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Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid

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Summary

The Taxpayer Relief Act of 1997 established two permanent federal income tax credits, effective since tax year 1998, for qualified postsecondary education expenses — the Hope Scholarship credit and the Lifetime Learning credit. The Economic Growth and Tax Relief Reconciliation Act of 2001 authorized a temporary income tax deduction for higher education expenses, which was extended from December 31, 2005, to December 31, 2007, in the Tax Relief and Health Care Act of 2006.

The Hope credit was introduced to help ensure that students have access to the first two years of undergraduate education. The Lifetime Learning credit and tuition and fees deduction provide support for students in any year of undergraduate and graduate study; they are unique in that they are available to individuals taking occasional courses. Only one of the three tax benefits may be taken in the same tax year for the same eligible student's qualified expenses.

Key features of the education credits and deduction dictate who the provisions benefit and the value of assistance they confer. Among these are the nonrefundable nature of the credits (i.e., persons must have income tax liabilities, which must exceed the maximum amount of the credits to claim their full value), the deduction's availability whether or not taxpayers take itemized deductions, and the statutory limits on benefit amounts and on taxpayers' income. Accordingly, middle- and upper middle-income individuals are the targeted beneficiaries of these tax incentives.

All three benefits apply to the tuition and fees required for enrollment that are not offset by grant aid (e.g., Pell Grants and scholarships) and other tax benefits (e.g., Coverdell Education Savings Accounts and Section 529 Plans). The value of the Hope credit rose to a maximum of $1,650 per student for tax year 2006; the Lifetime Learning credit, $2,000 per return since 2003. The value of the deduction depends on taxpayers' marginal tax rates, and it was available to persons higher up the income scale than typically served by the credits. The deduction covers qualified expenses of up to $4,000 per return in 2006, although a smaller deduction of up to $2,000 is available to somewhat higher-income taxpayers.

With the introduction of these tax benefits, individuals can now receive substantial amounts of federal financial assistance for postsecondary education from two parallel systems — the federal income tax system and the traditional student aid delivery system, which provides aid such as grants, loans, and work opportunities. The traditional system helps students meet current expenses; the tax system requires families to make outlays that are reimbursed through tax reductions determined near the end of or after an academic year. Tax benefits may offer streamlined delivery of aid, while most other aid is delivered through relatively cumbersome and labor-intensive processes. Some criticize the complexity of the tax process, however; and the availability of the tax benefits adds another system that students and families must navigate and learn to coordinate with any traditional aid received. This report will be updated as warranted.

Contents

List of Tables

Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid

The Taxpayer Relief Act of 1997 (TRA, P.L. 105-34) established two permanent federal income tax credits for qualified postsecondary education expenses: the Hope Scholarship credit and the Lifetime Learning credit. They became available to taxpayers filing returns for 1998 and thereafter. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) established a new temporary tax deduction for higher education expenses beginning in 2002. It was extended to December 31, 2007 in the Tax Relief and Health Care Act of 2006 (P.L. 109-432).[1]

At present, there are two parallel systems through which the federal government provides assistance for postsecondary education attendance — namely, the traditional student aid delivery system and the federal income tax system. The major Higher Education Act (HEA) Title IV programs that provide federal aid are the Pell Grant program (an estimated $13 billion in grant aid for FY2006) and the Federal Family Education Loan and Direct Loan programs (an estimated $60.6 billion in new loan volume for FY2006).[2]

The value of the higher education credits and tuition deduction places them among the largest sources of federal support to meet the costs of postsecondary education. Preliminary data from the Internal Revenue Service (IRS) show that taxpayers took $6.1 billion in education tax credits and $10.7 billion in higher education deductions on their 2004 federal income tax returns.[3]

There are important distinctions between the tax system as a mechanism for providing benefits for postsecondary education expenses and the traditional student aid delivery system. Tax incentives flow through a system that is dependent upon the

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[1] Information on legislative activity during the 110th Congress pertaining to the deduction and other education tax benefits enhanced temporarily by EGTRRA is provided in CRS Report RS21870, *Education Tax Benefits: Are They Permanent or Temporary?* by Linda Levine.

[2] A minority of new loan volume consists of federal funds; the majority is private capital supported by federal loan guarantees and subsidies.

[3] Internal Revenue Service, "Individual Income Tax Returns, Preliminary Data, 2004," *Statistics of Income Bulletin*, winter 2005-2006. (Hereafter cited as IRS, *Individual Income Tax Returns, Preliminary Data, 2004*.)

tax status of filing units and the level of qualified higher education expenses they incur. Tax benefits typically are not realized until after, sometimes well after, education spending has occurred. Benefit calculations are independent of any direct measurement of the ability to pay for postsecondary education. Further, the tax incentives are not subject to annual appropriations. In contrast, federal assistance provided through the traditional delivery system consists of grant, loan, and work aid. Much of this aid is awarded directly to students, while some is controlled and disbursed by financial aid officers at postsecondary institutions. A substantial portion of this assistance is awarded on the basis of students' financial need.[4] Finally, a significant portion of this assistance is subject to annual appropriations.

This report is intended to provide information about the direct assistance for education expenses provided through the federal income tax system, thereby placing HEA student aid programs in a broader context. The key features of these tax provisions — which largely dictate whom they assist and by how much — are explored. Further, it examines the relationship of the traditional student aid delivery system with the tax system as a conduit for postsecondary education assistance.

An Overview of the Benefits

The Hope Scholarship Credit

The Hope Scholarship credit is a *nonrefundable* credit against federal income tax liability for qualified higher education expenses.[5] Initially, the credit *for each eligible student* was 100% of the first $1,000 of qualified expenses and 50% of the second $1,000 of such expenses, for a maximum benefit of $1,500. Although the $1,000 figures became indexed to inflation after 2001, the formula specified in the TRA for this purpose did not result in the Hope credit's maximum value rising until tax year 2006 (i.e., 100% of the first $1,100 in qualified expenses and 50% of the second $1,100 = $1,650 per student).

Taxpayers can claim the credit for qualified higher education expenses of each eligible student for whom they claim tax exemptions, including themselves, their spouse, and dependent children.[6] Eligible students must have been enrolled on at least a half-time basis for at least one academic period during the tax year in a higher education program leading to a degree, certificate, or credential. They cannot have

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[4] While still dominant, the portion of student aid that is being awarded dependent on need may be declining. As reported by the Advisory Committee on Student Financial Assistance, "At the state level, new grant aid has shifted steadily in favor of merit-based aid and against need-based aid." (*Access Denied: Restoring the Nation's Commitment to Equal Educational Opportunity*, Feb. 2001, p. 8.) The Committee reports that 18.6% of state grant aid funds is now merit-based.

[5] Only individuals with income tax liability can benefit from a nonrefundable tax credit. A nonrefundable credit cannot be worth more than the amount of the tax liability. In contrast, if the value of a refundable credit exceeds tax liability, the federal government pays the taxpayer the amount of the difference between the two.

[6] Expenses paid by a dependent or someone other than the filer, spouse, or dependent are treated as if paid by the taxpayer.

finished the first two years of undergraduate education, and the credit can only be claimed for their first two years of study.[7] Individuals with a federal or state felony conviction for drug possession or distribution are not eligible for the credit.

Qualified higher education expenses are defined as tuition and fees required for enrollment at institutions eligible to participate in U.S. Department of Education (ED) student aid programs, including accredited public, private, and proprietary postsecondary institutions. They include those fees required as a condition for enrollment that are paid to the institution. Thus, fees for course-related books, supplies, and equipment as well as activity fees are included only if they are paid to the institution. Room and board, medical expenses including student health fees, and transportation are among the costs excluded from coverage.

Qualified tuition and fees expenses must be reduced by the amount of non-taxable educational assistance (exclusive of loans and gifts) that an eligible student receives. This includes education assistance that is excluded from taxpayers' gross income (e.g., Pell Grants, scholarships, veterans' educational benefits, and employer-provided tuition reimbursements).

The amount of the Hope credit is gradually reduced for individuals whose modified adjusted gross income[8] for 2006 is between $45,000 and $55,000 (for those filing joint returns, between $90,000 and $110,000). A taxpayer having income above the eligibility ceiling with a student who qualifies for the dependent exemption might decide *not* to make such a claim in the case of the credit, thereby enabling the student to claim the credit's full value if he/she has income below the phase-out threshold and has income tax liability against which a credit could be taken. As previously noted, the various income thresholds are indexed to inflation.

The Hope credit cannot be claimed for a student if the Lifetime Learning credit is claimed for the same student in the same tax year. Individuals for whom a Hope credit is claimed cannot concurrently benefit from the deduction for qualified higher education expenses taken for the same student in the same tax year. For additional information on coordination of the Hope credit with other postsecondary education tax benefits (e.g., Coverdell Education Savings Accounts and Section 529 Programs) and for a comparison of the three education tax benefits that are the subject of this report, see **Table 1**, below.

The Lifetime Learning Credit

The Lifetime Learning credit also is a nonrefundable tax credit for qualified tuition and fees. For qualified expenses paid on or after January 1, 2003, the credit *per tax return* is a maximum of $2,000, calculated as 20% of the first $10,000 in

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[7] The first two years of postsecondary education can include two one-year certificate programs. See 67 *Federal Register* 76687 (Dec. 26, 2002), where the Hope and Lifetime Learning credits' final regulations are published.

[8] In general, taxpayers' modified adjusted gross income equals their adjusted gross income (AGI). For taxpayers who exclude income earned abroad or from certain U.S. territories or possessions, modified AGI is their AGI increased by those excluded amounts.

qualified expenses. Unlike the Hope credit, the value of the Lifetime Learning credit is not adjusted for inflation.[9]

Also unlike the Hope credit, students eligible for the Lifetime Learning credit are those enrolled in one or more courses of undergraduate or graduate instruction to acquire or improve job skills. There is no limit on the number of years for which the Lifetime Learning credit may be claimed.

Like the Hope credit, the Lifetime Learning credit is available to individuals who pay the qualified higher education expenses of eligible students for whom they claim exemptions on their tax returns. Qualified tuition and related expenses are calculated and treated in the same fashion as they are under the Hope credit, including the reduction for nontaxable educational assistance. The Lifetime Learning and Hope credits share the same income-eligibility levels and income phase-out ranges.

The Lifetime Learning credit cannot be claimed for a student if the Hope credit is claimed for the same student in the same tax year. Individuals for whom a Lifetime Learning credit is claimed cannot concurrently benefit from the tax deduction for qualified higher education expenses. The Lifetime Learning credit also coordinates with other education tax benefits in the same manner as the Hope credit.

The Higher Education Deduction

The *above-the-line deduction* for taxpayers who pay qualified higher education expenses for eligible students became effective in 2002.[10] After expiring on January 1, 2006, it was reauthorized retroactive to its expiration and to December 31, 2007.

For 2006, the maximum deduction is $4,000 *per return*.[11] This deduction is available to individuals with an AGI of up to $65,000 ($130,000 in the case of filers of joint returns). There is a smaller deduction of $2,000 for taxpayers whose AGI was more than $65,000 but not more than $80,000 (more than $130,000 but not more than $160,000 for those filing joint returns).[12] Neither the amount of the deduction nor the income ceilings are adjusted for inflation. The amount of the deduction is not gradually reduced by formula as the AGI of taxpayers rises within an income range.

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[9] The TRA had set the credit for tax years 1999-2002 at 20% of the first $5,000 of qualified expenses, or $1,000 at most.

[10] An above-the-line deduction is taken as an adjustment to taxpayer's gross income on IRS 1040 form, and therefore can be claimed whether or not the taxpayer itemizes deductions. A deduction affects the calculation of AGI. Unlike a credit, it does not directly affect income tax liability.

[11] For 2002 and 2003, it was set at $3,000 per return.

[12] Unlike the credits, if an eligible student qualifies as a dependent of his/her parents — regardless of whether the parents take an exemption for their child — the parents can take the higher education deduction only if they actually pay the qualified expenses. Even if the dependent student paid the qualified expenses, no one could claim the higher education deduction.

Table 1. Major Features of the Higher Education Tax Credits and Deduction

Characteristic	Hope Scholarship Credit	Lifetime Learning Credit	Higher Education Deduction
Nature of the tax benefit	The credit reduces *income tax liability*. It is referred to as a "nonrefundable credit" because it can only be claimed by individuals who have tax liabilities remaining after they have taken personal/dependency exemptions, standard or itemized deductions, and other personal credits. As a result, the taxpayer may not be able to realize the full value of the Hope Credit.	Same	The deduction reduces *taxable income*. It is referred to as an "above-the-line" deduction because it is claimed as an adjustment to income on the 1040 form, and therefore is *available to taxpayers who do not itemize deductions*. The actual value of the deduction depends on the taxpayer's marginal tax rate. Generally, the higher the tax rate, the larger the deduction.
Who can claim it?	Taxpayers who claim an exemption on their returns for a student with qualified higher education expenses (e.g., a child, a spouse, or themselves).	Same	Same
For whom can it be claimed?	A student enrolled *at least half-time* for at least one academic period *in a program leading to an educational credential* at an eligible educational institution, who is *in their first two years of postsecondary school* and who has not had a felony drug conviction. The credit is available for two years per student.	A student enrolled in *one or more courses at the undergraduate level or graduate level* at an eligible educational institution who need not be pursuing an educational credential.	Same as Life Learning Credit
Qualified expenses	*Tuition and related expenses* required for enrollment or attendance at an eligible educational institution.	Same	Same
	These expenses must be reduced by any tax-free educational assistance (e.g., Pell Grants, scholarships, Veterans' educational assistance, and employer-provided educational benefits).	Same	Same
Eligible institutions	Any college, university, vocational school, or other postsecondary institution eligible to participate in an ED-administered student aid program.	Same	Same
Maximum value of the benefit	*$1,650* ***per student*** *in tax year 2006*. (100% of the first $1,100 of qualified expenses and 50% of the second $1,100 per student. *Each of the*	*$2,000* ***per return*** *in tax year 2006*. (20% of the first $10,000 of qualified expenses per return.)	*$4,000* ***per return*** *in tax year 2006*.

Characteristic	Hope Scholarship Credit	Lifetime Learning Credit	Higher Education Deduction
	dollar amounts is indexed for inflation annually.)		
Income eligibility limits	Taxpayers whose AGI is $55,000 or more ($110,000 or more for those filing joint returns) are not eligible for the credit in tax year 2006. The credit amount is gradually reduced for taxpayers whose AGI is between $45,000 and $55,000 ($90,000 and $110,000 for those filing joint returns). *The income ranges are adjusted annually for inflation*.	Same	The $4,000 deduction is not available to taxpayers whose AGI is more than $65,000 (more than $130,000 for those filing joint returns). Persons with AGIs of more than $65,000 but not more than $80,000 (more than $130,000 but not more than $160,000 for joint filers) are eligible for a lower maximum of $2,000. *There is no phase-out, and the income threshold is not indexed for inflation*.
Coordination of benefits (i.e., no double benefit allowed)	The Hope Credit cannot be claimed if the Lifetime Learning Credit, Tuition and Fees Deduction, or business expense deduction is taken for the same student in the same year.	Same	Same
	The Hope Credit cannot be claimed for the same qualified expenses paid with tax-free educational assistance, with tax-free withdrawals from Coverdell Accounts and from Section 529 Plans, and with tax-free interest on U.S. Savings Bonds.	Same	Same as Hope Credit except, with regard to QTPs, the deduction could not be claimed for the same qualified expenses paid with only the tax-free *earnings* portion of withdrawals.
	It can be claimed for qualified expenses paid with the proceeds of a loan.	Same	Same

Source: The tax information was derived from IRS, *Tax Benefits for Education*, Publication 970; provisions of the Internal Revenue Code; and commentary.

Note: These education tax benefits cannot be claimed by married individuals who file separate returns. AGI refers to "modified AGI" (e.g., AGI plus foreign earned income and housing exclusions), which are identical for most taxpayers.

Although the deduction reduces a taxpayer's AGI dollar for dollar, it ultimately is worth different amounts to taxpayers depending upon their marginal tax rates.[13] For example, the deduction is worth $450 in reduced tax liability to a taxpayer in the 15% tax bracket with $3,000 in qualified expenses (0.15 x $3,000) in tax year 2006. For an individual in the 25% tax bracket with the same amount of qualified expenses, the deduction produces a maximum of $750 in tax savings (0.25 x $3,000).

Taxpayers can take the deduction if they pay their own qualified higher education expenses or those of their spouses or dependents for whom they claim tax exemptions. As with the Lifetime Learning credit, there are no limitations on the level of postsecondary education enrollment (undergraduate and graduate enrollment) or the intensity of enrollment (a single course of study, half-time enrollment, or full-time enrollment). The qualified higher education expenses for the deduction are defined as they are for the two credits.

The deduction cannot be taken for the qualified higher education expenses of any individual for whom the Hope or Lifetime Learning credits are claimed. For the most part, qualified higher education expenses are reduced by tax-free educational assistance and coordinated with other tax benefits in the same fashion as they are for the credits. (See **Table 1**, above, for more detail.)

Intended Beneficiaries and Benefit Size

Higher education tax incentives, like other forms of federal financial aid, represent investments in human capital that are expected to yield benefits for society beyond those realized by individual recipients.[14] The tax benefits are not available to everyone seeking to meet postsecondary education expenses; rather, they are primarily focused on specific groups of individuals and provide them with different amounts of assistance.

The Beneficiaries

Middle-Income Families. The tax benefits were enacted to help preserve and enhance access to postsecondary education for students from middle- and upper middle-income families. This group of families is not centrally targeted by most other federal aid programs, which place primary emphasis on assisting students with the greatest amount of financial need. Yet, students of middle-income families make up a large proportion of the college population, and these families face the challenge of meeting costs of higher education that have been increasing at a rate that has consistently outpaced inflation in recent decades.

Available data on tax benefit recipients indicate that the higher education tax credits and deduction are, as intended, primarily serving middle- and upper middle-

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[13] The marginal tax rate is the tax rate applied to the last additional dollar of income.

[14] For additional information see CRS Report RL33238, *The Benefits of Education*, by Linda Levine.

income individuals. Preliminary IRS data reveal that 36% of the 2004 tax returns that claimed the education credits were from filers with an AGI of $50,000 or more, and 56% of the returns that claimed the deduction were from filers in that AGI-range as well. (See **Table 2**.) These tax filers accounted for 43% of the total amount claimed in these credits, and 55% in the deduction, for 2004. In contrast, only 9% of the returns claiming the credits, and 19% taking the deduction, were from tax filers with an AGI of less than $15,000; these returns accounted for 3% of the total amount of the two credits claimed and 21% of the amount of the deduction taken.

Table 2. Preliminary 2004 IRS Data for the Hope and Lifetime Learning Credits and the Higher Education Deduction

($ in thousands)

		Adjusted gross income				
	All returns	**Under $15,000**	**$15,000 under $30,000**	**$30,000 under $50,000**	**$50,000 under $100,000**	**$100,000 under $200,000**
Number of returns claiming credits	7,253,234	641,088	1,970,286	1,986,654	2,606,261	48,945
% of all returns claiming credits	100%	9%	27%	27%	36%	0%
Amount of credits claimed	$6,076,920	$210,644	$1,420,578	$1,807,230	$2,630,920	7,550
% of total claimed	100%	3%	23%	30%	43%	0%
Number of returns claiming deduction	4,738,193	891,667	565,051	613,908	1,483,651	1,183,916
% of all returns claiming deduction	100%	19%	12%	13%	31%	25%
Amount of deduction claimed	$10,677,851	$2,282,676	$1,145,319	$1,285,860	$3,154,913	$2,809,082
% of total claimed	100%	21%	11%	12%	29%	26%

Source: IRS, *Individual Income Tax Returns, Preliminary Data, 2004.*

Note: Sum of percentages may not equal 100% due to rounding. Data are not available for each credit individually.

Traditional and Nontraditional Students. Significantly, the Lifetime Learning credit and the deduction, which can be claimed for an unlimited number of years, support traditional and nontraditional students regardless of their enrollment or degree status. Part-time and full-time students can qualify, as can graduate, undergraduate and non-degree students. As a consequence, the Lifetime Learning credit and the deduction occupy a unique niche in the student aid landscape: the two tax incentives are widely available benefits that can support students who are taking occasional courses but are not necessarily enrolled in an educational credential or degree program. They may be a major source of direct financial aid available to many individuals who want to take courses periodically over the course of their careers to upgrade their skills.[15]

Even though the Lifetime Learning credit and the deduction have been designed to provide aid to a wide array of students, they likely will provide a good deal more benefit to traditional undergraduate and graduate students on a *per year* basis than to sporadic course-takers. This is due to the fact that the credit covers a maximum of $2,000 of eligible expenses incurred within a year's time, for example, and traditional students are likely to incur more costs. However, sporadic course-takers can receive support for an unlimited number of years, and may ultimately gain more value from the credit *over a series of years* than traditional students.

The Education Tax Benefits' Relative Worth

Since many students are eligible for more than one of these benefits, taxpayers likely will attempt to choose the one that provides the maximum value of tax savings to them. In general, when examining the relative worth of the benefits the following rules of thumb apply:

- For those middle-income taxpayers filing a joint return with one student who is eligible for the Hope credit and with incomes below the phase-out range, the Hope credit generally is more valuable than Lifetime Learning credit if qualified expenses are less than $8,500. For families with more than one student eligible for the Hope credit, the better choice for each child between the Hope credit and the Lifetime Learning credit will depend upon the qualified expenses of the additional student(s).
- For those middle-income taxpayers filing a joint return with a student eligible to receive either credit and with incomes below the phase-out range, the value of the higher education deduction never exceeds that of the Hope credit and only exceeds that of the Lifetime Learning credit when the amount of qualified expenses is $4,000 or less *and* the taxpayer's marginal tax rate is more than 20%.
- As income increases, the income thresholds at which the credits and deduction are eliminated become increasingly important in determining who can receive which benefit.

The figures in **Table 3** can be used to illustrate some of these points. For a married-couple family in the 15% tax bracket with one child eligible for the Hope credit who is attending a college at which tuition and fees total $10,000 for tax year 2006, the Lifetime Learning credit is worth its maximum of $2,000 in tax savings — higher than either the Hope credit maximum of $1,650 (which is reached when qualified expenses meet or exceed $2,200) or the deduction's value of $600 (0.15 x $4,000, the maximum amount of qualified tuition and fees that can be subtracted from income). If the same family had a second child who also is eligible for the Hope credit and who is attending a two-year public institution that charges tuition of

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[15] Among other more narrowly targeted benefits for individuals seeking to upgrade skills is employer education assistance.

$1,000, then the Hope credit would be the better choice for the second child ($1,000) and the Lifetime Learning credit would continue to be the better choice for the first child ($2,000); the total tax savings for the family from the education credits would be $3,000. Other combinations of the credits, or of the credits and the deduction, would produce a smaller tax savings for the family.

Table 3. Examples of Tax Savings from the Higher Education Tax Credits and Deduction

	Value of tax benefit per return			
			Higher education deduction	
Tuition and fees	Hope Scholarship Credit	Lifetime Learning Credit	15% marginal tax rate[a]	25% marginal tax rate[b]
$350	$350	$70	$53	$88
1,000	1,000	200	150	250
2,200[c]	1,650	440	330	550
4,000	1,650	800	600	1,000
5,500[d]	1,650	1,100	600	1,000
8,500	1,650	1,700	600	1,000
10,000	1,650	2,000	600	1,000
21,000[e]	1,650	2,000	600	1,000

Source: Congressional Research Service.

a. Represents married-couple family filing jointly with one child enrolled full-time in the freshman year of college at an eligible institution of higher education with an AGI below the Hope and Lifetime Learning credits' income phase-out range.
b. Represents married-couple family filing jointly with one child enrolled full-time in the freshman year of college at an eligible institution of higher education with an AGI below the Hope and Lifetime Learning credits' income phase-out range.
c. Average tuition and fees at two-year public postsecondary institution is $2,191 in 2005-2006, according to The College Board, *Trends in College Pricing 2005*.
d. Average tuition and fees at four-year public postsecondary institution is $5,491 in 2005-2006, according to The College Board, *Trends in College Pricing 2005*.
e. Average tuition and fees at four-year private postsecondary institution is $21,235 in 2005-2006, according to The College Board, *Trends in College Pricing 2005*.

The importance of the amount of qualified expenses in determining the relative value of the three tax benefits can be seen by looking at each expense level in the table's first column and then across the corresponding row. It is not until qualified tuition and fees are $8,500 that the Lifetime Learning credit produces more tax savings than the Hope credit for a family with one eligible student ($1,700 and $1,650, respectively). Because EGTRRA capped the maximum amount that may be taken as an adjustment against income at $4,000, the reduction in income tax liability yielded by the higher education deduction cannot match the tax savings of the Hope credit.

The comparative value of the deduction and the Lifetime Learning credit for families is more complex, being affected both by the deduction's limit on qualified expenses and a taxpayer's marginal tax rate. The $4,000 tuition and fee cap means that the higher education deduction produces a maximum reduction in income tax liability of $600 for a family with a 15% marginal tax rate and of $1,000 for family with a 25% marginal tax rate, both of whom have an AGI below the credit's income phase-out range. At $4,000 in qualified expenses, the Lifetime Learning credit is worth $800 (0.20 x $4,000), which is a smaller tax savings than the deduction affords for the family with the higher (25%), but not lower (15%), marginal tax rate. Generally, for families who have an AGI that allows them to take the full Lifetime Learning credit or the deduction, who incur tuition and fees of $4,000 or less, and who have a marginal tax rate above 20%, the deduction will be worth more than the credit.

Benefit Size and Tax Liability. An individual's tax liability level essentially functions as a floor for the credits. In other words, the Hope and Lifetime Learning credits can only provide assistance to those whose income is not completely offset by standard deductions and personal or dependent exemptions. If an individual's tax liability is below the maximum value of the credit, only the lesser amount may be claimed. According to one analysis based upon tax returns for 1999, "half of the higher education tax credit beneficiaries were not able to take the full credit for which they were eligible."[16]

Insufficient tax liability to claim an education credit's maximum value can come about not only through low income levels but also through "competing credits." In other words, other tax credits for which an individual is eligible, such as the dependent care tax credit, may reduce the filer's income tax liability below the amount of the education credits. For instance, if a tax filer has $1,000 in tax liability and qualifies for a $480 dependent care tax credit, $1,500 Hope credit for one student, and a $1,000 Lifetime Learning credit for another student, the filer can only receive a total tax benefit of $1,000 (i.e., the tax liability is less than the aggregate of credits for which the taxpayer is eligible).

Taxpayers seeking to claim the education credits also may be affected by the alternative minimum tax provisions that limit the aggregate nonrefundable personal credits a taxpayer can claim. As a result, some of these taxpayers may find the deduction to be a preferable option.

In contrast to the credits which reduce an individual's tax liability on a dollar for dollar basis, the deduction reduces a taxpayer's AGI. As previously shown, the potential impact of that reduction on tax liability is realized through the taxpayer's

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[16] Bridget Terry Long, *The Impact of Federal Tax Credits for Higher Education Expenses*, NBER Working Paper 9553 (Cambridge, MA: National Bureau of Economic Research, Feb. 2003). (Hereafter cited as Long, *The Impact of Federal Tax Credits*.)

marginal tax rate. Further, some taxpayers may have such limited tax liability *before* the application of the deduction that its actual benefit will be small.

Benefit Size and Qualified Expenses. Students attending postsecondary education institutions where the qualified higher education expenses are less than the maximum allowable tax benefits will not be able to claim their full benefits. At many public institutions, low tuition and fee levels are likely to limit the ability to realize the full tax benefits. For the Hope credit, qualified higher education expenses must be at least $2,200 for the maximum credit to be realized. As noted in **Table 3**, two-year public institutions have tuition and fees in 2005-2006 that are — on average — about that level ($2,191). Realizing the full value of the Lifetime Learning credit may be difficult for many students at public institutions in general: qualified expenses have to be at least $10,000 to actualize the maximum Lifetime Learning credit of $2,000, while the average tuition and fees at four-year public institutions in 2005-2006 is a much lower $5,491.

For the deduction, a taxpayer can claim the maximum tax-rate-dependent value only if qualified expenses are $4,000. At $4,000, only the average tuition and fees at two-year public institutions are less. The average tuition and fees of $5,491 at four-year public institutions in 2005-2006 is somewhat greater than the cap on qualified expenses. In contrast, the average tuition and fees of $21,235 at four-year private institutions in 2005-2006 far exceeds any of the tax benefit maximums. Tuition and fees are probably sufficiently high at many of these institutions to pose no barrier on their own to realization of the full value of the credits and deduction.

The ability to capture the full value of these tax benefits is further limited by their being claimed to reimburse students and their families only for the *net* cost of qualified expenses, that is, the qualified expenses remaining after any non-taxable educational assistance received (exclusive of loans and gifts) is subtracted. This reduces, if not eliminates, the tax benefits for many students receiving relatively large amounts of grant or scholarship aid. This is particularly the case for students receiving relatively large federal Pell Grant awards. Pell Grants are need-based grants that, in the 2005-2006 award year, provide a maximum of $4,050 to the neediest students (i.e., students whose families are expected to contribute no resources toward postsecondary education costs). *Students attending institutions with low tuition and fee charges and receiving large Pell Grants may have little or no net qualified expenses remaining for which to claim an education credit or deduction. At the same time, these low-income students and their families may not have much if any tax liability, also restricting their ability to benefit from the credits or deduction*.

As a result, students attending higher cost institutions, and those receiving relatively little grant or scholarship aid, are well positioned to capture a good deal of the potential value of their Hope and Lifetime Learning credits and higher education deduction, assuming their families have sufficient tax liability to realize the maximum benefit from the credits or deduction.

Relationship of Education Tax Benefits to the Traditional Student Aid Delivery System

The introduction of the higher education tax benefits represented a departure from the federal government's more common practice of primarily making aid available through the traditional student aid delivery system. Given that the federal government is the primary provider of direct aid to students, and tax benefits have quickly grown to become a major component of the federal aid effort, considerable discussion has emerged related to the merits of providing aid through the tax system.

Strengths and Weaknesses of the Approaches

Providing student financial support toward meeting the costs of college through the federal income tax system has a number of advantages and disadvantages relative to the traditional process of providing grants, loans, and work support. For example, one issue that distinguishes the traditional student aid system and the tax system is the timing of the awards. The traditional system provides aid such as grants and loans just in advance of the arrival of tuition bills. Tax benefits, in contrast, require families to make an initial capital outlay, which is "reimbursed" later in the academic year through tax refunds or reduced tax payments. This difference may limit the attractiveness of the tax system, at least for lower-income students who may not be able to meet current expenses that will be partly or fully reimbursed by a later tax benefit. Nevertheless, it is possible for taxpayers to adjust their tax withholding throughout the year to realize the tax benefits earlier; this would require some sophistication on the part of taxpayers. Further, for students enrolling in consecutive years, the tax benefit for a previous year may be provided in time to help meet the upcoming year's educational expenses. Finally, to the extent that these tax benefits are available primarily to middle- and upper middle-income individuals, the timing issue may be less important.

While tax credits and deductions may offer the advantage of streamlined delivery of funds to aid recipients who directly claim their financial assistance as part of their annual tax-filing process, most other aid is delivered through relatively cumbersome and labor-intensive processes that require considerable effort on the part of financial aid officers, ED personnel, and loan servicers, in the case of loans, who must collectively certify student eligibility for aid, monitor enrollment status, disburse funds, and deal with refunds and account reconciliation. Still, some have criticized the complexity of the process for taxpayers seeking to claim the tax benefits.[17] Further, there are institutional reporting requirements associated with the tax provisions that initially were viewed by some in the higher education community as potentially burdensome and expensive.[18]

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[17] See, for example Thomas R. Wolanin, *Rhetoric and Reality: Effects and Consequences of the HOPE Scholarship*, The Institute for Higher Education Policy, Apr. 2001. (Hereafter cited as Wolanin, *Rhetoric and Reality*.)

[18] The IRS interpreted the TRA to require educational institutions to report to the IRS a broad array of data for any individual enrolled for academic credit for whom the institution receives tuition and fee payments. Of particular concern had been the requirement for (continued...)

Given the extensive system already in place, the addition of the tax benefits, albeit delivered through an arguably more streamlined process, may actually increase the complexity of the overall national effort to help students and their families meet college costs. With the availability of the tax credits and the deduction, students and their families seeking to realize as much federally financed support as possible for college expenses must navigate not only the traditional financial aid system but also the federal income tax system. Potentially, the tax benefits may more likely be claimed successfully by sophisticated filers.

Direct Effect of Tax Benefits on Traditional Student Aid

Effect on Federal Student Aid. By statute, the receipt of the tax credits is to have *no effect* on a student's eligibility for, or level of, federal student aid. First, in calculating what a student and his or her family is expected to contribute toward college costs (expected family contribution or EFC) under the Higher Education Act (HEA) student aid programs, HEA Section 480(a)(2) states that the tax credits cannot be considered income or assets for purposes of that calculation. Second, HEA Section 480(j)(3) provides that the determination of need for HEA Title IV aid programs — student's cost of attendance minus the EFC and non-Title IV assistance — is not to include the credits as non-Title IV assistance. Any non-Title IV assistance included in this calculation reduces a student's need and, hence, his or her eligibility and level of assistance under need-based Title IV aid. There is no comparable language in the HEA governing the interaction between the higher education deduction and the Title IV assistance. As a result, it is possible that some taxpayers who benefit from the deduction (i.e., have less federal income tax liability) will, in turn, be found to have less financial need for traditional student aid.

Tax benefits and Title IV aid may interact, however, in the federal funding process. It is possible that, in congressional deliberations over the budget and spending for federal programs, the forgone tax revenue associated with the tax benefit provisions may have a negative impact on the willingness or ability of the Congress to devote funds to the traditional federal student aid programs.

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[18] (...continued)
institutions to report the following for each student: the identity of the taxpayer claiming the student as a tax dependent and the aggregate amounts of qualified expenses paid, scholarship and grant aid received, and aggregate refunds made. Although the IRS limited the reporting requirements in the first four years of implementation (1998-2001) to less than those stipulated in the TRA, even these more limited requirements were criticized as costing institutions substantial resources. P.L. 107-131 (signed into law on January 16, 2002) modifies some of the TRA's reporting requirements. Among other changes, it repeals the requirement regarding reporting of information about taxpayers who can claim students as dependents, and permits reporting of either the aggregate amounts of qualified expenses *paid* or the aggregate amounts *billed* to students. To reflect the changes made by the legislation, the IRS partially withdrew proposed regulations issued June 16, 2000, and proposed new regulations on April 29, 2002 (67 *Federal Register* 20923).

Effect on Packaging of Other Aid. The limited evidence available suggests that financial aid officers are far from uniform in whether or how they consider the tax benefits when packaging financial aid for students. Indeed, it is not clear whether the majority actively factors the tax benefits into this process at all.

Financial aid officers who want to factor the tax credits into their aid packaging calculations may find the effort complicated by the absence of information about the actual value of the tax benefits students will receive. As noted earlier, tax benefits are claimed and their value known by April 15 of the year after the payment for qualified expenses are made.

Certain other aspects of the design of the tax benefits may make it difficult to infer their value before they are claimed. The actual value of the tax benefits to recipients is affected by a series of offsets and limitations that are built into the design of the tax system (for example, as explored earlier, a recipient must have sufficient tax liability to claim the credit and even then the value of the credit may be reduced by competing credits that can be claimed). The potential effects of these internal offsets and limitations make it hard for financial aid officers to project the value of the credit when packaging aid.

Those financial aid officers who would take the tax provisions into account in packaging aid, and thereby, reduce other kinds of aid for recipients, must make assumptions about the benefits' value. If gaps exist between the credits' actual and assumed value the recipients may receive more or less aid than intended.

Effect on State Decisions Related to Tuition Levels and Available Sources of Aid. The effect of the tax benefits on the setting of tuition levels by states is largely unknown. State higher education officials face challenges similar to those faced by financial aid officers stemming from the hidden value of tax credits. They must make decisions about tuition levels at state institutions and about the structure and targeting of state aid programs which can be shaped in part by assumptions about the value of aid that they expect will be available to students. Precisely gauging the net financial benefit flowing from the tax benefits is problematic; however, some states have considered, at least, raising the tuition and fees in some schools in order to enable their students to "capture" as much of the tax benefits as possible. Some states have also considered targeting their state grant programs in ways that avoid inhibiting students' ability to capture the full value of other credits.[19] Such decisions regarding tuition and aid will affect whether and how the tax benefits will enhance recipients' ability to finance postsecondary education.

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[19] One study that explored available information on this issue concludes that the Hope Scholarship provides resources that "are an incentive for private and public institutions of higher education to increase tuition or to reduce aid to students. Indeed, the HOPE Scholarship benefits institutions of higher education *only if* they raise tuition or decrease student aid. Several states have considered or undertaken strategies to capture the HOPE Scholarship through either tuition increases or aid reduction." (Wolanin, *Rhetoric and Reality*, p. 29.) Another report suggests that the credits' inception was associated with disproportionately large tuition increases at schools whose prior tuition levels were less than needed to maximize the Hope credit. (Long, *The Impact of Federal Tax Credits*.)