

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

Scheduled for a Public Hearing  
Before the  
SUBCOMMITTEE ON SELECT REVENUE MEASURES  
of the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on May 1, 2008

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## INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on May 1, 2008, on simplifying existing tax benefits relating to higher education and improving access to higher education. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, includes a description of present law and analysis relating to tax benefits for higher education.

Part One describes in detail the present-law tax benefits relating to higher education, including benefits provided to individuals and private and public providers of education. Part Two includes background data relating to college enrollment and costs, economic analysis of tax benefits for higher education, and discussion of simplification concerns.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education* (JCX-35-08), April 29, 2008. This document can also be found on our website at [www.house.gov/jct](http://www.house.gov/jct).

## **PART ONE: PRESENT LAW**

### **I. TAX BENEFITS FOR INDIVIDUALS WHO INCUR HIGHER EDUCATION EXPENSES**

#### **A. Overview**

Present law includes a variety of provisions that provide tax benefits to individual taxpayers for higher education expenses. These provisions include tax benefits for current expenses, such as the 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 save for education expenses on a tax-favored basis through the use of other savings vehicles, such as Roth IRAs and deferred annuities, even though these vehicles are not designed specifically for education expenses. 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

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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 is available for taxable years beginning before January 1, 2008. 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.

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.<sup>9</sup> A taxpayer's total itemized deductions, including miscellaneous deductions in excess of two percent of adjusted gross income, may be further limited by the overall limit on itemized deductions that applies if adjusted gross income exceeds certain amounts.<sup>10</sup>

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

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

## **B. Tax Benefits for Current Expenses**

### **1. Hope credit**

Individual taxpayers are allowed to claim a nonrefundable credit, the Hope credit, against Federal income taxes of up to \$1,800 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program.<sup>11</sup> The Hope credit rate is 100 percent on the first \$1,200 of qualified tuition and related expenses, and 50 percent on the next \$1,200 of qualified tuition and related expenses. The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$48,000 and \$58,000 (\$96,000 and \$116,000 for married taxpayers filing a joint return) for 2008. The adjusted gross income phaseout ranges are indexed for inflation. Also, each of the \$1,200 amounts of qualified tuition and related expenses to which the 100 percent credit rate and 50 percent credit rate apply are indexed to inflation, with the amount rounded down to the next lowest multiple of \$100. Thus, for example, an eligible student who incurs \$1,200 of qualified tuition and related expenses is eligible (subject to the adjusted gross income phaseout) for a \$1,200 Hope credit. If an eligible student incurs \$2,400 of qualified tuition and related expenses, then he or she is eligible for a \$1,800 Hope credit.

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 tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the Hope credit, the Lifetime Learning credit (described below), or the section 222 deduction for qualified tuition and related expenses (described below) with respect to an eligible student.

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<sup>11</sup> Sec. 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2008.

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

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

An eligible student for purposes of the Hope credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible for the Hope credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor’s degree, an associate’s degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. To qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) no longer apply. The principal EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he or she claimed an exclusion from a Coverdell education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from a Coverdell education savings account.

## **2. Lifetime Learning credit**

Individual taxpayers are allowed to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses

incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents.<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 credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the Hope credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family—that is, the Hope credit is computed on a per student basis while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$48,000 and \$58,000 (\$96,000 and \$116,000 for married taxpayers filing a joint return) in 2008. These phaseout ranges are the same as those for the Hope credit, and are similarly indexed for inflation.

The Lifetime Learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during an academic period beginning during the first three months of the next taxable year. As with the Hope credit, 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 credit, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by 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 credit for that same taxable year with respect to other students. If, for a taxable year, a taxpayer claims a Hope credit with respect to a student, then the Lifetime Learning credit is not available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years). As with the Hope credit, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses (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

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<sup>12</sup> Sec. 25A. The Lifetime Learning credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2008.



be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. Eligible higher education institutions are defined in the same manner for purposes of both the Hope and Lifetime Learning credits. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the Lifetime Learning credit. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program, or the education is undertaken to acquire or improve the job skills of the student.

In contrast to the Hope credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level courses.<sup>13</sup> Additionally, in contrast to the Hope credit, 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.

As with the Hope credit, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

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

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

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.<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 of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of

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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.

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

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 adjusted gross income for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income 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, 2007.

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> 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 or Lifetime Learning credit is elected for such taxable year.

#### **4. Exclusion for employer-provided educational assistance**

If certain requirements are satisfied, up to \$5,250 annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax purposes and from wages for employment tax purposes.<sup>18</sup> This exclusion applies to both graduate and undergraduate courses.<sup>19</sup> For the exclusion to apply, certain requirements must be

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<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> Secs. 222(d)(1), 25A(g)(2).

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

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

<sup>19</sup> The exclusion has not always applied to graduate courses. The exclusion was first made inapplicable to graduate-level courses by the Technical and Miscellaneous Revenue Act of 1988. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation

satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The employer's educational assistance program must not discriminate in favor of highly compensated employees. In addition, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than five-percent owners of the employer and the spouses or dependents of such more than five-percent owners.

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

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>20</sup> In determining the amount deductible for this purpose, the two-percent floor on miscellaneous itemized deductions is disregarded.

The specific exclusion for employer-provided educational assistance was originally enacted on a temporary basis and was subsequently extended ten times.<sup>21</sup> EGTRRA deleted the exclusion's explicit expiration date. However, that change is subject to EGTRRA's sunset provision so that the exclusion will not be available for taxable years beginning after December 31, 2010. Thus, at that time, educational assistance will be excludable from gross income only if it qualifies as a working condition fringe benefit (i.e., the expenses would have been deductible

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Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1996, effective for courses beginning after June 30, 1996. The exclusion for graduate-level courses was reinstated by EGTRRA, although that change does not apply to taxable years beginning after December 31, 2010 (under EGTRRA's sunset provision).

<sup>20</sup> Sec. 132(d).

<sup>21</sup> The exclusion was first enacted as part of the Revenue Act of 1978 (with a 1983 expiration date).

as business expenses if paid by the employee). As previously discussed, to meet such requirement, the expenses must be related to the employee's current job.<sup>22</sup>

## **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 educational organization.<sup>23</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.

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>24</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 Herbert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program").<sup>25</sup> Payments for such services (other than excepted payments under the NHSC Scholarship Program and the Armed Forces Scholarship Program) are includible in gross income and wages.

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<sup>22</sup> Treas. Reg. sec. 1.162-5.

<sup>23</sup> Secs. 117(a), 3121(a)(20).

<sup>24</sup> Secs. 117(d), 3121(a)(20).

<sup>25</sup> Under EGTRRA's sunset provision, this exception does not apply to taxable years beginning after December 31, 2010.

## **C. Tax Benefits for Saving for Higher 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>26</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, 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.

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).

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.

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<sup>26</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.

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 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, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner") whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, 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.<sup>27</sup>

## **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>28</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 adjusted gross income between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return); the adjusted gross income of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.<sup>29</sup> However, distributions from a Coverdell education savings account

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<sup>27</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>28</sup> Sec. 530.

<sup>29</sup> In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by section 511.

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>30</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 higher education expenses” and “qualified elementary and secondary expenses.”

The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.<sup>31</sup> Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.<sup>32</sup>

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

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<sup>30</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>31</sup> Qualified higher education expenses are defined in the same manner as for qualified tuition programs.

<sup>32</sup> Sec. 530(b)(2)(B).

related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

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

Effective for taxable years beginning after December 31, 2010, the changes made by EGTRRA to Coverdell education savings accounts no longer apply. The EGTRRA changes scheduled to expire include: (1) the increase in the contribution limit to \$2,000 from \$500; (2) the expansion of qualified expenses to include elementary and secondary school expenses; (3) the increase in the phaseout range for married taxpayers filing jointly to \$190,000-\$220,000 from \$150,000-\$160,000; (4) special age and qualified education expense rules for special needs beneficiaries; (5) certain rules regarding the treatment of room and board as qualifying expenses; (6) certain rules regarding coordination with the Hope and Lifetime Learning credits; (7) certain rules regarding coordination with qualified tuition programs; and (8) a provision that treats first cousins as members of the family for purposes of the rollover and change in beneficiary rules.

### **3. Exclusion of interest earned on education savings bonds**

Interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.<sup>33</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 (defined in the same manner as for the Hope and Lifetime Learning credits). The amount of qualified higher education expenses taken into account for purposes of the exclusion is reduced by the amount of such expenses taken into account in determining the Hope or Lifetime Learning credits claimed by any taxpayer, or taken into account in determining an exclusion from gross income for a distribution from a qualified tuition program or a Coverdell education savings account, with respect to a particular student for the taxable year. Additionally, educational expenses taken into account in determining the interest

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<sup>33</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.



exclusion are not eligible for the deduction for qualified tuition and related expenses under section 222.

The exclusion is phased out for certain higher-income taxpayers, determined by the taxpayer's modified adjusted gross income during the year the bond is redeemed. For 2008, the exclusion is phased out for taxpayers with modified adjusted gross income between \$67,100 and \$82,100 (\$100,650 and \$130,650 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 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**

##### **In general**

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

##### **Traditional IRAs**

Under present law, an individual may make deductible contributions to a traditional IRA up to the lesser of \$5,000 (for 2008)<sup>34</sup> or the individual's compensation if the individual and the individual's spouse are not active participants in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to the maximum limit can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. Additional catch-up contributions of \$1,000 (for 2008) may be made by individuals age 50 and over.<sup>35</sup> The maximum contribution limit is reduced to the extent the individual makes Roth IRA contributions.

The adjusted gross income phaseout limits for a single individual who is an active participant in an employer-sponsored retirement plan are \$53,000 to \$63,000 (for 2008). The adjusted gross income phaseout limits for a married individual filing a joint return who is an active participant in an employer-sponsored plan are \$85,000 to \$105,000 (for 2008). If the individual is not an active participant in an employer-sponsored retirement plan, but the

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<sup>34</sup> The contribution limit is indexed for years after 2008. The contribution limit will revert to \$2,000 after 2010 under the EGTRRA sunset.

<sup>35</sup> The ability to make catch-up contributions will no longer be available after 2010 under the EGTRRA sunset.

individual's spouse is, the deduction limit is phased out for taxpayers with adjusted gross income between \$159,000 and \$169,000 (for 2008). To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual generally may make nondeductible contributions to an IRA.<sup>36</sup>

Another source of funds in a traditional IRA is rollover contributions from qualified retirement plans discussed below. With certain limited exceptions, distributions from qualified retirement plans may be rolled over tax free to a traditional IRA.<sup>37</sup>

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of basis, which generally means nondeductible contributions or after tax rollover contributions).<sup>38</sup> Includible amounts withdrawn prior to attainment of age 59½, death, or disability are subject to an additional 10-percent early withdrawal tax, unless an exception applies. One of the exceptions is for qualified higher education expenses (as defined under the rules relating to qualified tuition programs) of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer and his or her spouse, at an eligible educational institution. The amount of education expenses is reduced by certain scholarships and similar payments. Thus, if an individual uses amounts withdrawn from a traditional IRA for qualified education expenses, the amount withdrawn is includible in income (except to the extent attributable to a return of nondeductible contributions), but the 10-percent early withdrawal tax does not apply.

### **Roth IRAs**

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. Qualified distributions from a Roth IRA are not includible in gross income. A qualified distribution is a distribution that is made (1) after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) after attainment of age 59½, on account of death or disability, or for first-time homebuyer expenses of up to \$10,000. Distributions from a Roth IRA that are not qualified distributions ("nonqualified distributions") are includible in income to the extent attributable to earnings. In contrast to the pro rata rule for a distribution from a traditional IRA, a distribution from a Roth IRA is treated as being comprised first of nondeductible contributions. Thus, a

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<sup>36</sup> There is no adjusted gross income limit for an individual making nondeductible contributions to a traditional IRA.

<sup>37</sup> A rollover from a qualified retirement plan to an IRA is accomplished by a direct rollover (a direct payment or transfer of the distribution to the IRA) or by a contribution to the IRA of the amount of the distribution, or property distributed, within 60 days of the distribution. The following distributions are not eligible for tax-free rollover: certain periodic payments, required minimum distributions, and any distributions made on account of hardship. There are also special rollover rules for distributions to active duty personnel and certain disaster relief distributions. Secs. 72(t)(2)(G), 1400Q.

<sup>38</sup> Basis in traditional IRAs is recovered pro rata as a portion of each IRA distribution.

nonqualified distribution from a Roth IRA that does not exceed the aggregate amount of contributions is not includible in gross income.

Nonqualified distributions are also subject to a 10-percent early withdrawal tax unless an exception applies. The 10-percent early withdrawal tax is applied to the amount of the distribution that is includible in gross income. Thus, the early withdrawal tax does not apply to a distribution that is solely comprised of a nontaxable return of contributions to the account. The same education expenses exception to the early withdrawal tax that applies to traditional IRA distributions applies to distributions from Roth IRAs. Thus, if an individual wanted to use amounts in a Roth IRA for education expenses, the amount withdrawn from the Roth IRA would be nontaxable (and not subject to the 10-percent early withdrawal tax) if the distribution is a qualified distribution; if the distribution is not a qualified distribution, then the amount withdrawn would be includible in gross income to the extent attributable to earnings (i.e., the distribution exceeds the aggregate amount of contributions to the Roth IRA), but the 10-percent early withdrawal tax would not apply so long as the expenses are qualified education expenses.

The maximum annual contribution that may be made to a Roth IRA is the lesser of \$5,000 (for 2008) or the individual's compensation for the year.<sup>39</sup> Additional catch-up contributions of \$1,000 (for 2008) may be made by individuals age 50 and over.<sup>40</sup> The contribution limit is reduced to the extent an individual makes deductible or nondeductible contributions to any other IRA for the same taxable year.<sup>41</sup> As under the rules relating to IRAs generally, a contribution of up to the maximum dollar limit for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with adjusted gross income between \$101,000 and \$116,000 (for 2008) and for married couples filing a joint return with adjusted gross income between \$159,000 and \$169,000 (for 2008). Taxpayers with modified adjusted gross income of \$100,000 or less generally may convert a traditional IRA into a Roth IRA.<sup>42</sup> The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply.<sup>43</sup>

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<sup>39</sup> The contribution limit is indexed for years after 2008. The contribution limit will revert to \$2,000 after 2010 under the EGTRRA sunset.

<sup>40</sup> The ability to make catch-up contributions will no longer be available after 2010 under the EGTRRA sunset.

<sup>41</sup> Another source of funds for Roth IRAs is rollover contributions of distributions from qualified retirement plans that meet certain requirements.

<sup>42</sup> The limitation on account of a taxpayer's modified adjusted gross income is not applicable for tax years beginning after December 31, 2009.

<sup>43</sup> The amount converted is treated as a contribution to the Roth IRA for purposes of determining the portion of any nonqualified distribution that is includible in gross income. However, the 10-percent early distribution tax is recovered if the conversion amount is distributed from the Roth IRA within 5 years of the conversion.

## **Qualified retirement plans**

The Code provides favorable tax rules for a variety of employer-sponsored retirement plans. These plans are commonly referred to as “qualified retirement plans” and include tax-qualified plans described in section 401(a), retirement annuities that satisfy the requirements of section 403(a), tax-sheltered annuities described in section 403(b), and eligible deferred compensation plans maintained by certain governmental employers that satisfy the requirements of section 457(b) (“governmental section 457(b) plans”). There are a variety of limits on the maximum amount that may be contributed to qualified retirement plans.

Several types of qualified retirement plans are permitted to allow participants to voluntarily elect to defer a portion of their compensation. Under such an election, the participant elects to defer compensation that would be otherwise payable to the participant and the deferred compensation is credited to the participant’s account under the plan. In the case of a tax-qualified plan, such an election feature must be a qualified cash or deferral arrangement described in section 401(k). Thus, such a plan is commonly referred to as a “section 401(k) plan.” Tax-deferred annuities and governmental section 457(b) plans are also permitted to offer a salary reduction election feature that is similar to the deferral election feature of a section 401(k) plan.

As a condition of offering a deferral election, a qualified retirement plan must restrict a participant’s access to the deferred compensation. In the case of a section 401(k) plan, the deferrals generally may not be distributable to participants until severance from employment, death, disability, attainment of age 59½, or hardship on the part of the participant. Similar rules apply in the case of tax-deferred annuities and governmental section 457(b) plans. In the case of a section 401(k) plan and tax-deferred annuity, a hardship distribution must satisfy two requirements. First, it must be on account of an immediate and heavy need, and second, it must be necessary to satisfy that need. The following types of education expenses are deemed to satisfy the first requirement: payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the participant or the participant’s spouse, children, or dependents.<sup>44</sup> For governmental section 457(b), deferred amounts may be distributed to a participant in the event of an unforeseeable emergency, but the payment of college tuition does not generally constitute an unforeseeable emergency.<sup>45</sup>

Employer contributions and employee elective deferrals to a qualified retirement plan are not includible in an employee’s income until distributed, and are generally deductible for employers. Contributions to a qualified retirement plan generally are held in a tax-exempt trust. A distribution of benefits from a qualified retirement plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents a return of the employee’s after-tax contributions (i.e., basis). Special rules apply in certain situations.

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<sup>44</sup> Treas. Reg. secs. 1.401(k)-1(d)(3)(iii)(B) and 1.403(b)-6(d). Further, hardship distributions must be limited to the dollar amount of the employee’s elective deferrals.

<sup>45</sup> Treas. Reg. sec. 1.457(b)-6(c).

Early distributions from qualified retirement plans generally are subject to the additional 10-percent early withdrawal tax that applies to traditional IRAs and Roth IRAs. That is, includible amounts distributed prior to attainment of age 59½ are subject to an additional 10-percent tax, unless the distribution is due to death or disability or another exception applies. Unlike traditional IRAs and Roth IRAs, there is no exception to the 10-percent early withdrawal tax applicable to qualified retirement plans for education expenses. A hardship distribution is subject to the 10-percent early withdrawal tax unless another exception to the tax applies (e.g., a hardship distribution to a participant who has attained age 59½ is not subject to the early withdrawal tax).

Special limits apply in the case of elective compensation deferrals under qualified retirement plans. In the case of a section 401(k) plan or a tax-deferred annuity, the maximum annual amount of elective deferrals that can be made by an individual for any taxable year is \$15,500 (for 2008). In applying this limitation, elective deferrals under section 401(k) plans, tax-sheltered annuities, simplified employee pensions described in section 408(k) (“SEPs”), and SIMPLE plans described in section 408(p) are aggregated. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan or a tax-deferred annuity. As a result, the dollar limit on elective deferrals is increased for an individual who has attained age 50 by \$5,000 (for 2008). A special nondiscrimination test applies to elective deferrals that are made under a section 401(k) plan, and this test may limit the amount that can be deferred by highly compensated employees. A special nondiscrimination test applies in the case of tax-deferred annuities with a salary reduction feature.

The maximum annual deferral that can be made under a governmental section 457(b) plan generally is the lesser of (1) \$15,500 (for 2008) or (2) 100 percent of compensation. A special, higher limit applies for the last three years before a participant reaches normal retirement age (the “section 457 catch-up limit”). In the case of a section 457 plan of a governmental employer, a participant who has attained age 50 before the end of the taxable year may also make catch-up contributions up to a limit of \$5,000 (for 2008), unless a higher section 457 catch-up limit applies. Only contributions to section 457 plans are taken into account in applying these limits; contributions made to a tax qualified plan or section 403(b) plan for an employee do not affect the amount that may be contributed to a section 457 plan for that employee. Thus, for example, a State or local government employee covered by both a section 457 plan and a section 401(k) or 403(b) plan can contribute up to \$15,500 (for 2008) to each plan for a total of \$31,000.

### **Deferred annuities**

In general, earnings and gains on a deferred annuity contract are not subject to tax during the deferral of the contract (that is, “inside buildup” is not subject to current taxation). Amounts received under a deferred annuity are includible in gross income, except to the extent the amount received is a return of the individual’s investment in the contract.<sup>46</sup> Distributions from an

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<sup>46</sup> The rules for determining the amount of each payment that is attributable to the individual’s investment in the contract is determined under section 72 and depends on whether or not the amount is received as an annuity.

annuity contract prior to age 59½, death, or disability that are includible in gross income are also subject to an additional 10-percent early withdrawal tax, unless an exception applies. There is no exception for distributions for education expenses. Individuals could use deferred annuity contracts to save for future education expenses. Inside buildup on the contract would not be taxed; amounts withdrawn would be includible in gross income to the extent not attributable to the individual's investment in the contract and would be subject to the 10-percent additional tax unless the distribution is after age 59½ or another exception applies.

## **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) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. The 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 2008, the deduction is phased out ratably for taxpayers with adjusted gross income between \$55,000 and \$70,000 (\$115,000 and \$145,000 for married taxpayers filing a joint return). The income phaseout ranges are indexed for inflation and rounded to the next lowest multiple of \$5,000.

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

### **2. Exclusion of income from student loan forgiveness**

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.<sup>48</sup>

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

<sup>48</sup> Sec. 108(f).

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



## II. TAX BENEFITS RELATING TO PROVIDERS OF HIGHER EDUCATION

### A. Tax Exemption for Educational Institutions

Charitable and educational organizations described in section 501(c)(3) generally are exempt from Federal income tax. A charitable or educational organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.<sup>49</sup> The term “charitable” includes, for purposes of section 501(c)(3), the advancement of education or science.<sup>50</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>51</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.

In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;<sup>52</sup> (3) the organization may not be operated primarily to conduct an unrelated trade or business;<sup>53</sup> (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

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

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<sup>49</sup> Treas. Reg. sec. 1.501(c)(3)-1(c)(1).

<sup>50</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

<sup>51</sup> Treas. Reg. sec. 1.501(c)(3)-1(d)(3).

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

<sup>53</sup> Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

racially nondiscriminatory policy as to students and that it does not discriminate against applicants and students on the basis of race, color, or national or ethnic origin.<sup>54</sup>

Section 501(c)(3) organizations generally are not subject to Federal income tax on contributions received, on income from activities that are substantially related to the purpose of the organization's tax exemption, or on investment income. Section 501(c)(3) organizations are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.<sup>55</sup> In addition, colleges and universities that are agencies or instrumentalities of any government or any political subdivision of a government, or that are owned or operated by a government or political subdivision of a government, are subject to the tax on unrelated business income.<sup>56</sup> Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.

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<sup>54</sup> Rev. Proc. 75-50, 1975-2 C.B. 587 (establishing guidelines and recordkeeping requirements for determining whether private schools that are applying for recognition of exemption have racially nondiscriminatory policies as to students).

<sup>55</sup> Secs. 511-514. Tax-exempt corporations are taxed on their unrelated business taxable income at the regular corporate tax rates. Sec. 511(a). Charitable trusts and other tax-exempt trusts generally are subject to tax on their unrelated business taxable income under the rates generally applicable to taxable trusts. Sec. 511(b).

<sup>56</sup> Sec. 511(a)(2). For this purpose, government includes any foreign government (to the extent not contrary to a treaty), the United States and any of its possessions, any State, and the District of Columbia. The tax also applies in the case of a corporation wholly owned by one or more such colleges or universities.

## B. Charitable Deduction

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

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.<sup>57</sup> In general, 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.<sup>58</sup>

Within certain limitations, donors also are entitled to deduct their contributions to a section 501(c)(3) organization or to a Federal, State, or local governmental entity, including to qualified educational organizations such as colleges and universities, for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, noncharitable tax-exempt organizations generally are not deductible by the donor, though such organizations are eligible for the exemption from Federal income tax with respect to such donations. Recipients of charitable assistance generally may exclude the assistance from income as a gift.<sup>59</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.

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>60</sup> In addition, no charitable deduction is allowed for a contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the

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<sup>57</sup> Sec. 170(b), (e).

<sup>58</sup> 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, is not a private foundation. Secs. 509(a)(1) and 170(b)(1)(A)(ii).

<sup>59</sup> Sec. 102(a).

<sup>60</sup> Sec. 170(f)(17).

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>61</sup> Additional substantiation rules apply to contributions for which deductions of more than \$500 and more than \$5,000 are claimed.

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<sup>61</sup> Sec. 170(f)(8).

## **C. Tax-Exempt Financing for Facilities and Activities of Providers of Higher Education**

### **Overview**

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes.<sup>62</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.

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. Private activity bonds are bonds issued by a State or local government, but the proceeds of which are used to provide financing to nongovernmental persons (e.g., private businesses). The income exclusion for interest paid on State and local bonds does not apply to private activity bonds, unless such bonds are issued for certain permitted purposes (“qualified private activity bonds”). Subject to certain limitations, both governmental bonds and qualified private activity bonds may be used to finance educational facilities.

### **Governmental bonds**

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. Present law defines a governmental bond as any bond that is not a private activity bond. Present law provides two tests for determining whether a State or local bond is in substance a private activity bond, the private business test and the private loan test.<sup>63</sup>

#### **Private business tests**

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

- (1) More than 10 percent of the bond proceeds is to be used (directly or indirectly) by a private business (the “private business use test”); and

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<sup>62</sup> Sec. 103(a).

<sup>63</sup> Sec. 141(b)-(c).

- (2) More than 10 percent of the debt service on the bonds is secured by an interest in property to be used in a private business use or to be derived from payments in respect of such property (the “private payment test”).<sup>64</sup>

#### Private loan test

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

### **Qualified private activity bonds used for higher education**

#### Overview

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for certain private activities. In most cases, the aggregate volume of these qualified private activity bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State (the “State volume cap”). For calendar year 2008, the State volume cap, which is indexed for inflation, equals \$85 per resident of the State, or \$262.09 million, if greater.

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

The definition of a qualified private activity bond includes bonds issued by State or local governments to finance the activities of charitable organizations described in section 501(c)(3) (“qualified 501(c)(3) bonds”).<sup>65</sup> Generally, both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3)—including elementary, secondary, and post-secondary schools—may be financed with tax-exempt, qualified private activity bonds.

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<sup>64</sup> The 10-percent private business use and payment threshold is reduced to five percent for private business uses that are unrelated to a governmental purpose also being financed with proceeds of the bond issue.

<sup>65</sup> Sec. 141(e). Qualified private activity bonds also include exempt facility bonds, qualified mortgage or veterans’ mortgage bonds, small issue and redevelopment bonds, and student loan bonds. Present law also provides special rules for qualified private activity bonds issued within certain geographic areas (e.g., enterprise or empowerment zones, the New York Liberty Zone, and the Gulf Opportunity Zone) to provide incentives for businesses to locate in those areas.

Facilities financed with qualified 501(c)(3) bonds are required to be owned by a section 501(c)(3) organization or by a governmental unit. Moreover, a bond issue is not treated as a qualified 501(c)(3) bond (i.e., is not tax exempt) if such bond issue meets a modified version of the private business test. Under the modified version of the private business test, the maximum amount of private business use and private payments is five percent of the net proceeds<sup>66</sup> of the issue.<sup>67</sup> The use of bond proceeds or bond-financed property in unrelated trades or businesses (determined by applying section 513(a)) is treated as private business use. Thus, the use of bond proceeds by a section 501(c)(3) organization in an unrelated trade or business is limited to five-percent of the net proceeds of the bond issue.

Qualified 501(c)(3) bonds are not subject to a number of restrictions that apply to other qualified private activity bonds. For example, such bonds are not subject to the State volume cap discussed above.<sup>68</sup> In addition, unlike most qualified private activity bonds issued after August 7, 1986,<sup>69</sup> the interest income from qualified 501(c)(3) bonds is not a preference item for purposes of calculating the alternative minimum tax.

#### Qualified student loan bonds

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

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<sup>66</sup> The term “net proceeds” means the proceeds of a bond issue reduced by amounts in a reasonably required reserve or replacement fund (which is generally limited to 10 percent of the proceeds). Sec. 150(a)(3).

<sup>67</sup> Sec. 145(a)(2).

<sup>68</sup> Although qualified 501(c)(3) bonds are not subject to the State volume cap, prior to the Taxpayer Relief Act of 1997 (the “1997 Act”), the Code limited the amount of outstanding qualified 501(c)(3) bonds from which a section 501(c)(3) organization could benefit to \$150 million. In applying this \$150 million limit, all section 501(c)(3) organizations under common management or control were treated as a single organization. The limit did not apply to bonds for hospital facilities, defined to include acute care, primarily inpatient, organizations. The 1997 Act repealed the \$150 million limit for bonds issued after the date of enactment (August 5, 1997) to finance capital expenditures incurred after such date. The \$150 million limit continues to govern the issuance of other non-hospital qualified 501(c)(3) bonds (e.g., advance refunding bonds with respect to capital expenditures incurred on or before such date, new-money bonds for capital expenditures incurred on or before such date, or new-money bonds for working capital expenditures).

<sup>69</sup> Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and certain bonds issued before September 1, 1986.

## PART TWO: SELECTED ISSUES AND ANALYSIS

### I. BACKGROUND DATA RELATING TO EDUCATION

#### College Enrollment and Costs

Since 1991 more than 14 million students have enrolled annually in post-secondary education or training programs, with approximately 75 percent enrolled in public institutions and 25 percent in private institutions in 2004. Enrollment exceeded 15 million for the first time in 2000, and by 2005 had reached 17.5 million. The full-time equivalent enrollment has exceeded 10 million in every year since 1991, reaching 13.2 million in 2005. Of all those enrolled in 2005, 63 percent were enrolled in four-year institutions.

In the late 1970s, college costs lagged behind inflation, but they have generally risen faster than inflation since 1981. An exception to this trend has been for the cost of undergraduate tuition and fees at public two-year colleges, which began to moderate in the mid 1990s and rose by less than the rate of inflation in several years (see Table 1). Early in this decade, however, costs at these public two-year colleges rose sharply; more recently, there has been some moderation in the real rate of increase of these costs.

Since 1976, college tuition and fees generally have risen by more than twice the increase in the economy's overall price level. For the 1976-77 academic year, the total cost<sup>70</sup> of attending a four-year private college averaged \$3,977 (tuition and fees of \$2,534) and the total cost of attending a four-year public college averaged \$2,067 (tuition and fees of \$617). For the 1986-87 academic year, the comparable total cost figure had risen to \$10,039 (tuition and fees of \$6,658) for a four-year private college and to \$4,138 (tuition and fees of \$1,414) for a four-year public college. By the 2006-07 academic year, the comparable total cost figure had risen to \$28,896 (tuition and fees of \$20,492) for a four-year private college and to \$12,805 (tuition and fees of \$5,685) for a four-year public college. For the 2006-07 academic year, the average cost of tuition and fees at a two-year public college was \$2,017 and \$12,620 at a two-year private college.<sup>71</sup> Table 1 below details average tuition and fees by type of college in both current and constant (inflation adjusted) dollars since 1986.

Over the past decade, governmental funding of public higher education has declined as a share of total funding. Table 2 reports the revenues of public degree-granting institutions of higher education by source. As a percentage of all revenues, Federal funds and tuition and fees have risen modestly since the 1985-86 academic year, State and local funding has declined substantially, and other funding (such as from hospitals and auxiliary enterprises) has increased substantially.

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<sup>70</sup> "Total cost" includes tuition and fees and on-campus room and board costs.

<sup>71</sup> U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2007*.



Private institutions of higher education rely less heavily on public sources of funding, though the public sources remain a significant source of funds. Private institutions rely more heavily on tuition and fees for revenue, and, in contrast to public institutions, receive a significant fraction of revenue from gifts and investment returns on endowments. Endowment returns are a highly variable source of revenues, however. Table 3 shows revenues of private not-for-profit post-secondary degree granting institutions for selected years.

**Table 1.—Average Undergraduate Tuition and Fees, 1986-87 Through 2006-07**

| Year    | Current Dollars   |                  |                  |                 | Constant 2007 Dollars |                  |                  |                 |
|---------|-------------------|------------------|------------------|-----------------|-----------------------|------------------|------------------|-----------------|
|         | Private four-year | Private two-year | Public four-year | Public two-year | Private four-year     | Private two-year | Public four-year | Public two-year |
| 1986-87 | 6,658             | 3,684            | 1,414            | 660             | 12,368                | 6,843            | 2,626            | 1,227           |
| 1987-88 | 7,116             | 4,161            | 1,537            | 706             | 12,722                | 7,439            | 2,749            | 1,262           |
| 1988-89 | 7,722             | 4,817            | 1,646            | 730             | 13,212                | 8,243            | 2,817            | 1,249           |
| 1989-90 | 8,396             | 5,196            | 1,780            | 756             | 13,668                | 8,458            | 2,897            | 1,231           |
| 1990-91 | 9,083             | 5,570            | 1,888            | 824             | 14,109                | 8,652            | 2,933            | 1,280           |
| 1991-92 | 9,759             | 5,754            | 2,117            | 936             | 14,633                | 8,628            | 3,174            | 1,403           |
| 1992-93 | 10,294            | 6,059            | 2,349            | 1,025           | 14,985                | 8,820            | 3,420            | 1,492           |
| 1993-94 | 10,952            | 6,370            | 2,537            | 1,125           | 15,513                | 9,023            | 3,593            | 1,593           |
| 1994-95 | 11,481            | 6,914            | 2,681            | 1,192           | 15,835                | 9,536            | 3,697            | 1,645           |
| 1995-96 | 12,243            | 7,094            | 2,848            | 1,239           | 16,411                | 9,510            | 3,817            | 1,661           |
| 1996-97 | 12,881            | 7,236            | 2,987            | 1,276           | 16,826                | 9,452            | 3,902            | 1,667           |
| 1997-98 | 13,344            | 7,464            | 3,110            | 1,314           | 17,102                | 9,566            | 3,986            | 1,684           |
| 1998-99 | 13,973            | 7,854            | 3,229            | 1,327           | 17,576                | 9,879            | 4,062            | 1,669           |
| 1999-00 | 14,588            | 8,235            | 3,349            | 1,338           | 17,852                | 10,077           | 4,098            | 1,637           |
| 2000-01 | 15,470            | 9,067            | 3,501            | 1,333           | 18,362                | 10,762           | 4,155            | 1,582           |
| 2001-02 | 16,211            | 10,076           | 3,735            | 1,380           | 18,827                | 11,702           | 4,338            | 1,603           |
| 2002-03 | 16,826            | 10,651           | 4,046            | 1,483           | 19,170                | 12,135           | 4,610            | 1,690           |
| 2003-04 | 17,763            | 11,545           | 4,587            | 1,702           | 19,750                | 12,836           | 5,100            | 1,892           |
| 2004-05 | 18,604            | 12,122           | 5,027            | 1,849           | 20,076                | 13,081           | 5,425            | 1,995           |
| 2005-06 | 19,292            | 12,450           | 5,351            | 1,935           | 20,152                | 13,005           | 5,590            | 2,021           |
| 2006-07 | 20,492            | 12,620           | 5,685            | 2,017           | 20,778                | 12,796           | 5,764            | 2,045           |

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

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2007*.

**Table 2.—Current Funds and Revenues of Public Post-Secondary Degree-Granting Institutions  
By Source, Selected Years, 1985-86 Through 2004-05**

[Dollars in Millions]

| Year           | Tuition and Fees |         | State and Local Sources |         | Federal Sources |         | Other Sources* |         | Total   |
|----------------|------------------|---------|-------------------------|---------|-----------------|---------|----------------|---------|---------|
|                | Dollars          | Percent | Dollars                 | Percent | Dollars         | Percent | Dollars        | Percent |         |
| <b>1985-86</b> | 9,439            | 14.5    | 31,547                  | 48.5    | 6,852           | 10.5    | 17,167         | 26.4    | 65,005  |
| <b>1995-96</b> | 23,257           | 18.8    | 49,322                  | 39.9    | 13,672          | 11.1    | 37,250         | 30.2    | 123,501 |
| <b>2004-05</b> | 38,526           | 16.4    | 77,317                  | 32.9    | 30,071          | 12.8    | 88,927         | 37.9    | 234,842 |

\* Other sources includes income from educational activities, auxiliary enterprises, and hospitals.

Sources: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2007*, Tables 337, 339 and staff of the Joint Committee on Taxation calculations.

**Table 3.—Revenues of Private and Not-for-Profit Post-Secondary Degree-Granting Institutions  
By Source, Selected Years, 1997-98 Through 2004-05**

[Dollars in Millions]

| Year           | Tuition and Fees |         | Federal State and<br>Local Sources |         | Private Gifts,<br>Grants and<br>Contracts |         | Investment<br>Returns |         | Other Sources* |         | Total   |
|----------------|------------------|---------|------------------------------------|---------|---|---------|-----------------------|---------|----------------|---------|---------|
|                | Dollars          | Percent | Dollars                            | Percent | Dollars                                   | Percent | Dollars               | Percent | Dollars        | Percent |         |
| <b>1997-98</b> | 26,499           | 27.8    | 12,631                             | 13.3    | 13,246                                    | 13.9    | 22,312                | 23.4    | 20,554         | 21.6    | 95,241  |
| <b>2004-05</b> | 41,046           | 29.3    | 21,657                             | 15.5    | 16,739                                    | 11.9    | 30,432                | 21.7    | 30,278         | 21.6    | 140,151 |

\* Other sources includes income from educational activities, auxiliary enterprises, and hospitals.

Source: U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 2007*.

## **Selected Data on Individual Income Tax Benefits Related to Education**

Federal tax expenditures on higher education have grown significantly over the past decade.<sup>72</sup> Table 4 shows data for 2005 on the number of returns claiming the Hope and Lifetime Learning credits, the qualified tuition deduction, and the student loan interest deduction. For 2005, over 7 million returns claimed “tentative” education credits equaling approximately \$7.5 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>73</sup> After the effect of phaseouts and limitations due to nonrefundability of the credit, total credits claimed equaled \$6.1 billion. The Federal Pell Grant program, the largest Federal grant program for post-secondary students, disbursed grants to 5.1 million students totaling \$12.7 billion in the 2005-06 grant year.<sup>74</sup>

The qualified tuition deduction was claimed on 4.7 million returns, and the student loan interest deduction on 8.1 million returns. The amount claimed in qualified tuition deductions in 2005 was \$10.8 billion, while \$5.1 billion in deductions was claimed for student loan interest. While the deductions for qualified tuition exceed the amounts of Hope and Lifetime Learning credits claimed, the reduction in tax resulting from \$10.8 billion in deductions is less than the \$6.1 billion in tax reduction resulting from the credits.<sup>75</sup>

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<sup>72</sup> See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011* (JCS-3-07), Sept. 24, 2007, and earlier years’ versions of this report.

<sup>73</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.

<sup>74</sup> U.S. Department of Education, *2005-2006 Federal Pell Grant Program End-of-Year Report*, available at <http://www.ed.gov/finaid/prof/resources/data/ope.html>.

<sup>75</sup> The value of a deduction depends on the taxpayer’s marginal tax rate. A dollar of deductions is worth only  $t$  dollars in reduced liability, where  $t$  represents the taxpayer’s effective marginal tax rate. For \$10.8 billion in deductions to be worth as much as \$6.1 billion in credits, the average effective marginal tax rate would have to be 56.5 percent, as  $\$10.8 * 0.565 = \$6.1$ .

**Table 4.—Selected Individual Income Tax Return Data Related to Education  
2005**

|  | <b>Number of Returns<br/>(thousands)</b> | <b>Amount of Credit or<br/>Deduction<br/>(millions of dollars)</b> |
|--|--|--|
| Tentative Hope credit  | 2,950                                    | 3,705  |
| Tentative Lifetime Learning credit   | 4,462                                    | 3,747  |
| Total Tentative credits  | 7,190                                    | 7,451  |
| Total Hope and Lifetime Learning credits<br>after income and refundability limitations | 7,047                                    | 6,118  |
| Qualified tuition deduction  | 4,696                                    | 10,847   |
| Student loan interest deduction  | 8,073                                    | 5,053  |

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 5 shows that, by 2006, 9.3 million qualified tuition program accounts held \$106 billion in assets. Comparable cumulative account data is not available for the Coverdell education savings accounts. Table 6 shows annual contributions for Coverdell education savings accounts. In 2005, 529,000 taxpayers contributed over \$1 billion 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 5.—Qualified Tuition Program Accounts  
(sec. 529 Plans)**

| <b>Tax Year</b> | <b>Number of Accounts<br/>(thousands)</b> | <b>Account Value<br/>(millions of dollars)</b> |
|-----------------|---|--|
| 2002            | 4,380                                     | 26,849   |
| 2003            | 6,016                                     | 45,771   |
| 2004            | 7,208                                     | 64,688   |
| 2005            | 8,189                                     | 82,485   |
| 2006            | 9,270                                     | 105,693  |

Source: College Savings Plans Network, at <http://www.collegesavings.org/529PlanData.aspx>.

**Table 6.—Annual Coverdell Education Savings Account Contributions**

| <b>Tax Year</b> | <b>Number of Returns<br/>(thousands)</b> | <b>Annual Contributions<br/>(millions of dollars)</b> |
|-----------------|--|---|
| 2002            | 570                                      | 855   |
| 2003            | 476                                      | 733   |
| 2004            | 399                                      | 659   |
| 2005            | 529                                      | 1,010   |

Source: Staff of the Joint Committee on Taxation.

## **II. ECONOMIC ANALYSIS**

### **A. The Economics of Subsidizing Education**

#### **Overview of the goals of subsidies**

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

#### **Efficiency as a goal of subsidies to education**

Economists generally favor the outcomes of the free market and have reasoned that taxes or subsidies in the market generally lead to inefficient outcomes. That is, taxes or subsidies distort choices and divert resources from their highest and best use. However, economists also recognize that sometimes markets do not work efficiently. Economists observe that the consumption or acquisition of certain goods may create spillover, or external, effects that benefit society at large as well as the individual consumer who purchases the good. An example of such a good is a vaccination. The individual who is vaccinated benefits by not contracting an infectious disease, but the rest of society benefits as well. By not contracting the disease, the vaccinated individual also slows the spread of the disease to those who are not vaccinated. Economists call such a spillover effect a “positive externality.” On his or her own, the individual would weigh only his or her own reduced probability of contracting the disease against the cost of the vaccination. The individual would not account for the additional benefit the vaccination produces for society. As a result, the individual might choose not to be vaccinated, even though from society’s perspective the total reduction in the rate of infection throughout the population would be worth more than the cost of the vaccination. In this sense, the private market might produce too few of the vaccinations. That is, the private market outcome is inefficiently small. Economists have suggested that the existence of positive externalities provides a rationale for the government to subsidize the acquisition of the good that produces the positive externalities. The subsidy will increase the acquisition of the good to its more efficient level.

While much evidence suggests that job skill acquisition and education benefit the private individual in terms of higher market wages, many people have long believed that education also produces positive externalities. Commentators argue that society functions better with an educated populace and that markets function better with educated consumers. They observe that



education promotes innovation and that, because ideas and innovations are easily copied in the marketplace, the market return (wage or profit) from ideas and innovations may not reflect the full value to society from the idea or innovation. Just as a single individual does not appreciate the full benefit of a vaccination, a single individual may not be able to reap the full benefit of an idea or innovation. Thus, it is argued, subsidies for education are needed to improve the efficiency of society.

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

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

### **Equity as a goal of subsidies to education**

As noted above, there is evidence indicating that education and training are rewarded in the marketplace. Recognizing this market outcome, some argue that it is appropriate to subsidize education to ensure that educational opportunities are widely available, including to those less well off in society. Commentators argue that education can play an important role in reducing poverty and income inequality. They observe that even if there were no positive externalities from education, promoting economic equity within a market economy provides a basis for subsidizing education. If equity is the goal of expanded subsidies to education, the cost of the subsidies should be weighed in terms of the private benefits received by the target groups, rather than the social benefits that might be generated by any possible spillovers.

## **B. Issues with Respect to Tax Benefits for Individuals Relating to Higher Education Expenses**

### **Complexity**

As described above, there are numerous provisions in the Code that allow taxpayers to reduce the cost of post-secondary education. Although the existence of a variety of tax incentives for education may mean that more taxpayers are able to take advantage of one or more education incentives, understanding the tax benefits provided by the different provisions, the various eligibility requirements, the interactions between different incentives and provisions within each incentive, and the recordkeeping and reporting requirements, may be time consuming and confusing for taxpayers who are interested in reducing their current education expenses or saving for future expenses. Specific sources of complexity include the absence of a uniform definition of qualifying education expenses, different income limitations for the different incentives, and provisions designed to prevent duplicative tax benefits with respect to the same expenses. The complexities of the varying definitions of qualifying expenses are illustrated in Table 7, which appears at the end of this document. Taxpayers also must address uncertainties associated with the fact that some of the education tax provisions are not permanent, and that certain rules applicable to permanent tax incentives are set to expire in 2010 absent further congressional action. This is in addition to complexity that may exist independent of tax rules, such as that arising from the differences in the fee structures of qualified tuition programs and other savings vehicles, investment performance, and plan features.

Complexity concerns in this area have prompted a number of simplification proposals in recent years. The staff of the Joint Committee on Taxation made several simplification proposals relating to education tax incentives in April 2001. These proposals included: (1) establishing a uniform definition of qualified higher education expenses; (2) combining the Hope and Lifetime Learning credits; and (3) modifying the rules regarding the interaction of the various education tax incentives to provide a limitation that the same expenses could not qualify under more than one provision.<sup>76</sup> In that report, the staff stated that “taxpayers are confronted with a confusing array of choices with respect to Federal tax incentives for financing education,” but noted that structural reform in this area would have to consider, among other things, the advantages and disadvantages of exclusion or deferral from income, income limits, and transition issues.<sup>77</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 identified as possible measures: (1) combining the Hope and Lifetime Learning credits; (2) simplifying the definition

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<sup>76</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, at 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>77</sup> *Id.* at 135.

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>78</sup>

The President's Advisory Panel on Federal Tax Reform has recommended replacing the present-law education savings vehicles (and present-law medical accounts, such as health savings accounts) with "Save for Family" accounts. Up to \$10,000 could be contributed to such accounts annually. Contributions would be after-tax and distributions would not be includible in gross income if made for education expenses, health expenses, or expenses for the purchase of a primary residence.<sup>79</sup>

### **Targeting of Tax Incentives**

A related issue is whether the present-law tax incentives appropriately target the tax benefits. For example, some argue that credits for education expenses should be refundable in order to subsidize education for low-income individuals who need the subsidy the most but may have insufficient tax liability to realize the benefit of the existing Hope and Lifetime Learning credits. Others argue that refundable tax credits are administratively complex and that there are Federal spending programs, such as the Pell Grant program, that provide direct grants for education to a demographic group of individuals that is generally similar to the group that would be eligible for a refundable credit. 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>80</sup>

Some argue that the Lifetime Learning credit, which has a per-tax-return limit, fails to account for family size, and that it is more equitable to target benefits on a per-student basis, as is

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<sup>78</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>.

<sup>79</sup> The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System* 120 (Nov. 2005).

<sup>80</sup> The ability to obtain a loan from the educational institution or another source would mitigate this concern.

done for the Hope credit. Some have also pointed out that certain of the tax benefits are available only to a limited class. For example, the exclusion for qualified tuition reduction is available only to employees of qualified institutions.<sup>81</sup> While available to a broader group of potential beneficiaries than the tuition reduction, the exclusion for employer-provided educational assistance has also been criticized for being available only to individuals whose employer has such a program.<sup>82</sup> The tuition reduction exclusion applies with respect to dependents of the employee, whereas the general exclusion applies only to education of the employee.

Lastly, an issue that affects both tax incentives and direct expenditures to subsidize education concerns the ultimate economic incidence of the subsidies as compared to the statutory beneficiary. For example, it has been observed that the various individual tax benefits for education provide incentives for educational institutions to capture some of the benefit by raising their tuition and fees. This is particularly true for community colleges that charge less than the amount that is fully subsidized by the Hope credit (the first \$1,200 of tuition in 2008 is eligible for a 100 percent credit for Hope eligible students), because tuition can be raised to \$1,200 without the student paying more out-of-pocket on an after-tax basis, provided the student or parent has tax liability to offset. Additionally, State and local governments may choose to appropriate fewer funds to the public educational institutions or to financial aid programs in response to the increased support provided by the Federal government via individual tax incentives.<sup>83</sup> These responses by educational institutions and/or State and local governments have the potential to undermine the benefit provided at the Federal level. In particular, to the extent that colleges raise tuition in response to a Federal nonrefundable credit, students or parents without Federal tax liability to offset are unambiguously made worse off.

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<sup>81</sup> The staff of the Joint Committee on Taxation has recommended repeal of the exclusion for tuition reduction for this reason. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), Jan. 27, 2005, at 44-46.

<sup>82</sup> In addition to the objective of subsidizing education, the exclusion for employer-provided education assistance has also been justified on administrative and simplification grounds. In the absence of the exclusion, certain employer-provided education that is job related would be excludable from income. The specific exclusion under section 127 avoids the need to make the factual determination as to whether the education is job related.

<sup>83</sup> For evidence on the response of educational institutions with respect to tuition policy and governments with respect to appropriations for education, see Bridgett Terry Long, "The Impact of Federal Tax Credits for Higher Education Expenses," in *College Choices: The Economics of Where to Go, When to Go, and How to Pay for It* 101 (Caroline M. Hoxby ed., 2004).

**Table 7.—Treatment of Expenses Under Education Tax Benefits**

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

| <b>Provision</b>  | <b>Tuition</b>   | <b>Required Fees</b>  | <b>Books, Supplies, Equipment</b>  | <b>Room and Board</b>   | <b>Special Needs Services</b>       |
|---|--|---|--|---|-------------------------------------|
|   |  |   |  | included in the institution's cost of attendance for Federal student aid purposes, or (2) the actual invoiced amount for students residing in housing owned or operated by the institution. |                                     |
| 4. Exclusion for distributions from Coverdell education savings accounts (sec. 530)           | Included.  | Included.   | Same as qualified tuition programs.  | Same as qualified tuition programs.   | Same as qualified tuition programs. |
| 5. Savings bond interest exclusion (sec. 135)   | Same as Hope credit.   | Same as Hope credit, except that nonacademic fees are not excluded from the definition of fees. | Not included.  | Not included.   | Not included.                       |
| 6. Above-the-line deduction for interest on loans for qualified education expenses (sec. 221) | Included to the extent included in costs of attendance for Federal student aid purposes. | Included to the extent included in costs of attendance for Federal student aid purposes.        | Included to the extent included in costs of attendance for Federal student aid purposes. | Included to the extent included in costs of attendance for Federal student aid purposes.  | Not included.                       |

| <b>Provision</b>   | <b>Tuition</b>       | <b>Required Fees</b> | <b>Books, Supplies, Equipment</b> | <b>Room and Board</b> | <b>Special Needs Services</b> |
|--|----------------------|----------------------|-----------------------------------|-----------------------|-------------------------------|
| 7. Temporary above-the-line deduction for higher education expenses (sec. 222) | Same as Hope credit. | Same as Hope credit. | Not included.                     | Not included.         | Not included.                 |
| 8. Exclusion for scholarships (sec. 117(a))                                    | Included.            | Included.            | Included.                         | Not included.         | Not included.                 |
| 9. Exclusion for qualified tuition reduction (sec. 117(d))                     | Included.            | Not included.        | Not included.                     | Not included.         | Not included.                 |

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