Strengthening Federal Student Aid

Reforming Education Tax Credits and Deductions

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February 2016

It is not easy to think of tax credits and deductions as student aid. Many students and families would list grants, loans, and work-study jobs if asked what kinds of financial aid they receive. Students do not apply for tax aid through the Free Application for Federal Student Aid as they do for other types of federal aid, and tax credits and deductions are not listed on financial aid award letters from colleges. Advocates for student subsidies frequently argue that tax credits and deductions should not be included in the total because they do not arrive in time to help pay the bills and because their connection to paying for college is not obvious. But students and parents who paid tuition bills in 2013 saved about $18 billion through lower federal income taxes or larger tax refunds (Baum et al. 2015).

Many policy analysts are critical of the education tax credits and deductions because they go disproportionately to higher-income taxpayers and because the preponderance of evidence suggests that they have little to no impact on college enrollment and success (Long 2003; Hoxby and Bulman 2015). On the other hand, federal grant aid—mostly in the form of Pell grants—goes almost exclusively to students from households with incomes below $60,000 (Baum et al. 2015). Given the high and rising levels of tuition, many families with incomes above this level struggle to pay for college, and the tax provisions provide a route to subsidizing them. In any case, because eliminating the tax subsidies would amount to a tax increase on the middle class, this idea is a political nonstarter. And, even if the credits and deductions were eliminated, it is highly unlikely that the funds would be transferred to federal grant aid that is more targeted at low- and moderate-income students.

Accordingly, it makes sense to consider how the existing tax provisions could be improved. The Urban Institute's recent report on *Strengthening Federal Student Aid* reviews a number of reports that propose modifications to student loan repayment and to education tax credits and deductions (Baum and Johnson 2016). Our review seeks to put recommendations for reform into the context of sound public policy design, prioritizing simplicity and equity. The report also provides detailed comparisons across proposals and specific policy designs. In this brief, we summarize the key findings relating to education tax credits and deductions.

All of the proposals we reviewed agree that the existing system is too complicated, and most suggest simplifying it by consolidating the different credits and deductions into one credit. But some of these proposals add new complications, and few address the complexities of the formula for calculating the credit.

Equity is harder to define. All of the proposals that address income eligibility for a consolidated credit would target benefits lower down the income distribution. Evaluating equity depends on the goals of the program, but, as discussed below, modifications to the current system are desirable.

The Existing System

The American Opportunity Tax Credit (AOTC) was implemented in 2009 to expand the Hope tax credit, which reduced taxes owed by up to $1,800 for students in their first two years of college. The AOTC grants a tax credit equal to the first $2,000 plus 25 percent of the next $2,000 of expenditures on tuition, fees, and required books and supplies for students in their first four years of college. Up to 40 percent of the credit—$1,000—is refundable for filers with no tax liability and for those who owe less than the amount of the credit (figure 1). Individual tax filers with incomes up to $90,000 and joint filers with incomes up to $180,000 are eligible for the credit.[1] The AOTC accounts for most of the $18 billion in tax credits and deductions, but there are several other provisions that also benefit tax filers.

The Lifetime Learning Credit (LLC) is a nonrefundable credit equal to 20 percent of qualifying expenses up to $10,000, for a maximum of $2,000 per return. Income limits are lower than for the AOTC, at $64,000 for single and $128,000 for joint filers, but the LLC can be claimed for an unlimited number of years by graduate, undergraduate, and nondegree-seeking students. Eligibility for the tuition and fees deduction is similar, but the income limits are $80,000 and $160,000.[2] Unlike tax credits, which reduce taxes owed by a specified amount or generate tax refunds, deductions reduce taxable income, so the amount of the tax savings depends on the filer's tax bracket.

Simplification

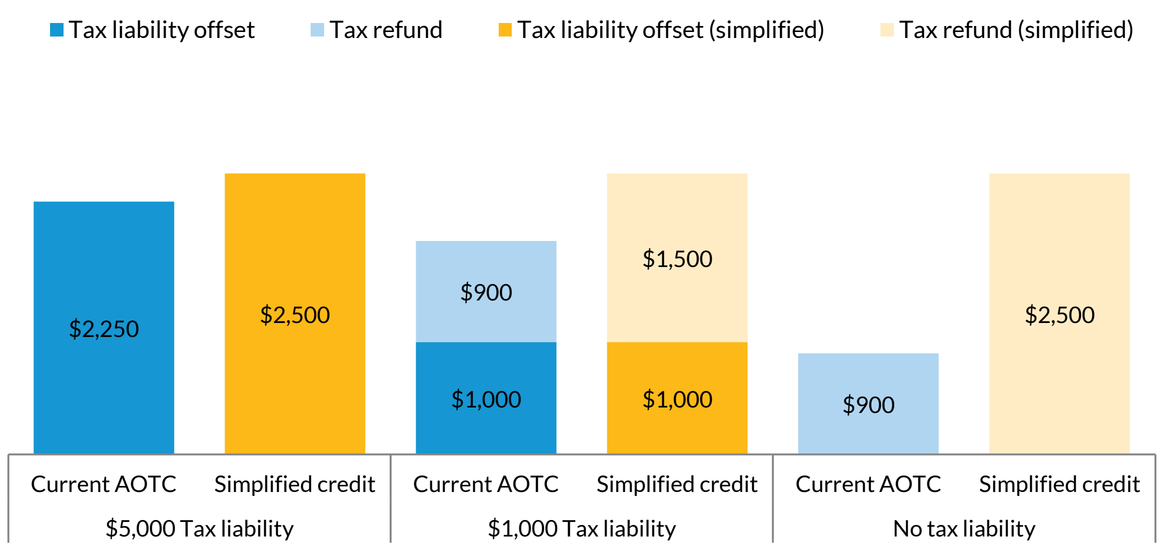
Nearly all of the proposals we reviewed would eliminate the tuition and fees deduction, which now benefits few taxpayers, and keep one modified tax credit modeled after the AOTC.[3] This would be a significant improvement. There is no good reason to force tax filers to choose among multiple complicated options with little information about which would actually be best for them.

But the design of the education tax credit should also be simpler. The complicated formula described above for the AOTC is unnecessary. Though the maximum credit is $2,500, what students and families actually qualify for is not straightforward. As shown in figure 1, a student with $3,000 in qualified expenses can claim credit amounts ranging from $900 to $2,250 under the current AOTC, depending on her tax liability. Even with $5,000 in tax liability and $3,000 in expenses, the student does not receive the full $2,500, because only 25 percent of the second $2,000 spent goes toward the credit. In contrast, a simplified credit could be equal to 100 percent of eligible expenditures up to a limit and be fully refundable. The simplified credit in figure 1 does not depend on tax liability and is always equal to the maximum $2,500 as long as the student spent at least that much on qualified expenses. This simple adjustment, however, does not surface in any of the numerous reports recently addressing reform of the tax benefits for students.

FIGURE 1

Examples of the Current AOTC Compared with a Simplified, Fully Refundable Credit

With $3,000 in qualified expenses and a maximum credit of $2,500



Source: IRS Form 8863 (Education Credits) for tax year 2014. Authors' calculations.
Notes: In all three examples, the current AOTC is equal to 100 percent of the first $2,000 spent ($2,000) plus 25 percent of the remaining amount up to $2,000 ($250), for a total of $2,250, of which 60 percent is nonrefundable ($1,350) and 40 percent is refundable ($900). The simplified version of the credit is equal to 100 percent of the first $2,500 spent ($2,500), of which 100 percent is refundable ($2,500).
Example 1 ($5,000 tax liability): Both the nonrefundable ($1,350) and refundable ($900) portions of the current AOTC offset tax liability. The refundable simplified credit ($2,500) also offsets tax liability.
Example 2 ($1,000 tax liability): The nonrefundable portion of the current AOTC ($1,350) more than offsets tax liability, but the $350 left over is nonrefundable; the student only receives the refundable portion of the current AOTC ($900) as a tax refund. The refundable simplified credit ($2,500) offsets the full tax liability, and the student receives the rest ($1,500) as a tax refund.
Example 3 (no tax liability): With no tax liability, the student receives only the refundable portion of the current AOTC ($900). Because the simplified credit is fully refundable, the student receives the full amount as a tax refund ($2,500).

Some of the ideas that surface in recent reports, though they have some merit, could complicate the system even further. These suggestions tend to emerge from attempts to design a system that directs more of its benefits to lower-income students.

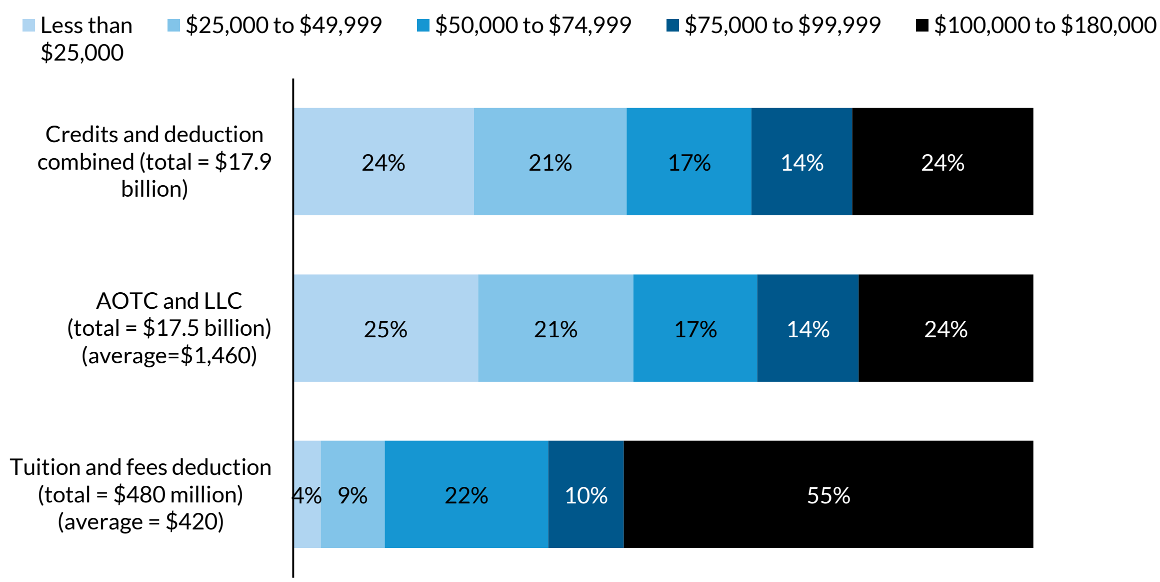
Equity Considerations

A central difficulty in designing effective education tax credits is their lack of clear purpose. President Clinton, in proposing the Hope and LLC credits in 1997, wanted "to make the typical community college affordable for every American and to achieve our goal of making 2 years of college education as universal as a high school diploma is today" (Clinton 1997). But, according to Crandall-Hollick (2014) at the Congressional Research Service, the tax credits are designed to help the middle class, "Education tax credits were intended to provide federal financial assistance to students from middle-income families, who may not benefit from other forms of traditional student aid, like Pell Grants."

The tax credits, as currently designed, do more for the middle class—and even those with higher incomes—than for typical community college students. In 2013, 13 percent of the benefits of the tuition and fees deduction and 46 percent of the benefits of the education tax credits went to tax filers with incomes below $50,000 (figure 2). Tax filers with incomes of $100,000 or higher received 55 percent of the benefits of the deduction and 24 percent of the benefits of the credits.

FIGURE 2

Distribution of Education Tax Credits and Deductions by Adjusted Gross Income, Tax Year 2013



Sources: Baum et al., 2015, figure 31B; IRS, Statistics of Income for tax year 2013, table 1.1.
Note: Distribution of all tax returns by adjusted gross income are as follows: less than $25,000: 40 percent; $25,000 to $49,999: 23 percent; $50,000 to $74,999:13 percent; $75,000 to $99,999: 9 percent; $100,000 to $199,999:11 percent; $200,000 or more: 4 percent.

Modify the Way Pell Grants Affect Eligibility for Tax Credits

Under the current system, any tax-free educational assistance a student receives—including Pell grants or other need-based grant aid—reduces the value of the credit by offsetting qualified expenses.[4] A full-time community college student receiving the maximum Pell grant and using it to pay for tuition and fees would, in most states, not have any remaining qualified expenses to claim under the AOTC. However, she could still have significant education-related expenses, such as room and board. Largely because of this provision, even the refundable portion of the AOTC leaves out many community college students (Delisle and Dancy 2015).

It might be reasonable to argue that, because Pell grants support low-income students, tax credits rightly subsidize students higher up the income scale. But this approach requires monitoring how the two policies fit together and what the distribution of total benefits is along the income scale. Under the current system, recipients of tax benefits can receive larger subsidies than Pell grant recipients with lower incomes whose incomes are not low enough to receive the maximum Pell grant. For example, a student with $2,000 in qualified expenses whose income is too high to qualify for Pell will be eligible for a tax reduction of $2,000, with up to $800 of that amount available in the form of a refund. As long as her tax liability is at least $1,200, she will receive the full $2,000. A lower-income student with no tax liability and a Pell award of $1,000 who has the same $2,000 in expenses will receive just the $800 refund, for a total subsidy of $1,800 from the two programs combined. More effectively extending the tax credit to Pell grant recipients could remedy this inequity.

An obvious solution is to allow Pell grants to be used for living expenses without being considered taxable income and then to apply the tax credit to tuition charges. Another is to exempt Pell from the credit calculation, regardless of how it is spent.

A third option, suggested in several proposals, is to expand the expenses eligible for the tax credit to include other costs of attendance, including housing, food, transportation, and other expenses. But this could get complicated. Some proposals recommend covering child care and transportation (Abernathy 2013; Reimherr 2013). Others would cover room and board or a portion of nontuition costs linked to the type of institution attended (AEE 2013; Mishory and O'Sullivan 2012). In the interest of simplicity, if qualifying expenses are expanded, the allowance should be a fixed amount per full-time student, regardless of actual expenditures. Asking students to document their nontuition expenses would both create bureaucratic complexity and open the door to abuse of the system.

Either discontinuing the practice of requiring need-based grant aid to be counted against tuition to avoid being taxed as income or allowing the tax credit to extend to nontuition expenditures would improve the targeting of the tax credit, allowing more lower-income students to benefit from it.

Apply a Lifetime Dollar Limit Instead of a Four-Year Limit

Another way to modify the AOTC to more equitably distribute subsidies is to replace the four-year limit with a dollar limit. Currently, to gain the maximum benefit of $10,000 ($2,500 multiplied by four years) from the AOTC, a student would need to be enrolled at least half time for four years and have $4,000 in qualified expenses each year after subtracting grant aid. The tax filer claiming the credit would additionally need at least $1,500 in tax liability each of the four years (because only $1,000 is refundable). To enable more students to gain this maximum benefit, a revised system could replace the current four-year limit on AOTC eligibility with an equivalent lifetime dollar limit of $10,000 (Consortium for Higher Education Tax Reform 2013; Mishory and O'Sullivan 2012; Reimherr et al. 2013).

The current four-year AOTC limit does not serve the most disadvantaged students well. Many have less than $4,000 in qualified expenses left over after subtracting grant aid and also tend to remain in school for longer than four years.[5] Though there are potential difficulties with Internal Revenue Service implementation, a $10,000 lifetime credit would be more equitable than the current policy. It is difficult to argue that students should get smaller subsidies for the same investment in education at the same cost if that investment is spread over a longer time period.

Conclusion

Recent proposals for addressing problems in the current system of education tax credits and deductions take the constructive approach of seeking improvement in a system many would prefer to eliminate. Since the use of the tax code to subsidize students is a political reality, simplifying the system for students and families and making it more equitable are important public policy goals. There are frequently trade-offs between these two goals, but, in the case of the tax credits and deductions, there are changes that can make the system both simpler and more effective for students.

For further discussion and analysis of the policy proposals discussed here, please see the full report (Baum and Johnson 2016). A reference table comparing proposed designs for reforming education tax credit and deduction is available at www.urban.org/research/publication/strengthening-federal-student-aid-assessment-proposals-reforming-federal-student-loan-repayment-and-federal-education-tax-benefits.

Notes

1. Eligibility phases out with household income. In tax year 2014, the phaseout ranges for the AOTC were from $160,000 to $180,000 for joint filers and from $80,000 to $90,000 for other filers. The amount of the credit decreases for incomes within the phaseout range from 100 percent down to 0 percent, so that a single filer with AGI of $85,000, in the middle of the phaseout range, is eligible for half the credit he or she would be eligible for with an AGI of $80,000. "Publication 970 (2014), Tax Benefits for Education," Internal Revenue Service, accessed December 21, 2015, https://www.irs.gov/publications/p970.
2. Eligibility for the LLC and the tuition and fees deduction also phase out with household income. In tax year 2014, the phaseout ranges for the LLC were from $108,000 to $128,000 for joint filers and from $54,000 and $64,000 for other filers. The maximum tuition and fees deduction drops from $4,000 to $2,000 for joint filers within $30,000 of the income limit and for other filers within $15,000. "Publication 970 (2014), Tax Benefits for Education," Internal Revenue Service.

3. The only proposals that do not recommend this are those that would eliminate tax credits and deductions entirely (Burd et al. 2013; Doyle 2013; Huelsman and Cunningham 2013) or do not discuss the LLC or the tuition and fees deduction (AEE 2013; Tanner 2013).

4. Pell grants used to cover tuition and fees are not taxable and, therefore, reduce qualifying expenses for the credit, but the portion of the funds used to cover living expense is taxable as income. Students must decide whether to allocate Pell grants toward tuition and fees or to living expenses when filing tax returns (IRS 2014).

5. Bound, Lovenheim, and Turner (2010) find that students at less selective universities and lower income students took longer to complete their bachelor's degrees.

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Acknowledgments

This brief was funded by the Bill & Melinda Gates Foundation as a part of its Reimagining Aid Design and Delivery project. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine our research findings or the insights and recommendations of our experts. Further information on the Urban Institute's funding principles is available at www.urban.org/support.

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