

**BACKGROUND AND PRESENT LAW RELATED  
TO TAX BENEFITS FOR EDUCATION**

Scheduled for a Public Hearing  
Before the  
WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT  
on October 7, 2015

Prepared by the Staff  
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## INTRODUCTION AND SUMMARY

The House Ways and Means Oversight Subcommittee has scheduled a public hearing on October 7, 2015, titled “Tax Policy and the Rising Costs of Higher Education.” This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation (“Joint Committee staff”), includes a description of present law and analysis relating to tax benefits for education.

Present law includes a variety of provisions that provide tax benefits to individual taxpayers for education expenses. These provisions include tax benefits for current expenses, such as the American Opportunity, Hope, and Lifetime Learning credits, the above-the-line deduction for certain higher education expenses, and the exclusions for employer-provided education assistance and scholarships. A deduction for education expenses generally is allowed under 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.

Present law also includes tax benefits for saving for future education expenses, including qualified tuition programs and Coverdell education savings accounts. Tax benefits are provided for past expenses through the allowance of a deduction for the payment of certain student loan interest and an income exclusion for the value of certain cancelled student loan indebtedness. Tax benefits are also provided for educational institutions through a variety of provisions, including (1) a tax exemption for, and deduction for charitable contributions to, educational organizations, and (2) an exclusion of interest on State and local government private activity bonds for education.

Of all these provisions, the credits for tuition for post-secondary education (*i.e.*, the Hope, American Opportunity, and Lifetime Learning credits) and the deduction for charitable contributions to educational institutions are the two largest tax expenditures for education, with total estimated values of \$110.1 billion and \$33.9 billion, respectively, for fiscal years 2014 to 2018.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Background and Present Law Related to Tax Benefits for Education* (JCX-133-15), October 5, 2015. This document can also be found on the Joint Committee on Taxation website at [www.jct.gov](http://www.jct.gov).

# I. TAX BENEFITS FOR INDIVIDUALS WHO INCUR EDUCATION EXPENSES AND EDUCATIONAL ORGANIZATIONS

## A. Overview

Present and recently expired law includes a variety of provisions that provide tax benefits to individual taxpayers for education expenses. These provisions include tax benefits for current expenses, such as the American Opportunity, Hope, and Lifetime Learning credits,<sup>2</sup> the above-the-line deduction for certain higher education expenses,<sup>3</sup> and the exclusions for employer-provided education assistance and scholarships.<sup>4</sup> Present law also includes tax benefits for saving for future education expenses, including qualified tuition programs<sup>5</sup> and Coverdell education savings accounts.<sup>6</sup> In addition, individuals may use for education expenses funds accumulated on a tax-favored basis through other savings vehicles, such as IRAs and health savings accounts, even though these vehicles are not designed specifically for education expenses. However, additional taxes may apply in that case. Finally, tax benefits are provided for past expenses through the allowance of a deduction for the payment of certain student loan interest and an income exclusion for the value of certain cancelled student loan indebtedness.<sup>7</sup> 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 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.<sup>8</sup> 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 deductions, exceed two percent of the taxpayer's adjusted gross income ("AGI").<sup>9</sup> A taxpayer's

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<sup>2</sup> Sec. 25A. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended ("Code").

<sup>3</sup> Sec. 222. This provision was available for taxable years beginning before January 1, 2015. Sec. 222(e).

<sup>4</sup> Secs. 127 and 117, respectively.

<sup>5</sup> Sec. 529.

<sup>6</sup> Sec. 530.

<sup>7</sup> Secs. 221 and 108(f), respectively.

<sup>8</sup> Treas. Reg. sec. 1.162-5.

<sup>9</sup> Sec. 67.

total itemized deductions, including miscellaneous deductions in excess of two percent of AGI, may be further limited by the overall limit on itemized deductions that applies if AGI exceeds certain amounts.<sup>10</sup>

Present law also includes a variety of tax benefits for education organizations, including K-12 and post-secondary schools. Certain of these benefits are discussed in part I.E, below.

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<sup>10</sup> Sec. 68.

## B. Tax Benefits for Current Expenses

### 1. Hope credit and American Opportunity credit

#### Hope credit

For taxable years beginning after 2017, individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to \$1,950 (estimated 2015 level) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.<sup>11</sup> The Hope credit rate is 100 percent on the first \$1,300 of qualified tuition and related expenses, and 50 percent on the next \$1,300 of qualified tuition and related expenses (estimated for 2015). These dollar amounts are indexed for inflation, with the amount rounded down to the next lowest multiple of \$100. Thus, for example, a taxpayer who incurs \$1,300 of qualified tuition and related expenses for an eligible student is eligible (subject to the AGI phaseout described below) for a \$1,300 Hope credit. If a taxpayer incurs \$2,600 of qualified tuition and related expenses for an eligible student, then he or she is eligible for a \$1,950 Hope credit.

The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$55,000 and \$65,000 (\$110,000 and \$130,000 for married taxpayers filing a joint return), as estimated by the JCT staff for 2015. The beginning points of the AGI phaseout ranges are indexed for inflation, with the amount rounded down to the next lowest multiple of \$1,000. The size of the phaseout ranges for single and married taxpayers are always \$10,000 and \$20,000 respectively.

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.

The Hope credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Hope credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the Hope credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (*e.g.*, in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a Hope credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified

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<sup>11</sup> Sec. 25A. For taxable years 2009-2017, the American Opportunity credit applies (discussed *infra*). Both the Hope credit and the American Opportunity credit (in the case of taxable years from 2009-2017) may be claimed against a taxpayer's alternative minimum tax liability.

tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may claim only one of the Hope credit, the Lifetime Learning credit, or an above-the-line deduction for qualified tuition and related expenses with respect to an eligible student.

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 for the possession or distribution of a controlled substance. A student may only claim the credit if the student has received a payee statement as required by section 6050S.

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

#### American Opportunity credit

The American Opportunity credit refers to modifications to the Hope credit that apply for taxable years beginning before 2018. The maximum allowable modified credit is \$2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified

credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses, and 25 percent on the next \$2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

The modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope credit to two more years of post-secondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom section 1(g) applies for such taxable year (generally, any child who has at least one living parent, does not file a joint return, and is either under age 18 or under age 24 and a student providing less than one-half of his or her own support).

## **2. Lifetime Learning credit**

Individual taxpayers may be eligible to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents.<sup>12</sup> Up to \$10,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (*i.e.*, the maximum credit per taxpayer return is \$2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

In contrast to the Hope and American Opportunity tax credits, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the Hope and American Opportunity tax credits, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return does not vary based on the number of students in the taxpayer's family—that is, the Hope credit is computed on a per student basis while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$55,000 and \$65,000 (\$110,000 and \$130,000 for married taxpayers filing a joint return) in 2015. These phaseout ranges are the same as those for the Hope credit as it applies for tax years beginning after 2017, 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 an academic period beginning during the first three months of the next taxable year. As with the

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<sup>12</sup> Sec. 25A. The Lifetime Learning credit may be claimed against a taxpayer's AMT liability.

Hope and American Opportunity credits, qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit. Repayment of a loan is not a qualified tuition expense.

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

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

As with the Hope credit, the Lifetime Learning credit is available for qualified tuition and related expenses, which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. However, unlike the American Opportunity tax credit, the Lifetime Learning credit is not available for the expenses of course materials. 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 Lifetime Learning credit. Expenses involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program, or the education is undertaken to acquire or improve the job skills of the student.

Qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level courses.<sup>13</sup> Additionally, in contrast to the Hope and American Opportunity tax credits, the eligibility of a student for the Lifetime Learning credit does not depend on whether the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

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<sup>13</sup> As explained above, the Hope credit is available only with respect to the first two years of a student's undergraduate education. The American Opportunity tax credit is available only with respect to the first four years of a student's post-secondary education.

As with the Hope and American Opportunity tax credits, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under 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.

### **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.<sup>14</sup> Qualified tuition and related expenses are defined in the same manner as for the Hope and Lifetime Learning credits, and include tuition and fees required for the enrollment or attendance by the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.<sup>15</sup> The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is \$4,000 for an individual whose AGI for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose AGI does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose AGI exceeds the relevant AGI limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2013.

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,<sup>16</sup> and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.<sup>17</sup>

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<sup>14</sup> Sec. 222.

<sup>15</sup> The deduction generally is not available for expenses with respect to a course of 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.

<sup>16</sup> Sec. 222(d)(1).

<sup>17</sup> Sec. 222(c). These reductions are the same as those that apply to the Hope, American Opportunity, and Lifetime Learning credits.

Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for an exclusion under 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, American Opportunity, 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 the employee's gross income for income tax purposes and from wages for employment tax purposes.<sup>18</sup> This exclusion applies to both graduate and undergraduate courses. 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 (*i.e.*, it does not apply to education provided to the spouse or a child of the employee).

In the absence of the specific exclusion for employer-provided educational assistance 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—that is, the expenses would have been deductible by the employee (if paid by the employee) under section 162 (as discussed above).<sup>19</sup> In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

#### **5. Qualified scholarships and tuition reduction**

Present law provides an exclusion from gross income and wages for amounts received as a qualified scholarship by an individual who is a candidate for a degree at a qualifying

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<sup>18</sup> Secs. 127 and 3121(a)(18).

<sup>19</sup> Sec. 132(d).

educational organization.<sup>20</sup> In general, a qualified scholarship is any amount received by such an individual as a scholarship or fellowship grant if the amount is used for qualified tuition and related expenses. Qualified tuition and related expenses include tuition and fees required for enrollment or attendance, or for fees, books, supplies, and equipment required for courses of instruction, at the qualifying educational organization. This definition does not include regular living expenses, such as room and board. A qualifying educational organization is 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 its educational activities are regularly carried on.<sup>21</sup>

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 (and their spouses and dependents) of certain educational organizations.<sup>22</sup>

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. An exception to this rule applies in the case of the National Health Services Corps Scholarship Program (the “NHSC Scholarship Program”) and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”). An additional exception to this rule, only with respect to qualified tuition reductions, is the exclusion of such qualified tuition reductions from income in the case of a graduate student at an educational organization described in section 170(b)(1)(A)(ii) who is engaged in research or teaching activities for the organization.<sup>23</sup> Such a tuition reduction is excluded from income despite the general rule described above, *i.e.*, that payments for such services are includible in gross income and wages.

## **6. Dependency exemption for students ages 19-23**

Under present law, taxpayers are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. The amount of these personal exemptions is

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<sup>20</sup> Secs. 117(a) and 3121(a)(20).

<sup>21</sup> This definition is different from the educational institutions whose students are eligible for the Hope, American Opportunity and Lifetime Learning credits, and the expired deduction for qualified tuition expenses. Eligible institutions for purposes of those credits and deductions must be eligible to participate in a student aid program administered by the U.S. Department of Education, while educational institutions for purposes of qualified scholarships and tuition do not have such a requirement. IRS Publication 970, p. 12 (2014). Additionally, an educational institution for purposes of the exclusion of qualified scholarships and tuition reduction is not limited to post-secondary educational institutions.

<sup>22</sup> Secs. 117(d) and 3121(a)(20).

<sup>23</sup> Sec. 117(d)(5).

adjusted annually for inflation. For 2015, the exemption amount is \$4,000. The deduction for personal exemptions is phased out for taxpayers with incomes above certain thresholds.<sup>24</sup>

A taxpayer may claim an exemption deduction for each individual the taxpayer claims as a dependent who is a qualifying child. For an individual to meet the definition of a qualifying child, that person must meet five tests, bearing on (1) relationship; (2) age; (3) principal place of abode; (4) support; and (5) whether the individual being claimed as a dependent has filed a joint return.

As a general matter, the age test provides that an individual may be considered a qualifying child (and thus be eligible to be claimed for a dependency exemption deduction) only if such an individual is under the age of 19 at the end of the calendar year.<sup>25</sup> However, a special rule provides that an individual who is under the age of 24 at the end of the calendar year will qualify as a qualifying child (provided that the individual meets the other criteria) if that individual is a student during the calendar year.

A student is defined as an individual who during each of five calendar months during the calendar year is: (1) a full-time student at an educational organization described in section 170(b)(1)(A)(ii) (*i.e.*, an institution that normally maintains regular faculty and curriculum and has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on),<sup>26</sup> or (2) is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in section 170(b)(1)(A)(ii), or of a State or political subdivision of a State.<sup>27</sup>

## 7. Gift tax exclusion for educational expenses

Under present law, gift tax is imposed on transfers of property by gift, subject to several exceptions. One exception is the gift tax annual exclusion of section 2503(b). Under this exclusion, a donor can transfer up to \$14,000 of property to each of an unlimited number of donees without incurring gift tax on such transfers.<sup>28</sup>

In addition to the gift tax annual exclusion, the Code provides that certain tuition payments are not considered transfers of property by gift for gift tax purposes.<sup>29</sup> This exclusion

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<sup>24</sup> Sec. 151(d)(3).

<sup>25</sup> Sec. 152(c)(3)(A).

<sup>26</sup> This is the same definition as is used for purposes of the exclusion for qualified scholarships and tuition reduction (and different from the definition used for the Hope, American Opportunity, and Lifetime Learning credits, as well as the expired deduction for qualified tuition expenses). See fn. 21, *supra*.

<sup>27</sup> Sec. 152(f).

<sup>28</sup> The Code provides an amount of \$10,000, adjusted in \$1,000 increments for inflation occurring after 1997. The inflation-adjusted amount for 2015 is \$14,000.

<sup>29</sup> Sec. 2503(e).

covers amounts paid on behalf of an individual as tuition to an educational organization described in section 170(b)(1)(A)(ii) (*i.e.*, an institution that normally maintains regular faculty and curriculum and has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on) for the education or training of such individual. No unlimited exclusion is permitted for books, supplies, dormitory fees, board, or other similar expenses that do not constitute direct tuition costs.<sup>30</sup> The exclusion applies only to direct transfers to the educational institution, not to reimbursements to donees for amounts paid by them for otherwise qualifying services, or to trusts to provide for the education of designated beneficiaries.<sup>31</sup> This exclusion applies without regard to the relationship of the donor and donee.

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<sup>30</sup> Treas. Reg. sec. 25.2503-6(b)(2).

<sup>31</sup> Treas. Reg. sec. 25.2503-6(c), ex. 2.

## C. Tax Benefits for Saving for Education Expenses

### 1. Section 529 qualified tuition programs

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.<sup>32</sup> 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”). 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”). 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,<sup>33</sup> and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time.<sup>34</sup>

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary’s qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not tax deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (*i.e.*, income on accounts in the plan is not subject to current income tax).

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<sup>32</sup> 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.

<sup>33</sup> The definition of an eligible educational institution for purposes of qualified higher education expenses is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits and the expired deduction for qualified tuition expenses. See fn. 21, *supra*.

<sup>34</sup> For taxable years 2009 and 2010 only, qualified higher education expenses included the purchase of any computer technology or equipment, or internet access or related services, if such technology or services were to be used by the beneficiary or the beneficiary’s family during any of the years a beneficiary was enrolled at an eligible institution.

A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to direct (directly or indirectly) the investment of any contributions (or earnings thereon), and must provide separate accounting for each designated beneficiary. 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.

Distributions from a qualified tuition program are excludable from the distributee's gross income to the extent that the total distribution does not exceed the qualified higher education expenses incurred for the beneficiary. If a distribution from a qualified tuition program exceeds the qualified higher education expenses incurred for the beneficiary, the portion of the excess that is treated as earnings generally is subject to income tax and an additional 10-percent tax. Amounts in a qualified tuition program may be rolled over without income tax liability to another qualified tuition program for the same beneficiary or for a member of the family of that beneficiary.

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. Decisions with respect to the contract or account are 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")<sup>35</sup> 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, 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.

## **2. Coverdell education savings accounts**

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.<sup>36</sup> 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 AGI between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

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<sup>35</sup> 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.

<sup>36</sup> Sec. 530.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.<sup>37</sup> However, distributions from a Coverdell 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 a Coverdell 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.<sup>38</sup>

Tax-free (and free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting 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 prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell 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 elementary and secondary expenses and qualified higher education expenses. 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 equipment (as defined in section 170(e)(6)(F)(i)) 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.

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 eligible education institution,<sup>39</sup> regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.<sup>40</sup> Moreover, qualified higher

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<sup>37</sup> In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

<sup>38</sup> 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.

<sup>39</sup> The definition of an eligible educational institution for purposes of qualified higher education expenses is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits and the expired deduction for qualified tuition expenses. See fn. 21, *supra*.

<sup>40</sup> Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

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 Coverdell education savings account.<sup>41</sup>

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.

### **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.<sup>42</sup> 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.<sup>43</sup> 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, American Opportunity, or Lifetime Learning credits claimed by any taxpayer, or taken into account in determining an exclusion from gross income for a distribution from a qualified tuition program or a Coverdell education savings account, with respect to a particular student for the taxable year.<sup>44</sup>

The exclusion is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 2015, the exclusion is phased out for taxpayers with modified AGI between \$77,200 and \$92,200 (\$115,750 and \$145,750 for married taxpayers filing a joint return). To prevent taxpayers from effectively avoiding the income phaseout limitation through the purchase of bonds directly in the child's

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<sup>41</sup> Sec. 530(b)(2)(B).

<sup>42</sup> 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.

<sup>43</sup> The definition of eligible higher educational institution for purposes of qualified higher education expenses is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits and the expired deduction for qualified tuition expenses. See fn. 21, *supra*.

<sup>44</sup> Additionally, educational expenses taken into account in determining the interest exclusion were not eligible for the recently-expired deduction for qualified tuition and related expenses under section 222.

name, 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**

Present law also provides vehicles for tax-favored saving for purposes other than education, such as for retirement (for example, qualified retirement plans and individual retirement arrangements), health expenses (for example, health savings accounts), or expenses for those with disabilities (“ABLE” accounts). Despite these intended purposes, as a practical matter, the funds in such arrangements are sometimes used for education expenses, though additional taxes may apply in that case.<sup>45</sup> However, distributions from an individual retirement arrangement (“IRA”) for qualified higher education expenses may be taken without having to pay the additional tax.<sup>46</sup>

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<sup>45</sup> See, e.g., secs.72(t) and 223(f)(4).

<sup>46</sup> Sec. 72(t)(2)(E). For more information on retirement savings arrangements, see Joint Committee on Taxation, *Present Law and Background Relating to the Tax Treatment of Retirement Savings* (JCX-32-12), April 13, 2012.

## **D. Tax Benefits Relating to Past Expenses (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.<sup>47</sup> 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.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (1) eligible educational institutions,<sup>48</sup> or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

The maximum allowable deduction per year is \$2,500. For 2015, the deduction is phased out ratably for taxpayers with AGI between \$65,000 and \$80,000 (\$130,000 and \$160,000 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.

### **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.<sup>49</sup>

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

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<sup>47</sup> Sec. 221.

<sup>48</sup> This definition of an eligible educational institution is the same as that used for the Hope, American Opportunity, and Lifetime Learning credits, and the expired deduction for qualified tuition expenses. See fn. 21, *supra*.

<sup>49</sup> Sec. 108(f).

where its education activities are regularly carried on.<sup>50</sup> Loan proceeds may be used not only for 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.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program or certain State loan repayment programs.

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<sup>50</sup> This definition of eligible educational institution is the same definition as is used for purposes of the exclusion for qualified scholarships and tuition reduction (and different from the definition used for the Hope, American Opportunity, and Lifetime Learning credits, as well as the expired deduction for qualified tuition expenses). See fn. 21, *supra*.

## E. Tax Benefits For Educational Organizations

### 1. Tax exemption for educational organizations

Charitable and educational organizations described in Code section 501(c)(3) generally are exempt from Federal income tax on contributions received, income from activities that are substantially related to the purpose of the organization's tax exemption, and investment income.<sup>51</sup> A charitable or educational organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.<sup>52</sup> The term "charitable" includes, for purposes of section 501(c)(3), the advancement of education or science.<sup>53</sup> 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.<sup>54</sup>

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.<sup>55</sup> In addition, college athletic organizations that promote certain aspects of athletic competition have generally been held to be educational and, thus, exempt under section 501(c)(3). The exemption is based on the principle that an athletic program conducted for the physical development and betterment of the students is an integral part of a university's overall educational activities.

Notwithstanding its tax-exempt status, a section 501(c)(3) organization generally must pay tax on income derived from a regularly carried on trade or business that is unrelated to the organization's exempt purposes. This system of taxation for unrelated income of otherwise tax-exempt organizations is sometimes referred to as the unrelated business income tax, or "UBIT."<sup>56</sup> In general, the revenue that a college or university derives from admission to athletic

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<sup>51</sup> Private foundations, a subset of section 501(c)(3) organizations, are subject to an excise tax on investment income of two percent (reduced to one percent if certain requirements are met). Sec. 4940.

<sup>52</sup> Treas. Reg. sec. 1.501(c)(3)-1(c)(1).

<sup>53</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

<sup>54</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(3).

<sup>55</sup> *Ibid.*

<sup>56</sup> See secs. 511-515.

events is considered to be income from a business related to educational purposes and not subject to the tax on unrelated business income.<sup>57</sup>

## 2. Charitable contribution deduction

In computing taxable income, an individual taxpayer who itemizes deductions or a corporate taxpayer 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 most educational organizations.<sup>58</sup>

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.<sup>59</sup> For individual taxpayers, more generous charitable contribution deduction rules apply to gifts made to public charities, such as colleges and universities, than to gifts made to private foundations. Contributions to a public charity generally are deductible up to 50 percent of the donor's AGI (30 percent for capital gain property), whereas contributions to most private foundations generally are deductible up to 30 percent of the donor's AGI (20 percent for capital gain property).<sup>60</sup> For corporate taxpayers, the deductible amount of charitable contributions generally is limited to 10 percent of taxable income.<sup>61</sup> For all taxpayers, gifts of capital gain property to a public charity generally are deductible at the property's fair market value,<sup>62</sup> whereas gifts of capital gain property (other than publicly traded stock) to most private foundations are deductible at the taxpayer's basis (cost) in the property.<sup>63</sup>

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.

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<sup>57</sup> In the legislative history of the Revenue Act of 1950, Pub. L. No. 81-814, Congress stated that “[a]thletic activities of schools are substantially related to their educational functions.” Therefore, “a university would not be taxable on income derived from a basketball tournament sponsored by it, even where the teams were composed of students of other schools.” H.R. Rep. No. 2319, 81<sup>st</sup> Cong., 2d Sess., at 37 (1950); S. Rep. No. 2375, 81<sup>st</sup> Cong., 2d Sess. (1950).

<sup>58</sup> Within certain limitations, donors also are entitled to deduct such contributions.

<sup>59</sup> Secs. 170(b) and (e).

<sup>60</sup> Sec. 170(b)(1).

<sup>61</sup> Sec. 170(b)(2).

<sup>62</sup> Sec. 170(e)(1). However, contributions of tangible personal property not for an exempt purpose of the donee organization are deductible at the taxpayer's basis in the property. Sec. 170(e)(1)(B)(i). A special rule determines the aggregate deduction for contributions of certain intellectual property. Secs. 170(e)(1)(B)(iii) and 170(m).

<sup>63</sup> Sec. 170(e)(1)(B)(ii) and 170(e)(5).

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of the contribution. In the case of a charitable contribution of money (regardless of the amount), applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.<sup>64</sup> In addition, a charitable deduction generally is not allowed for a contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.<sup>65</sup> Additional substantiation rules apply to contributions for which deductions of more than \$500 and more than \$5,000 are claimed.

### **3. Tax-exempt financing for facilities and activities of educational organizations**

#### **In general**

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes.<sup>66</sup> Because the interest income is excluded from gross income, investors generally are willing to accept a lower rate on tax-exempt bonds than they might otherwise accept on a taxable investment. This, in turn, lowers the borrowing cost for the beneficiaries of such financing.

#### **Governmental bonds**

Bonds issued by State and local governments may be classified as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or which are repaid with governmental funds. Like other activities carried out and paid for by State and local governments, the construction, renovation, and operation of public schools (including State universities) are activities eligible for financing with the proceeds of tax-exempt, governmental bonds.

#### **Qualified private activity bonds**

Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For these purposes, the term “nongovernmental person” generally includes the Federal Government and all other individuals and entities, including section 501(c)(3) organizations, other than States or local governments. Present law provides two tests for determining whether a State or local bond is in substance a

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<sup>64</sup> Sec. 170(f)(17).

<sup>65</sup> Sec. 170(f)(8).

<sup>66</sup> Sec. 103(a).

private activity bond, the private business test and the private loan test.<sup>67</sup> The exclusion from income for interest on State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”) and other Code requirements are met.<sup>68</sup> In most cases, the aggregate volume of these tax-exempt private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. Certain types of private activity bonds are exempted from the annual volume limits. For 2015, the State volume limit is the greater of \$100 multiplied by the State population, or \$301,515,000.<sup>69</sup>

The types of qualified private activity bonds that benefit educational institutions include qualified 501(c)(3) bonds, student loan bonds, and bonds for qualified public educational facilities.

### **Qualified 501(c)(3) bonds**

One type of qualified private activity bond is a bond issued by a State or local government to finance the activities of an organization described in section 501(c)(3) (“qualified 501(c)(3) bonds”). All property financed by the net proceeds of qualified 501(c)(3) bonds must be owned by a section 501(c)(3) organization or a State or local governmental unit. In addition, at least 95 percent of the net proceeds of qualified 501(c)(3) bonds generally must be used to finance projects or activities that further the exempt nonprofit purposes of the section 501(c)(3) organization, as contrasted with unrelated trade or business activities under section 513(a). The beneficiaries of this type of financing frequently are private, nonprofit hospitals and private, nonprofit colleges and universities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) may be financed with qualified 501(c)(3) bonds. Qualified 501(c)(3) bonds are not subject to the State volume cap on qualified private activity bonds.

### **Student loan bonds**

Qualified student loan bonds are bonds issued to finance eligible student loans. Interest on qualified student loan bonds is tax-exempt. Eligible student loans include Federally guaranteed loans under the Higher Education Act of 1965, and other loans financed as part of a program of general application approved by the State.<sup>70</sup>

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<sup>67</sup> Secs. 141(b) and (c).

<sup>68</sup> Sec. 141(e). Qualified private activity bonds also include exempt facility bonds; qualified mortgage or veterans’ mortgage bonds; small issue bonds, redevelopment bonds, student loan bonds, and qualified 501(c)(3) bonds.

<sup>69</sup> Rev. Proc. 2014-61, 2014-47 I.R.B. 860 (October 30, 2014).

<sup>70</sup> See sec. 144(b)(1)(A) (for requirements relating student loans under a program of general application to which the Higher Education Act of 1965 applies) and sec. 144(b)(1)(B) (for requirements relating to student loans under a program of general application approved by the State). The Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, eliminated Federally-guaranteed student loans and terminated the program that allowed the private sector to make loans under the Higher Education Act of 1965. Specifically, the legislation

## **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 public elementary and secondary 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. These bonds are subject to a separate annual volume cap equal to the greater of \$10 multiplied by the State population, or \$5 million.

### **4. Tax credit bonds for educational institutions**

#### **In general**

Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. Unlike tax-exempt bonds, qualified tax-credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax-credit bond on a credit allowance date is entitled to a tax credit.<sup>71</sup> The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Qualified tax credit bonds for educational institutions include qualified zone academy bonds (“QZABs”),<sup>72</sup> and qualified school construction bonds.<sup>73</sup>

#### **Qualified zone academy bonds**

QZABs are defined as any bond issued by a State or local government, provided that (1) 100 percent of the available project proceeds are 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.

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prohibited the origination of new Federal Family Education Loan Program (“FFELP”) loans after June 30, 2010, and required that all new Federal student loans be originated under the William D. Ford Federal Direct Loan Program.

<sup>71</sup> The amount of the credit is determined by multiplying the bond’s credit rate by the face amount on the holder’s bond. The credit rate for an issue of qualified tax credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax-credit bonds without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

<sup>72</sup> Sec. 54E.

<sup>73</sup> Sec. 54F.

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 an empowerment zone or enterprise community designated under the Code, 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.

For each of the calendar years 1998 through 2008, \$400 million of QZABs was authorized to be issued. The authorization was increased to \$1.4 billion for each of calendar years 2009 and 2010. The authorizations for calendar years 2011 through 2014 are \$400 million for each year, and zero thereafter. Unused allocation for any calendar year may be carried over to the first two years following the unused limitation year.

The annual aggregate bond cap for QZABs is allocated to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit authority to qualified zone academies within such State.

### **Qualified school construction bonds**

Qualified school construction bonds must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bond is issued by a State or local government within the jurisdiction of which such school is located; and (3) the issuer designates such bonds as a qualified school construction bond.

There is a national limitation on qualified school construction bonds of \$11 billion for each of calendar years 2009 and 2010, and zero after 2010, except that if the amount allocated to any State exceeds the amount of bonds issued during such year pursuant to the allocation, the limitation amount for such State for the following calendar year is increased by the amount of such excess.<sup>74</sup> Thus, if an amount allocated is unused for a calendar year, it may be carried forward to the following and subsequent calendar years. Of the \$22 billion authorized, as of December 31, 2013, \$18.7 billion has been issued.<sup>75</sup>

The national limitation is tentatively allocated among the States in proportion to respective amounts each such State is eligible to receive under section 1124 of the Elementary and Secondary Education Act of 1965 for the most recent fiscal year ending before such calendar year.<sup>76</sup> Forty percent of the national limitation is allocated among large local educational

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<sup>74</sup> Sec. 54F(e).

<sup>75</sup> Internal Revenue Service, Statistics of Income, published and unpublished data.

<sup>76</sup> For allocation purposes, a State includes the District of Columbia and any possession of the United States. The provision provides a special allocation for possessions of the United States other than Puerto Rico under the national limitation for States. Under this special rule an allocation to a possession other than Puerto Rico is made on the basis of the respective populations of individuals below the poverty line (as defined by the Office of Management and Budget) rather than respective populations of children aged five through seventeen. This special

agencies in proportion to the respective amounts each agency received under section 1124 of the Elementary and Secondary Education Act of 1965 for the most recent fiscal year ending before such calendar year. The amount each State is allocated under the above formula is reduced by the amount received by any local large educational agency within the State.<sup>77</sup>

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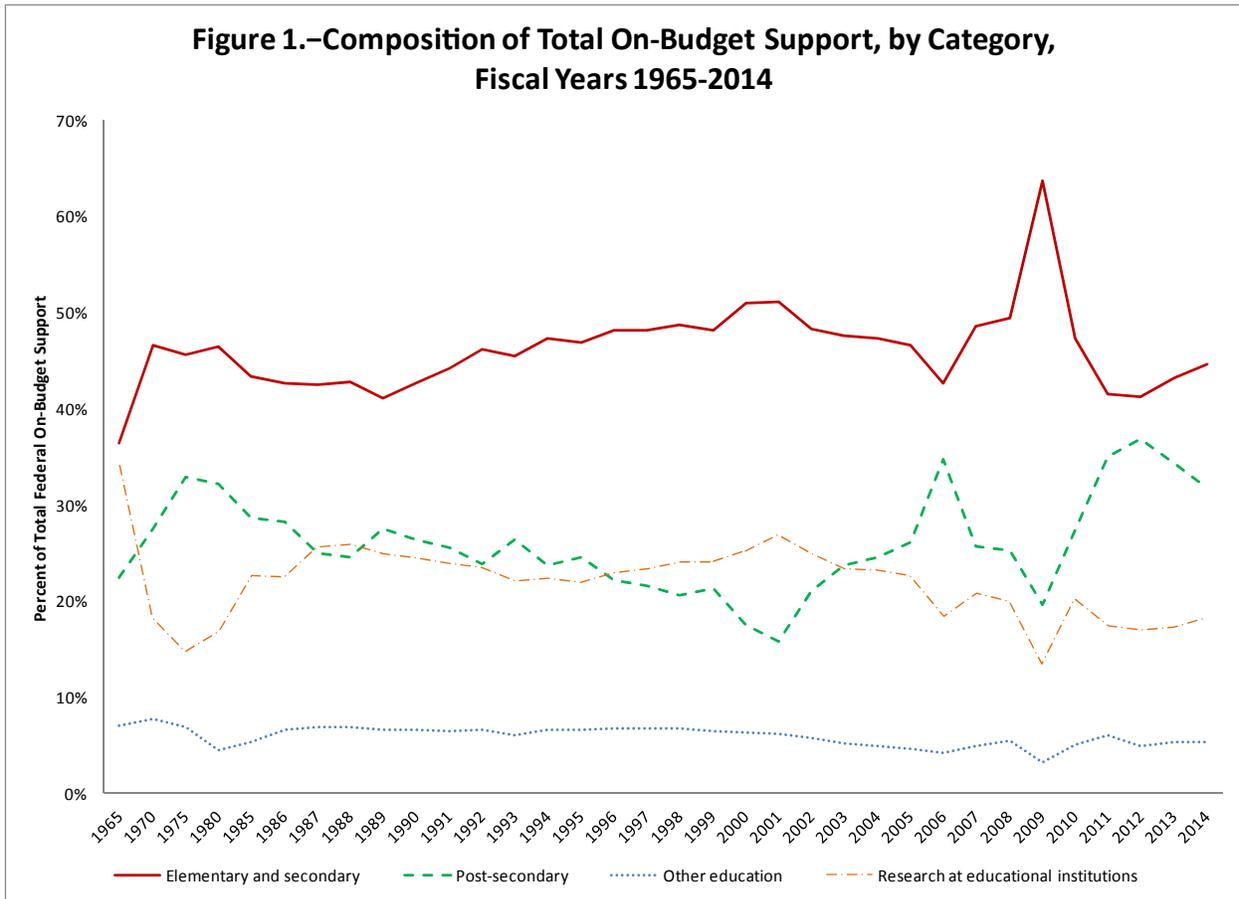
allocation reduces the State allocation share of the national limitation otherwise available for allocation among the States.

<sup>77</sup> With respect to a calendar year, the term large local educational agency means any local educational agency if such agency is: (1) among the 100 local educational agencies with the largest numbers of children aged five through 17 from families living below the poverty level, or (2) one of not more than 25 local educational agencies (other than in (1), immediately above) that the Secretary of Education determines are in particular need of assistance, based on a low level of resources for school construction, a high level of enrollment growth, or other such factors as the Secretary of Education deems appropriate. If any amount allocated to large local educational agency is unused for a calendar year the agency may reallocate such amount to the State in which the agency is located.

## II. BACKGROUND DATA RELATING TO EDUCATION FINANCE

### Sources of Revenue for Educational Institutions

The Federal government provides support to institutions for all levels of education: elementary, secondary, and post-secondary. The majority of Federal spending to institutions is directed to elementary and secondary education, but significant funds are also directed to post-secondary and research programs. In fiscal year 2014, 44.6 percent of total Federal on-budget support was directed to elementary and secondary institutions, while 31.8 percent and 18.3 percent of funds were directed to post-secondary institutions and research programs, respectively.



Source: Staff of Joint Committee on Taxation calculations based on U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics*, 2014.

In the United States, public education is financed by all three levels of government: Federal, State, and local. However, Table 1, below, shows that State and local governments provide the majority of funding for public elementary and secondary educational institutions. Only 10.2 percent of total revenues for public elementary and secondary schools stemmed from the Federal government in 2011-12.

**Table 1.—Revenues for Public Elementary-Secondary Education by Source, 2003-2012  
(thousands of dollars)**

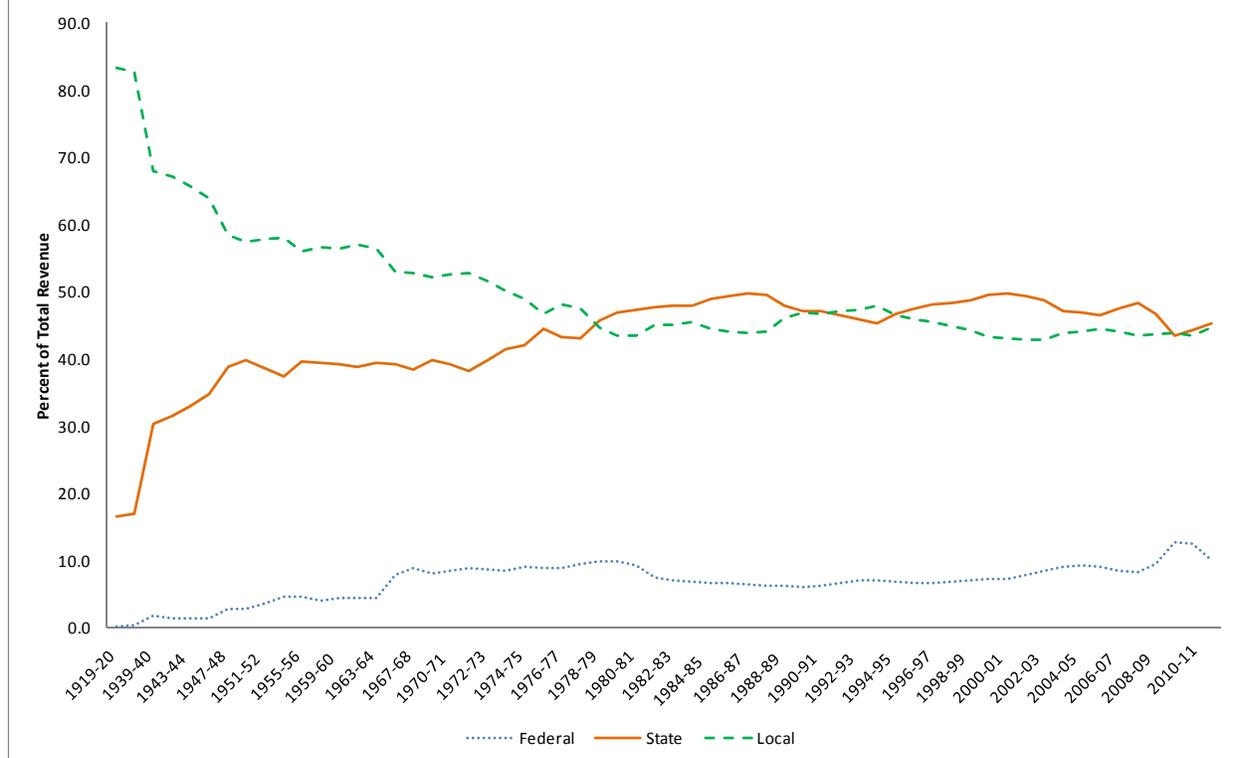
<b>School year</b>	<b>Total</b>	<b>Federal</b>	<b>State</b>	<b>Local</b>
2003-04	462,026,099	41,923,435	217,384,191	202,718,474
2004-05	487,753,525	44,809,532	228,553,579	214,390,414
2005-06	520,621,788	47,553,778	242,151,076	230,916,934
2006-07	555,710,762	47,150,608	263,608,741	244,951,413
2007-08	584,683,686	47,788,467	282,622,523	254,272,697
2008-09	592,422,033	56,670,261	276,525,603	259,226,169
2009-10	597,485,869	75,997,858	259,809,768	261,678,243
2010-2011	604,228,585	75,549,471	266,786,402	261,892,711
2011-2012	600,488,586	61,043,194	271,452,810	267,992,581

Source: U.S. Department of Education, National Center for Education Statistics, Common Core of Data (CCD), “National Public Education Financial Survey,”

Note: “Local” includes a relatively small amount from nongovernmental private sources (gifts and tuition and transportation fees from patrons). These sources accounted for two percent of total revenues in 2011-12.

Since 1919, there has been a dramatic decrease in the percent of total elementary and secondary school revenue from local sources, and a concurrent dramatic increase in revenue from State sources. In 1919-20, 83 percent of total school revenues were received from local sources, compared to 44.6 percent in 2011-12.

**Figure 2.—Revenues for Public Elementary-Secondary Education by Source, 1919-2012**



Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics*, 2014.

Table 2 on page 30 reports the revenue sources of all public post-secondary institutions for academic years 2005-2006 through 2012-2012. The composition of revenue sources for post-secondary institutions differs significantly from elementary and secondary institutions. For public post-secondary institutions, the majority of revenue stems from non-governmental sources. In 2012-13, State and local governments provided approximately 27.7 percent of post-secondary school revenues and the Federal government provided 16.0 percent. The remaining 56.3 percent derived from student tuition and fees, private donors, and other non-governmental sources.

Table 3 on page 31 reports the revenue sources of all private, non-profit post-secondary institutions for academic years 2005-2006 through 2012-2013. For private post-secondary institutions, student tuition and fees constitute a significant source of funds. State and local funding of private institutions is insignificant compared to State and local funding to public institutions. Private gifts, grants, contracts, other auxiliary activities, and investment returns, form a larger share of revenues for private institutions than for public institutions.

**Table 2.—Revenue Sources of All Public Post-Secondary Institutions, 2005-06 to 2012-13**

Year	Total	Tuition and Fees <sup>1</sup>		Federal Sources <sup>2</sup>		State and Local Sources <sup>3</sup>		Other Sources <sup>4</sup>	
		Dollars	Percent of Total	Dollars	Percent of Total	Dollars	Percent of Total	Dollars	Percent of Total
2005-06	\$246,164,836	\$41,770,600	17.0%	\$35,004,008	14.2%	\$83,063,486	33.7%	\$86,326,741	35.1%
2006-07	\$268,556,045	\$44,773,470	16.7%	\$35,549,339	13.2%	\$89,234,284	33.2%	\$98,998,953	36.9%
2007-08	\$273,109,306	\$48,070,012	17.6%	\$37,395,005	13.7%	\$96,312,265	35.3%	\$91,332,025	33.4%
2008-09	\$267,385,180	\$51,840,367	19.4%	\$40,863,660	15.3%	\$95,263,047	35.6%	\$79,418,106	29.7%
2009-10	\$303,329,538	\$55,930,482	18.4%	\$51,289,997	16.9%	\$92,289,556	30.4%	\$103,819,503	34.2%
2010-11	\$323,817,821	\$60,240,671	18.6%	\$56,121,873	17.3%	\$93,754,767	29.0%	\$113,700,510	35.1%
2011-12	\$317,306,882	\$65,386,643	20.6%	\$54,212,242	17.1%	\$89,770,645	28.3%	\$107,937,352	34.0%
2012-13	\$327,932,633	\$68,095,088	20.8%	\$52,571,420	16.0%	\$90,937,653	27.7%	\$116,328,474	35.5%

Source: Staff of Joint Committee on Taxation calculations using U.S. Department of Education, National Center for Education Statistics, Integrated Postsecondary Education Data System (“IPEDS”), Spring 2007 through Spring 2014, Finance component.

Notes:

<sup>1</sup> After deducting discounts and allowances.

<sup>2</sup> Includes Federal appropriations, grants, and contracts.

<sup>3</sup> Includes State and local appropriations, grants, and contracts and some operating revenues from private contracts and grants.

<sup>4</sup> Includes investment returns (gain or loss), educational activities, auxiliary enterprises, hospitals, and other activities.

This table provides information on degree-granting institutions only.

**Table 3.—Revenue Sources of All Private Non-Profit Post-Secondary Institutions, 2005-06 to 2012-13**

Year	Total	Tuition and Fees <sup>1</sup>		Federal Sources <sup>2</sup>		State and Local Sources <sup>3</sup>		Private Gifts, Grants, and Contracts <sup>4</sup>		Other <sup>5</sup>	
		Dollars	Percent of Total	Dollars	Percent of Total	Dollars	Percent of Total	Dollars	Percent of Total	Dollars	Percent of Total
2005-06	\$152,744,665	\$44,263,227	28.98%	\$19,683,291	12.89%	\$2,075,850	1.36%	\$18,346,525	12.01%	\$62,498,349	40.92%
2006-07	\$182,381,275	\$47,481,431	26.03%	\$20,193,637	11.07%	\$2,165,371	1.19%	\$20,193,231	11.07%	\$84,951,827	46.57%
2007-08	\$139,250,857	\$50,736,003	36.43%	\$20,204,523	14.51%	\$2,385,888	1.71%	\$20,991,936	15.07%	\$37,525,160	26.95%
2008-09	\$69,064,329	\$53,707,913	77.77%	\$21,023,733	30.44%	\$2,391,285	3.46%	\$17,671,730	25.59%	-\$31,051,704	-44.96%
2009-10	\$168,689,242	\$56,355,862	33.41%	\$22,913,792	13.58%	\$2,193,084	1.30%	\$18,017,260	10.68%	\$63,869,196	37.86%
2010-11	\$207,236,345	\$60,047,027	28.98%	\$24,334,677	11.74%	\$2,165,997	1.05%	\$22,100,617	10.66%	\$90,882,610	43.85%
2011-12	\$161,868,611	\$63,021,108	38.93%	\$24,147,119	14.92%	\$1,964,938	1.21%	\$21,617,966	13.36%	\$43,794,526	27.06%
2012-13	\$202,084,062	\$65,595,255	32.46%	\$23,714,629	11.74%	\$1,938,964	0.96%	\$22,336,587	11.05%	\$79,042,039	39.11%

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics, 2014*.

Notes:

<sup>1</sup> After deducting discounts and allowances.

<sup>2</sup> Includes Federal appropriations, grants, and contracts.

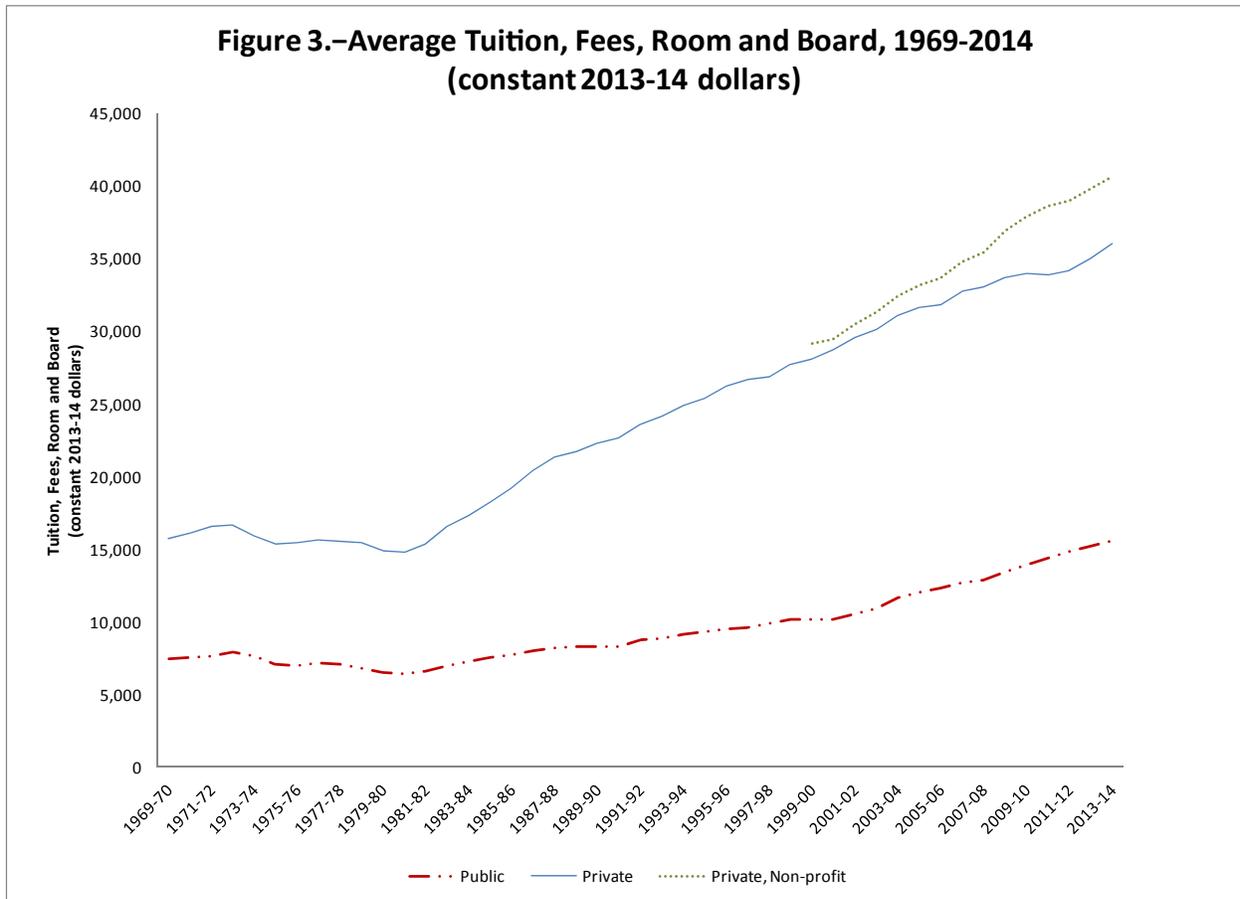
<sup>3</sup> Includes State and local appropriations, grants, and contracts, and some operating revenues from private contracts and grants.

<sup>4</sup> Includes contributions from affiliated entities.

<sup>5</sup> Includes investment returns (gain or loss), educational activities, auxiliary enterprises, hospitals, and other activities. This table provides information on degree-granting institutions only.

## College Costs

Since at least 1969, the cost of a post-secondary education has more than doubled in real terms for both public and private institutions. For the 1969-70 school year, average tuition, fees, room and board at a public institution cost \$7,443 in constant 2013-14 dollars. In 2013-14, average cost at a public institution was \$15,640 in constant 2013-14 dollars. Similarly, average per-student cost at a private institution rose from \$15,701 to \$35,987 (in constant 2013-14 dollars) over this same period.



Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics, 2014*.

Recent years have seen changes in the composition of Federal aid packages to individual students. Federal financial aid packages include relatively more loans and relatively fewer grants today than 20 years ago. Table 4 shows that between 1992 and 2012, the percentage of full-time, full-year undergraduates receiving some Federal financial aid increased from 45.6 percent to 72.8 percent. A relatively large proportion of this increase was in the number of students receiving Federal education loans. Between 1992 and 2012, the percentage of full-time, full-year undergraduates receiving Federal loans increased from 31.3 percent to 55.5 percent.

**Table 4.—Percentage of Full-Time, Full-Year Undergraduates Receiving Federal Financial Aid**

	1992-93	1995-96	2003-04	2007-08	2011-2012
1. Federal Grants	29.4	30.3	33.4	34.0	47.4
2. Federal Loans <sup>1</sup>	31.3	44.3	46.7	50.6	55.5
3. Work Study	6.8	8.5	10.7	10.6	11.9
<i>Percentage of Students with Some Federal Aid</i>	45.6	57.7	60.7	64.3	72.8

Source: U.S. Department of Education, National Postsecondary Student Aid Study

<sup>1</sup> Includes Parent Loans for Undergraduate Students (PLUS loans).

<sup>2</sup> Details on Federal work study participants are not available.

### **Individual Income Tax Benefits Related to Education**

Federal tax expenditures on higher education have grown significantly over the past decade.<sup>78</sup> Table 5, below, shows data for 2013 on the number of returns claiming the Hope and Lifetime Learning credits, the qualified tuition deduction, and the student loan interest deduction. For 2013, over 10 million returns claimed “tentative” education credits equaling approximately \$23.3 billion. These “tentative” amounts reflect the amount of credits claimed on tax returns prior to the application of the income phaseouts and limitations due to nonrefundability.<sup>79</sup>

The qualified tuition deduction was claimed on 1.9 million returns, and the student loan interest deduction on 11.5 million returns. The amount claimed in qualified tuition deductions in 2013 was \$4.3 billion, while \$11.6 billion in deductions was claimed for student loan interest.

<sup>78</sup> See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018* (JCX-97-14), August 5, 2014, and earlier years’ versions of this report.

<sup>79</sup> These data do not reflect the full effect of the phaseouts or refundability, as taxpayers who are fully phased out of the credit, or who can claim no credit due to tax liability limitations, will generally not file Form 8863 (Education Credits) from which this data is derived.

**Table 5.—Selected Individual Income Tax Return  
Data Related to Education, 2013**

	<b>Number of Returns (thousands)</b>	<b>Amount of Credit or Deduction (millions of dollars)</b>
Tentative Hope credit	10,475	23,676
Tentative Hope credit after income limitations	10,470	23,269
Refundable portion of Hope credit	10,399	9,253
Tentative Lifetime Learning credit	2,684	2,452
Total nonrefundable Hope and Lifetime Learning credits after income limitations	10,197	10,646
Refundable portion of Hope credit used to offset tax liability	5,000	4,020
Refunded portion of Hope credit	5,854	4,983
Qualified tuition deduction	1,893	4,341
Student Loan interest deduction	11,460	11,618

Source: Staff of the Joint Committee on Taxation.

The tax-preferred savings accounts for education have grown substantially in recent years, particularly with respect to the qualified tuition programs. While annual contribution data is not available for those accounts, Table 6 shows that, by 2014, 12.1 million qualified tuition program accounts held \$247.9 billion in assets.

**Table 6.—Qualified Tuition Program Accounts  
(Section 529 Plans)**

<b>Tax Year</b>	<b>Number of Accounts (thousands)</b>	<b>Account Value (millions of dollars)</b>
2002	4,380	26,849
2003	6,016	45,771
2004	7,208	64,668
2005	8,189	82,485
2006	9,270	105,693
2007	10,551	129,939
2008	11,175	104,938
2009	10,071	133,405
2010	10,162	157,428
2011	10,741	164,863
2012	11,105	190,717
2013	12,545	227,383
2014	12,106	247,895

Source: Staff of the Joint Committee on Taxation.

Comparable cumulative account data is not available for the Coverdell education savings accounts. However, Table 7, below, shows annual contributions for Coverdell education savings accounts. In 2013, 467,000 taxpayers contributed over \$433 million to these accounts. While direct comparisons of the qualified tuition programs and the Coverdell education savings accounts cannot be made from this data, the relatively small annual contributions to the Coverdell education savings accounts suggests that their cumulative account values would be much lower than those of the qualified tuition programs. This situation is likely a reflection of the \$2,000 annual contribution limitation imposed on Coverdell education savings accounts, while no similar limitation is imposed on qualified tuition programs.

**Table 7.—Annual Coverdell Education Savings  
Account Contributions**

<b>Tax Year</b>	<b>Number of Returns (thousands)</b>	<b>Annual Contributions (millions of dollars)</b>
2005	985	1,007
2006	931	932
2007	882	836
2008	798	749
2009	644	718
2010	592	527
2011	510	471
2012	426	471
2013	467	433

Source: Staff of the Joint Committee on Taxation.

### III. ECONOMIC ANALYSIS

#### A. The Economics of Subsidizing Education

##### Overview of the goals of subsidies

Educational institutions and the students that attend them receive public financial support through a variety of Federal, State, and local governmental policies because education is viewed as serving not only a private, but also a public purpose. The private benefits of investments in education include the higher wages and better health that accrue to the individual with higher educational attainment.<sup>80</sup> However, research shows that education likely confers a host of benefits for the larger community as well, including lower crime;<sup>81</sup> a more informed, civic-minded electorate;<sup>82</sup> increased social mobility;<sup>83</sup> better community health<sup>84</sup>; and more economic growth through increased labor productivity.<sup>85</sup> Because an individual chooses to invest in education based on the private benefits he expects to accrue, in the absence of government intervention he may choose a level of investment that is lower than socially optimal. In addition, investments in education differ from other types of investments in that they are neither collateralizable (students are often unable to offer potential lenders collateral for a loan) nor diversifiable (a given student can only invest in his own education). As a result, levels of investment are further expected to be lower than optimal.<sup>86</sup> Governmental subsidies for education may correct this underinvestment in the private market by increasing investment to levels that are consistent with the existence of both private and public benefits of education.

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<sup>80</sup> David Card, "The Causal Effect of Education on Earnings," in *Handbook of Labor Economics*, vol. 3, 1999, pp. 1801-1863; Cutler and Lleras Muney, "Education and Health: Evaluating Theories and Evidence," in Robert F. Schoeni *Making American Healthier: Social and Economic Policy as Health Policy*; Chinhui Juhn, Kevin M. Murphy, and Brooks Pierce, "Wage Inequality and the Rise in Returns to Skill," *Journal of Political Economy*, vol. 101, no. 3, 1993, pp. 410-442.

<sup>81</sup> Lance Lochner and Enrico Moretti. "The Effect of Education on Crime: Evidence from Prison Inmates, Arrests, and Self-Reports," *The American Economic Review*, vol. 94, no.1, 2004, pp. 155-189.

<sup>82</sup> Kevin Milligan, Enrico Moretti, and Philip Oreopoulos. "Does Education Improve Citizenship," *Journal of Public Economics*, vol. 88, no. 9-10, 2004, pp. 1667-1695; Thomas Dee, "Are There Civic Returns to Education?" *Journal of Public Economics*, vol. 88, no. 9, 2004, pp. 1697-1720.

<sup>83</sup> Daniel Aronson and Bhash Mazumder. "Intergenerational Economic Mobility in the U.S.: 1940 to 2000," *Journal of Human Resources*, vol. 43, no. 1, 2008, pp. 139-172.

<sup>84</sup> Michael Grossman, "Education and Non-Market Outcomes," in Eric A. Hanuskek and Finis Welch (eds.), *Handbook of Health Economics*, vol. 1A, 2006, pp. 577-633.

<sup>85</sup> Enrico Moretti, "Workers' Education, Spillovers and Productivity: Evidence from Plant-Level Production Functions," *American Economic Review*, vol. 94, no. 3, 2004, pp. 656-690.

<sup>86</sup> Caroline M. Hoxby, "Tax Incentives for Higher Education," *Tax Policy and the Economy*, vol. 12, 1998, pp. 49-82.

## **The role of the Federal government in education finance**

The Federal government supports elementary, secondary, and post-secondary educational institutions through a variety of tax and expenditure programs. On the expenditure side, State and local governments provide the vast majority of total revenues for elementary and secondary education (89.8 percent of total revenues in fiscal year 2012), with the Federal government providing a much smaller portion (10.2 percent of total revenues in fiscal year 2012).<sup>87</sup> Federal direct expenditures to elementary and secondary schools most often take the form of institutional categorical funds targeted to a specific use or program. For example, the Federal government provides aid to States for elementary and secondary school programs such as Title I; special education; math, science, and teacher quality; drug education; vocational education; nutrition; and bilingual education programs. States then distribute these funds to local districts, usually according to state-specific funding formulas.

The Federal government also finances institutions of higher education through direct expenditures. However, for most post-secondary institutions, the majority of revenue stems from State appropriations, grants, and contracts.<sup>88</sup> In fiscal year 2014, direct State support for public higher education totaled \$76.9 billion, compared to \$9.4 billion of direct local government support,<sup>89</sup> and \$57.0 billion of Federal on-budget support.

The Federal government also supports all levels of education through the provision of a variety of tax preferences. The Federal government subsidizes the cost of elementary, secondary, and post-secondary education through tax policies such as the preferential tax treatment of charitable contributions and the exclusion of interest on State and local government bonds. In 2015, these two Federal tax expenditures for education added up to an estimated \$11.0 billion.<sup>90</sup> For post-secondary students, the Federal government provides subsidies for education in three ways: through tax benefits to individuals to be used for tuition, fees, and other educational expenses; through preferred tax treatment of student loans; and through tax subsidies for education savings plans. The largest of these programs are the Hope tax credit, the Lifetime Learning tax credit, and the deduction for interest on student loans. In 2015, the tax credits for tuition for post-secondary education, together with the deduction for interest on student loans cost an estimated \$26.1 billion.<sup>91</sup>

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<sup>87</sup> U.S. Department of Education, National Center for Education Statistics, Common Core of Data (CCD), "National Public Education Financial Survey (NPEFS)," Fiscal Year 2012.

<sup>88</sup> Other sources of revenue include private gifts, hospital revenues, auxiliary enterprises, sales and services of education activities, Federal research grants and contracts, and Federal appropriations such as Federal land grants. GAO calculations based on U.S. Department of Education, National Center for Education Statistics, Integrated Postsecondary Education Data System (IPEDS).

<sup>89</sup> "State Higher Education Finance, FY 2014," State Higher Education Executive Officers, Boulder, CO: April 12, 2015, p.17, Table 1.

<sup>90</sup> Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018* (JCX-97-14), August 5, 2014.

<sup>91</sup> *Ibid.*

## B. Selected Issues with Respect to Tax Benefits Relating to Education Expenses

There are a number of important factors to consider in designing effective educational tax policy and a number of dimensions along which Federal educational tax policy may be evaluated. First, the complexity of policies may be important since individuals are less likely to respond to incentives in expected ways if policies are overly complex. Second, the responsiveness of State, local, and private sources to Federal programs may be considered in order to gauge policy effectiveness and avoid unintended policy consequences. Third, student responsiveness to policies may bear on the overall effectiveness of such policies for improving ultimate goals, such as educational access, enrollment, and graduation. Finally, the targeting of incentives and benefits and the implications for distributional consequences may be of concern.

### Complexity

A variety of Code provisions allow taxpayers to reduce the cost of post-secondary education. The existence of these numerous tax incentives for education may mean that more taxpayers are able to take advantage of one or more education incentives. However, 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.<sup>92</sup> 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. Taxpayers may also face uncertainty when education tax provisions are not permanent. Furthermore, additional complexity may exist independent of tax rules, such as that arising from the differences in the fee structures of qualified tuition programs and other savings vehicles, investment performance, and plan features.

Complexity in the Federal tax code may prevent less than fully informed taxpayers from making optimal economic decisions and minimizing their tax liability. Research provides evidence of this for a variety of tax provisions,<sup>93</sup> including educational tax provisions. Studies indicate that complexity in financial aid rules and tax-based student aid prevents individuals

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<sup>92</sup> Tatyana Guzman, “Federal Tax Benefits for Education: Do They Work?” *Tax Notes*, June 9, 2014, p. 1179.

<sup>93</sup> Emmanuel Saez and Raj Chetty, “Teaching the Tax Code: Earnings Responses to an Experiment with EITC Recipients,” *American Economic Journal: Applied Economics*, vol. 5(1), 2013, pp. 1-31; Jeffrey Liebman and Erzo Luttmer, “Would People Behave Differently If They Better Understood Social Security? Evidence from a Field Experiment,” NBER Working Paper, No. 17287, 2011; Damon Jones, “Information, Preferences, and Social Benefit Participation: Experimental Evidence from the Advance Earned Income Tax Credit and 401(k) Savings,” *American Economic Journal: Applied Economics*, vol. 2(2): 2011, pp. 147-163; Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, “Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block,” *Quarterly Journal of Economics*, vol. 121(4), 2006, pp. 1311-1346; Charles De Bartolome, “Which Tax Rate Do People Use: Average or Marginal?” *Journal of Public Economics*, vol. 56, 1995, pp. 79-96.

from making economic choices which minimize educational expenses.<sup>94</sup> For example, a taxpayer may be eligible for more than one higher education tax credit from a menu of Federal policies, but is legally restricted to choosing one. One study finds that because the menu is overly complex, less than fully informed taxpayers often make less than optimal choices and fail to minimize their tax liability.<sup>95</sup>

Complexity concerns have prompted a number of simplification proposals in past years. One report by the Joint Committee staff proposes: (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.<sup>96</sup> This report states “taxpayers are confronted with a confusing array of choices with respect to Federal tax incentives for financing education,” and notes that structural reform in this area should consider, among other things, the advantages and disadvantages of exclusion or deferral from income, income limits, and transition issues.<sup>97</sup>

The American Bar Association Section of Taxation, the American Institute of Certified Public Accountants Tax Division, and the Tax Executives Institute have also supported harmonization and simplification of education tax incentives, and jointly identify as possible measures: (1) combining the Hope and Lifetime Learning credits; (2) simplifying the definition of student; (3) establishing a single amount of expenses 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 phaseout 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.<sup>98</sup>

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<sup>94</sup> Susan Dynarski, and Judith Scott-Clayton, “The Cost of Complexity in Federal Student Aid: Lessons from Optimal Tax Theory and Behavioral Economics,” *National Tax Journal*, vol. 59(3), 2006, pp. 319-356.

<sup>95</sup> Nicholas Turner, “Why Don’t Taxpayers Maximize Their Tax-Based Student Aid? Salience and Inertia in Program Selection,” *The B.E. Journal of Economic Analysis and Policy*, vol. 11(1), 2011.

<sup>96</sup> 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* (JCS-3-01), Apr. 2001, vol. II, pp. 122-43. Some changes made by EGTRRA address the third category, interaction of the various provisions to limit the same expenses to only one type of benefit.

<sup>97</sup> *Ibid.* at 135.

<sup>98</sup> American Bar Association Section of Taxation, American Institute of Certified Public Accountants Tax Division, and Tax Executives Institute, *Tax Simplification Recommendations 6-7* (2001) (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”), available at <http://www.abanet.org/tax/pubpolicy/2001/0102simpl.pdf>.

## **Response of State and local governments, institutions, and private donors to Federal policies**

State and local governments, institutions, and private donors may respond to Federal policies, creating unintended effects and altering policy outcomes. For example, if the Federal government appropriates new categorical grants to a State for a particular program in order to increase revenue for that program,<sup>99</sup> but the State substitutes existing general funds for the program with the new Federal dollars, total spending in the program may not increase.<sup>100</sup> Similarly, if post-secondary educational institutions respond to Federal or State loan, grant, and scholarship programs by increasing tuition and fees, Federal or State funds are effectively redirected from students to institutions.<sup>101</sup>

There may be similar effects with Federal provision of individual tax benefits for education. Observers note that certain individual tax benefits for education provide incentives for educational institutions to capture some of the benefit by increasing tuition and fees. In this case, the government subsidy to the students is partially or fully offset by higher tuition and fees, effectively transferring the benefit of the subsidy from the student to the institution. This may be particularly attractive to community colleges that charge less than the amount of the subsidy provided by the credit, because tuition can be raised to the amount of the credit without requiring the student to pay more out-of-pocket on an after-tax basis, provided the student or parent has tax liability to offset. In this way, the institution is able to extract the Federal subsidy without imposing any additional burden on the student.

State and local governments may also respond to Federal provision of individual tax benefits. For example, they may appropriate fewer State and local funds to public educational institutions or to financial aid programs, effectively replacing State and local funds with Federal subsidies. This type of response results in net increases in aid to students of less than the amount of the Federal subsidy and may even result in no net increase.<sup>102</sup> In fact, if colleges raise tuition in response to a Federal nonrefundable credit, students or parents without Federal tax liability to offset are unambiguously made worse off by the credit.

Finally, institutions and private donors may respond to Federal tax benefits to individuals. Economists note that if private donors reduce voluntary contributions in response to Federal tax

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<sup>99</sup> The Federal government provides categorical grants to States for programs such as Title I; Head Start; special education; math, science, and teacher quality; drug education; vocational education; nutrition; and bilingual education programs.

<sup>100</sup> Thomas Dee and Jeffrey Levine, "Fate of New Funding: Evidence from the Massachusetts Education Finance Reforms," *Educational Evaluation and Policy Analysis*, vol. 26 (3), 2004, pp. 199-215; James R. Hines and Richard H. Thaler, "The Flypaper Effect," *Journal of Economic Perspectives*, vol. 9(4), 1995, pp. 217-226.

<sup>101</sup> Bridget Terry Long, "How do Financial Aid Policies Affect Colleges? The Institutional Impact of the Georgia HOPE Scholarship," *Journal of Human Resources*, vol. 39, no. 4, 2004, pp. 1045-1066.

<sup>102</sup> For evidence on the response of educational institutions with respect to tuition policy and governments with respect to appropriations for education, see Bridget Terry Long, "The Impact of Federal Tax Credits for Higher Education Expenses," in *College Choices*: Caroline M. Hoxby (ed.), *The Economics of Where to Go, When to Go, and How to Pay for It*, 2004.

benefits, the net effect of these subsidies will be zero; that is, the private contributions are “crowded out” by public support. In theory, private contributions could potentially decrease by a dollar for every dollar increase in governmental support, fully offsetting any increase in Federal benefits. Empirical investigations of this hypothesis, however, generally show less than complete “crowding out.” In other words, private contributions do decrease in response to increases in public contributions, but by less than 100 percent.<sup>103</sup> At least some of this decrease in private contributions may be due to the fact that institutions also respond to increases in Federal tax benefits to individuals by reducing their fundraising efforts.<sup>104</sup>

### **Response of students to Federal policies**

If increasing postsecondary enrollment rates and improving graduation rates are goals of Federal tax-based student aid programs, an issue of interest to policymakers is whether and how students respond to incentives in Federal tax-based educational aid. For example, tax credits for post-secondary education lower the cost of attendance and may provide incentives for students to enroll in college, to shift from part-time enrollment to full-time enrollment, and to graduate once enrolled. However, do these programs induce individuals who would not have otherwise pursued post-secondary education to do so? Or do they provide subsidies to individuals who would have pursued post-secondary education irrespective of these policies?

Many economists voice concern that because Federal tax credits for higher education generally target middle-class families, and because individuals from middle-class families are generally more likely to enroll in post-secondary education than lower income families, these credits may benefit students who would have attended college even in the absence of Federal aid.<sup>105</sup> Existing studies exploring the effect of Federal tax credits on post-secondary enrollment rates are few and somewhat mixed. One such study demonstrates no effect of tax credits on enrollment decisions of students who would not attend college in the absence of tax-based aid,<sup>106</sup> and another study suggests a small positive effect on these students.<sup>107</sup> Several studies which examine the effect of other types of aid on enrollment may provide some insight into the expected effect of tax-based aid. These other studies generally find that significant increases in

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<sup>103</sup> Karine Nyborg and Mari Rege, “Does Public Policy Crowd-Out Private Contributions to Public Goods?” *Public Choice*, vol. 115, No. 3, 2003, pp. 397-418; James Andreoni, “An Experimental Test of the Public Goods Crowding-Out Hypothesis,” *American Economic Review*, vol. 83, No. 5, 1993, pp. 1317-1327.

<sup>104</sup> James Andreoni and Abigail A. Payne, “Do Government Grants to Private Charities Crowd-Out Giving or Fund-Raising?” *The American Economic Review*, vol. 93, No. 3, 2003, pp. 792-812.

<sup>105</sup> See, for example: Long, *supra* at fn. 101: Caroline M. Hoxby, “Tax Incentives for Higher Education,” in James M. Poterba (ed.), *Tax Policy and the Economy*, vol. 12, MIT Press, 1998, pp. 49-82.

<sup>106</sup> Bridget Long, “The Impact of Federal Tax Credits for Higher Education,” in Hoxby, Caroline M. (ed.), *College Choices: The Economics of Which College, When College, and How to Pay For It*, University of Chicago Press, 2004, pp. 101-168.

<sup>107</sup> Nicholas Turner, “The Effect of Tax-Based Federal Student Aid on College Enrollment,” *National Tax Journal*, vol. 64, No. 3, 2001, pp. 839-362.

funding, such as with the Georgia HOPE scholarship program,<sup>108</sup> Social Security student benefits,<sup>109</sup> and State and institutional grants,<sup>110</sup> lead to increases in enrollment.

### **Targeting tax incentives**

Another issue of potential concern to policymakers is whether the present-law tax incentives appropriately target tax benefits. For example, tax credits for higher education generally benefit middle class families. Income eligibility limits and phase-out ranges prevent high-income families from taking advantage of these benefits, and non-refundability of the credits often prevents lower-income families from benefitting because they may not have sufficient levels of tax liability. One study shows that students from families with more than \$40,000 of annual income receive approximately 65 to 70 percent of the total expenditures from these tax credits.<sup>111</sup>

As a result, some argue that tax credits for education expenses should be refundable in order to subsidize education for low-income individuals who may find the subsidy a compelling incentive to enroll in college, but may have insufficient tax liability to take advantage of the credits. Others argue that refundable tax credits are administratively complex and that other Federal spending programs, such as the Pell Grant program, provide direct grants for education to low-income individuals. They also argue that the Pell grant has the advantage of providing its subsidy at the time the education expense is incurred, whereas a refundable credit, unless made advanced-refundable, would provide the subsidy after the education expenses are incurred when the tax return is filed and processed.<sup>112</sup>

There are various other issues with targeting in Federal tax-based educational aid programs, including consistency and coordination between the financial aid system and the Federal tax code. A lack of coordination may lead to conflicting and perverse incentives. For example, some evidence suggests that the 529 saving plans and Coverdell Educational Savings Accounts disadvantage families that are on the margin of financial aid eligibility. For these families, each additional dollar of savings in a 529 plan or a Coverdell account reduces financial

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<sup>108</sup> Christopher Cornwell, David Mustard, and Deepa Sridhar, "The Enrollment Effect of Merit Based Financial Aid: Evidence from Georgia's HOPE Program," *Journal of Labor Economics*, vol. 24, No. 4, 2006, pp. 761-786.

<sup>109</sup> Susan M. Dynarski, "Does Aid Matter? Measuring the Effect of Student Aid on College Attendance and Completion," *American Economic Review*, vol. 93, no. 1, 2003, pp. 279-288.

<sup>110</sup> Thomas J. Kane, "A Quasi-Experimental Estimate of the Impact of Financial Aid on College-Going," *NBER Working Paper No. 9703*, National Bureau of Economic Research, Cambridge, MA, 2003; Wilbert Van der Klaauw, "Estimating the Effect of Financial Aid Offers on College Enrollment: A Regression-Discontinuity Approach," *International Economic Review*, vol. 43, no. 4, 2002, pp. 1249-1287.

<sup>111</sup> Elaine Maag and Jeffrey Rohaly, "Who Benefits from the Hope and Lifetime Learning Credit?" Tax Policy Center, Urban Institute and Brookings Institution, Washington, D.C., 2007.

<sup>112</sup> The ability to obtain a loan from the educational institution or another source would mitigate this concern.

aid eligibility, potentially reducing other grants and loans by more than a dollar. As a result, it is possible for a family to be worse off from saving than not saving under the current policies.<sup>113</sup>

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<sup>113</sup> Sue Dynarski, "Tax Policy and Education Policy: Collision or Coordination? A Case Study of the 529 Coverdell Saving Incentives," *Tax Policy and the Economy*, vol. 18, 2004, pp. 81-116.