

**PRESENT LAW AND ANALYSIS
RELATING TO TAX BENEFITS
FOR HIGHER EDUCATION**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
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Prepared by the Staff
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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on July 22, 2004, on the role of higher education financing in strengthening U.S. competitiveness in a global economy. This document,¹ prepared by the staff of the Joint Committee on Taxation, includes a description of present law and an analysis relating to tax benefits for higher education.

Part One is an executive summary of the items discussed in the document. Part Two describes in detail the present-law tax benefits relating to education, including benefits provided to individuals and private and public providers of education. Part Three includes background data relating to college enrollment and costs, economic analysis of tax benefits for education, and discussion of simplification concerns with respect to tax benefits for higher education.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education* (JCX-52-04), July 21, 2004.

PART ONE: EXECUTIVE SUMMARY

I. PRESENT LAW

Present law contains a variety of provisions that provide tax benefits relating to higher education and higher education expenses. Individuals may take advantage of a myriad of provisions, including provisions providing tax benefits for current higher education expenses, saving for future expenses, and expenses that have already been incurred (i.e., expenses relating to student loans). Present law also confers tax benefits on the public and private institutions and governments that provide higher education. These tax provisions result in significant tax expenditures. Tax benefits for individuals with respect to education expenses are estimated to result in a tax expenditure for fiscal years 2004-2008 of almost \$50 billion.² The tax benefits with respect to the providers of higher education (excluding the tax exemption for educational organizations) are estimated to be \$35 billion for fiscal years 2004-2008.³

A. Tax Benefits for Individuals

In general

Present law provides a variety of tax benefits for individuals who incur higher education expenses. To the extent that one of these benefits does not apply, e.g., because there is a limit on the expenses eligible for a benefit, then higher education expenses generally are not deductible by the individual. However, a deduction for education expenses generally is allowed under Internal Revenue Code (“the Code”) section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment.⁴ Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee,

² See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008* (JCS-8-03), December 22, 2003, at 25. The tax expenditure items included in this total are the Hope and Lifetime Learning credits, the deduction for interest on student loans, the deduction for higher education expenses, the exclusion of earnings on amounts in qualified tuition programs and Coverdell education savings accounts, the exclusion of interest on education savings bonds, and the exclusions for employer-provided educational assistance and qualified scholarships and tuition reduction. Tax expenditures are an estimate of the economic benefits that are provided through the tax laws by reference to a normal income tax law. For a variety of reasons, tax expenditures are not the same as revenue estimates, and do not represent the revenue effect of a repeal of the provision. *Id.* at 2, 18.

³ *Id.* at 25. The tax expenditures included in this total are the exclusion of interest on State and local government student loan bonds and the deduction for charitable contributions to educational institutions.

⁴ Treas. Reg. sec. 1.162-5.

education expenses are subject to the two-percent floor on itemized deductions, and also to the overall limit on itemized deductions.

Tax benefits for current expenses

Hope tax credit

The Hope tax credit is a nonrefundable tax credit of up to \$1,500 per year (indexed) per eligible student for qualified tuition and fees for the first two years of post-secondary education. In order to qualify for the credit, the student must be enrolled on at least a half-time basis in a degree program. The Hope credit is phased out for taxpayers with incomes above certain levels. A taxpayer may not claim the Hope credit and the Lifetime Learning credit or the above-the-line deduction with respect to the same student in the same year. In 2000, 6.8 million tax returns claimed education tax credits (i.e., either the Hope or Lifetime Learning credit) of \$4.9 billion.

Lifetime Learning credit

The Lifetime Learning credit is a nonrefundable tax credit of up to 20 percent of qualified tuition and fees. Up to \$10,000 of such expenses per taxpayer return are eligible for the credit. In contrast to the Hope credit, the maximum credit is not indexed for inflation, the credit applies on a per-return rather than per-student basis, and the credit is not limited to the first two years of post-secondary education. The Lifetime Learning credit is available whether or not the student is enrolled on at least a half-time basis. The same income phaseout applies to the Lifetime Learning credit as applies to the Hope credit. A taxpayer may not claim the Lifetime Learning credit and the Hope credit or the above-the-line deduction with respect to the same student in the same year.

Above-the-line deduction

For 2004 and 2005, an above-the-line deduction of \$4,000 of higher education expenses is available to taxpayers whose adjusted gross income does not exceed \$65,000 (\$130,000 in the case of married taxpayers filing a joint return) and \$2,000 for individuals with adjusted gross income not in excess of \$80,000 (\$160,000 for married taxpayers filing a joint return). The deduction applies to tuition and fees. A taxpayer may not claim the above-the-line deduction with respect to a student for whom a Hope or Lifetime Learning credit is claimed in the same year. The above-the-line deduction is not available after 2005.

Exclusion for employer-provided educational assistance

If certain requirements are satisfied, up to \$5,250 annually of employer-provided educational assistance is excludable from gross income and wages for employment tax purposes. The exclusion expires after 2010 under the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).

Qualified scholarships and tuition reduction

Qualified scholarships for qualified tuition, fees, books, supplies, and equipment received by an individual who is a degree candidate are excludable from gross income. Qualified tuition

reduction for certain education provided to employees of an educational organization (and their spouses and dependents) is excludable from gross income and wages. These exclusions do not apply to any amount received that is compensation for services by the student as a condition of receiving the scholarship or tuition reduction.

Tax benefits for saving for higher education expenses

Section 529 qualified tuition programs

A qualified tuition program is a program established by a State (or instrumentality of the State) or a qualified educational institution. In the case of a State program, the qualified tuition program may be either a prepaid tuition program or a savings account program. In the case of a program of a qualified educational institution, the program may only be a prepaid tuition program. Contributions to a qualified tuition program are not tax deductible for Federal income tax purposes. However, amounts in the account accumulate on a tax-free basis (i.e., income on accounts in the plan are not subject to current income tax) and distributions are tax free if used for qualified educational expenses. Qualified expenses include tuition, fees, books, supplies and equipment and, in the case of a student enrolled on at least a half-time basis, room and board. Distributions that are not for qualified expenses are includible in gross income and subject to an additional 10-percent tax.

There is no dollar limit on the amount that can be contributed to a qualified tuition program, however, the program is required to provide adequate safeguards that the contributions will not exceed the amount necessary to provide for the qualified expenses of the account beneficiary.

Special estate and gift tax rules apply to qualified tuition programs. For example, an individual may contribute up to five times the annual gift tax limit in a single year (currently, the annual limit is \$11,000) on behalf of a beneficiary.

A number of the provisions relating to qualified tuition programs are subject to the EGTRRA sunset, including the provision allowing private educational organizations to establish such programs and the exclusion from income for distributions for qualified expenses.

Coverdell education savings accounts

A Coverdell education savings account is a trust or custodial account established on behalf of an eligible beneficiary. Contributions to a Coverdell education savings account are not deductible for Federal income tax purposes, however, income on amounts in the account accumulates on a tax-free basis. Distributions from a Coverdell education savings account are tax-free if used for qualified expenses; other distributions are includable in gross income and subject to an additional 10-percent tax. Qualified expenses include higher education expenses as defined for purposes of qualified tuition programs (i.e., tuition, fees, books, supplies, equipment and, in some cases room and board expenses). In addition, qualified expenses include certain elementary and secondary expenses. The maximum amount that may be contributed to a Coverdell education savings account in any year by an individual contributor for a beneficiary is \$2,000. The contribution limit for individual contributors is phased out based on the contributor's adjusted gross income.

A number of provisions relating to Coverdell education savings accounts are subject to the EGTRRA sunset, including the increase in the contribution limit from \$500 to \$2,000.

Exclusion of earnings on education savings bonds

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed the qualified higher education expenses paid by the taxpayer during the year. Qualified higher education expenses are defined as under the Hope and Lifetime Learning credits, and include qualified tuition and fees. The exclusion is phased out for taxpayers with income above certain levels.

Other tax-favored savings arrangements

Present law provides favorable tax treatment for a number of savings vehicles. While not designed specifically for saving for educational expenses, they may be used by taxpayers for such purpose. These savings vehicles include Roth IRAs, traditional IRAs, deferred annuities, and qualified retirement plans. The special rules relating to each type of arrangement vary.

Tax benefits relating to past expenses (provisions relating to student loans)

Deduction for student loan interest

Up to \$2,500 per year of student loan interest is deductible as an above-the-line deduction. The deduction is phased out for taxpayers with incomes above certain levels. Certain provisions relating to the student loan interest deduction are subject to the EGTRRA sunset, including an increase in the income levels at which the deduction is phased out.

Exclusion of income for student loan forgiveness

Gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided the forgiveness is contingent upon the student working for a certain period of time in certain professions for any of a broad class of employers.

B. Tax Benefits for Providers of Education

Tax exemption for educational institutions

If certain requirements are satisfied, private educational organizations are generally exempt from tax. In general, educational organizations operated by a government also are exempt from tax. Both private and public colleges and universities may be subject to tax on their unrelated business income.

Ability to receive tax-deductible contributions

Public and private tax-exempt education organizations may receive tax deductible contributions.

Tax benefits for certain types of bonds for educational facilities and activities

Present law confers a benefit on governments and certain other parties that provide educational facilities and activities through the preferential treatment accorded State and local bonds. Generally, the interest paid on bonds issued by State and local governments is exempt from Federal income tax. This exemption provides State and local governments with the ability to finance governmental projects, including public schools and universities, at a lower cost than is possible through the use of taxable financing because tax-exempt bonds may generally be issued at a lower interest rate.

II. DATA AND ANALYSIS

Background data on college enrollment and costs

Since 1991, more than 14 million students have enrolled annually in post-secondary education programs, with approximately 77 percent enrolled in public institutions and 23 percent in private institutions in 2001. Of all those enrolled in 2001, 61 percent were enrolled in four-year institutions. College costs have generally risen faster than inflation since 1981. For the 2002-2003 academic year, the average cost of attending a four-year private college (including tuition, fees, and on-campus room and board) was \$23,940 (tuition and fees of \$16,948). The comparable figure was \$9,828 for a public college (tuition and fees of \$4,059). Over the past decade, governmental funding of public higher education has declined as a share of total funding. Federal funds have remained relatively constant, State and local funding has declined, and tuition and fees have increased.

Economic analysis

There are a number of arguments given for subsidizing education. It is commonly argued that there are “positive externalities” to the acquisition of education; that is, the full benefits of education are not captured by the individual in the form of higher future income, and society at large captures some of the benefits of the individual’s investment in education. In such a circumstance, individuals may not acquire the socially optimal level of education, and thus subsidies for education may promote economic efficiency by encouraging greater educational attainment. Others also argue that subsidies are justified on equity grounds to reduce poverty and promote income equality.

Under a theoretical income tax, any expenditures undertaken in the present for returns that are expected in the future should be capitalized and recovered as the future returns are earned. However, education expenses not related to future earnings would be considered consumption, and should be neither deductible nor amortizable. Under present law, educational expenditures are afforded varying treatment, with expenditures receiving treatment equivalent to expensing (e.g., the above-the-line deduction for higher education expenses), better than expensing (e.g., expenses eligible for the Hope credit), or no tax benefits (e.g., direct expenses that exceed the dollar limits or the adjusted gross income limits placed on the Hope and Lifetime Learning credits or the above-the-line deduction). Given the variety and complexity of educational benefits afforded through the tax code, it is difficult to determine the extent to which

educational expenditures are subsidized by the tax code, relative to investments in physical capital.

Simplification concerns

While present law confers tax benefits for educational expenses, the benefits for individuals have often been cited as a source of complexity in the tax laws, particularly given the number of different benefits and the varying qualifications for each benefit. The expiring nature of some of the provisions may also add to complexity.

PART TWO: PRESENT LAW

I. TAX BENEFITS FOR INDIVIDUALS WHO INCUR HIGHER EDUCATION EXPENSES

A. Overview

Present law includes a variety of provisions that provide tax benefits to individual taxpayers for higher education expenses. These include tax benefits for current expenses, such as the Hope and Lifetime Learning credits,⁵ the above-the-line deduction for certain higher education expenses,⁶ and the exclusions for employer-provided education assistance and scholarships.⁷ Present law also includes tax benefits for saving for future education expenses, including qualified tuition programs⁸ and Coverdell education savings accounts.⁹ In addition, individuals may save for education expenses on a tax-favored basis through the use of other savings vehicles, such as Roth IRAs and deferred annuities, even though these vehicles are not designed specifically for education expenses. Tax benefits are provided for past expenses, i.e., payment of student loan interest¹⁰ and the forgiveness of certain student loan indebtedness.¹¹ These provisions, and other provisions relating to education, are discussed in more detail, below.

If an individual does not qualify for any of the specific tax benefits for higher education expenses, then the individual generally may not deduct such expenses. However, a deduction for education expenses generally is allowed under Code section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment.¹² Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous

⁵ Sec. 25A.

⁶ Sec. 222.

⁷ Secs. 127 and 117, respectively.

⁸ Sec. 529.

⁹ Sec. 530.

¹⁰ Sec. 221.

¹¹ Sec. 108(f).

¹² Treas. Reg. sec. 1.162-5.

deductions, exceed two percent of the taxpayer's adjusted gross income.¹³ A taxpayer's total itemized deductions, including miscellaneous deductions in excess of two percent of adjusted gross income, may be further limited by the overall limit on itemized deductions (the so-called "Pease provision").¹⁴

B. Tax Benefits for Current Expenses

1. Hope credit

Individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to \$1,500 per 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.¹⁵ The Hope credit rate is 100 percent on the first \$1,000 of qualified tuition and related expenses, and 50 percent on the next \$1,000 of qualified tuition and related expenses. The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$42,000 and \$52,000 (\$85,000 and \$105,000 for married taxpayers filing a joint return) for 2004. The adjusted gross income phase-out ranges are indexed for inflation. Also, each of the \$1,000 amounts of qualified tuition and related expenses to which the 100 percent credit rate and 50 percent credit rate apply are indexed to inflation, with the amount rounded down to the next lowest multiple of \$100. The first adjustment to these amounts as a result of inflation is expected in 2006. Thus, for example, an eligible student who incurs \$1,000 of qualified tuition and related expenses is eligible (subject to the adjusted gross income phaseout) for a \$1,000 Hope credit. If an eligible student incurs \$2,000 of qualified tuition and related expenses, then he or she is eligible for a \$1,500 Hope credit. In 2000, 6.8 million tax returns claimed education credits of \$4.9 billion.¹⁶

The 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.¹⁷

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 the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan

¹³ Sec. 67.

¹⁴ Sec. 68.

¹⁵ Sec. 25A.

¹⁶ This amount includes amounts for the Lifetime Learning credit, discussed below.

¹⁷ The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2004.

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 elect either the Hope credit, the Lifetime Learning credit (described below), or the section 222 deduction for qualified tuition and related expenses with respect to an eligible student.

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.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses 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 section 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 section 162 or any other section of the Code.

An eligible student for purposes of the Hope credit is an individual who is 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. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. In order to qualify as an eligible

educational institution, an institution must be eligible to participate in Department of Education student aid programs.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he or she claimed an exclusion from an education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from an education savings account.

2. Lifetime Learning credit

Individual taxpayers are allowed 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.¹⁸ 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).¹⁹ In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

In contrast to the Hope credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the Hope credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will 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 adjusted gross income between \$42,000 and \$52,000 (\$85,000 and \$105,000 for married taxpayers filing a joint return) in 2004. These phaseout ranges are the same as those for the Hope credit, and are similarly indexed for inflation.

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 the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit. As with the Hope credit, repayment of a loan is not a qualified tuition expense.

As with the Hope credit, 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 the 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

¹⁸ Sec. 25A.

¹⁹ The Lifetime Learning credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2004.

qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

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 credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a Hope 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 credit, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses.

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. Eligible higher education institutions are defined in the same manner for purposes of both the Hope and Lifetime Learning credits. 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 expenses unless this education is part of the student’s degree program.

In contrast to the Hope credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level (and professional degree) courses.²⁰

As with the Hope credit, 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 section 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). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

In addition to allowing a credit for the tuition and related expenses of a student who attends classes on at least a half-time basis as part of a degree or certificate program, the Lifetime Learning credit also is available with respect to any course of instruction at an eligible educational institution (whether enrolled in by the student on a full-time, half-time, or less than half-time basis) to acquire or improve job skills of the student. Undergraduate and graduate students are eligible for the Lifetime Learning credit. Moreover, in contrast to the Hope credit, the eligibility of a student for the Lifetime Learning credit does not depend on whether the

²⁰ As explained in B.1. above, the Hope credit is available only with respect to the first two years of a student’s undergraduate education.

student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Effective for taxable years beginning after December 31, 2010, the changes to the Lifetime Learning credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Lifetime Learning credit in the same year that he or she claimed an exclusion from an education savings account. Thus, after 2010, taxpayers cannot claim a Lifetime Learning credit in the same year he or she claims an exclusion from an education savings account.

3. Above-the-line deduction for certain higher education expenses

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.²¹ Qualified tuition and related expenses are defined in the same manner as for the Hope and Lifetime Learning credits, to include tuition and fees required for the enrollment or attendance of 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.²² 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.

For taxable years beginning in 2004 or 2005, the maximum deduction is \$4,000 for an individual whose adjusted gross income 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 adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, a married individual who does not file a joint return, or an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2005.

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,²³ and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain United States Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings

²¹ Sec. 222.

²² The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

²³ Sec. 222(d)(1) and sec. 25A(g)(2).

account.²⁴ Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if exclusion under section 529 is claimed with respect to expenses eligible for an exclusion under section 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 credit or Lifetime Learning credit is elected for such taxable year.

4. Exclusion for employer-provided educational assistance

If certain requirements are satisfied, up to \$5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax purposes and from wages for employment tax purposes.²⁵ This exclusion applies to both graduate and undergraduate courses.²⁶ In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than five-percent owners of the employer and the spouses or dependents of such more than five-percent owners.

For purposes of the exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include (1) tools or supplies that may be retained by the employee after completion of a course, (2) meals, lodging, or transportation, and (3) any education involving sports, games, or hobbies. The exclusion for employer-provided educational assistance applies only with respect to education provided to the employee, e.g., it does not apply to education provided to the spouse or a child of the employee.

²⁴ Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

²⁵ Secs. 127 and 3121(a)(18).

²⁶ The exclusion has not always applied to graduate course. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion for graduate-level courses was reinstated by EGTRRA.

In the absence of the exclusion under section 127, employer-provided educational assistance is excludable from gross income and wages only if the education expenses qualify as a working condition fringe benefit, i.e., the expenses would have been deductible by the employee (if paid by the employee) under section 162 (as discussed above).²⁷ In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

The exclusion for employer-provided educational assistance was originally enacted on a temporary basis and has been extended several times.²⁸ The exclusion was made permanent by EGTRRA, that is, the expiration of the provision itself was eliminated. However, the exclusion is subject to the general sunset provision of EGTRRA, so that the exclusion will not be available after December 31, 2010. Thus, at that time, educational assistance will be excludable from gross income only if it is related to the employee's current job, as determined under Treasury regulations described in A., above.

5. Qualified scholarships and tuition reduction

Present law provides an exclusion from gross income and wages for amounts received as a qualified scholarship or as qualified tuition reduction.²⁹ A qualified scholarship is excludable if provided to an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. This tax-free treatment does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, present law provides an exclusion from gross income and wages for qualified tuition reductions for certain education provided to employees of certain educational organizations (and their spouses and dependents).³⁰

The exclusions for qualified scholarships and qualified tuition reductions do not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction. Thus, payments for such services are includible in gross income and wages.

²⁷ Sec. 132(d).

²⁸ The exclusion was enacted as part of the Revenue Act of 1978 (through 1983). Since then, it has been extended nine times on a temporary basis.

²⁹ Secs. 117 and 3121(a)(20).

³⁰ Secs. 117(d) and 3121(a)(20).

C. Tax Benefits for Saving for Higher Education Expenses

1. Section 529 qualified tuition programs

Overview

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.³¹ A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a “prepaid tuition program”).³² In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a “savings account program”).³³ Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary’s higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance.³⁴ Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time.³⁵

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”) whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions,

³¹ For purposes of this description, the term “account” is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

³² Sec. 529(b)(1)(A).

³³ Sec. 529(b)(1)(A).

³⁴ Sec. 529(e)(3)(A).

³⁵ Sec. 529(e)(3)(B).

recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.³⁶

Section 529 does not provide for any quantitative limits on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account, other than to require that the account provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary.³⁷ Many qualified tuition programs impose limits on the maximum amount of contributions that may be made, or account balances that may accrue, for the benefit of a designated beneficiary.³⁸

Contributions to a qualified tuition account must be made in cash.³⁹ A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to directly or indirectly direct the investment of any contributions (or earnings thereon),⁴⁰ and must provide separate accounting for each designated beneficiary.⁴¹ A qualified tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan.⁴²

³⁶ Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term account owner, which is a commonly used term among qualified tuition programs.

³⁷ Sec. 529(b)(6).

³⁸ For example, a qualified tuition program might provide that contributions to all accounts established for the benefit of a particular designated beneficiary may not exceed a specified limit (e.g., \$250,000), or that the maximum account balance for all accounts established for the benefit of a particular designated beneficiary may not exceed a specified limit. In the case of prepaid tuition contracts, the limit might be expressed in terms of a maximum number of semesters.

³⁹ Sec. 529(b)(2).

⁴⁰ Sec. 529(b)(4).

⁴¹ Sec. 529(b)(3).

⁴² Sec. 529(b)(5).

Special rules apply to coordinate qualified tuition programs with other education benefits, including Coverdell education savings accounts, the HOPE credit, and the Lifetime Learning credit.⁴³

Income tax treatment

A qualified tuition program, including a savings account or a prepaid tuition contract established thereunder, generally is exempt from income tax, although it is subject to the tax on unrelated business income.⁴⁴ Contributions to a qualified tuition account (or with respect to a prepaid tuition contract) are not deductible to the contributor or includible in income of the designated beneficiary or account owner. Earnings accumulate tax-free until a distribution is made. If a distribution is made to pay qualified higher education expenses, no portion of the distribution is subject to income tax.⁴⁵ If a distribution is not used to pay qualified higher education expenses, the earnings portion of the distribution is subject to Federal income tax,⁴⁶ and a 10-percent additional tax (subject to exceptions for death, disability, or the receipt of a scholarship).⁴⁷ A change in the designated beneficiary of an account or prepaid contract is not treated as a distribution for income tax purposes if the new designated beneficiary is a member of the family of the old beneficiary.⁴⁸

Gift and generation-skipping transfer (“GST”) tax treatment

A contribution to a qualified tuition account (or with respect to a prepaid tuition contract) is treated as a completed gift of a present interest from the contributor to the designated beneficiary.⁴⁹ Such contributions qualify for the per-donee annual gift tax exclusion (\$11,000

⁴³ Sec. 529(c)(3)(B)(v) and (vi).

⁴⁴ Sec. 529(a). An interest in a qualified tuition account is not treated as debt for purposes of the debt-financed property rules. Sec. 529(e)(4).

⁴⁵ Sec. 529(c)(3)(B). Any benefit furnished to a designated beneficiary under a qualified tuition account is treated as a distribution to the beneficiary for these purposes. Sec. 529(c)(3)(B)(iv).

⁴⁶ Sec. 529(c)(3)(A) and (B)(ii).

⁴⁷ Sec. 529(c)(6).

⁴⁸ Sec. 529(c)(3)(C)(ii). For this purpose, “member of family” means, with respect to a designated beneficiary: (1) the spouse of such beneficiary; (2) an individual who bears a relationship to such beneficiary which is described in paragraphs (1) through (8) of section 152(a) (i.e., with respect to the beneficiary, a son, daughter, or a descendant of either; a stepson or stepdaughter; a sibling or stepsibling; a father, mother, or ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister; a brother or sister of a father or mother; and a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law), or the spouse of any such individual; and (3) the first cousin of such beneficiary. Sec. 529(e)(2).

⁴⁹ Sec. 529(c)(2)(A).

for 2004), and, to the extent of such exclusions, also are exempt from the generation-skipping transfer (GST) tax. A contributor may contribute up to five times the per-donee annual gift tax exclusion amount to a qualified tuition account and, for gift tax and GST tax purposes, treat the contribution as having been made ratably over the five-year period beginning with the calendar year in which the contribution is made.⁵⁰

A distribution from a qualified tuition account or prepaid tuition contract generally is not subject to gift tax or GST tax.⁵¹ Those taxes may apply, however, to a change of designated beneficiary if the new designated beneficiary is in a generation below that of the old beneficiary.⁵²

Estate tax treatment

Qualified tuition program account balances or prepaid tuition benefits generally are excluded from the gross estate of any individual.⁵³ Amounts distributed on account of the death of the designated beneficiary, however, are includible in the designated beneficiary's gross estate.⁵⁴ If the contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed that are allocable to the years within the five-year period remaining after the year of the contributor's death are includible in the contributor's gross estate.⁵⁵

EGTRRA sunsets

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to qualified tuition programs no longer apply. The EGTRRA changes scheduled to expire include: (1) the provision that made qualified withdrawals from section 529 accounts exempt from income tax; (2) repeal of the pre-EGTRRA requirement that there be more than a de minimis penalty imposed on amounts not used for educational purposes and the imposition of the 10-percent additional tax on distributions not used for educational purposes; (3) the provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under section 529 if they receive a ruling or determination to that effect from the IRS, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries; (4) certain provisions permitting rollovers from one account to another account; (5) certain rules regarding the treatment of room and board as qualifying expenses; (6) certain rules regarding coordination with Hope and Lifetime Learning credit provisions; (7) a provision that

⁵⁰ Sec. 529(c)(2)(B).

⁵¹ Sec. 529(c)(5)(A).

⁵² Sec. 529(c)(5)(B).

⁵³ Sec. 529(c)(4)(A).

⁵⁴ Sec. 529(c)(4)(B).

⁵⁵ Sec. 529(c)(4)(C).

treats first cousins as members of the family for purposes of the rollover and change in beneficiary rules; and (8) changes made for the education expenses of special needs beneficiaries.

2. Coverdell education savings accounts

Taxpayers may establish certain trusts or custodial accounts created exclusively for the purpose of paying qualified education expenses of a named beneficiary (“Coverdell education savings accounts”).⁵⁶ Annual contributions to Coverdell education savings accounts may not exceed \$2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified adjusted gross income between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the adjusted gross income of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to an education savings account generally are subject to tax when withdrawn.⁵⁷ However, distributions from an education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of an education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.⁵⁸

Tax-free (and free of additional 10-percent tax) transfers or rollovers of account balances from one education savings account benefitting one beneficiary to another education savings account benefitting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the old beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in an education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include “qualified higher education expenses” and “qualified elementary and secondary expenses.”

The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an

⁵⁶ Sec. 530.

⁵⁷ In addition, education savings accounts are subject to the unrelated business income tax (“UBIT”) imposed by section 511.

⁵⁸ This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.⁵⁹ Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the education savings account.⁶⁰

The term “qualified elementary and secondary school expenses,” means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment⁶¹ or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary’s family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

Qualified education expenses generally include only out-of-pocket expenses. Such qualified education expenses do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income. Thus, total qualified education expenses are reduced by scholarship or fellowship grants excludable from gross income under section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance, that are excludable from the employee’s gross income under section 127.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to education savings accounts no longer apply. The EGTRRA changes scheduled to expire include: (1) the increase in the contribution limit to \$2,000 from \$500; (2) the expansion of qualified expenses to include elementary and secondary school expenses; (3) the increase in the phaseout range for married taxpayers filing jointly to \$190,000-\$220,000 from \$150,000-\$160,000; (4) special age and qualified education expense rules for special needs beneficiaries; (5) certain rules regarding the treatment of room and board as qualifying expenses; (6) certain rules regarding coordination with Hope and Lifetime Learning credit provisions; (7) certain

⁵⁹ Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

⁶⁰ Sec. 530(b)(2)(B)

⁶¹ As defined in section 170(e)(6)(F)(i).

rules regarding coordination with qualified tuition programs; and (8) a provision that treats first cousins as members of the family for purposes of the rollover and change in beneficiary rules.

3. Exclusion of interest earned on education savings bonds

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.⁶² “Qualified higher education expenses” include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer’s spouse, or a dependent of the taxpayer at certain eligible higher educational institutions (defined in the manner as for the Hope and Lifetime Learning credits). The amount of qualified higher education expenses taken into account for purposes of the exclusion is reduced by the amount of such expenses taken into account in determining the Hope or Lifetime Learning credits claimed by any taxpayer, or taken into account in determining an exclusion from gross income for a distribution from a Coverdell education savings account or a qualified tuition program, with respect to a particular student for the taxable year. Additionally, educational expenses taken into account in determining the exclusion are not eligible for the deduction for qualified tuition and related expenses under section 222.

The exclusion is phased out for certain higher-income taxpayers, determined by the taxpayer's modified adjusted gross income during the year the bond is redeemed. For 2004, the exclusion is phased out for single taxpayers with modified adjusted gross income between \$59,850 and \$74,850 (\$89,750 and \$119,750 for married taxpayers filing a joint return). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, present law provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

4. Other tax-favored savings arrangements

In general

Present law contains a number of different vehicles that provide for tax-favored saving. Many of these arrangements are designed primarily to provide for retirement saving; however, they may be used to save for any purpose, including to provide for anticipated future education expenses. These arrangements include Roth IRAs, traditional IRAs, qualified retirement plans, and deferred annuities.

⁶² Sec. 135. If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bear to the aggregate redemption amount (sec. 135(b)).

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. Qualified distributions from a Roth IRA are not includible in gross income. A qualified distribution is a distribution that is made (1) after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) after attainment of age 59-1/2, on account of death or disability, or for first-time homebuyer expenses of up to \$10,000. Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to a 10-percent early withdrawal tax unless an exception applies. One of the exceptions is for qualified higher education expenses (as defined under the rules relating to qualified tuition programs) of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer and his or her spouse, at an eligible educational institution. The amount of education expenses is reduced by certain scholarships and similar payments. Thus, if an individual wanted to use amounts in a Roth IRA for education expenses, the amount withdrawn from the Roth IRA would be nontaxable (and not subject to the 10-percent early withdrawal tax) if the distribution is a qualified distribution; if the distribution is not a qualified distribution, then the amount withdrawn would be includible in gross income to the extent attributable to earnings, but the 10-percent early withdrawal tax would not apply.

The maximum annual contribution that may be made to a Roth IRA is the lesser of \$3,000 (for 2004) or the individual's compensation for the year.⁶³ The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to the maximum dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. Additional catch-up contributions of \$500 (for 2004) may be made by individuals age 50 and over.⁶⁴ The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with adjusted gross income between \$95,000 and \$110,000 and for married couples filing a joint return with adjusted gross income between \$150,000 and \$160,000. Taxpayers with modified adjusted gross income of \$100,000 or less generally may convert a traditional IRA to which deductible or nondeductible contributions have been made into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply.

⁶³ The contribution limit is scheduled to increase to \$4,000 in 2005 through 2007, and \$5,000 for 2008, and to be indexed thereafter. The contribution limit will revert to \$2,000 after 2010 under the EGTRRA sunset.

⁶⁴ The maximum permissible catch-up contribution increases to \$1,000 for 2006 and thereafter. The ability to make catch-up contributions will no longer be available after 2010 under the EGTRRA sunset.

Traditional IRAs

Under present law, an individual may make deductible contributions to a traditional IRA up to the lesser of \$3,000 (for 2004)⁶⁵ or the individual's compensation if the individual and the individual's spouse are not active participants in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to the maximum limit can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. Additional catch-up contributions of \$500 (for 2004) may be made by individuals age 50 and over.⁶⁶ The maximum contribution limit is reduced to the extent the individual makes Roth IRA contributions.

The adjusted gross income phase-out limits for a single individual who is an active participant in an employer-sponsored retirement plan are \$45,000 to \$55,000 for 2004 and \$50,000 to \$60,000 for 2005 and thereafter. The adjusted gross income phase-out limits for a married individual filing a joint return who is an active participant in an employer-sponsored plan are \$65,000 to \$75,000 for 2004, \$70,000 to \$80,000 for 2005; \$75,000 to \$85,000 for 2006; and \$80,000 to \$100,000 for 2007 and thereafter. If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction limit is phased out for taxpayers with adjusted gross income between \$150,000 and \$160,000. To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to an IRA.

Amounts held in a deductible IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59-1/2, death, or disability are subject to an additional 10-percent early withdrawal tax, unless an exception applies. The same exception to the early withdrawal tax that applies to Roth IRA distributions applies to distributions from traditional IRAs. Thus, if an individual uses amounts withdrawn from a traditional IRA for qualified education expenses, the amount withdrawn is includible in income (except to the extent attributable to a return of nondeductible contributions), but the 10-percent early withdrawal tax does not apply.

⁶⁵ The contribution limit is scheduled to increase to \$4,000 in 2005 through 2007, and \$5,000 for 2008, and to be indexed thereafter. The contribution limit will revert to \$2,000 after 2010 under the EGTRRA sunset.

⁶⁶ The maximum permissible catch-up contribution increases to \$1,000 for 2006 and thereafter. The ability to make catch-up contributions will no longer be available after 2010 under the EGTRRA sunset.

Qualified retirement plans

Employer contributions and employee pre-tax contributions to a qualified retirement plan are not includible in an employee's income until distributed, and are generally deductible for employers. Contributions to a qualified retirement plan are held in a tax-exempt trust. A distribution of benefits from a qualified retirement plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents a return of the employee's after-tax contributions (i.e., basis). Special rules apply in certain situations. Early distributions from qualified retirement plans generally are subject to an additional 10-percent early withdrawal tax. That is, includible amounts distributed prior to attainment of age 59-1/2 are subject to an additional 10-percent tax, unless the distribution is due to death or disability or another exception applies. There is no exception to the 10-percent early withdrawal tax applicable to qualified plans for education expenses.

Present law imposes a number of requirements on qualified retirement plans that must be satisfied in order for the plan to obtain tax-favored status. One of these requirements is that a qualified retirement plan must be maintained for the exclusive benefit of employees. In addition, minimum participation and coverage rules and nondiscrimination rules are designed to ensure that qualified retirement plans benefit an employer's rank-and-file employees as well as highly compensated employees. There are also limits on the maximum contributions and benefits under qualified plans.

Deferred annuities

In general, earnings and gains on a deferred annuity contract are not subject to tax during the deferral of the contract (that is, "inside buildup" is not subject to current taxation). Amounts received under a deferred annuity are includible in gross income, except to the extent the amount received is a return of the individual's investment in the contract.⁶⁷ Distributions from an annuity contract prior to age 59-1/2, death, or disability that are includible in gross income are also subject to an additional 10-percent early withdrawal tax, unless an exception applies. There is no exception for distributions for education expenses. Individuals could use deferred annuity contracts to save for future education expenses. Inside buildup on the contract would not be taxed; amounts withdrawn would be includible in gross income to the extent not attributable to the individual's investment in the contract and would be subject to the 10-percent additional tax unless the distribution is after age 59-1/2 or another exception applies.

⁶⁷ The rules for determining the amount of each payment that is attributable to the individual's investment in the contract is determined under section 72, and depends on whether or not the amount is received as an annuity.

D. Tax Benefits Relating to Past Expenses (Provisions Relating to Student Loans)

1. Deduction for student loan interest

Certain individuals 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.⁶⁸ 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. In 2000, 4.5 million tax returns claimed student loan interest deductions totaling 2.6 billion dollars.

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) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, 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 maximum allowable deduction per year is \$2,500. For 2004, the deduction is phased out ratably for single taxpayers with adjusted gross income between \$50,000 and \$65,000 and between \$105,000 and \$135,000 for married taxpayers filing a joint return. The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of \$5,000.

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to the student loan provisions no longer apply. The EGTRRA changes scheduled to expire include: (1) increases that were made in the adjusted gross income phaseout ranges for the deduction, and (2) rules allowing a deduction for voluntary payment of interest and rules that extended deductibility of interest beyond the first 60 months of required interest payments.

2. Exclusion of income from student loan forgiveness

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.⁶⁹

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for

⁶⁸ Sec. 221.

⁶⁹ Sec. 108(f).

tuition and required fees, but also to cover room and board expenses. The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation.

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan must be contingent upon the student working in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity.

II. TAX BENEFITS RELATING TO PROVIDERS OF HIGHER EDUCATION

A. Tax Exemption for Educational Institutions

Charitable and educational organizations described in section 501(c)(3) generally are exempt from Federal income tax. A charitable or educational organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.⁷⁰ The term “charitable” includes, for purposes of section 501(c)(3), the advancement of education or science.⁷¹ The term “educational,” as used in section 501(c)(3), relates to the instruction or training of individuals for the purpose of improving or developing their capabilities, or the instruction of the public on subjects useful to individuals and beneficial to the community.⁷²

The following types of organizations may qualify as educational within section 501(c)(3): (1) an organization, such as a primary or secondary school, a college, or a professional or trade school, that has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled student body in attendance at a place where the educational activities are regularly carried on; (2) an organization whose activities consist of conducting public discussion groups, forums, panels, lectures, or other similar programs; (3) an organization that presents a course of instruction by correspondence or through the use of television or radio; (4) a museum, zoo, planetarium, symphony orchestra, or other similar organization; and (5) a nonprofit children’s day care center.

In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;⁷³ (3) the organization may not be operated primarily to conduct an unrelated trade or business;⁷⁴ (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

A private school that otherwise satisfies the requirements of section 501(c)(3) as an educational institution will not qualify for exemption unless it has a racially nondiscriminatory policy as to students. For example, a private school must include a statement in its charter, bylaws, or other governing instrument, or in a resolution of its governing body, that it has a

⁷⁰ Treas. Reg. sec. 1.501(c)(3)-1(c)(1).

⁷¹ Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

⁷² Treas. Reg. sec. 1.501(c)(3)-1(d)(3).

⁷³ Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

⁷⁴ Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

racially nondiscriminatory policy as to students and that it does not discriminate against applicants and students on the basis of race, color, or national or ethnic origin.⁷⁵

Section 501(c)(3) organizations generally are not subject to Federal income tax on contributions received, on income from activities that are substantially related to the purpose of the organization's tax exemption, or on investment income. Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries. Section 501(c)(3) organizations are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.⁷⁶ In addition, colleges and universities that are agencies or instrumentalities of any government or any political subdivision of a government, or that are owned or operated by a government or political subdivision of a government, are subject to the tax on unrelated business income.⁷⁷

B. Charitable Deduction

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity, including to a qualified educational organization. Qualified educational organizations include most colleges and universities.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.⁷⁸ In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations.⁷⁹

⁷⁵ Rev. Proc. 75-50, 1975-2 C.B. 587 (establishing guidelines and recordkeeping requirements for determining whether private schools that are applying for recognition of exemption have racially nondiscriminatory policies as to students).

⁷⁶ Secs. 511 through 514. Tax-exempt corporations are taxed on their unrelated business taxable income at the regular corporate tax rates (sec. 511(a)). Charitable trusts and other tax-exempt trusts generally are subject to tax on their unrelated business taxable income under the rates generally applicable to taxable trusts (sec. 511(b)).

⁷⁷ Sec. 511(a)(2). For this purpose, government includes any foreign government (to the extent not contrary to a treaty), the United States and any of its possessions, any State, and the District of Columbia. The tax also applies in the case of a corporation wholly owned by one or more such colleges or universities.

⁷⁸ Secs. 170(b) and (e).

⁷⁹ An educational organization that normally maintains a regular faculty and curriculum, and normally has a regularly enrolled body of pupils or students in attendance at the place where

Within certain limitations, donors also are entitled to deduct their contributions to a section 501(c)(3) organization or to a Federal, State, or local governmental entity, including to qualified educational organizations such as colleges and universities, for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor, though such organizations are eligible for the exemption from Federal income tax with respect to such donations. Recipients of charitable assistance generally may exclude the assistance from income as a gift.⁸⁰

In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For example, amounts paid for tuition are not deductible as a charitable contribution. For contributions of \$250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.⁸¹

C. Tax Benefits for Certain Types of Bonds for Educational Facilities and Activities

1. Tax-exempt bonds

In general

Interest on debt incurred by States or local governments (“State or local government bonds”) is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds.⁸² Like other activities carried out and paid for by State and local governments, the construction, renovation, and operation of public schools (including State universities) is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called “private activity bonds.”⁸³ The term “private person” includes the Federal Government

its educational activities are regularly carried on, is not a private foundation. Sec. 509(a)(1) and sec. 170(b)(1)(A)(ii).

⁸⁰ Sec. 102(a).

⁸¹ Sec. 170(f)(8).

⁸² Sec. 103(a).

⁸³ Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax. State or local government bonds that are not private activity bonds are referred to as “governmental bonds.”

and all other individuals and entities other than States or local governments. Present law provides two tests for determining whether a State or local government bond is in substance a private activity bond, the private business test and the private loan test.⁸⁴

Private business test

Private business use and private payments result in State or local government bonds being private activity bonds if both parts of the two-part private business test are satisfied--

- (1) More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the “private business use test”); and
- (2) More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the “private payment test”).⁸⁵

Private loan test

The second standard for determining whether a State or local government bond is a private activity bond is whether an amount exceeding the lesser of (1) five percent of the bond proceeds or (2) \$5 million is used (directly or indirectly) to finance loans to private persons. Private loans include both business and other (e.g., personal) uses and payments by private persons; however, in the case of business uses and payments, all private loans also constitute private business uses and payments subject to the private business test. Present law provides that the substance of a transaction governs in determining whether the transaction gives rise to a private loan. In general, any transaction which transfers tax ownership of property to a private person is treated as a loan.

Activities eligible for financing with tax-exempt private activity bonds

Overview

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. For 2004, the annual volume limits are equal to \$80 per resident of the State, or \$233,795,000 if greater.

⁸⁴ Secs. 141(b) and (c)

⁸⁵ The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue. For example, a privately operated cafeteria in a government office building financed as part of the building’s construction could represent a related private business use. On the other hand, a separate, private manufacturing facility financed with proceeds of the same bond issue would constitute an unrelated private business use of bond proceeds.

Qualified 501(c)(3) bonds

Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code -- including elementary, secondary, and post-secondary schools -- may be financed with tax-exempt bonds (“qualified 501(c)(3) bonds”). Bonds to finance activities of these organizations are not subject to the annual aggregate State volume limits.

Qualified student loan bonds

States and local governments may issue tax-exempt private activity bonds to finance certain student loans. Eligible student loans include Federally guaranteed loans under the Higher Education Act of 1965 (“GSL loans”) and other loans financed as part of a program of general application approved by the State.⁸⁶ Non-GSL student loans may be financed with tax-exempt bonds only if no loan under the program exceeds the difference between the total cost of attendance and other forms of student assistance for which the borrower may be eligible.

Qualified public educational facilities

States or local governments may issue tax-exempt private activity bonds to finance certain types of exempt facilities, including qualified public educational facilities. Qualified educational facilities are elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than necessary, the Code includes arbitrage restrictions limiting the ability of States and local governments to profit from the investment of tax-exempt bond proceeds.⁸⁷ In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods” before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

⁸⁶ Sec. 144(b)(1).

⁸⁷ Sec. 648 of Pub. L. No. 98-369 exempts the Texas Permanent University Fund from the arbitrage rules for tax-exempt bonds.

Present law includes three exceptions to the arbitrage rebate rules applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance.⁸⁸ Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.⁸⁹ Third, governmental bonds issued by “small” governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than \$5 million of tax-exempt governmental bonds in a calendar year. The \$5 million limit is increased to \$15 million if at least \$10 million of the bonds are used to finance public schools.⁹⁰

2. Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, certain States and local governments are given the authority to issue “qualified zone academy bonds.” A total of \$400 million of qualified zone academy bonds was authorized to be issued in each of 1998 through 2003. The \$400 million aggregate bond authority was allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation for up to two years (three years for authority arising before 2000), thereby permitting the limited issuance of qualified zone academy bonds beyond 2003.

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate (set daily by the Treasury Department) multiplied by the face amount of the bond.⁹¹ A taxpayer holding a qualified zone

⁸⁸ In the case of certain governmental bonds (including bonds to finance public schools), the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

⁸⁹ Retainage amounts are limited to no more than five percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued. Issuers qualifying for this “construction bond” exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

⁹⁰ EGTRRA amended section 148(f)(4)(D)(vii) to increase the additional amount of governmental bonds that small governmental units may issue for public schools without being subject to the arbitrage rebate requirements from \$5 million to \$10 million. However, the amendment is subject to the general sunset provisions of EGTRRA and will not be available after December 31, 2010.

⁹¹ Sec. 1397E.

academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Present value is determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

Qualified zone academy bonds are defined as bonds issued by a State or local government, provided that: (1) at least 95 percent of the proceeds is used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in a designated empowerment zone or a designated enterprise community, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

PART THREE: DATA AND ANALYSIS

I. BACKGROUND DATA ON COLLEGE ENROLLMENT AND COSTS

Since 1991 more than 14 million students have enrolled annually in post-secondary education or training programs, with approximately 77 percent enrolled in public institutions and 23 percent in private institutions in 2001. The full-time equivalent enrollment has exceeded 10 million in every year since 1991. Of all those enrolled in 2001, 61 percent were enrolled in four-year institutions.

In the late 1970s, college costs lagged behind inflation, but they have generally risen faster than inflation since 1981. The only exception has been for the cost of two-year colleges which, since 1995, has moderated and risen less than the rate of inflation in several years.

Since 1976, college tuition and fees generally have risen by more than twice the economy's overall price level. For the 1976-77 academic year, the total cost⁹² of attending a four-year private college averaged \$3,977 (tuition and fees of \$2,534) and the total cost of attending a four-year public college averaged \$1,935 (tuition and fees of \$617). For the 1986-87 academic year, the comparable total cost figure had risen to \$10,039 (tuition and fees of \$6,658) for a four-year private college and to \$4,138 (tuition and fees of \$1,414) for a four-year public college. By the 2002-2003 academic year, the comparable total cost figure had risen to \$23,940 (tuition and fees of \$16,948) for a four-year private college and to \$9,828 (tuition and fees of \$4,059) for a four-year public college. For the 2002-2003 academic year, the average cost of tuition and fees at a two-year public college was \$1,479 and \$10,755 at a two-year private college.⁹³ Table 1 below details average tuition and fees by type of college in both current and constant (inflation adjusted) dollars since 1986.

Over the past decade, governmental funding of public higher education has declined as a share of total funding. Table 2 reports the revenues of public degree-granting institutions of higher education by source. As a percentage of all revenues, Federal funds have remained relatively constant, State and local funding has declined, tuition and fees have increased, and other funding has increased modestly.

⁹² "Total cost" includes tuition and fees, and on-campus room and board costs.

⁹³ Department of Education. National Center for Education Statistics, *Digest of Education Statistics 2003*.

Table 1.—Average Undergraduate Tuition and Fees, 1986-87 Through 2002-2003

Year	Current Dollars				Constant 2002 Dollars			
	Private four-year	Private two-year	Public four-year	Public two-year	Private four-year	Private two-year	Public four-year	Public two-year
1986-87	6,658	3,684	1,414	660	10,733	5,938	2,279	1,065
1987-88	7,116	4,161	1,537	706	11,041	6,456	2,385	1,095
1988-89	7,722	4,817	1,646	730	11,466	7,154	2,444	1,084
1989-90	8,396	5,196	1,780	756	11,861	7,340	2,514	1,068
1990-91	9,083	5,570	1,888	824	12,244	7,509	2,545	1,111
1991-92	9,759	5,754	2,117	936	12,699	7,487	2,755	1,218
1992-93	10,294	6,059	2,349	1,025	13,004	7,654	2,968	1,295
1993-94	10,952	6,370	2,537	1,125	13,463	7,830	3,118	1,382
1994-95	11,481	6,914	2,681	1,192	13,742	8,276	3,209	1,427
1995-96	12,243	7,094	2,848	1,239	14,242	8,253	3,313	1,442
1996-97	12,881	7,236	2,987	1,276	14,602	8,203	3,386	1,446
1997-98	13,344	7,464	3,110	1,314	14,841	8,302	3,459	1,461
1998-99	13,973	7,854	3,229	1,327	15,253	8,574	3,525	1,449
1999-00	14,588	8,235	3,349	1,338	15,492	8,745	3,557	1,421
2000-01	15,470	9,067	3,501	1,333	15,935	9,340	3,606	1,373
2001-02	16,211	10,076	3,735	1,380	16,338	10,155	3,764	1,391
2002-03	16,948	10,755	4,059	1,479	16,757	10,634	4,013	1,462

Notes: Current dollar figures are adjusted to constant dollars by reference to the average CPI of the calendar years spanned by the academic year for which the tuition is reported.

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2003*, forthcoming.

**Table 2.—Current Funds and Revenues of Public Postsecondary Degree-Granting Institutions
By Source, Selected Years, 1985-1986 Through 2000-2001**

[Amount in Millions]

Year	Tuition and Fees		State and Local Sources		Federal Sources		Other Sources		Total
	Dollar	Percent	Dollar	Percent	Dollar	Percent	Dollar	Percent	
1985-86	9,439	14.5	31,547	48.5	6,852	10.5	17,167	26.4	65,005
1995-96	23,257	18.8	49,322	39.9	13,672	11.1	37,250	30.2	123,501
2000-01	31,920	18.1	69,948	39.6	19,745	11.2	55,032	31.2	176,645

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2003*, forthcoming.

II. ECONOMIC ANALYSIS

A. The Economics of Subsidizing Education

Overview of the goals of subsidies

All levels of government make substantial direct expenditures to subsidize post-secondary education. In addition, private educational organizations channel gifts from private persons into subsidies for the education of other persons. By exempting such organizations from income tax and permitting the gifts to such organizations to be deductible, additional implicit subsidies under the Code are created for education. Other subsidies for education provided by the Code permit students to receive tax-free qualified scholarships, tax-free employer-provided educational assistance, tax-free cancellation of certain governmental student loans, and a deduction for student loan interest. Students and parents also are provided the benefits of the Hope and Lifetime Learning credits, the exclusion from income of earnings on education savings accounts and qualified tuition programs, and the exclusion from income of the interest on U.S. savings bonds used to pay for post-secondary education.⁹⁴ Analysts attempt to evaluate subsidies in terms of their efficiency, equity, and administrability. In this regard, subsidies to post-secondary education have been argued to improve both economic efficiency and to promote economic equity.

Efficiency as a goal of subsidies to education

Economists generally have a predilection for favoring the outcomes of the free market and have reasoned that taxes or subsidies in the market generally lead to inefficient outcomes. That is, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. An example of such a good is a vaccination. The individual who is vaccinated benefits by not contracting an infectious disease, but the rest of society benefits as well, because by not contracting the disease the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a "positive externality."⁹⁵ On his or her own, the individual would weigh only his or her own reduced probability of contracting the disease against the cost of the vaccination. The individual would not account for the additional benefit the vaccination produces for society. As a result, the individual might choose not to be vaccinated, even though from society's perspective, total reduction in the rate of

⁹⁴ Certain income limits restrict some benefits. Part Two, above, describes tax benefits under present law that subsidize education.

⁹⁵ For a more complete discussion of the notion of "positive externality," see Harvey S. Rosen, *Public Finance* (Homewood, Illinois: Irwin), 1988, 142-146. Rosen discusses the notion of positive externality as applied to education. Rosen notes (at 144-145), "That college increases productivity may be true, but as long as the earnings of college graduates reflect their higher productivity, there is no externality."

infection throughout the population would be more than worth the cost of the vaccination. In this sense, the private market might produce too few of the vaccinations. The private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of the good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

While much evidence suggests that job skill acquisition and education benefit the private individual in terms of higher market wages, many people have long believed that education also produces positive externalities. Commentators argue that society functions better with an educated populace and that markets function better with educated consumers. They observe that education promotes innovation and that, because ideas and innovations are easily copied in the market place, the market return (wage or profit) from ideas and innovations may not reflect the full value to society from the idea or innovation. Just as a single individual does not appreciate the full benefit of a vaccination, a single individual may not be able to reap the full benefit of an idea or innovation. Thus, it is argued, subsidies for education are needed to improve the efficiency of society.

On the other hand, recognizing that a subsidy might be justified does not identify the magnitude of the subsidy necessary to promote efficiency nor the best method for delivery of the subsidy. It is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. Given that the United States already provides substantial subsidies to post-secondary education, it is not possible to say whether new subsidies would increase or decrease economic efficiency without some empirical analysis of the social benefits that would arise from creating new subsidies.

Some observers note that, aside from potential spillover effects that education might create, the market for financing education may be inefficient. They observe that, while investors in housing or other tangible assets have property that can be pledged to secure financing to procure the asset, an individual cannot generally pledge his or her future earnings as security for a loan to obtain education or training designed to increase the individual's future earning potential. This inability to provide security for education loans constrains borrowing as an alternative to finance education for some taxpayers. Taxpayers who cannot borrow to finance education or training may forgo the education or training even though it would produce a high return for the investor. This inefficiency in the market for education finance may offer a justification for public subsidies. The inefficiency in the market for financing is likely most acute among lower-income taxpayers who generally do not have other assets that could be pledged as security for an education loan. This suggests that this potential source of market inefficiency also relates to the considerations of equity as a rationale for subsidies of education (discussed below).

Equity as a goal of subsidies to education

As noted above, there is evidence indicating that education and training are rewarded in the market place. Recognizing this market outcome, some argue that it is appropriate to subsidize education to ensure that educational opportunities are widely available, including to those less well off in society. Commentators argue that education can play an important role in reducing poverty and income inequality. They observe that even if there were no positive externalities

from education, promoting economic equity within a market economy provides a basis for subsidizing education.⁹⁶ If equity is the goal of expanded subsidies to education, the cost of the subsidies should be weighed in terms of the private benefits received by the target groups, rather than the social benefits that might be generated by any possible spillovers.

B. Treatment of Education Expenses Under an Income Tax

Educational expenditures

Students and their families incur direct educational expenses when they pay tuition and fees. Federal, State, and local governments and private persons make expenditures on behalf of students by funding State and local and private educational institutions. Such expenditures by governments or private persons are equivalent to the government or private person transferring funds to the student which the student subsequently pays over to the educational institution. Lastly, students incur implicit expenditures for education by choosing schooling over the alternative of taking a job and earning a wage. The time spent in school means forgone income. Alternatively viewed, it is as if the student worked, was paid, and used the wages to purchase education. Analysts have concluded that the largest cost of obtaining an education comes from forgone wages.⁹⁷

Post-secondary education helps individuals develop general analytic and reasoning skills (e.g., problem solving) and often job specific skills (e.g., nursing training) that enhance the student's ability to earn a future income. In this way, expenditures on education are like an investment in a capital good: an outlay is made in the present for a machine that will produce income over a number of years in the future. It is because of this similarity that economists often refer to expenditures on education as investment in "human capital." However, some part of expenditures on post-secondary education are not as obviously investments in human capital but are more like consumption. For example, the chemical engineering student who takes an elective course in the history of music probably would not find her future earning potential increased by that particular elective. It is difficult to determine what portion of post-secondary education represents consumption for any given student and what portion represents investment in human capital.

The distinction between education as investment and education as consumption is not important to the efficiency/externality rationale for providing a subsidy to education, as externalities can arise from either consumption or investment. However, the distinction between education as investment and education as consumption is important to the equity rationale for

⁹⁶ For a cautionary note on the importance of the subsidy given, see Dennis Zimmerman, "Expenditure-Tax Incidence Studies, Public Higher Education, and Equity," *National Tax Journal*, 26, March 1973." Zimmerman finds that the subsidy structure can just as easily promote a less equal distribution of lifetime income.

⁹⁷ See Michael J. Boskin, "Notes on the Tax Treatment of Human Capital," in Department of the Treasury, *Conference on Tax Research, 1975* (Washington, D.C.: Department of the Treasury), 1977, 185-195.

providing a subsidy to education, as the equity rationale generally is based upon education as an investment in future earning potential. The distinction between education as investment and education as consumption also is important for analysis of the income tax treatment of expenditures on education--that is, should education expenses be deductible to properly measure a taxpayer's net income?

Educational expenses under a theoretical income tax

Under a theoretical income tax, any expenditures undertaken in the present for returns that are expected in the future should be capitalized and recovered as the future returns are earned. Consumption expenditures are neither deductible nor amortizable under a theoretical income tax. Thus, certain expenditures on education should be capitalized by the taxpayer and recovered against future earnings. As discussed above, the relevant expenditures to be capitalized would only be those that represent investments in human capital,⁹⁸ not those related to consumption. Of course, making such decisions would be quite difficult in practice. For example, the would-be chemical engineer of the example above may not know whether her future employment will be in the chemical industry or perhaps as a chanteuse, making it difficult to know how to account for the costs of the chemical engineering courses and the music course. Many educational expenses are paid by a parent on behalf of a student. In such case, the theoretical income tax would permit amortization only by the student.

Educational expenses under the present-law income tax

As discussed above, there are three types of expenditures made by students on their education: (1) payment via implicit or explicit transfers received from governments or private persons; (2) forgone wages; and (3) direct payment of tuition and other educational expenses by the student.

By not including the transfers from governments or private persons in the income of the student, present law offers the equivalent of expensing of those expenditures undertaken on behalf of the student by governments and private persons.⁹⁹ This treatment (the equivalent of expensing) also is provided for direct transfers to students in the form of qualified scholarships or employer-provided educational assistance, which are excludable from income. Similarly, because forgone wages are never earned, the implicit expenditure incurred by students forgoing present earnings also receives expensing under the present-law income tax.

The present-law treatment of direct payment of tuition and other educational expenses by the student is subject to various tax treatments. With certain exceptions, the present-law income tax treats direct payments of tuition and other educational expenses as consumption, neither

⁹⁸ For a discussion of government policy towards human capital investment, see C. Eugene Steuerle, "How Should Government Allocate Subsidies for Human Capital?" *American Economic Review*, 86, May 1996, 353-357.

⁹⁹ Of course, the actual government expenditures themselves represent a wealth transfer to the student. It is only the income tax treatment of such expenditures (that is, not counting them as income to the student) that is the equivalent of expensing.

deductible nor amortizable. A direct exception is the deduction for qualified tuition and related expenses provided under section 222. Other exceptions include the direct payment of education expenses with earnings from education savings accounts and qualified tuition programs or interest earned on U.S. savings bonds by low- and middle-income taxpayers. Such payments are permitted an exclusion from income tax. By not counting such interest or earnings in income, such amounts (the earnings components, but not the principal) are afforded treatment equivalent to expensing. Another exception to this treatment is expenses that qualify for the Hope credit or the Lifetime Learning credit.¹⁰⁰ The Hope credit provides income tax treatment that is the equivalent of an investment tax credit for educational expenditures that qualify for the credit. For the first \$1,000 of qualified expenditures, a taxpayer receives a \$1,000 credit, which is the equivalent of a 100-percent investment tax credit. Such 100-percent investment tax credit is more generous tax treatment than is expensing. A 100-percent investment tax credit is, from the taxpayer's perspective, preferred to expensing because it permits a deduction from taxes owed, rather than a deduction from taxable income itself. Thus, a 100-percent credit allows a dollar-for-dollar credit against taxes owed, whereas the value of a deduction from taxable income depends on the taxpayer's marginal tax rate.¹⁰¹ For the next \$1,000 of expenditures, the taxpayer receives the equivalent of a 50-percent investment tax credit. The Lifetime Learning credit is the equivalent of a 20-percent investment tax credit on qualified expenditures.

The theoretical income tax would have all expenditures toward investment in human capital capitalized and recovered against the student's future earnings. By permitting the equivalent of expensing for the indirect expenditures related to a student's education (and direct expenditures made in the form of qualified scholarships, employer-provided education assistance, and the deduction for education expenses permitted under code section 222), the present-law income tax subsidizes investment in human capital relative to investment in physical capital.¹⁰² For direct expenditures by the student that qualify for the Hope credit, the treatment of the first \$2,000 of qualified educational expenses in the first two years of post-secondary

¹⁰⁰ Other tax benefits for direct expenditures on education expenses, such as the deductibility of certain interest expense or withdrawals from IRAs without imposition of the early withdrawal tax, provide only minor benefits in comparison to expensing or amortization treatment of the full amount of education expenses.

¹⁰¹ Specifically, the cost to the taxpayer of a dollar of expenditure on education that is permitted to be deducted is $(1-t)$ times the amount of the expenditure, where t is the taxpayer's marginal tax rate. For a taxpayer in the 28-percent tax bracket, a thousand dollar expenditure on education that is permitted to be deducted is only \$720 (the tax benefit of the deduction is thus \$280). If the taxpayer is allowed a credit for the thousand dollar expenditure, there is no cost to the taxpayer of the thousand dollar expenditure (that is, the tax benefit is the full \$1,000). In general, a taxpayer will prefer expensing treatment if his or her marginal tax rate exceeds the percentage value of the credit.

¹⁰² Expensing is more generous cost recovery than is capitalization and amortization. Under simplifying assumptions, the expensing of investment is economically equivalent to the nontaxation of the returns to that investment. Amortization attempts to measure, and tax annually, the return to the investment.

education provides greater subsidy than that provided for investment in physical capital.¹⁰³ Though certain educational expenses are thus afforded income tax treatment that is as favorable or more favorable than expensing, the present-law income tax generally permits no recovery of the direct tuition or other educational costs paid by the student that do not qualify for the Hope or Lifetime Learning credits or the section 222 deduction.¹⁰⁴ On balance, the variety and complexity of educational benefits afforded through the tax code, when coupled with expenditures that do not receive favorable tax treatment, make it difficult to determine the extent to which educational expenditures are subsidized by the tax code, relative to investments in physical capital.

¹⁰³ Additionally, the Lifetime Learning credit provides a subsidy whose value in relation to expensing will vary depending on the marginal tax rate of the taxpayer. A taxpayer in a marginal rate bracket in excess of the value of the credit (20 percent under present law) would prefer expensing of such expenditures, whereas a taxpayer with a marginal rate bracket less than the value of the credit would prefer the present credit to expensing.

¹⁰⁴ As noted previously, exceptions include the direct payment of education expenses with earnings from education savings accounts and qualified tuition programs or interest earned on U.S. savings bonds by low- and middle-income taxpayers. Again, it is only the earnings from such accounts, not the principal that is afforded the favorable tax treatment.

III. SIMPLIFICATION CONSIDERATIONS WITH RESPECT TO TAX BENEFITS FOR INDIVIDUALS RELATING TO HIGHER EDUCATION EXPENSES

As described above, there are numerous provisions in the Code that allow taxpayers to reduce the cost of post-secondary education.¹⁰⁵ The education incentives in the Code are structured in several different ways. Some are structured as savings incentives (e.g., Coverdell education savings accounts and qualified tuition programs), some are designed to reduce the cost of post-secondary education at the time educational expenses are incurred (e.g., the Hope and Lifetime Learning credits and the deductions for certain education expenses), some provide exclusions from income for amounts used to pay for educational expenses (e.g., interest on education savings bonds), and some reduce the cost of borrowing money to pay for educational expenses (e.g., the student loan interest deduction). Although the existence of a variety of tax incentives for education may mean that more taxpayers are able to take advantage of one or more education incentives, understanding the tax benefits provided by the different provisions, the various eligibility requirements, the interactions between different incentives and provisions within each incentive, and the recordkeeping and reporting requirements, may be time consuming and confusing for taxpayers who are interested in reducing their current education expenses or saving for future expenses. Specific sources of complexity include the absence of a uniform definition of qualifying education expenses, different income limitations for the different incentives, and provisions designed to prevent duplicative tax benefits with respect to the same expenses. The complexities of the varying definitions of qualifying expenses are illustrated in Table 3. Taxpayers also must address uncertainties associated with the fact that some of the tax provisions are not permanent, and that certain rules applicable to permanent tax incentives are set to expire in 2010 absent further Congressional action. This is in addition to complexity that may exist independent of tax rules, such as that arising from the differences in fee structures, investment performance, and plan features that have been the subject of a recent Congressional hearing regarding qualified tuition programs.¹⁰⁶

Complexity concerns in this area have prompted a number of simplification proposals in recent years. The staff of the Joint Committee on Taxation made several simplification proposals relating to education tax incentives in April 2001. These included: (1) establishing a uniform definition of qualified higher education expenses; (2) combining the Hope and Lifetime Learning credits; and (3) modifying the rules regarding the interaction of the various education tax incentives to provide a limitation that the same expenses could not qualify under more than one provision.¹⁰⁷ In that report, the staff stated that “taxpayers are confronted with a confusing

¹⁰⁵ See Part Two, Present Law, above.

¹⁰⁶ Hearing Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services, *Investing for the Future: 529 State Tuition Savings Plans*, June 2, 2004.

¹⁰⁷ Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, Volume II, 122-143 (JCS-3-01), April 2001. Some changes made by

array of choices with respect to Federal tax incentives for financing education,” but noted that structural reform in this area would have to consider, among other things, the advantages and disadvantages of exclusion or deferral from income, income limits, and transition issues.¹⁰⁸ The Administration’s fiscal year 2005 budget proposed expanding the Lifetime Learning credit to subsume the separate deductions for student loan interest and qualified higher education expenses, and simplifying the definitions of qualified higher education expenses and qualified higher education institution for various incentives.¹⁰⁹ The American Bar Association Section of Taxation, the Tax Division of the American Institute of Certified Public Accountants, and Tax Executives Institute have supported harmonization and simplification of education tax incentives, and identified as possible measures: (1) combining the Hope and Lifetime Learning credits; (2) simplifying the definition of student; (3) establishing a single amount eligible for the credit; (4) eliminating or standardizing the income ranges required for eligibility; (5) granting (in lieu of credits) exemption amounts to taxpayers who qualify for the credit under present law; (6) easing the requirements for the interest deduction and coordinating the phase-out amounts with other education incentives; and (7) replacing current tax benefits with a new universal education deduction or credit, i.e., developing one or two education-related deductions or credits to replace the current provisions.¹¹⁰

Legislative proposals have been introduced to address simplification issues, including S. 2050, a bill to repeal the EGTRRA sunsets with respect to education provisions of such Act,¹¹¹ and H.R. 4136, the Education Tax Credit Simplification Act of 2004, that would combine the Hope and Lifetime Learning credits and provide a uniform definition of qualifying higher education expenses.¹¹²

EGTRRA address the third category, interaction of the various provisions to limit the same expenses to only one type of benefit.

¹⁰⁸ *Id.* at 135.

¹⁰⁹ Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2005 Revenue Proposals*, February 2004.

¹¹⁰ American Bar Association, American Institute of Certified Public Accountants Tax Division and the Tax Executives Institute; American Bar Association Section of Taxation, Government Submissions, *available at* <http://www.abanet.org/tax/pubpolicy/2001/01simple/7.html> (noting that “[f]or many taxpayers, analysis and application of the intended incentives are too cumbersome to deal with compared with the benefits received,” and that “there are so many individual tests that must be satisfied for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or because they pay tuition or other qualifying expenses during the wrong tax year”), 6-7.

¹¹¹ S. 2050 was introduced on February 3, 2004, by Mr. Grassley.

¹¹² H.R. 4136 was introduced on April 2, 2004, by Mr. Houghton. The bill generally is effective for taxable years beginning after December 31, 2003.

Table 3.—Treatment of Expenses Under Education Tax Benefits

Provision	Tuition	Required Fees	Books, Supplies, Equipment	Room and Board	Special Needs Services
1. Hope Credit (sec. 25A)	Included, except that tuition is a qualified expense with respect to any course or other education involving sports, games, or hobbies, only if such course or other education is part of the individual's degree program.	Included, except that (1) required fees with respect to any course or other education involving sports, games, or hobbies is included only if such course or other education is part of the individual's degree program; and (2) nonacademic fees are not included.	Not included.	Not included.	Not included.
2. Lifetime Learning Credit (sec. 25A)	Same as Hope credit.	Same as Hope credit.	Not included.	Not included.	Not included.
3. Exclusion for distributions from qualified tuition programs (sec. 529)	Included.	Included.	Included, if required for enrollment or attendance.	Included in the case of students enrolled on at least a half-time basis. Amount of room and board expenses taken into account may not exceed the greater of: (1) the room and board amount included in the institution's cost of attendance for Federal student aid purposes, or (2) the actual invoiced amount for students residing in housing owned or operated by the institution.	Included for special needs beneficiaries. ¹

Provision	Tuition	Required Fees	Books, Supplies, Equipment	Room and Board	Special Needs Services
4. Exclusion for distributions from Coverdell education savings accounts (sec. 530)	Included.	Included.	Same as qualified tuition programs.	Same as qualified tuition programs.	Same as qualified tuition programs.
5. Savings bond interest exclusion (sec. 135)	Same as Hope credit.	Same as Hope credit, except that that nonacademic fees are not excluded from the definition of fees.	Not included.	Not included.	Not included.
6. Above-the-line deduction for interest on loans for qualified education expenses (sec. 221)	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Included to the extent included in costs of attendance for Federal student aid purposes.	Not included.
7. Temporary above-the-line deduction for higher education expenses (sec. 222)	Same as Hope credit.	Same as Hope credit.	Not included.	Not included.	Not included.
8. Exclusion for scholarships (sec. 117(a))	Included.	Included.	Included.	Not included.	Not included.
9. Exclusion for qualified tuition reduction (sec. 117(d))	Included.	Not included.	Not included.	Not included.	Not included.
10. Gift tax exclusion (sec. 2503(e))	Included.	Not included.	Not included.	Not included.	Not included.

¹ The term “special needs services” and “special needs beneficiary” are not defined in present law. Legislative history indicates that the Treasury Secretary is to define a “special needs beneficiary” to include an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education. Treasury has not yet issued regulations regarding this definition