



Higher Education Tax Benefits: Brief Overview and Budgetary Effects

Margot L. Crandall-Hollick
Analyst in Public Finance

March 12, 2013

Congressional Research Service

7-5700

www.crs.gov

R41967

Introduction

Since 1997, education tax benefits have become an increasingly important component of federal higher education policy. Fourteen tax benefits are currently available for college students and their parents to help pay for higher education. The available tax benefits are a mixture of credits, deductions, exclusions, and other incentives. The benefits can be placed into one of three general categories: incentives for current year expenses, preferential tax treatment of student loans, and incentives for saving for college. The Joint Committee on Taxation (JCT) estimates the cost to the federal government of education tax benefits—the revenue foregone from offering these benefits—to be \$78.9 billion between 2011 and 2015.¹²

This report provides a brief overview of the higher education tax benefits that are currently available to students and their families. The report contrasts higher education tax benefits with traditional student aid, presents a brief history of higher education tax policy over the past 60 years, summarizes key features of the available tax benefits, and provides JCT estimates of revenue losses resulting from individual tax provisions. The summary is contained in **Table 1** and provides information on various aspects of each tax benefit including the type of benefit (credit, deduction, etc.), the annual dollar amount of the benefit, what expenses qualify for the benefit, what level of education the benefit can be claimed for, income levels at which the benefit phases out, and if the provision is temporary, when it expires. **Table 2** contains estimates of the annual forgone federal revenue attributable to each provision.

Tax Benefits Versus Traditional Student Aid

The federal government provides financial assistance for higher education expenses in two ways: tax benefits and traditional student aid (loans, grants and work-study assistance). To qualify for traditional financial aid, students first submit a free application for federal student aid (FAFSA) to the Department of Education. Financial aid officers at the student's college or university use the asset and income information provided by the Department of Education to determine the student's federal financial aid award.³ This financial aid is then used to pay for higher education expenses at the time they are due.

A summary of available traditional financial aid is beyond the scope of this report. For more information, please see CRS Report RL31618, *Campus-Based Student Financial Aid Programs Under the Higher Education Act*, by David P. Smole and Alexandra Hegji; CRS Report R40122, *Federal Student Loans Made Under the Federal Family Education Loan Program and the William D. Ford Federal Direct Loan Program: Terms and Conditions for Borrowers*, by David P. Smole; and out-of-print CRS Report R41437, *Federal Pell Grant Program of the Higher Education Act: Background, Recent Changes, and Current Legislative Issues*, by Shannon M. Mahan (available from the author upon request).

¹ U.S. Congress, Joint Committee on Taxation, Estimates of Federal Tax For Fiscal Years 2011-2015, January 17, 2012, JCS-1-12.

² These cost estimates do not reflect the legislative changes made by the American Taxpayer Relief Act (P.L. 112-240, ATRA) as tax expenditure figures which incorporate these changes are not currently available.

³ This information can also be used to calculate any aid provided by the college or university to the student.

In contrast, most tax-based higher education assistance becomes available after higher education expenses have been incurred—sometimes several months afterward. Aside from tax preferred college savings accounts, taxpayers must wait until they file their federal income tax returns to claim any federal higher education tax benefits. Another difference between the two forms of educational assistance is that traditional financial aid is often directed toward students with financial need, while tax benefits are generally available to eligible taxpayers regardless of need.

Brief Historical Perspective of Tax Benefits

Tax benefits for higher education were first introduced nearly 60 years ago. While most of these benefits were originally structured as deductions and exclusions, which reduce taxable income, they now include tax credits, which directly reduce tax liability.

Between 1954 and 1996, eight tax benefits for education were enacted:

1. an exclusion for scholarship, fellowship, and tuition reductions;
2. a parental exemption for students age 19 to 23 who were enrolled in college;
3. a business expense deduction for work-related education;
4. an exclusion for employer-provided education assistance;
5. an exclusion for the interest earned on educational savings bonds;
6. an exclusion of qualifying cancelled student loans from taxable income;
7. an unlimited gift tax exclusion for amounts paid by a donor directly to an educational institution for tuition payments on behalf of the donee; and
8. an exclusion for earnings from qualified tuition programs (QTPs), also known as Section 529 Plans.

The deduction for student loan interest, which had existed since 1954, was eliminated with the passage of the Tax Reform Act of 1986 (TRA 86, P.L. 99-514). TRA 86 disallowed all forms of personal interest deductions other than for mortgage interest.

The Taxpayer Relief Act of 1997 (P.L. 105-34) enacted five new education tax benefits:

1. the Hope Tax Credit;
2. the Lifetime Learning Credit;
3. a reinstatement of the student loan interest deduction;
4. an exclusion for earnings accruing to Education individual retirement accounts (later renamed Coverdell education savings accounts); and
5. a cancellation of the penalty for early withdrawals from individual retirement accounts (IRAs).

More recently, 2 additional tax benefits were enacted, bringing the total number of education tax benefits to 15, although only 14 are in effect in a given year, since the Hope Tax Credit was temporarily replaced by the American Opportunity Tax Credit (AOTC).

1. An above-the-line deduction⁴ for higher education expenses (the “tuition and fees” deduction) was authorized by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16)⁵.
2. The AOTC was enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5). This credit temporarily replaced the Hope Credit for the 2009 and 2010 school years.

A number of expiring tax benefits and modifications to other tax benefits were extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) through the end of 2012 including the AOTC; the exclusion for employer provided educational assistance; modifications to the exclusion of scholarships, grants, and tuition reduction concerning specific scholarships; modifications to the student loan interest deduction; and modifications to Coverdells. In addition, P.L. 111-312 extended the tuition and fees deduction through the end of 2011.

The American Taxpayer Relief Act (P.L. 112-240; ATRA) extended several tax provisions or modifications to tax provisions either permanently or temporarily. For more information on how ATRA modified these provisions, see the shaded text box below.

The American Taxpayer Relief Act and Education Tax Incentives

- **Employer-Provided Education Assistance:** Prior to ATRA, this provision was scheduled to expire at the end of 2012. As a result of ATRA, this tax provision is permanent. Specifically, taxpayers can exclude up to \$5,250 (not adjusted for inflation) of qualifying employer provided educational assistance from taxation.
- **Student Loan Interest Deduction:** Prior to ATRA, several modifications to this provision (enacted as part of EGTRRA) were scheduled to expire. Upon their expiration, the deduction could only have been claimed by eligible taxpayers for the first 60 months of interest payments. In addition, the income phase-out levels would have been reduced to \$40,000-\$50,000 (\$60,000-\$70,000 for married joint filers) adjusted for inflation. As a result of ATRA, up to \$2,500 of student loan interest can be deducted from gross income for the entire duration of repayment. The amount that can be deducted phases out for taxpayers with income between \$55,000-\$70,000 (\$110,000-\$140,000 for married joint filers), adjusted for inflation. These changes are permanent.
- **Coverdell Education Savings Accounts (ESAs):** Prior to ATRA, several modifications to this provision (enacted as part of EGTRRA) were scheduled to expire. Specifically, if these modifications had expired, the maximum contribution would have reverted to \$500 per beneficiary per year; qualified expenses would have been limited to higher education expenses; the phase-out range for married taxpayers would have been \$150,000-\$160,000; contributions could only have been made until the beneficiary was 18 and the balance of the account would have to be distributed when the beneficiary turned 30, for both special needs and non-special needs beneficiaries; a taxpayer could not have claimed an education credit if they also took a tax-free distribution from their Coverdell; and contributions to a Coverdell would have been subject to a 6% excise tax if contributions for the same beneficiary were made to a 529 plan. As a result of ATRA: the maximum contribution amount for a beneficiary is \$2,000 per year; qualified expenses include both elementary and secondary school expenses and higher education expenses; the phaseout range for married taxpayers is \$190,000-\$220,000 (which is double the phaseout range for unmarried taxpayers); age limitation are waived for special needs beneficiaries; beneficiaries who take tax-free distribution for Coverdells can also claim education tax credits (although expenses paid for with Coverdells funds cannot be used to claim the credits); and contributions can be made to both a 529 plan and a Coverdell for the same beneficiary without penalty. These changes are permanent.

⁴ Above-the-line deductions, unlike itemized deductions, are available to all tax filers. Taxpayers who claim the standard deduction cannot benefit from itemized deductions.

⁵ This provision was originally scheduled to expire in 2006 under EGTRRA. It was subsequently extended by P.L. 109-432 (2006-2007), P.L. 110-343 (2008-2009), and P.L. 111-312 (2010 and 2011).

- **National Health Service Corps Scholarships and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program:** Students must generally pay taxes on any part of a scholarship, fellowship, or tuition reduction that can be attributed to teaching, research, or other services that have been performed, are being performed, or will be performed. Prior to ATRA, a temporary exception to this general rule was allowed for funding received from the National Health Service Corps Scholarships and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program. As a result of ATRA, this exception was made permanent. Hence, funds from these two scholarships are not taxable.
- **American Opportunity Tax Credit (AOTC):** The AOTC was a temporary tax credit enacted as part of the American Recovery and Reinvestment Act (P.L. 111-5; ARRA) which replaced the Hope Scholarship credit. Prior to ATRA, the AOTC was in effect from 2009-2012. ATRA extended the credit for five more years, through the end of 2017. Hence, through the end of 2017, taxpayers are eligible to claim a credit of up to \$2,500 (\$1,000 of which is refundable).
- **Tuition and Fees Deduction (“above-the-line”):** Prior to ATRA the \$4,000 above-the line deduction for tuition and fees had expired at the end of 2011. ATRA reinstated this provision for 2012 and 2013.

Summary and Cost of Current Benefits

Table 1 summarizes the higher education tax benefits currently available. The benefits can be divided into three groups: incentives for current year higher education expenses, incentives that provide preferential tax treatment of student loan expenses, and incentives for saving for college. Generally, a taxpayer cannot claim more than one tax benefit for the same education expense.

The benefits available are either a tax credit, deduction, exemption, or exclusion. While these terms are sometimes used interchangeably, they are different. It is important to understand the distinction between the types of incentives:

- **Tax credits** reduce the amount an individual owes in taxes directly, on a dollar for dollar basis. Credits are available to all qualified taxpayers, whether they itemize deductions or not. Credits can be nonrefundable or refundable. Nonrefundable credits cannot exceed taxes owed, and therefore can only reduce an individual’s tax liability to zero. Refundable credits can exceed taxes owed, meaning a taxpayer with no tax liability receives the credit amount as a refund check. A tax credit is partially refundable if, in cases where the credit is larger than the taxpayer’s tax liability, the IRS only refunds part of the difference. *Education tax credits include the Hope Credit and Lifetime Learning Credit, both nonrefundable and the American Opportunity Tax Credit which is partially refundable.*
- **Tax deductions** reduce the amount of a taxpayer’s income which is subject to taxation (“taxable income”) by the amount of the deduction. As a result, deductions reduce a taxpayer’s tax liability, but only by a percentage of the amount deducted depending on the taxpayer’s highest marginal tax bracket.⁶ Hence, deductions are generally less valuable than a given dollar amount in tax credits. Generally, the amount that may be deducted is equal to a portion of some

⁶ For example, a \$4,000 deduction for someone whose highest marginal tax bracket is the 10% bracket will result in a \$400 reduction in that taxpayer’s tax bill. If the taxpayer’s highest marginal tax bracket is the 35% bracket, their tax bill will fall by \$1,400.

expense incurred. Deductions can either be “above the line” or “itemized.” Above the line deductions are typically more advantageous than itemized deductions and may be claimed by most taxpayers. Itemized deductions may only be claimed by those taxpayers who itemize all their deductions on their tax returns. The alternative to itemizing is claiming the standard deduction. *Education tax deductions include the business deduction for work related expenses (an itemized deduction), the deduction for tuition and fees, and the student loan interest deduction (both “above-the-line” deductions).*

- **Tax exemptions** reduce the amount of a taxpayer’s income which is subject to taxation, by a fixed dollar amount per exemption claimed. Generally, every taxpayer is allowed to claim one exemption for themselves, one exemption for a spouse, and one for each dependent. Exemptions function similarly to deductions in that they reduce the income that is subject to taxation, but they are based on fixed amount per person instead of actual expenses. An exemption’s value to a taxpayer is also similar to the value of a deduction in terms of being proportional to a taxpayer’s highest marginal tax bracket. *Parents of students between the ages of 19 and 23 are eligible for a personal tax exemption for their children.*
- **Tax exclusions** are amounts of income that are not included as income for tax purposes because the tax code explicitly excludes—or exempts—them from taxation. *Education tax exclusions include the exclusion of certain scholarships, grants, and tuition reductions, the exclusion of employer provided educational assistance, the exclusion of qualifying cancelled student loans, and the exclusion of direct transfers to educational institutions.*

As **Table 1** shows, there are a number of limitations to the available tax benefits. Some benefits are subject to an annual limit, or “cap.” For example, the maximum annual American Opportunity Tax Credit that may be claimed is \$2,500. A number of the tax benefits may be limited by the type of “qualifying” expenses they are used to offset. For some tax benefits, only tuition and required fees qualify. Generally fees that must be paid to the educational institution as a condition of enrollment or attendance are considered “required fees.” Other tax benefits can be used to offset course-related books, supplies, and materials. And still other benefits may be used to cover travel and other expenses.

A number of higher education tax benefits also have income limitations. When an income limitation does exist, it is in the form of an income phase-out range. Taxpayers with incomes below the start of the phase-out range are eligible to claim the maximum tax benefit amount. The amount of the credit that can be claimed is then reduced for individuals with incomes within the phase-out range, and is zero for those with incomes above the phase-out range. In addition, the expiration date for the provision, if temporary, is provided.

Table 2 presents the JCT cost estimates for each available tax benefit. The JCT advises that these estimates cannot be simply summed to estimate the aggregate revenue loss from multiple tax provisions. This is because of interaction effects. When the revenue loss associated with a specific tax provision is estimated, the estimate is made assuming that there are no changes in other provisions or in taxpayer behavior. When individual tax expenditures are summed, the interaction effects may lead to different revenue loss estimates. Consequently, aggregate tax expenditure estimates, derived from summing the estimated revenue effects of individual tax expenditure provisions, are unlikely to reflect the actual change in federal receipts associated with removing various tax provisions.

Table I. Overview of Education Tax Benefits, 2013

	Type of Benefit	Annual Limit	Qualifying Expenses	Qualifying Education Level	Income Phase-out Range	Expiration
TAX BENEFITS FOR TUITION AND RELATED EXPENSES						
American Opportunity Credit <i>IRC Sec. 25A</i>	Tax Credit- Partially Refundable 40% of credit may be refundable (up to \$1,000)	\$2,500 credit per student	(1) Tuition and required enrollment fees (2) Course-related books, supplies and equipment	first 4 years of postsecondary education (undergraduate)	\$80K-\$90K \$160K-\$180K (married joint)	December 31, 2017
HOPE Credit ^a <i>IRC Sec. 25A</i>	Tax Credit- Nonrefundable	\$1,800 credit per student (2008 levels) ^a	(1) Tuition and required enrollment fees	first 2 years of postsecondary education (undergraduate)	\$48K-\$58K \$96K-\$116K (married joint) (2008 levels) ^a	None
Lifetime Learning Credit <i>IRC Sec. 25A</i>	Tax Credit- Nonrefundable	\$2,000 credit per tax return	(1) Tuition and required enrollment fees	Undergraduate and Graduate Courses to acquire or improve job skills	\$52K-\$62K \$104K-\$124K (married joint)	None
Deduction for Tuition and Fees <i>IRC Sec. 222</i>	Deduction (“Above the Line”) of qualified expenses from gross income	\$4,000 deduction	(1) Tuition and required enrollment fees	Undergraduate and Graduate	\$65K-\$80K \$130K-\$160K (married joint)	December 31, 2013
Business Deduction for Work Related Education Expenses <i>IRC Sec. 162</i> <i>Reg. §1.162-5</i>	Deduction (Itemized) of qualified expenses from AGI	None	(1) Tuition and required enrollment fees (2) Transportation and travel (3) Other necessary expenses	Education must be required by employer or law to keep present job, salary, status or maintain or improve job skills	None	None

	Type of Benefit	Annual Limit	Qualifying Expenses	Qualifying Education Level	Income Phase-out Range	Expiration
Exclusion of Scholarships, Grants, and Tuition Reductions <i>IRC Sec. 117</i>	Exclusion from taxable income if scholarship, grant is used to pay qualifying education expenses. In addition, the National Health Service Corps Scholarships and F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program are excludible from taxation.	None	(1) Tuition and required enrollment fees (2) Course-related books, supplies and equipment	Undergraduate and Graduate	None	None
Exclusion of Employer Provided Educational Assistance <i>IRC Sec. 127</i>	Exclusion from taxable income	\$5,250 exclusion	(1) Tuition and required enrollment fees (2) Course-related books, supplies and equipment	Undergraduate and Graduate	None	None
Parental Personal Exemption for Dependent Students 19-23 Years Old <i>IRC Sec. 151 & 152</i>	Exemption of fixed amount per dependent	\$3,800 per dependent	NA	Student must be under 24 by the end of the tax year and enrolled full time at a qualifying institution	None	None
TAX BENEFITS FOR STUDENT LOANS						
Student Loan Interest Deduction <i>IRC Sec. 221</i>	Deduction (“Above the line”) of interest paid	\$2,500	(1) Tuition and required enrollment fees (2) Course-related books, supplies and equipment (3) Room and board (4) Other necessary expenses (including transportation)	Undergraduate and Graduate	\$60K-\$75K \$125K-\$155K (married joint)	None

	Type of Benefit	Annual Limit	Qualifying Expenses	Qualifying Education Level	Income Phase-out Range	Expiration	
	Exclusion of Qualifying Cancelled Student Loans <i>IRC Sec. 108(f)</i>	Exclusion from taxable income	None	(1) Tuition and required enrollment fees (2) Course-related books, supplies and equipment (3) Room and board (4) Other necessary expenses (including transportation)	Undergraduate and Graduate	None	None
TAX BENEFITS FOR EDUCATION SAVINGS PLANS							
	Qualified Tuition Programs (529 Plans) <i>IRC Sec. 529</i>	Earnings not taxed	None	(1) Tuition and required enrollment fees (2) Books, supplies and equipment (3) Expenses for special needs services (4) Room and board if at least half-time student	Undergraduate and Graduate	None	None
	Coverdell Education Savings Account ^b <i>IRC Sec. 530</i>	Earnings not taxed	\$2,000 contribution per beneficiary	K-12 Expenses (1) Tuition and fees (2) Books, supplies and equipment (3) Academic tutoring (4) Special needs services (5) Room and board (6) Uniforms (7) Transportation (8) Required supplementary items and services (9) The purchase of a computer if it is used by the beneficiary or their family. Higher Education Expenses (1) Tuition and required enrollment Fees (2) Books, Supplies and Equipment (3) Expenses for special needs services (4) Payments to QTP (5) Room and board if at least half-time student	K-12 Undergraduate and Graduate	\$95K-\$110K \$190K-\$220K (married joint)	None

	Type of Benefit	Annual Limit	Qualifying Expenses	Qualifying Education Level	Income Phase-out Range	Expiration	
	Exclusion of Interest on Education Savings Bonds <i>IRC. Sec. 135</i>	Interest not taxed	Amount of qualified education expenses	(1) Payments to Coverdell ESAs (2) Payments to QTPs	Undergraduate and Graduate	\$72,850-\$87,850 \$109,250-\$139,250 (married joint)	None
	Early Withdrawals from IRAs <i>IRC Sec. 72(t)</i>	No 10% additional tax on early withdrawal	Amount of qualified education expenses	(1) Tuition and required enrollment fees (2) Books, supplies and equipment (3) Expenses for special needs services (4) Room and board if at least half-time student	Undergraduate and Graduate	None	None
	Uniform Transfers to Minors <i>IRC Sec. 2503(e)</i>	Exclusion from income of direct transfer to educational institution	Unlimited	(1) Amounts paid directly to educational institution for tuition	Undergraduate and Graduate	None	None

Sources: Internal Revenue Service, *Publication 970: Tax Benefits for Education 2011*; U.S. Congress, Joint Committee on Taxation, *List Of Expiring Federal Tax Provisions 2010-2020*, 112th Congress, January 21, 2011, JCX-2-11; CCH Tax Law Editors, *U.S. Master Tax Guide 2011*; and Internal Revenue Service, Revenue Procedure 2011-52.

Notes: NA = not applicable.

- a. The parameters for the Hope Credit are for 2008, the most recent year for which the credit was in effect. The credit is scheduled to return in 2013, at which time the annual limit and income phase-out ranges will be adjusted for inflation.
- b. The income phaseouts for Coverdells apply to any individual who contributes to the Coverdell (including the beneficiary).

Table 2. Estimated Budgetary Impact of Tax Benefits for Higher Education Expenses, 2013-2017

(billions of dollars)

Tax Benefit	2013	2014	2015	2016	2017	Total
American Opportunity Tax Credit (AOTC) ^{Error! Reference source not found.,a} and Lifetime Learning Credit	20.1	24.5	26.8	27.4	27.6	126.4
Parental Personal Exemption for Students aged 19 to 23	4.8	5.0	5.1	5.2	5.3	25.4
Exclusion of Scholarship and Fellowship Income	2.5	2.7	2.8	3.0	3.1	14.1
Deduction for Student Loan Interest	1.3	1.4	1.4	1.5	1.5	7.1
Exclusion of Employer-Provided Education Benefits	1.1	1.2	1.2	1.2	1.2	5.9
Exclusion of Earnings of Qualified Tuition Programs (529 Plans)	0.8	0.9	1.1	1.2	1.3	5.3
Exclusion of Tuition Reductions	0.2	0.2	0.2	0.2	0.3	1.1
Exclusion of Certain Discharged Student Loans	0.2	0.2	0.2	0.2	0.2	1.0
Deduction for Tuition and Fees ^c	0.7	0.2	0.0	0.0	0.0	0.9
Exclusion of Earnings of Coverdell Education Savings Accounts	0.1	0.1	0.1	0.1	0.1	0.6
Exclusion of Interest On Education Savings Bonds	d	d	d	d	d	d
Total	31.8	26.4	38.9	40.0	40.6	186.9

Source: Joint Committee on Taxation, Estimates of Federal Tax For Fiscal Years 2012-2017, February 1, 2013, JCS-1-13.

Notes: A positive estimate corresponds to a federal revenue cost. Items may not sum due to rounding.

- a. This provision was extended by P.L. 112-240 through the end of 2017. Beginning in 2018, the AOTC is scheduled to expire and revert back to the non-refundable Hope Credit.
- b. These estimates include the outlays resulting from the refundable portion of the AOTC.
- c. This provision was extended by P.L. 112-240 through the end of 2013.
- d. Revenue losses for 2011-2015 are less than \$50 million.

Author Contact Information

Margot L. Crandall-Hollick
 Analyst in Public Finance
 mcrandallhollick@crs.loc.gov, 7-7582