student can be an owner of a college savings plan or prepaid tuition plan, the plan's assets in those cases would not be reflected in the EFC calculation.[43] Both sets of FAFSA instructions similarly state that the college savings plans are to be treated as assets of the parents when the parent owns the account.

The CCRAA subsequently clarified that the value of the account shall be treated as an asset of the parent when calculating the EFC for dependents students, no matter who the account owner. However, this provision will not become effective until July 1, 2009.

## Section 529 College Savings Plans: Income Treatment

The HEA does not address the treatment of untaxed income from college savings plans, though, as noted previously, it has a broad requirement that other untaxed income is to be included in total income. The *Handbook* categorically states that the distribution from the account "should not be treated as estimated financial assistance." Similarly, the 2004 *Dear Colleague* letter declares that untaxed 529 distributions, "are not counted as parent or student income."

All sets of FAFSA instructions are silent regarding this treatment. As was described for the Section 529 prepaid tuition plans (see above), filers could include this income among "any other untaxed income and benefits" called for by Worksheet B, or may be dissuaded by the caution in the Worksheet B instructions that this untaxed income is not to include student aid.[44]

---

[42] Provision enacted by the College Cost Reduction and Access Act of 2007, P.L. 110-84.

[43] According to the College Savings Plan Network, several states allow minors to be owners of prepaid tuition and college savings plans, but depending upon the age of the minor, a state may require that an individual be named to manage the account on the minor's behalf. In addition, if Uniform Gift to Minors Act and Uniform Transfer to Minors Act accounts are liquidated and reinvested in Section 529 plans, their assets continue to belong to the student.

[44] The changes enacted by the CCRAA regarding the treatment of withdrawals to pay QHEEs for prepaid tuition plans will also apply to college savings plans. Similarly, the provision will not be effective until July 1, 2009.

### Coverdell Education Savings Accounts: Asset Treatment

Prior to the enactment of the DRA, the HEA did not address Coverdell Accounts directly. Coverdell Education Savings Accounts are now defined as a qualified education benefit for the purposes of Title IV. Thus, as in the case of 529 prepaid and college savings plans, the HEA now specifies that they are not considered an asset of the dependent student when calculating the EFC. All three *Dear Colleague* letters declare that Coverdells shall be included as parental assets in the EFC calculation if the parent is the account owner. In the *Handbook*, ED also states that these assets are to be included and, further, that "[t]heir value should be reported on the FAFSA as an asset of the account owner unless the owner of the accounts is a dependent student."

### Coverdell Education Savings Accounts: Income Treatment

The HEA does not address the treatment of untaxed Coverdell withdrawals beyond the language already described suggesting a broad reach to the definition of untaxed income and benefits. The 2004 *Dear Colleague* letter states that such income is not to be included as parental or student income in calculating the EFC.

FAFSA filers do not receive this message about what ED appears to intend because the FAFSA-accompanying instructions and the online instructions are silent as to the treatment of the untaxed income. Filers may report withdrawals from the accounts in response to Worksheet B's open-ended question regarding "other untaxed income and benefits" or consider them to be student aid excluded from that question.

## Concluding Issues

Although the DRA clarified the different treatment accorded prepaid tuition plans and college savings plans in the need analysis formula, and the CCRAA addressed the issue of account ownership and treatment of withdrawals as income in the need analysis formula, one thing that remains clear is that FAFSA filers do not receive clear or timely guidance, either through the FAFSA-accompanying instructions or the online instructions, about whether and how the asset value of these tax-favored savings or the untaxed income derived from them are to be reported. Consequently, families with similar financial and other characteristics can be treated in very different ways depending upon how they interpret the instructions they do receive, or how they act in the absence of guidance.

## Author Contact Information

Linda Levine
Specialist in Labor Economics
llevine@crs.loc.gov, 7-7756

Charmaine Mercer