



CRS Report for Congress

Education Tax Benefits: Are They Permanent or Temporary?

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Summary

Federal income tax benefits available to individuals to mitigate escalating costs associated with postsecondary education have multiplied within the past decade. Some of these benefits are authorized permanently (e.g., the Hope Scholarship Credit, Lifetime Learning Credit, Coverdell Education Savings Accounts, and Section 529 Programs — Prepaid Tuition Plans and College Savings Plans), while others are authorized temporarily (e.g., the Higher Education Deduction and the Educator Classroom Expense Deduction). But complicating this distinction is the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), in which Congress enhanced temporarily aspects of permanent education tax benefits. This report very briefly describes the education tax benefits available to individuals and highlights their permanent-versus-temporary features. It discusses legislation that would remove the applicability of EGTRRA's sunset provision to these education tax benefits and bills that would extend the higher education deduction for tuition and related fees authorized by EGTRRA. This report will be updated as legislative activity occurs.

Education Tax Benefits

Permanently Authorized Provisions

The Taxpayer Relief Act of 1997 (P.L. 105-34) established two permanent federal income tax credits — *the Hope Scholarship and Lifetime Learning Credits* — for qualified postsecondary education expenses. Since tax year 1998, persons with income tax liabilities¹ may subtract from them the tuition and related fees paid on behalf of

¹ To take advantage of nonrefundable credits, taxpayers must have income tax liabilities remaining after they have taken personal/dependency exemptions, standard or itemized
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students (e.g., a child, spouse, or themselves) claimed as exemptions on their returns. Before determining the amount of the tuition and fees for which the credits can be claimed, qualified expenses must be reduced by any tax-free scholarships and financial aid (e.g., Pell Grants) awarded to the student. The two credits are intended to aid different student populations: for the Hope credit, students enrolled at least half-time in a program leading to an educational credential who are in their first two years of postsecondary school; and for the Lifetime credit, students enrolled in one or more courses at the undergraduate or graduate level who need not be pursuing an educational credential. The Hope credit is capped at \$1,650 per student in tax year 2006, and the Lifetime credit at \$2,000 per return. Only one of the credits may be claimed for a given student. In tax year 2006, the amount of the credits is gradually reduced for a single return tax filer with a modified adjusted gross income (AGI) between \$45,000 and \$55,000 (a joint filer, between \$90,000 and \$110,000). AGI limits may be adjusted annually for inflation.²

The *Education Savings Bond program*, which became effective in 1990 pursuant to Section 6009 of the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) is permanent as well. Bond owners who apply the principal and interest of Series EE and I bonds toward tuition and related fees on behalf of a dependent student at the undergraduate or graduate level in the same year in which the bonds are redeemed may be eligible to exclude the interest from their taxable income. The bond must be registered in the taxpayer's and/or spouse's name rather than the dependent's name. The taxpayers must claim an exemption for the student and must meet AGI limits in the year in which bond proceeds are used toward tuition and related fees. In tax year 2006, the exclusion begins to phase out at an AGI above \$63,100 for a single filer and above \$94,700 for a joint filer. The exclusion cannot be taken by single filers whose AGI is at least \$78,100 (for joint filers, \$124,700). AGI limits may be adjusted annually for inflation.³

Temporarily Authorized Provisions

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) extended through December 31, 2010 the temporary *exclusion for employer-provided educational assistance*, which was set to expire for courses beginning after December 31, 2001. It also allowed the \$5,250 annual limit on education assistance to again cover graduate as well as undergraduate courses. The income exclusion originated with enactment of the Revenue Act of 1978 (P.L. 95-600).⁴

¹ (...continued)

deductions, and other personal credits.

² For additional information, see CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by Adam Stoll and Linda Levine. (Hereafter cited as CRS Report RL31129, *Higher Education Tax Credits and Deduction*.)

³ For additional information see CRS Report RL32155, *Tax-Favored Higher Education Savings Benefits and Their Relationship to Traditional Federal Student Aid*, by Linda Levine and Charmaine Mercer. (Hereafter cited as CRS Report RL32155, *Tax-Favored Higher Education Savings Benefits*.)

⁴ For additional information, see CRS Report 97-243, *The Current Status of Employer Education* (continued...)

The *Higher Education Deduction* originated in EGTRRA, which authorized the deduction for tuition and related fees for tax years 2002 through 2005. In December 2006, the Congress reauthorized the deduction retroactive to its expiration date and extended it to December 31, 2007, in the Tax Relief and Health Care Act of 2006 (P.L. 109-432). The tax provision allows both itemizers and non-itemizers to take the deduction (i.e., it is “above-the-line”). It is meant to assist the same student population as the Lifetime Learning credit, but the deduction extends to taxpayers with incomes somewhat above the limit for the credit (i.e., an AGI of \$65,000 or less for a single filer/\$130,000 or less for a joint filer). It is capped at \$4,000 per return, and cannot be taken for the same student for whom a Hope Scholarship or Lifetime Learning credit is claimed. A smaller deduction, capped at \$2,000 per return, is available to higher-income taxpayers whose AGI does not exceed \$80,000 for a single return and \$160,000 for a joint return. Neither the amount of the deduction nor the AGI limits are adjusted for inflation, and the amount of the deduction is not phased out as AGI increases.⁵

The above-the-line *deduction for classroom expenses of elementary and secondary (K-12) school educators* initially was authorized for tax years 2002 and 2003 in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). It was reauthorized retroactive to its expiration date and through December 31, 2005 as part of the Working Families Tax Relief Act of 2004 (P.L. 108-311). Like the higher education deduction, it subsequently was reauthorized retroactive to its expiration date and extended to December 31, 2007, in P.L. 109-432. As a result, the classroom expense deduction is available in tax years 2006 and 2007 to teachers, instructors, counselors, principals, and aides employed at least 900 hours in a school year at public and private K-12 schools. It is limited to \$250 for purchases of certain items (e.g., books and supplies) used by educators in the classroom.⁶

Permanently Authorized Provisions with Temporary Amendments

EGTRRA changed temporarily, typically for tax years 2002 through 2010, certain aspects of three other permanently authorized education tax benefits. Two of the benefits are meant to encourage individuals to save toward future educational expenses (i.e., the Coverdell Education Savings Accounts and Section 529 Programs). The third is the Student Loan Interest Deduction.

Coverdell Education Savings Accounts (CESAs). These trust or custodial accounts originated as Education IRAs in P.L. 105-34 for the purpose of providing a tax-free savings vehicle for higher education expenses. They became available in 1998. The appeal of the permanently authorized CESAs was enhanced in EGTRRA starting in tax

⁴ (...continued)

Assistance, by Linda Levine.

⁵ See CRS Report RL31129, *Higher Education Tax Credits and Deduction*.

⁶ For additional information see CRS Report RS21682, *The Tax Deduction for Classroom Expenses of Elementary and Secondary School Teachers*, by Linda Levine. (Hereafter cited as CRS Report RS21682, *The Tax Deduction for Classroom Expenses of Elementary and Secondary School Teachers*.)

year 2002, but on January 1, 2011, absent congressional action, the following modifications will be supplanted by their prior versions:⁷

- The annual limit on individuals' after-tax contributions to a beneficiary's account was quadrupled to \$2,000 from \$500.
- The "marriage penalty" was eliminated as well, such that a joint filer with an AGI below \$220,000 is now eligible to make contributions to CESAs compared to prior law when their AGI had to be below \$160,000.
- CESA withdrawals accorded tax-free treatment were extended from payment of qualified higher education expenses (e.g., tuition, books, and supplies) to payment of qualified K-12 expenses (e.g., tuition, tutoring, computers, supplies, and uniforms).
- Higher education expenses were expanded to include, for example, special needs services for special needs beneficiaries.⁸ For special needs beneficiaries, the under-18 age limit for contributions to CESAs was eliminated, as was the requirement that funds in CESAs generally be distributed to beneficiaries by age 30.
- The date by which contributions to CESAs can be made was extended to the tax filing date for that year. The length of time for corrective withdrawals of excess contributions and associated earnings to avoid a 6% excise tax was extended to June 1 from the due date of the beneficiary's tax return for the contribution year.
- The definition of a beneficiary's family members was extended to first cousins into whose accounts funds may be rolled over tax-free from existing accounts and who may be named as new beneficiaries of existing accounts. This too is the case for Section 529 Plans, discussed below.
- Before determining the qualified expenses that CESA withdrawals can offset, expenses must be reduced by the amount of tax-free scholarships and financial aid (e.g., Pell Grants). Taxpayers then can claim a Hope or Lifetime Credit or a Higher Education Deduction for the remaining tuition and fees of a given student, as well as make tax-free withdrawals from CESAs if the withdrawals do not go toward the same expenses for which the other benefits are claimed. (Before January 1, 2002, taxpayers could not claim the credits unless they waived the tax-free treatment of CESA withdrawals.) If, through December 31, 2010, CESA withdrawals become taxable because of receipt of tax-free assistance and of education credits or deductions, the withdrawals will not be subject to the 10% tax penalty usually assessed nonqualified distributions. This too is the case for Section 529 Plans.

Section 529 Programs. Few states sponsored Qualified Tuition Programs (QTPs) before their federal tax treatment was clarified at Section 529 of the Internal Revenue Code by the Small Business Job Protection Act of 1996 (P.L. 104-188). There are two types of permanently authorized QTPs or 529 Programs for higher education expenses:

⁷ For additional information see CRS Report RL32155, *Tax-Favored Higher Education Savings Benefits*.

⁸ Definitional changes relate to room and board as well. They similarly apply to Section 529 Programs.

prepaid tuition plans and college savings plans. After-tax contributions to beneficiaries' 529 college savings plans are invested by account owners in one of many portfolios predetermined by state sponsors, and withdrawals from the accounts can pay for a variety of postsecondary expenses. After-tax contributions to prepaid tuition plans on behalf of beneficiaries are collectively invested by plan sponsors to serve as a hedge against tuition inflation. EGTRRA extended sponsorship of prepaid tuition plans from states to institutions of higher education effective through December 31, 2010. The Pension Protection Act of 2006 (P.L. 109-280) made permanent this and other temporary amendments to 529 plans included in EGTRRA. For example, P.L. 109-280 made permanent the tax-free treatment of 529 withdrawals used to pay qualified education expenses and the ability of taxpayers to contribute to a 529 Plan and a CESA in the same year for the same beneficiary without incurring a penalty; to take an education credit or deduction for tuition and fees in the same year that tax-free withdrawals are made from a 529 plan, provided that the distributions are not used toward the same expenses for which the credit or deduction is claimed; and to make one tax-free same-beneficiary rollover in a 12-month period.⁹

Student Loan Interest Deduction. An above-the-line deduction from taxable income of up to \$2,500 in annual interest payments on student loans was permanently authorized as of 1998 in the Taxpayer Relief Act of 1997. The loans must have been used toward the cost of attendance for students enrolled at least half-time in undergraduate and graduate programs leading to an educational credential. In tax years 2002 through 2010, the deduction no longer is restricted to interest paid within the first 60 months during which interest payments are required. Unlike under prior law, EGTRRA also allows voluntary payments of interest to be deducted over the period. In addition, the act temporarily raises the AGI of a taxpayer who may claim the tax benefit (from \$55,000 to \$65,000 for a single filer and from \$75,000 to \$130,000 for a joint filer), effective in 2002. From tax year 2003 through 2010, the income limits may be adjusted annually for inflation.

Legislation Related to the Relationship Between EGTRRA and Education Tax Benefits

The 110th Congress is expected to consider the application of EGTRRA's sunset provision (Title IX) to the act's "Affordable Education Provisions" (Title IV) generally, and to the Higher Education Deduction that the act authorized specifically: Subtitle A — Education Savings Incentives; Subtitle B — Educational Assistance; Subtitle C — Liberalization of Tax-Exempt Financing Rules for Public School Construction; and Subtitle D — Other Provisions (i.e., section 431's establishment of the Higher Education Deduction).

⁹ For additional information, see CRS Report RL32155, *Tax-Favored Higher Education Savings Benefits*; and CRS Report RL31214, *Saving for College Through Qualified Tuition (Section 529) Programs*, both by Linda Levine.

Activity During the 109th Congress

Two pieces of legislation were enacted during the 109th Congress that pertain to the education tax benefits previously discussed in this report. The first — the Pension Protection Act of 2006, P.L. 109-280 — included making permanent only the enhancements to Section 529 plans provided in EGTRRA. The second — the Tax Relief and Health Care Act of 2006 (P.L. 109-432) — included extending the higher education deduction and educator deduction through December 31, 2007.

Activity During the 110th Congress

The Administration's FY2008 revenue proposals would permanently extend the enhancements that EGTRRA made to the aforementioned education tax benefits — *with the exception of the above-the-line deduction for higher education (tuition and fee) expenses*. The Administration also would make permanent the above-the-line deduction for classroom expenses of eligible educators and allow the Saver's Credit for contributions to Section 529 plans.¹⁰

Some Members appear to support retaining the Higher Education Deduction as evidenced by legislation to expand the tax provision or extend it permanently (e.g., H.R. 193 and H.R. 411). S. 359 would remove applicability of EGTRRA's sunset provision to the Higher Education Deduction and enhance the deduction, while also amending the deduction's definition of an eligible student to conform to that of the Hope credit (i.e., carrying at least half the normal full-time work load for the course of study being pursued).

Some Members also appear to favor simplifying use of the federal tax code to help individuals better afford college.¹¹ For example, S. 614 would replace the higher education deduction and two education credits and with one credit, and S. 97 would replace the two credits with one credit. Proposals to eliminate the Higher Education Deduction and Lifetime Learning Credit or to retain them but substitute the Hope Credit's definition of an eligible student would curtail people's access to tax provisions that reduce the cost of taking courses during one's working life to acquire or improve job skills.

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¹⁰ For information on legislative activity related to the educator deduction CRS Report RS21682, *The Tax Deduction for Classroom Expenses of Elementary and Secondary School Teachers*.

¹¹ For examples of the complexity that families face choosing between the three tax provisions see CRS Report RL31129, *Higher Education Tax Credits and Deduction*