Reform of Education Tax Credit Provisions: Policy Considerations to Improve and Simply Benefits

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This paper examines current law on the existing federal education tax credits and deductions used to pay post-secondary education costs as well as some of these reform proposals, including the 2005 Advisory Panel and 2010 National Commission's recommendations as they relate to post-secondary education costs, as a basis for preparing tax reform recommendations to simplify the various education tax benefits. In addition, the authors propose a tax refund application that will assist taxpayers in repaying their federal student loans.

INTRODUCTION

Education tax provisions have been in the U.S. Tax Code for several years and have provided significant benefits to taxpayers in financing their higher education costs. In 1997, the Taxpayer Relief Act (P.L. 105-34) created several new tax benefits for post-secondary education. In 2012-13, according to the College Board (2013), tax credits and deductions to pay for tuition costs represent approximately \$16.4 billion (9 percent) of all federal student aid. Education tax credit parameters were significantly increased by the American Opportunity Tax Credit in 2009, causing tax credits claimed to increase from \$7.0 billion in 2008 (in 2011 dollars) to \$15.4 billion in 2009 and to \$18.8 billion in 2010 (College Board, 2013). Moreover, in 2010, approximately 7.6 million taxpayers deducted \$7.0 billion in student loan interest, generating \$1 billion in taxpayer savings (College Board, 2013). On June 25, 2014, the House Ways and Means Committee passed the Student and Family Tax Simplification Act (H.R. 3393) to reform the existing educational tax provision in the U.S. Tax Code. This paper will examine and analyze some of these reform proposals, including the 2005 Advisory Panel and 2010 National Commission's recommendations as they relate to post-secondary education costs, as a basis for preparing tax reform recommendations to simplify the various education tax benefits.

TAX PROVISIONS AFFECTING HIGHER EDUCATION

The U.S. Internal Revenue Code has numerous tax provisions that impact higher education, which can be sub-divided into four (4) categories: provisions that impact *current* education costs (HOPE, American Opportunity, Lifetime Learning Tax Credit, Tuition and Fees Deduction, etc.); tax benefits for *saving for college* (§529 Plans); provisions for *educational institutions* (§501(c)(3)); and tax benefits relating to *past education costs* (Student Loan Interest Deduction). Table 1 below summarizes the main provisions that specifically impact higher education.

TABLE 1
TAX PROVISIONS IMPACTING HIGHER EDUCATION COSTS

IRC §	*Tax Provision*
25A	HOPE, Lifetime Learning, American Opportunity Tax Credits
108(f)	Exclusion of Income from Certain Student Loan Forgiveness
117	Qualified Scholarships and Tuition Reduction
127	Employer-provided Educational Assistance
135	Exclusion of Interest Earned on Education Savings Bonds
162	Deduction for Job-related Expenses
221	Student Loan Interest Deduction
222	Tuition and Fees Deduction
529	Qualified Tuition Savings Programs
530	Coverdell Education Savings Accounts

Source: Internal Revenue Code of 1986

Tax deductions and tax credits are considered tax expenditures, where taxpayers expend monies from their own funds and then claim a tax deduction or credit on their tax return—in effect, incrementally lowering their tax burden (Howard, 1997). This contrasts with revenue expenditure, which is when the government expends monies for a particular program (Pell Grants) based on annual appropriations; in the financial aid literature, it is often referred to as "direct aid."

While many of the provisions indicated on Table 1 have been in existence for many decades, several provisions were enacted with the Taxpayer Relief Act of 1997 (P.L. 105-34). Many of the older provisions include §§ 162 and 501(c)(3), which have been in existence the longest and were not enacted solely for education purposes. IRC §162 is the deduction for ordinary and necessary business expenses, allowing businesses to deduct costs of payroll, rent, utilities, supplies, etc., all needed to carry out a business. Within this provision, Treasury Regulation §1.162-5, allows an employee a deduction for education expenses if it maintains or improves a skill required in the employee's trade. Another older provision is the tax exemption status for educational organizations. In 1950, Congress enacted IRC §501(c)(3), which provides charitable, religious and educational organizations an exemption from federal income taxes on contributions received, income from mission-oriented activities, and investment income. In addition, it allows donor-taxpayers the ability to deduct contributions made to such organizations. There are exceptions to §501(c)(3), but not-for-profit and public colleges and universities benefit tremendously from this provision, particularly in fundraising pursuits.

For several decades, taxpayers could not write off the cost of tuition on their tax returns, with the exception of unreimbursed job-oriented training (§162 discussed above). Student loan interest was also nondeductible. This changed in 1997 with the enactment of the Taxpayer Relief Act, signed into law by President Clinton (P.L. 105-34), which authorized several tax benefits impacting students attending (or planning to attend) post-secondary education, including college savings programs (§529, §530), the deductibility of student loan interest (§221), and two college tuition tax credits, the HOPE Scholarship tax credit and the Lifetime Learning tax credit (§25A). In 2001, the Tuition and Fees Deduction (§222) (P.L. 107-16) was enacted, then in 2009, the HOPE provisions were expanded in §25A, enacting the American

Opportunity tax credit (P.L. 111-5). The creation of these various tax provisions beginning in the late 1990s has been a significant shift in how higher education is subsidized indirectly through the Code.

In 1997 when President Clinton proposed his education tax initiatives, there had been modest increases in appropriations to federal direct student aid programs in 1996 and in 1997. Clinton had to govern over a divided government, along with a strong need to rein in a federal budget deficit. Moreover, the Republican-controlled 105th Congress (1997-99) was uninterested in creating any new spending programs. This caused the White House to examine other ways to assist middle-class Americans; while the majority of the focus on the 1997 tax bill centered on the HOPE and Lifetime Learning tax credits, while the student loan interest deduction was a byproduct of that legislation. The rules for each education tax provision are complex and confusing to many taxpayers (President's, 2005). The HOPE (currently the American Opportunity Tax Credit) and Lifetime Learning Tax Credits, as well as the above-the-line Tuition Deduction, and the deduction for Student Loan Interest are examined below.

The HOPE Scholarship Tax Credit

For taxable years beginning before 2009 and after 2017, individual taxpayers are allowed to claim a nonrefundable tax credit, the HOPE Scholarship tax credit, against federal income taxes of up to $1,800 (estimated 2013 level) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program (§25A). The HOPE credit rate is 100 percent on the first $1,200 of qualified tuition and related expenses, and 50 percent on the next $1,200 of qualified tuition and related expenses. These dollar parameters are indexed for inflation, with the amount rounded down to the next lowest multiple of $100. For example, a taxpayer who incurs $1,200 of qualified tuition and related expenses for an eligible student is eligible (subject to the adjusted gross income ("AGI") phase-out described below) for a $1,200 HOPE credit. If a taxpayer incurs $2,400 of qualified tuition and related expenses for an eligible student, then s/he is eligible for a $1,800 HOPE credit (Joint Committee on Taxation, 2013).

The HOPE credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified aggregate gross income falling between $53,000 and $63,000 ($106,000 and $126,000 for married taxpayers filing a joint return). The AGI phase-out parameters are indexed for inflation, with the amount rounded down to the next lowest multiple of $1,000. The size of the phase-out ranges for single and married taxpayers are always $10,000 and $20,000 respectively. For taxable years beginning in 2015, a taxpayer's modified AGI in excess of $55,000 ($110,000 for a joint return) is used to determine the phase-out (Rev. Proc. 2014-61, p. 9). In order to qualify for the credit, qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year (Joint Committee on Taxation, 2013).

The HOPE credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the HOPE credit. The repayment of a loan itself is not a qualified tuition or related expense. A taxpayer may claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (*e.g.*, in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may claim only one of the HOPE credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student (Joint Committee on Taxation, 2013).

The HOPE credit is available for qualified tuition and related expenses, which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program (Joint Committee on Taxation, 2013).

Qualified tuition and related expenses generally include only out-of-pocket expenses. They do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under §117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The HOPE credit is not allowed with respect to any education expense for which a deduction is claimed under §162 or any other section of the Code (Joint Committee on Taxation, 2013).

An eligible student for purposes of the HOPE credit must be enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis, which is considered a course of study of at least one half the normal full-time work load for at least one academic period that begins during the taxable year (Joint Committee on Taxation, 2013).

American Opportunity Tax Credit (AOTC)

The American Opportunity tax credit (AOTC) refers to modifications to the HOPE credit that applies for taxable years beginning in 2009-2017. The maximum allowable modified credit is $2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses was expanded to include course materials. This modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the HOPE credit to two more years of post-secondary education (Joint Committee on Taxation, 2013).

The AOTC is phased out ratably for taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The credit may be claimed against a taxpayer's AMT (Alternative Minimum Tax) liability. Unlike the HOPE credit, part of the AOTC may be refundable. Forty percent of a taxpayer's otherwise allowable AOTC is refundable. However, no portion of the credit is refundable if the taxpayer claiming the credit is a child to whom §1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support) (Joint Committee on Taxation, 2013).

Lifetime Learning Tax Credit (LLTC)

Individual taxpayers may be eligible to claim a nonrefundable credit, the Lifetime Learning credit, against federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. Up to $10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (*i.e.*, the maximum credit per taxpayer return is $2,000). In contrast with the HOPE credit, the maximum credit amount is not indexed for inflation. (Joint Committee on Taxation, 2013).

In contrast to the HOPE and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE and American Opportunity tax credits, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family—that is, the HOPE credit is computed on a per student basis while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between $53,000 and $63,000 ($107,000 and $127,000 for married taxpayers filing a joint return) in 2012. These phase-out ranges are the same as those for the HOPE credit as it applies for tax years beginning before 2009 and after 2017, and are similarly indexed for inflation (Joint Committee on Taxation, 2013).

The Lifetime Learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. As with the HOPE and American Opportunity credits, qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit. Repayment of a loan is not a qualified tuition expense (Joint Committee on Taxation, 2013).

As with the HOPE and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (*e.g.*, in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by a parent or other taxpayer, the student may not claim the Lifetime Learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision (Joint Committee on Taxation, 2013).

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a HOPE or American Opportunity tax credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a HOPE or American Opportunity tax credit with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years). As with the HOPE and American Opportunity tax credits, a taxpayer may not claim the Lifetime Learning credit and also claim the §222 deduction for qualified tuition and related expenses (Joint Committee on Taxation, 2013).

As with the HOPE credit, the Lifetime Learning credit is available for qualified tuition and related expenses, which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. However, unlike the American Opportunity tax credit, the Lifetime Learning credit is not available for the expenses of course materials.

Table 2 below examines the benefit use ratios for each year since enactment of the tuition tax credits up through 2012. The benefit use ratio measures the relationship between the dollar amounts of the tax credits claimed divided by the number of claimants. The lower the ratio, the lower the tax benefits claimed, while the higher the ratio, the greater the benefits claimed. While the results below do not reveal a ratio increase in the earlier periods of the tax credit availability, after 2003, the ratio did systematically increase proportionately. From 1998 to 2008, the amounts represent only HOPE and LLTC claimants--combined. The American Opportunity Tax Credit was enacted in 2009. Beginning that year, the AOTC had a refundable portion; therefore, the data were segregated to reflect the refundable portion of the tax credit. The refundable portion (up to 40 percent of the AOTC is refundable) operates similar to the Earned Income Tax Credit, where taxpayers with zero tax liability are allowed to receive a tax refund. Such amounts are not paid from tax withholding refunds, but are paid out of appropriations. In 1998, there were approximately $3.4 billion in tax credits claimed; by 2012, the dollar amount claimed had risen to approximately $14.5 billion in combined HOPE, LLTC, and AOTC (Publication 1304, 2013). Unfortunately, the IRS does not separate the reporting of the non-refundable portion of the three tuition tax credits to reveal the breakdown of each specific education tax credit. Moreover, it would be incorrect to conclude from this data that there were approximately 15 million claimants in 2012, since some of the taxpayers who received a refundable AOTC may have also claimed a non-refundable portion.

To understand more fully, Table 2 does reveal that taxpayers are claiming education tax credits at high rates. Part of the increase in benefit use rates beginning in 2009 was partly due to the fact that AOTC eligibility parameters were much greater than HOPE/LLTC (AOTC claimant single filer phase out begins at an AGI starting at $80,000, where joint filers phase out beginning at $160,000). Secondly, the AOTC allows for a $2,500 maximum credit (up to 40 percent refundable), which was higher than the HOPE or LLTCs. Third, which was part demographic, from 2008 to 2012, there were a significant number of enrolled college students.

TABLE 2
EDUCATION TAX CREDIT BENEFIT RATES (1998 TO 2012)

	All Tax Filers		
Tax Year	***Dollar Claims***	***Number of Claimants***	***Benefit Use Index***
1998*	$ 3,376,647	4,652,596	0.73
1999	$ 4,772,443	6,436,654	0.74
2000	$ 4,851,178	6,815,316	0.71
2001	$ 5,156,254	7,212,554	0.71
2002	$ 4,882,853	6,475,134	0.75
2003	$ 5,843,029	7,298,227	0.80
2004	$ 6,016,805	7,180,884	0.84
2005	$ 6,119,631	7,057,251	0.87
2006	$ 7,022,420	7,725,138	0.91
2007	$ 6,910,412	7,435,044	0.93
2008	$ 7,632,594	7,740,979	0.99
2009--Nonrefundable**	$ 10,836,636	10,598,706	1.02
2009--Refundable	$ 3,502,175	4,394,166	0.80
2010--Nonrefundable	$ 12,272,073	11,867,055	1.03
2010--Refundable	$ 4,240,639	5,344,865	0.79
2011--Nonrefundable	$ 12,366,511	12,054,606	1.03
2011--Refundable	$ 4,646,517	5,911,412	0.79
2012--Nonrefundable	$ 10,522,539	10,079,053	1.04
2012--Refundable	$ 4,017,534	5,058,762	0.79

*1998 was the first year the Education tax credits were available.
**2009 was the first year of the American Opportunity Tax Credit (AOTC) which authorized a refundable portion; the data are separated to reflect the non-refundable credit vs. the refundable credit. The Lifetime Learning Tax Credit (LLTC) is included in the non-refundable numbers.
Source: IRS Statistics of Income (Publication 1304)

Tuition and Fees Deduction

An individual taxpayer is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year (§222). Unlike the tax credits discussed above, which may be offset against an individual's income tax, tax deductions are offset against income. This deduction is a before-AGI deduction on the income tax return. Qualified tuition and related expenses are defined in the same manner as for the HOPE and Lifetime Learning credits, and include tuition and fees required for the enrollment or attendance by the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution. The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is $4,000 for an individual whose AGI for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose AGI does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose AGI exceeds the relevant AGI limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction began in 2001 and expired at the end of 2014, but was recently extended by Congress until December 31, 2015 (it is possible that Congress might re-extend).

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual, and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account. Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for an exclusion under §222. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope, American Opportunity, or Lifetime Learning credit is elected for such taxable year (Joint Committee on Taxation, 2013).

Qualified tuition and related expenses for purposes of the tuition and fees deduction include tuition and fees incurred with respect to undergraduate or graduate-level courses. As with the HOPE and American Opportunity tax credits, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under §117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127).

Table 3 below provides the benefit use rates for the Tuition and fees deduction. Interestingly, the tuition and fees deduction, while not as widely used as the tuition tax credits, has a higher benefit ratio, on average. Many tax software programs will calculate if the deduction is more beneficial than the tax credit. Until the AOTC was enacted in 2009, the pre-2009 phase-outs for the HOPE and LLTC were lower than the tuition and fees deduction; as Table 3 reveals, approximately 4.6 million taxpayers claimed a deduction in 2008. In 2009, when the income phase-out parameters for the AOTC increased beyond the tuition and fees deduction limit, many taxpayers claimed the AOTC—the tuition and fees deduction claimants dropped to approximately 2.4 million. The tuition and fees deduction primarily benefits those taxpayers who were on the upper side of the income limitation prior to 2009. However, the deduction is easier to use than the tax credits in that they do not use income phase-outs. A single filer can claim a deduction up to $4,000 as long as their income does not exceed $65,000; and if it falls below $80,000, the taxpayer can still claim a lower deduction of $2,000. Nonetheless, if a taxpayer has a $2,000 deduction or a $2,000 credit, a credit will often provide the greatest tax benefit.

TABLE 3 TUITION AND FEES DEDUCTION (2002 TO 2012)			
	All Tax Filers		
Tax Year	***Dollar Claims***	***Number of Claimants***	***Benefit Use Index***
2002*	$ 6,154,145	3,444,941	1.79
2003	$ 6,683,631	3,571,154	1.87
2004	$ 10,589,279	4,710,253	2.25
2005	$ 10,928,436	4,731,924	2.31
2006	$ 9,632,076	4,028,959	2.39
2007	$ 10,647,111	4,570,841	2.33
2008	$ 11,031,337	4,588,503	2.40
2009**	$ 5,439,714	2,425,639	2.24
2010	$ 4,383,982	2,003,930	2.19
2011	$ 4,310,353	1,933,121	2.23
2012	$ 4,686,828	2,112,590	2.22

*2002 was the first year that the Tuition and Fees Deduction was available.
**2009 was the year the AOTC was enacted with higher income phase-outs.
Source: IRS Statistics of Income (Publication 1304)

Student Loan Interest Deduction

Taxpayers who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit (§221). Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. The student loan interest deduction was enacted in 1997 along with the HOPE and LLTCs.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (1) eligible educational institutions, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

The maximum allowable deduction per year is $2,500. For 2012 through 2014, the deduction is phased out ratably for taxpayers with AGI between $60,000 and $75,000 ($125,000 and $155,000 for married taxpayers filing a joint return). The income phase-out ranges are indexed for inflation and rounded to the next lowest multiple of $5,000. For taxable years beginning in 2015, the phase-out range for the deduction begins at $65,000 for individual tax filers ($130,000 for joint filers) and is completely phased out with modified AGI of $80,000 or more for individual tax filers ($160,000 for joint filers) (Rev. Proc. 2014-61, p. 17). The student loan interest deduction was enacted as a permanent provision in 1997; however, in 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) (P.L. 107-16) temporarily suspended or modified three provisions of the deduction: the sixty-month rule, deductibility of voluntary interest payment, and the income phase-outs.

The student loan interest deduction reduces the taxpayer's income which is subject to taxation; in general, deductions reduce a taxpayer's liability, but only by a percentage of the amount deducted depending on the taxpayer's highest marginal tax bracket (Crandall-Hollick, 2012, p. 4). For example, a $5,000 deduction for a taxpayer whose highest marginal tax bracket is 20 percent will result in a $1,000 reduction in that taxpayer's tax liability. Prior to the enactment of §221, taxpayers were able to deduct student loan interest as an itemized deduction as deductible consumer interest. However, consumer interest was repealed by the Tax Reform Act of 1986 (P.L. 99-514) and was phased-out between 1987 and 1990. Tax year 1991 was the first year taxpayers were unable to deduct any consumer interest. As indicated earlier, the Taxpayer Relief Act of 1997 (P.L. 105-34) created several new education tax benefits, including the HOPE and Lifetime Learning tax credits (§25A) and the student loan interest deduction (§221). According to Crandall-Hollick (2012), the most recent version of the student loan interest deduction provides more benefit as an "above-the-line" deduction than as an itemized deduction (as it was prior to the Tax Reform Act of 1986) (p. 4).

Table 4 below provides an understanding of the benefit use ratio from 1998 to 2012, the most recent year of available IRS data (Publication 1304). Each year the dollar amount of student loan interest claims increased, proportionate with the increases in student loan borrowing. The number of benefit claimants increased from approximately 3.8 million to 10.8 million. In addition, Table 5 below indicates the amount of federal student loan borrowing from 2001-2002 and 2011-2012, which nearly doubled in dollar amounts borrowed and loan volume. This does not include private loan borrowing. The significant average debt levels held by students, particularly by graduates at age 24, can adversely impact their lifetime wealth accumulation. When a graduate enters the workforce after college, often begins paying rent, begins paying down their student loans, possibly buying or leasing a car, and beginning to fund retirement. These are daunting for any individual, but graduates with student loans face more difficulty in balancing these economic challenges. According to Hiltonsmith (2013), wealth loss will be greater for students with higher-than-average student debt levels, negatively impacting their ability to acquire a home, automobile, save for retirement or begin college savings for their children. In his study, Hiltonsmith found that average student debt burdens of $53,000 for a dual-headed household possessing bachelor's degrees would result in a loss of lifetime wealth of approximately $207,890 by retirement age when compared to a student debt-free household (2013, p. 10). Of this projected wealth loss, nearly two-thirds are estimated to come from lower retirement savings, while the other third of the loss from lower home equity. Steuerle, McKernan, Ratcliffe, and Zhang (2013) argue that the overall wealth of each generation of Americans has increased, but found that younger cohorts' (1970-78) average wealth is not outpacing older cohorts due to the Great Recession, stagnant wages, and a jobless recovery. Increased student loan indebtedness is seems to be the primary factor contributing to this problem.

In addition, other challenges have impacted young professionals entering the job market. Recently, the supply of good-paying jobs has declined, putting pressure on wages. This negatively impacts the financial liquidity of recent graduates, forcing many to move back into their parent's homes because they cannot afford to live independently. In addition, many graduates have had to repay their student loans instead of build-up savings. The overall net worth of young people has stagnated in 2010, compared to their elders. In 2004, the net worth of individuals between the ages 20 to 28 was approximately $55,228;

by 2010, individuals at the same age had net worth of approximately $37,223 (Davidson and Brodesser-Akner, 2014, p. 20).

TABLE 4 STUDENT LOAN INTEREST DEDUCTION BENEFIT RATES (1998 TO 2012)			
	All Tax Filers		
Tax Year	*Dollar Claims*	*Number of Claimants*	*Benefit Use Index*
1998	$ 1,730,762	3,763,742	0.46
1999	$ 2,254,531	4,136,502	0.55
2000	$ 2,639,472	4,477,986	0.59
2001	$ 2,711,733	4,405,667	0.62
2002	$ 4,469,546	6,640,784	0.67
2003	$ 4,409,816	6,953,370	0.63
2004	$ 4,398,734	7,527,249	0.58
2005	$ 5,052,720	8,072,896	0.63
2006	$ 6,187,425	8,605,148	0.72
2007	$ 7,513,854	9,163,092	0.82
2008	$ 7,761,966	9,185,924	0.84
2009	$ 8,397,082	9,800,217	0.86
2010	$ 9,298,678	10,288,629	0.90
2011	$ 9,673,065	10,051,849	0.96
2012	$ 10,693,660	10,764,802	0.99
Source: IRS Statistics of Income (Publication 1304)			

Table 5 below reveals the federal subsidized and unsubsidized student loan borrowing between 2001-2002 and 2011-2012. The table indicates that the number of borrowers nearly doubled during that time; moreover, the amounts borrowed (in 2012 dollars) more than doubled during this ten-year period. The table below does not include the principal borrowed from private student loans.

TABLE 5 FEDERAL STUDENT LOAN BORROWING (2001-02 TO 2011-12)		
	Academic Year	
Sub+Unsub Total Borrowers	**01-02**	**11-12**
# Student Borrowers *(000)*	5,353	10,407
Total $ Amount (Millions in Current Dollars)	$32,072	$88,363
Total $ Amount (Millions in 2012 Dollars)	$41,397	$89,607
Avg. per Borrower (Current)	$5,992	$8,490
Avg. per Borrower (Constant)	$7,734	$8,610
Source: College Board, 2013		
Note: The number of borrowers (in thousands) and average amount borrowed through federal loan programs in current and 2012 dollars.		

TAX REFORM PROPOSALS

While Congress has not taken up tax reform since 1986, there have been several panels that have made recommendations for reforming the U.S. Tax Code. In this section, these reform recommendations will be examined with regard to the tuition tax credit and deduction provisions, as well as the student loan interest deduction. In a tax reform effort, lawmakers attempt to simultaneously insure sufficient revenues are raised to cover the cost of operating the U.S. government, while "trimming the 'equity ornaments,'" by reducing or eliminating costly tax deductions and credits that clutter up the U.S. Tax Code (Silliman, 2008, p. 24). Politically, achieving fundamental tax reform seems next to impossible. Moreover, the tax provisions for post-secondary education are extremely lengthy and cumbersome to the average taxpayer. There are currently three tuition tax credits (AOTC, HOPE and LLTC) as well as an ever-expiring tuition tax deduction and student loan interest deduction. However, Congress continues to argue for means necessary to simplify the tax code. Several bills have been introduced over the years in Congress, but none have moved out of committee except H.R. 3393 (voted on by the Ways and Means Committee in the U.S. House of Representatives on June 25, 2014). There was no action taken by the full House and no measure was advanced in the U.S. Senate. An examination of the some of the formal reform proposals is provided below.

President's Advisory Panel on Federal Tax Reform

On November 1, 2005, President George W. Bush's tax reform advisory panel issued a significant report making several recommendations to the U.S. Tax Code. With regard to education tax benefits, the report cited that "under current law, there are a number of duplicative and overlapping tax benefits for higher education costs" (President's, 2005, p. 84). The report continued:

The differing definitions, allowable amounts, eligibility rules, and phase-outs that accompany these education benefits have added tremendous complexity for middle-class families. Not surprisingly, this complexity leads to taxpayer confusion. One recent study found, based on a sample of tax returns, that more than one fourth of taxpayers eligible to claim one of these benefits failed to do so. Other taxpayers have no idea whether they are entitled to claim a tax benefit until they sit down to do their taxes and figure out which provisions might apply. It is not clear that the structure of these benefits actually encourages individual to obtain more education than they would have in the absence of these tax benefits (President's, 2005, p. 84).

The Panel's recommendation was to take the two tuition tax credits (HOPE and LLTC) along with the tuition and fees deduction and the student loan interest deduction, by "replacing" these provisions with a Family Credit allowance of $1,500 for families with full-time students age 20 and under. The advantage of the proposal was to simplify the ability to receive a tax credit for college tuition paid out-of-pocket. The disadvantage is that the age limitation would make ineligible adult college students, as well as prevent any tax benefit for the student loan interest deduction. The Advisory Panel's proposals never received a hearing in Congress; however, the report has served as a valuable study on the complexity issues that exist in the tax code, even to this day.

National Commission on Fiscal Responsibility and Reform

In December 2010, a report was issued called, "The Moment of Truth," by the National Commission on Fiscal Responsibility and Reform, appointed by President Barack Obama. The report was broader in scope than the 2005 Advisory Panel's report in that it not only dealt with tax reform but also examined Social Security, discretionary spending, and other entitlement reform. The arguments made on tax reform, including education tax provisions, was to "enact fundamental tax reform by 2012 to lower tax rates, reduce deficits, and simplify the Code" (National, 2010, p. 29). Specifically, the Commission recommended eliminating all income tax expenditures and replacing with a few tax credits (with limitations) for mortgage interest and charitable giving; all of the education tax benefits were proposed to be eliminated. Unlike the 2005 Advisory Panel which proposed a replacement for the tuition tax benefits, the Commission's goal was to lower tax rates significantly by repealing nearly all tax expenditures, including the education tax provisions. Similar to the 2005 panel's findings, the Commission's report never received a hearing in Congress.

H.R. 3393 Student and Family Simplification Act

The proposal would permanently replace the HOPE and Lifetime Learning credits with a modified version of the AOTC. Under current law, the credit rate is 100 percent on the first $2,000 of qualified tuition and related expenses, and 25 percent on the next $2,000 of qualified tuition and related expenses, for a maximum credit of $2,500. *Under the House proposal, the taxpayer's credit for the first $1,500 of qualified tuition and related expenses is refundable*.

The proposal *lowers the phase-out range of the credit*. The credit phases out for joint filers with MAGI between $86,000 and $126,000, and for all other filers with MAGI between $43,000 and $63,000. Both the credit amounts and the phase-out ranges are indexed for inflation for taxable years beginning after 2018. The proposal repeals the provision that denies the credit with respect to qualified tuition and related expenses for the enrollment or attendance of any student who has been convicted of a felony offense consisting of the possession or distribution of a controlled substance. In addition, the proposal adds a provision requiring a taxpayer to include the employer identification number of the institution to which qualified tuition and related expenses was paid (H.R. 3933).

The proposed provision would deem Pell Grants to be applied first against expenses not covered by the AOTC. Thus, qualified tuition and related expenses that may be used for calculating the AOTC would be reduced by Pell Grants only to the extent the Pell Grants exceed the non-AOTC covered costs of college attendance. Also, to reduce credit overpayments, educational institutions subject to current reporting requirements would be required to report amounts paid rather than amounts billed. The proposal was to be effective for tax years beginning after 2014. The objective of the revised AOTC was to help to simplify the tax benefits relating to education by consolidating four similar, but not identical, tax benefits – AOTC, HOPE, and LLTC, and the deduction for qualified tuition and related expenses – into a single, easy-to-understand tax credit. *The estimated cost savings: According to the Joint Committee on Taxation, the provision would increase revenues by $29.4 billion over 2014-2023 and would increase outlays by $38.1 billion over 2014-2023* (Committee on Ways and Means, 2014).

In addition to the tuition tax credit proposals, H.R. 3393 proposed repealing the deduction for interest on education loans beginning after 2014. According to the Joint Committee on Taxation, the repeal of this provision would increase revenues by $13.0 billion over 2014-2023. Lastly, the bill would repeal the deduction for qualified tuition and related expenses (§222). The provision would be effective for tax years beginning after 2013; however, Congress recently extended the tuition and fees deduction through December 31, 2015. The Joint Committee on Taxation did not have a revenue effect estimate over 2014-2023 since §222 had expired when the Ways and Means Committee was considering the bill. Other education tax benefits were also considered, but are beyond the scope of this paper.

The Ways and Means Committee voted on H.R. 3393 on June 25, 2014 with a roll call vote of 22 to 13 and the measure was reported out of committee and was voted on by the full House as part of the Tax Reform Act of 2014. The U.S. Senate did not consider the bill so the measure did not advance. Since H.R. 3393 was the first measure voted on to reform the education tax benefits since enacted in 1997, 2001, and 2009—this served as a basis for evaluation for this study.

REFORMING EDUCATION TAX CREDITS AND DEDUCTIONS

The three (3) measured proposals taken by the Bush Advisory Panel, the National Commission on Fiscal Responsibility and Reform, and recently with H.R. 3393 (Student and Family Tax Simplification Act) as part of the failed Tax Reform Act of 2014, serve as ideas for reforming and improving the education tax credits and deductions. There were some strengths in H.R. 3393 as well as concerns. The strengths include simplifying and consolidating the education tax provisions (tax credits and the deduction for tuition) and instituting the AOTC as a permanent provision, replacing the HOPE credit. The proposal made for a larger tax credit and making it refundable. The bill also better coordinates the Pell Grant and the proposed tuition tax credit.

The bill contains several problems. First, while it is advisable to streamline the various tax credits and deduction into a single tax credit, the revised AOTC would essentially eliminate tax benefits for lifetime learners and graduate students. The removal of benefits for graduate students is very harmful. Congress recently ended the in-school interest subsidy for federal subsidized loans for graduate students; ending the ability to benefit from the LLTC, coupled with the removal of the interest subsidy, would add an unfair burden on graduate students. The bill also inserted income phase-out limits to amounts enacted in 1997, while indexed for inflation, fall well below the AOTC phase-outs; this would result in many middle-income families not benefiting from the revised tax credit.

According to the American Council on Education (ACE), the proposed legislation "takes away benefits from one set of students—both low- and middle-income, as well as graduate students—to pay for aid to a narrower set of low-income students" (American, 2014, p. 4). ACE cites that approximately 1.95 million students with incomes at or below $75,000 claimed a LLTC, including 1 million with incomes of $40,000 or less (American, 2014, p. 4).

The repeal of the student loan interest deduction under H.R. 3393 would harm loan borrowers significantly. According to ACE, approximately 34 percent of undergraduates used federal loans to finance their education. Since 1998, the student loan interest deduction has been a popular tax expenditure. Lenders are required to send the borrower a 1098-E form, reporting the reportable interest paid during a tax year, similar to a 1098-INT which reports mortgage interest. One of the limitations of the student loan interest deduction is that the availability of the deduction phases out at relatively lower income levels. In 2015, phase-outs begin at modified AGIs of $65,000 for single filers and $130,000 for joint filers. Therefore, as one begins to earn a greater salary, the tax benefits of IRC §221 begin to phase out rapidly. While the deduction provides limited tax benefits, some tax filers realize none or only limited deductibility.

A Proposal to Simplify the Education Tax Benefits

Using the recommendations from the three (3) proposals above as a basis for developing a proposal in this study, the authors recommend that lawmakers consider consolidating the three tuition tax credits, the tuition and fees deduction, and the student loan interest deduction into <u>one simple provision</u>. We call it the HOPE Education Tax Credit. The features of the HOPE Education Credit would include:

- Repeal provisions of IRC §§221, 222, which are the student loan interest deduction and tuition and fees deduction. Modify IRC §25A below.
- A taxpayer can claim up to $2,500 of the first out-of-pocket, unreimbursed, qualified ***tuition and fees*** for a taxpayer, their spouse, and qualifying dependent(s) during the tax year at a post-secondary institution in a course of study leading to a degree or certificate (at the undergraduate or graduate levels).
- A taxpayer can claim up to $2,500 in qualified ***student loan interest*** paid during the tax year for the taxpayer, their spouse, and qualifying dependent(s). This can be for interest paid for federal student loans and private student loans. Any interest while in school can only be claimed as long as the tuition and fees portion of the credit is not claimed.
- The HOPE Education Tax Credit can only be claimed by single filers or married filers who file jointly.
- Up to the first 40 percent of the qualified tuition and fees portion of the credit (no more than $2,000, if more than one claimant) may be refunded to the taxpayer if there is no income tax liability to offset against the credit. The qualified student loan interest portion is not refundable.
- A taxpayer may claim either a credit for qualified tuition and fees for themselves, their spouse, and qualifying dependent(s), or a credit for qualified student loan interest for themselves, their spouse, and qualifying dependent(s)—but not both.

- Eliminate income phase-outs, similar to the current tuition and fees deduction. Single filers can deduct up to $2,500 until their adjusted gross income reaches $80,000 ($160,000 for married filers). Can be claimed on all tax returns.
- The amount of the HOPE Education Tax Credit (as well as the income limitations) would be indexed annually for inflation.

There are three examples below that illustrate the HOPE Education Tax Credit proposal:

Example 1. Taxpayers A and B, married filers, have two qualifying dependents, C and D. A is in medical school, paying $35,000 in tuition (all paid for with loans, which deferred during school), C is an undergraduate student, and the parents paid $1,800 in out-of-pocket costs (the rest of the tuition was paid with a Pell Grant and scholarships), and B paid $4,000 in student loan interest during the tax year. D is in a private high school, with tuition of $10,000. The taxpayers' adjusted gross income is $144,000. *How much in education tax credits can be claimed?*

Taxpayers A and B can claim a total HOPE Education Tax Credit of $6,800, as follows:
A gets a credit up to $2,500 for tuition.
B gets a credit up to $2,500 for student loan interest paid.
C gets a credit up to $1,800 for tuition paid by parents.
D is ineligible for a tax credit since the tuition is not post-secondary.

Example 2. Taxpayer A is single with adjusted gross income of $21,000, filing a 1040EZ. The taxpayer is ineligible for the EITC (Earned Income Tax Credit), but is a part-time doctoral student paying $18,000 in tuition and fees (using federal student loans). Also, since the loans are unsubsidized, the student has the option to pay the interest while the loans are currently in-school deferment. A pays the interest of $2,225 in interest during the tax year. *How much in education tax credits can be claimed?*

Taxpayer A can claim a total HOPE Education Tax Credit of $2,500, as follows:
A can receive a credit up to $2,500 for tuition, or
A can receive a credit up to $2,225 for student loan interest paid.
A can claim the highest of the two ($2,500), but not both.

Example 3. Similar facts as Example 2. Taxpayer A is single with adjusted gross income of $21,000, filing a 1040EZ. The taxpayer is ineligible for the EITC (Earned Income Tax Credit), but is a part-time doctoral student paying $1,200 in tuition and fees (after scholarships and using federal student loans). Also, since the loans are unsubsidized, the student has the option to pay the interest while the loans are currently in-school deferment. A pays the interest of $2,000 in interest during the tax year. *How much in education tax credits can be claimed?*

Taxpayer A can claim a total HOPE Education Tax Credit of $2,000, as follows:
A can receive a credit up to $1,200 for tuition, or
A can receive a credit up to $2,000 for student loan interest paid.
A can claim the highest of the two ($2,000), *but not both*.
A cannot claim an additional credit of $500 from the tuition paid to bring the credit to $2,500. A taxpayer can only get the higher of the two—*but not both*.

The aim of this proposal is to allow the credit to be available for taxpayers (or their dependents) for either, tuition and fees for those enrolled in a course of study (***during college activity***) or for student loan interest paid (***post-college activity***). The proposed credit is structured to avoid using percentages—and allows claimants to calculate the credit for out-of-pocket costs paid—up to $2,500 per taxpayer, their spouse (and for each qualifying dependent), per year. The income phase-outs are the most confusing for taxpayers to estimate any benefit, and are eliminated in the proposal above. Also, the tuition and fees credit includes tuition paid graduate study, encouraging life-long learning in a challenging and dynamic labor market. The proposal does not have an age limit, as Congress refined the definition of a qualifying dependent several years ago—and is included in this proposal. With regard to the student loan interest portion of the tax credit, considering the significant student loan debt levels in the United States, taxpayers will realize a much greater tax benefit with the provision structured as a tax credit. The HOPE Education Tax Credit proposal will provide greater liquidity for taxpayers who are having challenges paying for college tuition costs or repaying student loans. The President's Advisory Panel's recommendation to simplify into a Family Credit provided the idea for allowing a single tax provision. The National Commission's recommendation to eliminate all education tax benefits seems politically unlikely given that millions of taxpayers benefit from the existing provisions. There is a great interest in preserving education tax benefits. Lastly, taxpayers will only have to go to one tax provision when seeking to determine if they qualify or the extent to which they benefit. Instead of having five (5) sets of rules that are confusing—as is currently the case, the HOPE Education Tax Credit proposal aims at simplifying this important tax benefit that impacts millions of Americans.

A Proposal to Apply Tax Refunds to Student Loan Principal

Along with the simplified education tax credit discussed above, the authors propose that the IRS consider administratively allowing taxpayers the ability to use part or all of their federal income tax refund to pay down their federal student loan principal. Taxpayers are currently allowed to instruct the IRS to deposit their refund in their bank account using their bank routing number and account number. Given the vast amount of federal student loan indebtedness, the taxpayer could elect to have their federal refund sent electronically and applied to their federal student loan. It would require that the IRS collect student loan information similar to what is needed when a taxpayer enters as a vendor for online banking. Also, the refund could be paid toward their dependent's student loan, if they elect. Income tax refunds are overpaid taxes—and taxpayers have the right to use those monies as they wish. But, making it easy for taxpayers to take a part or all of their refund and apply to their (or their spouses or their dependent's) student loan is an option that might cause taxpayers to see the importance in "transferring" funds toward their outstanding student debt load. This proposal can be an effective way for taxpayers to take their refund and pare down their student debt levels.

CONCLUSION

The three tuition tax credits and deduction, as well as the deductibility of student loan interest, provide important benefits to taxpayers in financing college costs. While the U.S. Tax Code is not an optimal platform for financing college tuition costs, since 1998 several million taxpayers have claimed these tuition and student loan interest benefits. The best improvement would be one that caused for a single tuition tax credit that covered both undergraduate and graduate tuition, eliminating income phase-outs, and providing a refundable provision for lower-income taxpayers lacking a positive tax liability to offset the credit. By converting the student loan interest deduction and converting it into a tax credit, more taxpayers may realize greater relief in paying off their student loans. Congress should view these provisions as providing future returns by having a more educated workforce that will generate and pay federal taxes needed to finance the government and pay for necessary costs to assist future generations. The proposal to allow taxpayers to direct part or all of their federal tax refund toward their federal student loans would also be a viable option to assist many loan holders a simple way to make additional student loan principal payments annually.

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