Reforming the Tax Incentives for Higher Education

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REFORMING THE TAX INCENTIVES FOR HIGHER EDUCATION

Camilla E. Watson*

Federal spending on higher education has long been controversial, primarily because it has grown exponentially since the 1950s but it has produced a system which many regard as too expensive and grossly inefficient. The soaring costs are placing higher education beyond the reach of many Americans, and of those who enter college, less than half complete their degrees. Particular criticism has been directed toward the education tax incentives, enacted mostly in the late 1990s, which shifted federal funding for higher education from direct benefits to students in the form of grants, loans and work-study programs to indirect benefits through the tax system. The crux of this criticism is that the tax incentives, in addition to being costly and highly complex, have had virtually no effect on college enrollment and retention. Congress has studied this problem for the past few years and has several bills currently on the table to reform these incentives. There are other proposals pending as well, such as those of President Obama and the Education Consortium from the private sector. This article critiques these various proposals and explains why they are not likely to achieve the desired result of increasing college enrollment and retention, particularly among lower-income individuals. The article suggests a reform of the education tax incentives that is different from any of the current proposals and is more likely to achieve the desired result in a simpler, fairer, and more efficient manner.

TABLE OF CONTENTS

I. INTRODUCTION ................................................................. 84
II. EDUCATION TAX INCENTIVES ........................................... 89
   A. Advantages of the Incentives ......................................... 91

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B. General Disadvantages of the Incentives ........................92
   1. Do Subsidies Lead to Increased Tuition Costs ..........94
   2. Complexity & Mismatch in Timing .......................98
   3. Tax Breaks for Higher Income Taxpayers .............103

III. CURRENT PROPOSALS .........................................................104
   A. House Proposals ......................................................105
      1. Ways and Means Committee .................................105
      2. The House Budget Committee Discussion Draft ......109
   B. The Schumer Bill and the Senate Finance Committee
      Response ...............................................................110
   C. The Obama Proposal ...............................................112
   D. The Education Consortium Proposal .......................116

IV. ALTERNATIVE SUGGESTIONS FOR REFORM ......................118
   A. Direct Benefits ...................................................118
   B. Indirect Benefits ..................................................122
      1. Savings Incentives ............................................122
      2. Current Cost Incentives ....................................127
      3. After College – Repaying Student Loans ............136
   C. Increased Awareness of Benefits .............................138
   D. Feasibility of the Proposal ....................................139

V. CONCLUSION .....................................................................140

I. INTRODUCTION

During President Clinton’s first term in office, college enrollment was
flat, and less than a quarter of those aged twenty-five to twenty-nine held a
bachelor’s degree or higher. Since increasing direct spending for education

1 During the first term of the Clinton administration, college enrollment by recent high
school graduates actually decreased, albeit by an average of only 0.205% per year (from 1992
to 1993, enrollment decreased 1.26%; from 1993 to 1994, it decreased 0.18%; from 1994 to
1995, it decreased 0.12%; from 1995 to 1996, it increased 0.74%; from 1996 to 1997, it
increased 0.95%). See THOMAS D. SNYDER ET AL., NAT'L CTR. FOR EDUC. STATISTICS, U.S.
DEP’T OF EDUC., DIGEST OF EDUCATION STATISTICS 2014, at 426 tbl.303.10 (50th ed. 2014)
[hereinafter NCES DIGEST], http://nces.ed.gov/pubs2016/2016006.pdf. During the George
H.W. Bush administration, however, enrollment had increased 7% overall (representing an
average increase of 1.75% during each of his four years in office). See id. This difference will
be explored in more depth in Follow the Money: The Evolution and Inefficiency of Federal

2 See NCES DIGEST, supra note 1, at 38 tbl.104.20 (23.2% held postsecondary degrees
in 1990; 24.7% held such degrees in 1995).
Reforming Higher Education Tax Incentives

was not politically feasible, early in Clinton’s second term, federal funding of higher education shifted from direct funding through grants, loans, and work-study programs to indirect funding through the tax code. Today, the federal government spends over $180 billion on higher education, of which over $130 billion is spent via direct funding through grants and loans, around $34 billion is spent indirectly through foregone revenue attributable to the

3 In 1995, during the third year of Clinton’s presidency, the Democrats lost control of Congress. See generally James P. Pfiffner, President Clinton, Newt Gingrich, and the 104th Congress, in On Parties: Essays Honoring Austin Ranney 135 (Nelson W. Polsby & Raymond E. Wolfinger eds., 2000) (discussing the relationship between President Clinton and the Republican-controlled Congress). In the 104th Congress, for the first time since 1952, the Republicans held a majority of the seats in both the House and the Senate. 104th Congress Adjourns, CNN (Oct. 4, 1996, 5:30 PM), http://www.cnn.com/US/9610/04/congress/. In 1996, Congress began to consider tax reform. The new Republican majority pushed for a cut in the capital gains tax rate, while Clinton pushed for more tax breaks for the middle class, particularly the lower middle class. See Ann Curley & John King, Senate Panel Settles On Tax Cuts, CNN (June 20, 1997), http://www.cnn.com/ALLPOLITICS/1997/06/19/tax.clinton/ (discussing Clinton’s opposition to specific capital gains proposals). The education tax incentives represented the compromise position between a Democratic president and a Republican Congress.

4 I refer to “direct funding” to mean financial aid that the federal government pays directly, whether to the recipient or to the postsecondary institution on behalf of the student. This differs from the government’s definition of direct funding, which is loans and grants paid directly by the federal government without the involvement of private lenders. See Federal Versus Private Loans, studentaid.ed.gov, https://studentaid.ed.gov/sa/types/loans/federal-vs-private (last visited Oct. 31, 2016). The term “indirect funding” is used to connote foregone revenue from the use of tax incentives, although this lost revenue represents real dollars in terms of the federal budget. See infra note 33.


It is generally more politically expedient to obtain funding through tax expenditures than through appropriations. See Bridget T. 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, 102 (Caroline M. Hoxby ed., 2004) (noting that “federal budget rules favor tax expenditures over discretionary spending programs”).

6 Office of Mgmt. & Budget, Exec. Office of the President, Analytical Perspectives: Budget of the United States Government, Fiscal Year 2016 117–18 tbl.29–1 (2015) [hereinafter 2016 Budget Perspectives]. The majority of this amount, around $100 billion, is spent on student loans; over $32 billion is spent on grants, of which Pell Grants constitute the majority ($31.5 billion), and around $1 billion is spent on grants to colleges and universities. Id. See also Federal Student Aid, New Am. [hereinafter Atlas Education Programs Overview], https://www.newamerica.org/education-policy/policy-explainers/higher-ed-workforce/federal-student-aid/ (last visited Oct. 31, 2016).
tax incentives, and around $15 billion is spent directly in veterans’ educational assistance.

Commentators have criticized federal funding of higher education in general and the tax incentives in particular—even though the United States spends more per student on education than any other country in the developed world—because the quality of education and educational attainment have fallen in the past fifteen years. Today, around half of students from middle-

7 2016 BUDGET PERSPECTIVES, supra note 6, at 224–25 tbl.14–1. The largest of these tax expenditures (around $15.6 billion) is attributable to the American Opportunity Tax Credit (AOTC). Id. at 224. See also discussion infra note 24.

8 See COLL. BD., TRENDS IN STUDENT AID 2015, at 10 tbl.1 (2015). See also infra note 38.


Based on a six-year completion rate beginning in 2007, only about half of those who enrolled in college (59%) earned a degree. INST. OF EDUC. SCI., THE CONDITION OF EDUCATION 234–37 (2015), http://nces.ed.gov/programs/coe/indicator_ctr.asp. In 1995, the United States was 12.6 points above the OECD average in college completion and tied for first with New Zealand; in 2000, the United States was only 6.3 points above the OECD average, while New Zealand remained first at 15.9 points above the United States; in 2003, the United States was 1 point below the OECD average; and in 2008, it was 0.4 points below the average. OECD, EDUCATION AT A GLANCE, supra note 11, at 63 tbl.A3.2a. The Obama administration has cited this decline as the rationale for its “First In the World” competition for education
Reforming Higher Education Tax Incentives

and higher-income families who enroll in college complete their degrees by age twenty-five, and this rate drops drastically for students from lower-income families, for whom the completion rate is less than one-in-ten. These dismal rates raise the specter of inefficiency in funding for education and have led to several current proposals to reform federal spending on higher education. Many of these proposals focus on education tax incentives because they are low-hanging fruit; virtually everyone agrees that these incentives collectively do not work well.

Both the House and the Senate have held hearings for the past several years on reform of federal spending for higher education, with particular emphasis on the tax incentives. In his opening statement during the Senate Finance Committee hearing in 2012, Senator Orrin Hatch noted: “In evaluating the education tax incentives, we use the same three factors that are used in evaluating all tax incentives: equity, efficiency and simplicity.” None of the witnesses who spoke during this hearing, however, thought that the current incentives met any of those criteria, and they were not alone.

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15 Id. at 4 (statement of Sen. Orrin Hatch, Member, S. Comm. on Fin.).

16 See id. (statements of Max Baucus, Chairman, S. Comm. on Fin.; Dr. Susan Dynarski, Professor, University of Michigan, Faculty Research Associate, National Bureau of Economic Research, and Research Associate, Center for Analysis of Postsecondary Education and Employment; Scott A. Hodge, President, Tax Foundation; Lynne Munson, President and
This general view has been summed up by Professor Michael Graetz: "The education tax incentives represent the greatest increase in federal funding for higher education since the GI Bill. But no one can tell you what they are, how they work, or how they interact. Planning to pay for college around these tax breaks is essentially impossible for middle-income families."

The House and Senate hearings have culminated in several bills currently under consideration by Congress. While there is no clear consensus on which proposal (or combination of proposals) will prevail, it is clear that the education tax incentives will be reformed at some point in the not too distant future. Since Congress cannot agree on the direction that the reform should take, the questions remain: which of the conflicting political ideologies will prevail, will there be any compromise, and will the ultimate reform produce results that are fairer, simpler, and more efficient than the current system? The overarching question is whether the federal investment in education will produce results that can be justified to those who actually bear the cost, i.e., the taxpayers.

The myriad proposals currently pending reflect, for the most part, the underlying political ideologies of Congress. They range from drastic cutbacks in spending for education to free community college. While these proposals share some common features, even these commonalities work at cross-purposes with the goals of making federal spending and student financial assistance for higher education simpler, fairer, and more

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Executive Director, Common Core; James R. White and George A. Scott, U.S. Government Accountability Office; Molly Corbett Broad, President, American Council on Education; Michael Binder, Center for Fiscal Equity).


18 See discussion infra notes 100–107, 111–165 and accompanying text.

19 See discussion infra notes 134–135, 143–151 and accompanying text.

20 See discussion infra notes 178–186 and accompanying text. The 2016 Democratic presidential nominee, Hillary Clinton, also proposed to make college debt-free for those in need, although her proposal was not quite as generous as the Obama proposal. For a brief discussion of her proposal, see College Compact: Costs Won’t Be a Barrier, HILLARY FOR AM. (2016), https://www.hillaryclinton.com/briefing/factsheets/2015/08/10/college-compact-costs/.

21 "A purpose usually unintentionally contrary to another purpose of oneself or of something or someone else." Definition of Cross-Purpose, MERRIAM-WEBSTER, http://www.merriam-webster.com/dictionary/cross-purpose (last visited Oct. 31, 2016). "If two people or groups are at cross purposes, they do not understand each other because they have different intentions." Cross Purposes Meaning, CAMBRIDGE DICTIONARY, http://dictionary.cambridge.org/dictionary/english/cross-purposes (last visited Oct. 31, 2016). In the case of reforming the tax incentives for higher education, however, the purposes are not unintentionally contrary. Instead, they are intentionally contrary because the political ideologies are contrary, and thus, they work at cross-purposes to each other.
efficient. In fact, none of the proposals currently on the table is likely to be much more effective overall than the present system, and some may even exacerbate the system’s complexity, unfairness, and inefficiency.

Meaningful reform of the education tax incentives cannot occur without a clearly articulated goal and a rational method of attaining that goal. Thus, Congress should consider reform of these incentives in the context of a broader reform of federal funding for higher education.

This article is the first of a two-part examination of federal funding policy for higher education. It focuses primarily on indirect federal funding through the education tax incentives, critiques the current proposals, and suggests alternatives for reform of these incentives.

II. THE EDUCATION TAX INCENTIVES

There are currently a jaw-dropping eighteen tax incentives (depending upon how one counts them) to help students and their families pay the spiraling costs of higher education. These run the full gamut of tax benefits: exclusions, deductions, credits, and exemptions. They apply before (saving for college), during (paying current college costs), and after college (paying student loans). The revenue cost of these incentives has increased every

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22 The second article, tentatively entitled Follow the Money: The Evolution and Inefficiency of Federal Funding for Higher Education, will trace federal funding from the early 1950s through the first term of the Obama administration. It will analyze the effect that the various changes in federal funding have had on enrollment and retention based on ethnicity, gender, and income levels. The article also will examine the type of institution in which these students have enrolled (i.e., two-year, four-year, public, private, for-profit, not-for-profit), and how federal funding and other extraneous factors have affected enrollment and retention levels at the various institutions.

23 I.R.C. §§ 25A (Hope, American Opportunity and Lifetime Learning tax credits), 32(c)(3) (increasing the age limit to twenty-three for a full-time student as a qualifying child under the Earned Income Tax Credit), 72(t)(2)(E) (excluding early IRA distributions used for education from tax and penalty), 108(f) (excluding student loan forgiveness under specified circumstances), 117(a) (excluding scholarships and fellowships), 117(d) (excluding tuition reduction for employees of education institutions and their families), 127 (excluding employer-provided educational assistance), 132(a)(3), (j)(8) (excluding certain work-related education expenses paid by an employer), 134 (excluding veterans education and training expenses), 135 (excluding interest on education savings bonds), 152(c)(3) (creating the parental personal exemption for full-time students under age twenty-four), 162 (allowing for the deduction of work-related education expenses via Treas. Reg § 1.162-5(a) (as amended in 1967)), 221 (allowing for the deduction of student loan interest), 222 (allowing for the deduction of tuition and fees), 529 (exempting qualified tuition programs), 530 (exempting Coverdell education savings accounts), 2503(e)(2)(A) (exempting — from gift tax — tuition payments made directly to an educational institution on behalf of a student). Usually, in discussing reform of these incentives, I.R.C. §§ 132, 162, and 2503 are not mentioned, primarily because they have become so ingrained in the tax code that no one talks of removing (or reforming) them.

24 See discussion supra note 23 and accompanying text.
year since the early 2000s, costing taxpayers billions of dollars.25 The cost of these incentives regularly equals or exceeds spending for Pell Grants, the largest federal need-based postsecondary student grant program.26 These incentives, however, have had only a slight effect overall on college enrollment trends.27 Given the cost of education tax incentives, the meager return on investment makes them a highly inefficient expenditure.

A. Advantages of the Incentives

Despite the myriad well-founded criticisms of the education tax incentives, there are some advantages to providing federal funding through tax benefits. First, it is politically more expedient to provide funds indirectly through the tax code than to appropriate funds to students or educational institutions directly through the budget. Tax incentives for education offer something for everyone politically: tax cuts for Republicans; an increase in


The highest amount, over $13 billion, will be spent on the American Opportunity Tax Credit. 2017 BUDGET PERSPECTIVES, supra, at 230 tbl.14-1. The next four highest-cost education tax incentives are the deductibility of charitable contributions for education ($5.2 billion), the parental personal exemption for students age nineteen or over ($4.4 billion), the exclusion for scholarships and fellowships ($3.25 billion), and the Lifetime Learning Credit ($2.45 billion). Id.

26 GREER & LEVIN, supra note 9, at 1. Other educational assistance grants administered by the federal government are Supplemental Education Opportunity Grants (grants from the United States Department of Education directed to the educational institutions to award to students based on need; these grants may supplement the Pell Grant), Iran and Afghanistan Service Grants (need-based grants for children or wards of service members who died while in service in Iran or Afghanistan after the events of 9/11), and TEACH grants (available for those enrolled in higher education who agree to teach in an area of high need in a low-income elementary or secondary school for at least four years). See Federal Student Grant Programs, FED. STUDENT AID (July 2014), https://studentaid.ed.gov/sa/sites/default/files/federal-grant-programs.pdf.

27 See George B. Bulman & Caroline M. Hoxby, The Returns to the Federal Tax Credits for Higher Education 22–23, 30 (Nat’l Bureau of Econ. Research, Working Paper No. 20833, 2015), http://www.nber.org/papers/w20833.pdf. During Clinton’s two terms in office, college enrollment by recent high school graduates increased by an average of only 0.88% per year and most of that increase was attributable to his second term. See NCES DIGEST, supra note 1, at 426 tbl.303.10.
access to higher education, particularly for minorities and the underprivileged, for Democrats. President Clinton employed this tactic when Congress enacted the education tax incentives in 1997. Second, a tax incentive does not carry the stigma of a “government handout,” even for refundable credits, which equate to a tax refund. Third, tax incentives for education promote voluntary compliance by fostering favorable taxpayer views of the tax system. If a taxpayer does not benefit directly, he or she may benefit indirectly from the positive external benefits of an educated populace, such as a stronger economy, a stronger democracy, a lower rate of crime, and even better health. Fourth, Pell Grants and federally subsidized loans


29 Some, however, argue that refundable tax credits are a welfare system. For a discussion of this debate, see Tami Luhby, Are Tax Credits Welfare?, CNN MONEY (Nov. 3, 2008, 8:25 AM), http://money.cnn.com/2008/10/31/news/economy/taxes_welfare/.

30 Not only do college graduates earn more than those without a higher degree, but as Mark J. Mazur, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, stated while testifying before the Senate Finance Committee in 2014: “there are spillover benefits of a highly skilled and educated workforce that enhance the productivity and wages of other workers.” Less Student Debt from the Start: What Role Should the Tax System Play?: Hearing Before the S. Comm. on Fin., 113th Cong. 9 (2014) [hereinafter 2014 S.Hrg.] (statement of Hon. Mark J. Mazur, Assistant Secretary for Tax Policy, U.S. Department of the Treasury).

31 Cf. Stephen Lurie, Highly Educated Countries Have Better Governments, THE ATLANTIC (Mar. 6, 2014), http://www.theatlantic.com/education/archive/2014/03/highly-educated-countries-have-better-governments/284273/ (finding a statistical correlation between education levels and successful governments—and hypothesizing that education makes for better voters—but arguing that a stronger democracy is “[not the] reason that more educated societies make more accountable government.”).


33 See Kyle C. Post, Higher Education Tax Incentives: Why Current Reform Is Necessary, 23 S. I.J. 73, 76 (2013) (“[T]hose with more education are less likely to smoke, ‘drink a lot,’ be overweight, or use illegal drugs and are more likely to exercise and obtain preventive care.”). Other examples of positive externalities are less reliance on government benefits, greater civic participation, a more literate electorate, more inclination to volunteer, greater parental involvement in children’s education, and more scientific breakthroughs and innovative companies. See 2014 S.Hrg., supra note 30, at 85 (statement of Mark J. Mazur, Assistant Secretary for Tax Policy, U.S. Department of the Treasury); 2012 S.Hrg., supra note 14, at 33 (statement of Sen. Max Baucus, Chairman, S. Comm. on Fin.).

are available to lower-income students on the basis of means-tested need. Still, there are students from middle-income families who cannot meet the means test and are not eligible for Pell Grants or subsidized loans, but nevertheless they may be in need of financial assistance. Because of this inequity, tax incentives targeted to the middle class are efficient and fair.

B. General Disadvantages of the Incentives

Still, there are inherent problems with the incentives. The federal government spends more than twenty percent of its support for postsecondary education on them.\footnote{In fiscal year 2014-2015, student loans encompassed 58.5\% of federal aid for education, grants encompassed 18.5\%, and tax incentives encompassed 22.4\%. See \textit{Federal Student Aid Report FY 2015}, supra note 25, at 7; 2017 \textit{Budget Perspectives}, supra note 25, at 230 tbl.14-1.} In fiscal year 2013, this was more than $41 billion.\footnote{Office of Mgmt. & Budget, Exec. Office of the President, \textit{Analytical Perspectives: Budget of the United States Government, Fiscal Year 2015} 207 tbl.14.1 (2014) [hereinafter 2015 Budget Perspectives].} Although the federal government delivers these benefits indirectly to taxpayers through the tax code, this large amount of foregone revenue in fact represents direct spending by the federal government.\footnote{See \textit{discussion supra} note 4. Stanley Surrey, the author of the tax expenditure theory, explained that “tax credits, deductions, and exemptions are similar to direct governmental expenditures because they provide special benefits to favored individuals and result in higher tax rates for all other individuals.” W. Edward Afield, \textit{Winning the Crowd: Harnessing Taxpayer Choices to Improve Educational Quality}, 63 CATH. U. L. REV. 297, 306 n.47 (2014).} This raises a related problem, namely, that the cost of the incentives varies from year to year and is thus not easily controllable. For instance, from 2008 to 2010 the amount of education tax credits claimed increased markedly.\footnote{See Margot L. Crandall-Hollick, Cong. Research Serv., R42561, \textit{The American Opportunity Tax Credit: Overview, Analysis, and Policy Options} 7–8 (2016), http://fas.org/sgp/crs/misc/R42561.pdf. This increase derived primarily from the fact that more people enrolled in postsecondary institutions after the Great Recession of 2008 because they could not find jobs. The broader Pell Grant eligibility rules — plus the fact that Congress enacted the American Opportunity Tax Credit (AOTC) as a temporary, refundable credit in 2009 — also contributed to this enrollment increase. See \textit{Pell Grant Funding and History}, New Am. [hereinafter Pell Grant Overview], https://www.newamerica.org/education-policy / policy-explainers/ higher-ed-workforce/ federal-student-aid/ federal-pell-grants/pell-grant-funding/ (last visited Oct. 31, 2016).}
Congress has raised questions not only about the cost of these incentives and whether that cost is justified, but also about whether the federal government should provide incentives for education through the tax code, rather than through direct, targeted financial assistance. The argument in favor of tax incentives is that they “reflect Americans’ values” about education. Since the federal government provides incentives through the tax code to influence other fundamental decisions, such as whether to marry, divorce, have children, work, establish a retirement plan, etc., it makes good sense for the federal government to provide tax incentives to encourage the pursuit of higher education.

Nevertheless, drawbacks remain. When the federal government administers education policy through the tax code, it not only makes the Code more complicated and increases compliance costs for taxpayers, but it also increases the likelihood that the intended beneficiary will not receive the benefit. Additionally, the Internal Revenue Service (Service), an overburdened and underfunded agency, must administer the tax incentives. The chance of undetected fraud therefore remains high and it grows when multiple government entities oversee funding for a single federal program.

Commentators criticize the education tax incentives on three general grounds. First, they may actually increase tuition costs, thus negating the

39 See, e.g., STAFF OF S. FIN. COMM., 113TH CONG., TAX REFORM OPTIONS FOR DISCUSSION 3, 12 (Comm. Print 2013).

40 See id. at 1.


42 In addition to the AOTC, the tax code contains a number of other refundable credits, such as the Earned Income Tax Credit, the Child Tax Credit and the Affordable Care Act. Some postulate that the erroneous application of education credits contributes to the tax gap. See Letter from Jeffrey A. Porter, Chair, Am. Inst. of CPAs Tax Exec. Comm., to H. Comm. on Ways and Means 4–5 (Mar. 27, 2014), http://www.aicpa.org/Advocacy/Tax/Downloadable/Documents/AICPA%20Comment%20Letter-%20Education%20HR%203393%20AOTC%2003-27-14.pdf (highlighting the 2011 Treasury Inspector General for Tax Administration (TIGTA) report and noting that “over four years, erroneous education credits could potentially reach $12.8 billion”).

43 Four Departments administer federal assistance for higher education: the Department of Education, which administers loans, grants, and work-study programs provided through Title IV of the Higher Education Act; the Internal Revenue Service (Service), which administers the education tax incentives; the Department of Veterans Affairs, which administers the Post-9/11 Veterans Educational Assistance Act of 2008, as well as other programs for veterans, service members, and their dependents; and the Department of Defense, which provides tuition assistance to current service members.

44 In addition to the general criticism, others express concern about the unfair tax advantages that such incentives provide to higher education institutions. Specifically, Sen. Charles Grassley has expressed concern that while higher education institutions remain tax-
benefit of the incentive, because institutions may “capture” the amount of the tax credit by raising tuition.\textsuperscript{45} Second, they do not provide sufficient inducement for lower- and middle-income taxpayers to enroll in postsecondary institutions because of their complexity and the mismatch in timing between paying for tuition and obtaining the tax benefit.\textsuperscript{46} Third, they are poorly targeted because they simply provide a tax break for higher-income taxpayers whose children would have enrolled in college regardless of the tax incentives.\textsuperscript{47}

1. Do Subsidies Lead to Increased Tuition Costs?

Widespread concern persists over the rising cost of college tuition, which has outpaced both inflation and the cost of health care.\textsuperscript{48} Some of the concern centers on whether federal funding for education is one of the factors that has led to the skyrocketing cost of college tuition and whether the tax incentives create a “higher education bubble” by encouraging students to assume more debt than they feasibly will be able to repay.\textsuperscript{49}

William Bennett, Secretary of Education under President Reagan, famously speculated that colleges captured federal financial aid by increasing
Reforming Higher Education Tax Incentives

This has become known as "the Bennett hypothesis." Still, despite exhaustive studies to prove the hypothesis, the data remain inconclusive. Studies that support the hypothesis have received criticism for using flawed assumptions. Conservative members of Congress, along with others, however, continue to tout the hypothesis as fact. This is a prime example of


52 Some studies lend credence to the hypothesis. See, e.g., DAVID O. LUCCA ET AL., FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 733, CREDIT SUPPLY AND THE RISE IN COLLEGE TUITION: EVIDENCE FROM THE EXPANSION IN FEDERAL STUDENT AID PROGRAMS 3 (2015) (concluding that while student aid programs increase access to postsecondary education, Pell Grants and subsidized loans increase tuition sticker price by around forty and sixty cents on the dollar, respectively); Nicholas Turner, Who Benefits from Student Aid? The Economic Incidence of Tax-Based Federal Student Aid, 31 ECON. EDUC. REV. 463 (2012); see also Megan McArdle, Megan McArdle on the Coming Burst of the College Bubble, NEWSWEEK (Sept. 17, 2012, 1:00 AM), http://www.newsweek.com/megan-mcardle-coming-burst-college-bubble-64671; Christopher Lau, The Incidence of Federal Subsidies in For-profit Higher Education 37–38 (Nov. 17, 2014) (unpublished Ph.D. dissertation, Northwestern University), http://gradstudents.wcas.northwestern.edu/~cvl901/lau_jmp.pdf.) (showing that "57% of federal grant aid and 51% of federal loan aid is passed on to for-profit colleges"). Other studies, however, refute it. See, e.g., DONALD E. HELLER, AM. COUNCIL ON EDUC., DOES FEDERAL FINANCIAL AID DRIVE UP COLLEGE PRICES? 18 (Apr. 2013) (concluding that "the process involves far too many variables for it to be essentially explained by the simplistic notion that tuition-setting boards sit around and say, '[w]ell, Pell Grants are going up $200 next year, so we can raise tuition $100."); ALISA F. CUNNINGHAM ET AL., NAT’L CTR. FOR EDUC. STATISTICS, STUDY OF COLLEGE COSTS AND PRICES, 1988-89 TO 1997-98, at 99-102, 133 (2001) (showing that increases in federal financial aid had no impact on tuition at either public or private non-profit institutions); Warren, supra note 51 (pointing to various studies from "15 years of federal research" that show "no link between student aid and tuition increases").

53 See, e.g., Rising Costs of Higher Education and Tax Policy: Hearing Before the H. Comm. on Ways and Means Subcomm. on Oversight, 114th Cong. 2–3 (2015) [hereinafter H. Oversight Hrg.] (statement of Terry W. Hartle, Senior Vice-President, American Council on Education) (criticizing a recent Federal Reserve Bank of New York study on the grounds that it considered only published price, rather than net price; tuition is not a factor in the determination of the amount of an individual’s Pell Grant, but the study considered only Pell Grants and Stafford loans, and not other factors that have an influence on the price, such as state support and institutional aid).

54 See, e.g., 2014 S.Hrg., supra note 30, at 5 (opening statement of Sen. Orrin G. Hatch, Member, S. Comm. on Fin.) (stating with respect to the Bennett hypothesis: "I do not think anybody can deny that he was right."); 2014 S.Hrg., supra note 30, at 16 (statement of Scott A. Hodge, President, Tax Foundation) (discussing how education tax credits cause colleges to increase their tuition); H. BUDGET COMM., 113TH CONG., EXPANDING OPPORTUNITY IN AMERICA, DISCUSSION DRAFT 44 (July 24, 2014) ("[T]here is growing evidence that these
how political ideologies work at cross-purposes to what should be the common goal of promoting a more educated populace.  

Critics of the Bennett hypothesis argue that it remains impossible to tell whether federal assistance increases the cost of higher education because various factors contribute to the rising costs. For instance, states have cut their funding for education since the early 1980s, with the steepest cuts occurring after the Great Recession of 2008. In addition, at both private and public institutions, the recessions of 2001 and 2008 shrunk endowments and resulted in decreased donations. In response to these cuts, public institutions have been forced to raise tuition with noticeable effect, since over seventy percent of all college students attend public institutions. At research institutions, tuition has increased to pay for expensive labs and other accouterments of research that do not generate alternate income streams to offset their costs. Furthermore, postsecondary institutions are not only human resource federal subsidies are actually fueling tuition inflation.”).  

Those who tout this hypothesis as fact, in the face of overwhelming evidence to the contrary, do not focus on a goal of an educated populace, but instead focus on “the economic effects of trading the elimination of these tax credits for lower tax rates for all Americans.” 2014 S.Hrg., supra note 30, at 16 (statement of Scott A. Hodge, President, Tax Foundation). English professor Christopher Newfield, in his book UNMAKING THE PUBLIC UNIVERSITY, “posits that conservative elites have worked to de-fund higher education explicitly because of its function in creating a more empowered, democratic, and multiracial middle class.” Anna Victoria, Higher Education and Student Debt: Why Is Education So Expensive?, PLUCK MAGAZINE (Jan. 2012), http://pluckmagazine.com/debt/articles/article_victoria_01.php.  

Some evidence exists, however, that prices at for-profit schools increase when the amount of the Pell Grant increases. See 2012 S.Hrg., supra note 14, at 11, 44 (statement of Dr. Susan Dynarski, Professor, University of Michigan, Faculty Research Associate, National Bureau of Economic Research, and Research Associate, Center for Analysis of Postsecondary Education and Employment).  


Id. Over the past decade, published tuition at public, four-year institutions grew by an average of 42%, but net tuition grew by 32%. At private, non-profit institutions, published tuition grew by 24%, but the average net price decreased by 13%. See H. Oversight Hrg., supra note 53, at 2 (statement of Terry W. Hartle, Senior Vice President, American Council on Education). The lower amount of net tuition is attributable, in large part, to institutional grant aid, which has already doubled over the past decade from $25.2 billion in 2003-2004 to $48.2 billion in 2013-2014. See H. Oversight Hrg., supra note 53, at 2 (statement of Terry W. Hartle, Senior Vice President, American Council on Education).  

See Victoria, supra note 55. According to Terry W. Hartle, not only has state support for education fallen by 29% since 1998, but “a 1 percent decrease in state appropriations can result in a 3-5 percent increase in tuition.” H. Oversight Hrg., supra note 53, at 3 (statement of Terry W. Hartle, Senior Vice President, American Council on Education).  

See NCES DIGEST, supra note 1, at 426 tbl.303.10.  

Victoria, supra note 55.
intensive, but that resource must be highly educated and well-trained. In order
to attract and retain such talent, institutions must pay competitive wages,
including benefits, the costs of which have increased sharply in recent years.62
A cut in full-time faculty or an increase in class size is not only unpopular with
students, but those changes can also detrimentally affect both academic
quality63 and the length of time it takes students to complete their education,
which increases costs for students in the long run.

Moreover, in the past twenty to thirty years, there have been enormous
strides in technology. Postsecondary institutions must keep pace with these
advances, not only because students demand it, but also because technology
has become a part of both the education process and its delivery system.64
This involves a huge cost and investment in infrastructure, staff, data
security, and other ongoing expenses.

Finally, postsecondary institutions have had to increase staff to fulfill the
federal regulatory requirements that accompany federal financial assistance.
One school estimates that about seven percent of its operating budget is
attributable to costs associated with federal regulations.65 College officials state
that many of these regulations are “unnecessarily burdensome and duplicative”
and do not provide “meaningful benefits.”66

In considering the rising costs of higher education, there are several factors
to bear in mind. First, only about twenty-five percent of students pay the
“sticker” price of tuition.67 Second, increases in the costs of higher education

62 See H. Oversight Hrg., supra note 53, at 5 (statement of Terry W. Hartle, Senior Vice
President, American Council on Education). Benefit expenses currently account for about 25%
of total human resource costs. Id.
63 Id.
64 According to a statement of the American Council on Education: “This is evidenced
by the rising use of wireless classrooms, lecture capture and podcasting, mobile apps, and e-
portfolios . . . . No one wants colleges and universities to be equipped with scientific and
technology resources from 2000 as they try to meet the needs of students in 2014 and beyond.”
2014 S.Hrg., supra note 30, at 118.
65 H. Oversight Hrg., supra note 53, at 6 (statement of Terry W. Hartle, Senior Vice
President, American Council on Education). Most of these regulations emanate from the U.S.
Department of Education. Id.
66 Id.
67 One determines the tuition price paid by calculating what it costs the institution to
provide the education, less subsidies. Subsidies can consist of “state funding, financial aid,
endowment earnings, gifts from alumni and friends, and auxiliary enterprises such as college
bookstores.” Id. at 2. According to a recent study, the gap between the sticker price and the
net price that students pay has widened. Tuition Discounts at Private Colleges Continue to
org/About_NACUBO/Press_Room/2015_Tuition_Discounting_Study.html (estimating that
the average institutional discount rate for academic year 2015–16 is 48.6% for first-time, full-
time freshmen and 42.5% for all undergraduates).
are felt more sharply today because the median household income has fallen since 2008—it is now at roughly the same level as in 1995. Similarly, family net worth has fallen with stock market volatility. Finally, the overall increase in college tuition is skewed by the price of tuition at for-profit institutions, which far outpaces tuition prices at public, non-profit institutions. The majority of students who default on their loans attend for-profit institutions and are unable to find jobs after graduation that pay sufficient incomes to enable them to repay their student loans. Another cohort of student loan defaulters are those who, whether attending a for-profit or a non-profit institution, dropped out before completing their degrees.

2. Complexity & Mismatch in Timing

The sheer number of education tax incentives is daunting and clearly indicates the complexity of these incentives. This complexity raises its own set of problems. First, it increases compliance costs. The incentives offer every type of tax benefit—exclusions, exemptions, deductions, and credits—but not all of these benefits are equal. An exclusion never appears on an income tax return, so there is little to no compliance cost involved. In order to benefit from a deduction or credit, however, an individual must file a return. Thus, the partially refundable AOTC requires filing a return and

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68 See H. Oversight Hrg., supra note 53, at 6 (statement of Mary Francis McCourt, Senior Vice President and Chief Financial Officer, Indiana University, on behalf of the National Association of College and University Business Officers).

69 Id.


74 Another fundamental difference between an exclusion and a deduction or a credit is that an exclusion represents a nontaxable receipt of an economic benefit, while a deduction or credit involves a payment (i.e., an economic detriment). In order to benefit from an education tax incentive that is a deduction or credit, the taxpayer must pay a "qualified education expense" out of his or her own funds or those given to the taxpayer as a gift. A "qualified education expense" does not include amounts paid with Pell Grants or other nontaxable grants,
keeping records, which will increase compliance costs as well as the potential for fraud.\textsuperscript{75}

Second, sixteen of the eighteen incentives are designed to encourage enrollment by students from lower- and middle-income families. These incentives have different income limitations and apply to different educational costs— with some being more liberal than others—and they offer different benefits. They also are mutually exclusive, so a choice of one incentive requires a reduction in the amount of "qualifying tuition and fees" that may be considered for any other incentive. This reduces a taxpayer's eligibility to use a different incentive that could produce greater tax savings.\textsuperscript{76} Thus, choosing the right tax incentive for individualized situations is a

- scholarships, or fellowships.

Stated differently, when the taxpayer receives an economic benefit, such as a gift, scholarship, or a Pell Grant, he or she does not have to pay taxes on that amount. When the taxpayer pays a "qualified education expense" with those funds, it reduces the amount of qualified education expenses available for other benefits, such as the refundable AOTC. If the taxpayer pays qualified education expenses with amounts received as a gift, however, he or she gets the tax benefit of the education tax incentive even though the gift (like the scholarship, fellowship, or Pell Grant) is excludable from income tax.

In both cases, the taxpayers must present proof that they paid a qualified education expense (with a Service Form 1098-T (Tuition Statement) obtained from the educational institution). Taxpayers must also keep records and file tax returns in order to benefit. The difference is that the gift recipients benefit twice: they get a tax-free gift as well as the education tax benefits. The Pell Grant and scholarship recipients, however, only benefit once: they must pay a qualified education expense in order to exclude the amount of the grant, fellowship, or scholarship from income tax, and to the extent of that payment, it will remain ineligible for any education tax benefit. \textit{See also infra} note 138 and accompanying text.

\textsuperscript{75} In order to claim the AOTC, an individual must file a tax return with a Form 8863 (Education Credits) attached. In addition, the institution must issue a Form 1098-T (Tuition Statement). There have been problems of confusion, particularly among part-time students, erroneously claiming the credit and of institutions not submitting the Form 1098-T in a timely manner. \textit{See CRANDALL-HOLICK, supra} note 38, at 15–16. It is currently estimated that 45.3\% of American households pay no income tax. Roberton Williams, \textit{New Estimates of How Many Households Pay No Federal Income Tax}, FORBES (Oct. 6, 2015, 11:19 PM) http://www.forbes.com/sites/beltway/2015/10/06/new-estimates-of-how-many-households-pay-no-federal-income-tax. The problem with this estimate, however, is that it includes non-filers as well as those who file but otherwise owe no tax. Some of the non-filers may have had taxes withheld, but believe they are not required to file a return because they do not owe any further tax. \textit{Id.} One study estimated that the number of non-payers spiked to 51\% during the recession that began in 2008. Chuck Marr & Chye-Ching Huyang, \textit{Misconceptions and Realities About Who Pays Taxes}, CTR. ON BUDGET AND POLICY PRIORITIES (Sept. 17, 2012), http://www.cbpp.org/research/misconceptions-and-realities-about-who-pays-taxes.

\textsuperscript{76} Another example of this kind of limitation is the inability to combine the AOTC and Lifetime Learning Credit. The AOTC is available only for the first four years of postsecondary education. If a taxpayer should take the Lifetime Learning Credit, which is a smaller credit but is available for an unlimited number of years, the taxpayer's ability to take full advantage of the larger AOTC from that point on would be limited. \textit{See also infra} note 135.
complicated process that could easily result in the wrong choice. That could be particularly disadvantageous for lower- and middle-income families because they could “leave money on the table” and not get the full tax benefits to which they are entitled.\textsuperscript{77}

Third, the income limitations may operate unfairly. In order to ensure that the benefits are available only to lower- and middle-income taxpayers, Congress provided phase-outs to reduce or eliminate the benefits based on the taxpayer’s income. These phase-outs are based on “modified adjusted gross income” (mAGI), which is adjusted gross income with several items of excludable income included.\textsuperscript{78} The arbitrariness of the income limitations,\textsuperscript{79} however, raises several problems. For one, there is no consideration of the difference in cost of living in different localities.\textsuperscript{80} For another, the use of the mAGI allows no consideration of certain expenses that remain beyond the control of the taxpayer but nevertheless affect the taxpayer’s ability to pay higher education costs. These expenses include things such as extraordinary medical expenses, existing student loans, casualty losses, and the erosion of savings or equity in times of recession.\textsuperscript{81} These financial detriments do not affect the taxpayer’s mAGI.\textsuperscript{82} Thus, the mAGI may reflect an income level

\textsuperscript{77} According to the Government Accountability Office (GAO), “[T]hey found about 14% of filers (1.5 million of almost 11 million eligible returns) failed to claim a credit or deduction for which they appear eligible.” 2012 S.Hrg., supra note 14, at 14, 155 (statement of James White, Director, Tax Issues, Government Accountability Office).

\textsuperscript{78} The definition of mAGI may vary among the provisions. See, e.g., I.R.C. §§ 25A(d) (increasing the adjusted gross income by amounts excluded from income under §§ 911, 931, or 933), 221(b)(2)(C) (determining adjusted gross income without regard to §§ 221, 199, 222, 911, 931 and 933, and after the application of §§ 86, 135, 137, 219 and 469).

\textsuperscript{79} See Schenk & Grossman, supra note 9, at 325 (noting the arbitrariness of the income limitations).

\textsuperscript{80} The American Council on Education made this point. See Letter from Molly Corbett Broad, President, Am. Council on Educ., to H. Ways and Means Comm. 3 (Apr. 4, 2014) (noting that where one lives may affect the ability to claim education tax incentives and that the reduced income phase-out limits exacerbate this discrepancy).

\textsuperscript{81} See Neal Gabler, The Secret Shame of Middle-Class Americans, THE ATLANTIC, May 2016, at 52–63 (detailing normal life choices that have led to devastating debt that, in turn, has led to financial impotence, exemplified by the 71% of people polled by the Pew Charitable Trusts who expressed concern about having enough money to cover day-to-day expenses). Many of those who may have relied on home equity to finance their children’s education have found not only that it is harder to get a home-equity loan or to refinance, but also that their equity has dropped considerably in the wake of the Great Recession of 2008. Id. at 57–58. In addition, some parents may be saddled with their own student loans.

\textsuperscript{82} This is because the expenses mentioned are either itemized deductions (also called “below-the-line” deductions under I.R.C. § 63(d)) that do not affect adjusted gross income, I.R.C. § 62, or they are not deductible at all, as in the case of a reduction in value of an investment portfolio, which is deductible as an investment loss only to the extent that there has been a sale (i.e., a realization event) of any of the portfolio assets. I.R.C. § 1211.
Reforming Higher Education Tax Incentives

not indicative of the taxpayer’s ability to pay the costs of higher education. Moreover, the phase-outs have a built-in cliff effect, meaning that one dollar of mAGI over the limitation amount will cause the taxpayer to lose the entire deduction.  

On the other side of the coin, the definition of mAGI does not consider the taxpayer’s assets. A taxpayer could have a large amount of assets that do not generate much taxable income. The taxpayer’s mAGI may therefore be low, but her ability to pay higher education expenses may be much higher than her mAGI would indicate. A taxpayer’s mAGI may also be artificially low if she has significant investment deductions, such as depreciation or depletion that would reduce her adjusted gross income. Taxpayers in both cases may be considered higher-income from a financial standpoint, but each would be entitled to an education tax credit if her mAGI were to fall below the maximum phase-out amount.

Adding to the complexity is a persistent uncertainty about these incentives, as some are slated to sunset at a future point. In the past, Congress has extended some of these incentives at the eleventh hour and eventually has made others permanent. When Congress looks for ways to cut the budget in the future, as it more than likely will at some point, the education tax incentives may be a tempting place to start because of their high cost. This makes long-term planning to pay the costs of higher education difficult.

What is more, the education tax credits along with most of the other education tax incentives only apply to tuition and related costs. They do not

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83 As Schenk and Grossman observed, "A taxpayer with $160,000 of AGI could receive a $2000 deduction for education expenses, which in a 25% tax bracket would produce tax savings of $500. If, however, he had $160,001 AGI, he would receive no deduction. Thus, the additional dollar in income produces a loss of $499." Schenk & Grossman, supra note 9, at 301.

84 See I.R.C. § 62(a)(4). Schenk and Grossman raise these points, supra note 9, at 328.

85 For example, Congress extended through December 31, 2016 the deduction in section 222 of the Code for qualified tuition and related expenses, and the AOTC, which was originally set to expire at the end of 2017, was made permanent under the Protecting Americans from Tax Hikes (PATH) Act of 2015, Pub. L. No. 114-113, §§ 102, 152, 129 Stat. 3040, 3044, 3066 (2015).


87 At least one reformer suggests that Congress should eliminate the education credits in favor of flattening tax rates for everyone. See 2012 S.Hrg., supra note 14, at 13, 135 (statement of Scott A. Hodge, President, Tax Foundation). The reformer suggested it as a means of simplifying the tax code and improving the economy. Id. at 133–35.
apply to other major costs of postsecondary education, such as living expenses, transportation, insurance, and nontuition related fees, which, particularly at four-year institutions, may exceed the tuition costs. Moreover, the benefits offered by the tax incentives generally are too small to have a direct influence on the fundamental decisions of whether to attend college, what type of institution to attend, and how long to attend, among others.

The mismatch in timing between the obtainment of benefits from the tax incentives and the payment of tuition exacerbates these problems. College tuition generally is due in the summer or fall before attendance, but the education tax incentives do not produce a benefit until the following year, when the taxpayer files his or her tax return. This can result in a delay of up to eight to ten months between the time the tuition is due and the taxpayer receives the refund. In some cases, the delay takes as long as fifteen months. When there is a long delay, the taxpayer may consume the tax benefit for personal use rather than use it for its intended purpose. The timing mismatch also means that the tax benefits are not likely to have an effect on the amount of a student’s loan, which must be determined before the tuition payment is due.

The problems of complexity and the mismatch in timing between receipt of the benefit and the payment of tuition makes the education tax incentives highly inefficient.

3. Tax Breaks for Higher Income Taxpayers

The education tax incentives also are highly regressive because they favor higher-income taxpayers over lower-income taxpayers. The greater the tax bracket of the taxpayer, the greater the benefit. A tax benefit, whether a deduction, exclusion or credit, is worth almost nothing to those who either have no taxable income or who fall into the lowest income tax bracket. President Obama alleviated some of this concern in 2009 with the partially refundable AOTC, which allows a taxpayer with little to no taxable income to obtain a partial refund. As one study noted, “tax provisions are best

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88 As Schenk and Grossman note: “in most cases there is no financial assistance for other costs, such as room and board, books, transportation, and other personal expenses and therefore there will be significant, unmet financial need.” Schenk & Grossman, supra note 9, at 317–18.
89 Id. at 324–25. An exception is a two-year community college with lower tuition. In that case, the tax benefits, particularly the refundable AOTC, may be meaningful for a lower-income taxpayer. Id. at 314.
90 See Schenk & Grossman, supra note 9, at 353–54.
91 See supra note 46.
92 See Long, supra note 5, at 132.
93 I.R.C. § 25A(i). Currently, 40% of this credit (up to $1000) is refundable. The AOTC,
looked at as a means to transfer wealth."\textsuperscript{94} This study concluded that the education tax incentives, in general, remain unlikely to change behavior or influence decisions—regardless of income—about whether or not to pursue higher education.\textsuperscript{95}

Other inequities built into the tax incentives favor higher-income families over lower-income families. For example, the AOTC and Lifetime Learning credits are calculated on the basis of "qualified tuition and related expenses."\textsuperscript{96} These expenses must be reduced by any amount paid with tax-free scholarships or Pell Grants.\textsuperscript{97} They are not reduced, however, by amounts paid with gifts and inheritances.\textsuperscript{98} This is one of the few instances in the tax code in which the taxpayer may "double dip" (i.e., gain a double tax benefit).\textsuperscript{99} Since students who pay tuition and related expenses through gifts and inheritances tend to be from higher-income families, this constitutes an inherent bias against lower-income taxpayers.

### III. CURRENT PROPOSALS

There has been no shortage of bills and other proposals to reform federal spending for higher education, many of them focusing specifically on the education tax incentives. The primary criterion in addressing the education tax incentives under these proposals appears to be "use it or lose it": those that taxpayers use more often (in that they represent a larger tax expenditure) remain, with modifications, while those that are used less often must go.

The House Ways and Means Committee released a bill late in 2014,\textsuperscript{100} along with an ambitious "discussion draft," to rewrite the Code, including the

\textsuperscript{94} Schenk & Grossman, \textit{supra} note 9, at 365.

\textsuperscript{95} \textit{Id.} at 360-65. The incentives' ineffectiveness in encouraging greater enrollment and retention by lower- and middle-income families has already been pointed out. \textit{See supra} Part II.B.2. Those in the higher-income levels would have pursued postsecondary education without the tax incentives. Simply put, the tax benefit for them is a windfall. Schenk & Grossman, \textit{supra} note 9, at 364-65.

\textsuperscript{96} I.R.C. § 25A(f)(1). This definition includes only tuition and fees in the case of the Lifetime Learning Credit, but for the AOTC it also includes course materials. \textit{Id.} § 25A(i)(3).

\textsuperscript{97} \textit{See id.} § 25A(g)(2); \textit{supra} note 74.

\textsuperscript{98} I.R.C. § 25A(g)(2)(C).

\textsuperscript{99} This may even be a triple benefit because (1) the gift is not subject to income tax by the recipient, \textit{id.} § 102, (2) the gift, if paid as tuition directly to the educational institution, is free from gift tax by the payor, \textit{id.} § 2503(e)(2), and (3) despite being tax exempt, the amount of the gift does not reduce the qualified tuition for purposes of determining the section 25A credits, \textit{id.} § 25A(g)(2)(C).

\textsuperscript{100} Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014).
education tax incentives.\textsuperscript{101} It also held hearings in 2015 on \textit{The Rising Costs of Higher Education and Tax Policy}.\textsuperscript{102} The House Budget Committee also released a discussion draft in 2014, which focused heavily on Pell Grants.\textsuperscript{103} The Senate Finance Committee held hearings on education tax reform in 2012,\textsuperscript{104} and again in 2014, on the role of the tax system in reducing student debt.\textsuperscript{105} While there has been no official proposal to date from the Senate Finance Committee, Senator Charles Schumer (D-NY) introduced a bill\textsuperscript{106} on which a working committee of the Senate Finance Committee commented.\textsuperscript{107} In addition, President Obama proposed his own changes to increase college access,\textsuperscript{108} and a group called "Consortium for Higher Education Tax Reform,"\textsuperscript{109} funded by the Bill and Melinda Gates Foundation, released a proposal.\textsuperscript{110}

\textsuperscript{101} H. COMM. ON WAYS AND MEANS, 113TH CONG., TAX REFORM ACT OF 2014, DISCUSSION DRAFT, SECTION-BY-SECTION SUMMARY (2014). This draft aimed to rewrite the Code yet achieve tax-neutral reform, in keeping with the 1986 Tax Reform Act.

\textsuperscript{102} H. Oversight Hrg., supra note 53.

\textsuperscript{103} H. BUDGET COMM., 113TH CONG., EXPANDING OPPORTUNITY IN AMERICA, DISCUSSION DRAFT 44 (2014).

\textsuperscript{104} See 2012 S.Hrg., supra note 14.

\textsuperscript{105} 2014 S.Hrg., supra note 30.


\textsuperscript{108} See \textit{Fiscal Year 2017 Budget Overview}, OFF. MGMT. & BUDGET, https://www.whitehouse.gov/omb/overview (last visited Nov. 1, 2016) (proposing tuition-free community college, strengthening Pell Grants, simplifying the federal application for student financial assistance, and simplifying and expanding education tax benefits).

\textsuperscript{109} The Consortium consists of a partnership of four organizations: the Center for Postsecondary and Economic Success at CLASP, Young Invincibles, the New America Foundation's Education Policy Program, and The Education Trust. The Consortium remains dedicated to reforming federal tax policy for higher education to increase access to college, make college more affordable, and increase college completion rates by low and modest-income individuals. CONSORTIUM FOR HIGHER EDUC. TAX REFORM, HIGHER EDUCATION TAX REFORM: A SHARED AGENDA FOR INCREASING COLLEGE AFFORDABILITY, ACCESS AND SUCCESS 5 (2013).

\textsuperscript{110} This proposal takes the form of a report. CONSORTIUM FOR HIGHER EDUC. TAX REFORM, THE CONSORTIUM FOR HIGHER EDUCATION TAX REFORM REPORT (2014) [hereinafter CONSORTIUM REPORT], http://www.clasp.org/resources-and-publications/publication-1/2014.06.20-Consortium-for-Higher-Ed-Tax-Reform-FINAL.pdf. The author selected the
A. House Proposals

1. Ways and Means Committee

The House Ways and Means Committee’s proposal remains the most comprehensive of the current proposals. Released in late 2014, its bill proposes to repeal ten of the eighteen education tax incentives: the Hope Credit, the Lifetime Learning Credit, the American Opportunity Credit, the exclusion of interest on U.S. savings bonds used to pay qualified higher education expenses, the deduction of interest on student loans, the deduction of qualified tuition and related expenses, new contributions to Coverdell education savings accounts, the exclusion of discharge of certain student loan indebtedness, the exclusion of qualified tuition reductions, the exclusion of employer provided educational assistance, and the exception to the ten percent penalty for early distributions from retirement plans used to pay higher education expenses.

The bill retains qualified tuition plans (QTPs) without modification.
These plans remain, by far, the most generous of the education tax incentive savings plans. They place no limit on contributions and no tax on the distribution, as long as the taxpayer uses the distribution for a qualified education expense.  The QTP definition of qualified education expense remains the broadest of any of the three tax incentive savings plans. It not only includes tuition and related fees, but also books, supplies, equipment, computers and related expenses, and room and board.  Although these plans are used by approximately three-percent of taxpayers, most of these taxpayers are higher-income families. Thus, they carry political clout, and these plans hold a considerable amount of money. Under the House bill, QTPs would be the only tax-favored college savings plan.

The bill replaces the ten repealed incentives with a single modified AOTC to provide an incentive for those currently in school. This new AOTC would continue to provide a credit of up to $2500 against $4000 in qualifying expenses, calculated as under the current AOTC. The new AOTC, like the current one, would continue to remain available for the first four years of postsecondary education. The definition of “qualified tuition and related expenses” would expand to include not only tuition and fees, but

the institution issues a tuition waiver equal to the amount of the contributions, plus the tax-free accumulation. If the beneficiary decides not to attend that institution, the contributor can roll over the contribution and accumulation to another eligible institution. Eligible institutions are those eligible to participate in student aid programs administered by the U.S. Department of Education. These include public, private, non-profit, and proprietary institutions, as well as vocational institutions. A qualified savings plan is also maintained by the state and works basically the same as the qualified tuition plan, except that the taxpayer does not prepay tuition. The tax consequences of the two remain the same—no tax on the accumulation and no tax on the distribution, as long as the taxpayer uses the distribution for a qualified educational purpose. See I.R.S. Pub. 970, Tax Benefits for Education 59–62 (Jan. 29, 2016), https://www.irs.gov/pub/irs-pdf/p970.pdf.

125 1.R.C. § 529(c).
127 U.S. GOV’T ACCOUNTABILITY OFF., GAO-13-64, HIGHER EDUCATION: A SMALL PERCENTAGE OF FAMILIES SAVE IN 529 PLANS 14–15 (2012). According to the report, the majority of these contributors earn over $250,000. Id. at 15 n.39.
130 Id. (proposed I.R.C. § 25A(a)). The $2500 credit is calculated by considering 100% of the first $2000 in qualified tuition and related expenses, plus 25% of such expenses paid that exceed $2000 but do not exceed $4000. Id.
131 Id. (proposed I.R.C. § 25A(d)).
also course materials.\textsuperscript{132} The new credit would increase the refundable amount from forty percent to sixty percent (from $1000 to $1500),\textsuperscript{133} although it would lower the income limitations to almost half their present values.\textsuperscript{134}

The lower phase-out limits of this bill would mean that fewer families would benefit from the credit. Also, the repeal of the Lifetime Learning Credit and the failure to extend the new AOTC beyond the first four years of postsecondary education would mean that graduate and professional students generally would not be able to take advantage of any education tax credit, regardless of their income levels.\textsuperscript{135}

The House Ways and Means proposal also addresses Pell Grants. Two problems persist with respect to such grants, both of which the proposal addresses. First, Pell Grants remain excludable from income if the taxpayer uses them for “qualifying tuition and related expenses.”\textsuperscript{136} The definition of qualifying tuition and related expenses, however, does not include room and board (although there is no restriction on the grant itself that precludes the student from using it for room and board).\textsuperscript{137} If the student uses any portion of his or her Pell Grant for room and board, that portion will be taxable. Second, spending Pell Grant funds on qualified tuition and related expenses reduces the amount of these expenses that may be considered for the AOTC, as well as for any other education tax incentive.\textsuperscript{138} Thus, the neediest students (and other scholarship recipients) face a catch-22: they may either designate

\begin{itemize}
\item \textsuperscript{132} \textit{Id.} (proposed I.R.C. § 25A(e)(2)).
\item \textsuperscript{133} \textit{Id.} (proposed I.R.C. § 25A(b)).
\item \textsuperscript{134} The income limitations are based on mAGI, defined as “the adjusted gross income of the taxpayer for the taxable year, increased by any amount excluded from gross income under §§ 911, 931, or 933.” \textit{Id.} (proposed I.R.C. § 25A(c)). This same limitation appears in the current AOTC. See I.R.C. § 25A(d)(3). The current AOTC phases out between $80,000 to $90,000 for single filers and between $160,000 and $180,000 for joint filers. \textit{Id.} at § 25A(i)(4). The modified AOTC would phase out between $43,000 and $64,000 for single filers and between $86,000 and $126,000 for joint filers. H.R. 1 § 1201 (proposed I.R.C. § 25A(c)). Under the House Ways and Means bill, Congress would index these levels for inflation, beginning after 2018. \textit{Id.} (proposed I.R.C. § 25A(g)).
\item \textsuperscript{135} The Lifetime Learning Credit remains unlimited in the number of years in which the taxpayer may claim it. I.R.C § 25A(c). Thus, graduate and professional students may claim it. It remains, however, a “per taxpayer” credit rather than a “per student” credit, which makes it less advantageous for taxpayers with more than one child in graduate school. \textit{Id.} at § 25A(c)(1). The AOTC, on the other hand, is a “per student” credit, meaning the taxpayer may claim more than one such credit per return if the taxpayer has multiple children in college, provided these children are in their first four years of college. \textit{Id.} at § 25A(i).
\item \textsuperscript{136} \textit{See id.} at § 117(b)(2) (defining “qualified tuition and related expenses”).
\item \textsuperscript{137} \textit{Id.}
\item \textsuperscript{138} \textit{See id.} at § 25A(g)(2). This prevents the taxpayer from obtaining a double tax benefit (“double dipping”).
\end{itemize}
their grant/scholarship amounts for living expenses, which would make them
taxable but would preserve qualified tuition and related expenses for the
AOTC, or they may spend the grants on qualified expenses and claim them
as such, but forfeit the AOTC refund. The House Ways and Means proposal provides that Congress will not
tax Pell Grants if used for room and board, and the student may apply the
grant to those expenses first without reducing qualified education expenses
for purposes of the new refundable AOTC. Thus, under the Ways and
Means bill, Congress would exclude Pell Grants from income regardless of
how the student used them, and Pell recipients would become eligible for the
refundable AOTC.

2. The House Budget Committee Discussion Draft

In 2014, the House Budget Committee released a discussion draft to
reform Pell Grants in anticipation of the reauthorization of the Higher
Education Act. This draft proposes to fix the tax problems of the grants in
the same manner as the Ways and Means bill. While the Budget Committee
draft does not address the education tax incentives, it is noteworthy in its

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139 Students may designate how they spend their Pell Grants, regardless of how the school allocates the grant. Fact Sheet: Interaction of Pell Grants and Tax Credits: Students May Be Foregoing Tax Benefits by Mistake, U.S. DEP’T TREASURY (June 10, 2014), https://www.treasury.gov/connect/blog/Documents/Pell%20AOTC%204%20pager.pdf.

140 The optimal strategy is actually quite complex and may vary from student to student, because it depends on the student’s (or parents’, if the student is a dependent) marginal tax rate (which may change depending on how much of the grant is included in income), the amount of tax liability, the amount of the expenses, etc. See supra note 134.

141 Tax Reform Act of 2014, H.R. 1, 113th Cong. § 1202 (2014). The student could pay these expenses with a student loan and the student then would be able to claim the AOTC refund.

142 H. BUDGET COMM., 113TH CONG., EXPANDING OPPORTUNITY IN AMERICA, DISCUSSION DRAFT 44 (July 24, 2014).

proposal to cut funding from the Pell Grant program.\footnote{See David Reich & Brandon Debot, Ctr. on Budget & Pol'y Priorities, House Budget Committee Plan Cuts Pell Grants Deeply, Reducing Access to Higher Education (2015), http://www.cbpp.org/sites/default/files/atoms/files/3-24-15bud.pdf.} In all, this draft calls for spending cuts for higher education of $180 billion over ten years,\footnote{Id. at 6.} which would severely jeopardize the viability of the Pell Grant program. It proposes a ten-year freeze on the amount of the maximum Pell Grant and eliminates mandatory budget funding of the grants.\footnote{Id. at 1.} This would place the grants entirely within the congressional appropriations process, making them vulnerable to the vicissitudes of Congress and the austerity measures of sequestration.\footnote{If Congress fails to pass a budget, or if the deficit increases beyond a certain limit, it triggers sequestration—a series of deep cuts to government programs. Congress authorized this measure in the Balanced Budget and Emergency Deficit Control (Gramm-Rudman-Hollings) Act of 1985, Pub. L. No. 99-177, 99 Stat. 1037. Congress implemented sequestration in 2013 to produce spending cuts of $1.2 trillion over ten years. See David Reich, Ctr. on Budget & Pol’y Priorities, Sequestration and Its Impact on Non-Defense Appropriations (2015), http://www.cbpp.org/sites/default/files/atoms/files/2-19-15bud.pdf.}

The purported rationale for these cuts is two-fold. First, the Pell Grant program faces a funding deficit.\footnote{2016 Budget Perspectives, supra note 6, at 138 (describing funding cliff in 2018).} Second, Pell Grants, along with other forms of federal financial aid to students, contribute to the rising costs of tuition.\footnote{See discussion supra notes 48–72 and accompanying text.} It has been noted, however, that neither is accurate.\footnote{See Reich & Debot, supra note 144, at 1–2.} The Pell program experienced unprecedented costs in the aftermath of the Great Recession of 2008, when the job market was flat and many people who could not find jobs chose to enroll or re-enroll in college.\footnote{See Republican Staff of H. Comm. on Educ. and the Workforce, 113th Cong., Strengthening America’s Higher Education System 6 (2014) (The rapid growth of the program was caused by a perfect storm of factors: the recent economic downturn that led to}
however, the economy has improved and costs for the Pell program have declined, to the point that the program currently produces a surplus. The Congressional Budget Office (CBO) estimates that the costs of the program will continue to decline over the next decade.

B. The Schumer Bill and the Senate Finance Committee Response

In 2013, Senator Charles Schumer introduced a bill “to extend and modify the American Opportunity Tax Credit.” This bill would repeal the Lifetime Learning Credit and modify the AOTC, although like the current AOTC, it would also remain a permanent credit, with forty percent refundability. The bill, however, would increase the amount of the credit from $2500 to $3000 for those students attending school at least half-time, and it would raise the upper income limitations. The bill would eliminate the current restriction on use of the credit to the first four years of postsecondary education, but would cap the benefit at a lifetime amount of $15,000. The Schumer bill also would make Pell Grants tax-free regardless of use, provided that the use conforms to the requirements of the grant. Like the House Ways and Means bill, the bill also would allow a student to designate the amount of the Pell Grant to expenses other than qualified tuition and related expenses, allowing the student, or the student’s parents, to benefit from both the tax exclusion of the Pell Grant and the AOTC refund.

Senator Schumer’s bill was referred to the Senate Finance Committee and analyzed by a Working Group of that committee, which criticized the...

152 See Danielle Douglas-Gabriel, It Looks as if the Government Can Afford to Revive Year-Round Grants for Needy College Students, WASH. POST: GRADE POINT (Mar. 24, 2016), https://www.washingtonpost.com/news/grade-point/wp/2016/03/24/it-looks-as-if-the-government-can-afford-to-revive-year-round-grants-for-needy-college-students/ (reporting that the Pell program projects to have a $7.7 billion surplus this year); see also CONSORTIUM FOR HIGHER EDUC. TAX REFORM, supra note 110, at 3 (Foreword) (pleading for any savings from reform of education funding to be redirected to students and not “diverted to overall deficit reduction”).

153 The CBO projects a decline in costs of 0.5% per year, on average, in the program over the next decade. See REICH & DEBOT, supra note 144.


155 Id. § 2 (proposed I.R.C. § 25A(g)).

156 Id. § 2(a) (proposed I.R.C. § 25A(b)(1)).

157 These limitations would increase from the current levels of $80,000 to $90,000 for single filers, $160,000 to $180,000 for joint filers, to $80,000 to $100,000 for single filers, $160,000 to $200,000 for joint filers. Id. § 2(a) (proposed I.R.C. § 25A(c)).

158 Id. § 2(a) (proposed I.R.C. § 25A(d)).

159 Id. § 3(a) (proposed I.R.C. § 117(b)).

160 Id. § 2(a) (proposed I.R.C. § 25A(d)(3)(B)).
Reforming Higher Education Tax Incentives

bill's proposed lifetime cap. The Working Group thought the added complexity of tracking the use of the credit for purposes of the cap would raise compliance costs for taxpayers and further overburden the Service by increasing the potential for undetected fraud.

The cap may cause additional problems in determining the appropriate allocation between taxpayers. For instance, if parents claim the credit and have more than one child in college, and one of those children later tries to claim a credit on his or her own, how, if at all, should the credit claimed by the parents be allocated in determining the cap?

The Senate Finance Committee remained interested in reforming the education tax incentives. In June 2014, it held hearings to examine the role of the tax system in reducing student debt. In July 2015, the Bipartisan Tax Working Group discussed not only the Schumer bill, but it also discussed reform of the education tax incentives in the broader context of reforming the tax system.

C. The Obama Proposal

In 2015, as part of his State of the Union address, President Obama proposed free community college for students who enroll at least half-time, maintain at least a 2.5 GPA, and have adjusted gross income of less than $200,000. The President's proposal is the broadest of any of the other current proposals in that it focuses not only on tax incentives and financial aid to students, but also addresses incentives to institutions that graduate large numbers of low-income students, and it provides oversight for institutions

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162 Id.

163 Id.


167 See The President’s Budget: Fact Sheets on Key Issues, Empowering All Americans with the Education and Skills They Need, OFF. MGMT. & BUDGET, https://www.whitehouse.
and students that receive federal aid.\textsuperscript{168}

The President proposes a modified, permanent AOTC, similar to those of the Ways and Means bill and the Schumer bill. Under the President’s proposal, however, the availability of the credit would expand to five years of postsecondary education instead of the four years provided under current law.\textsuperscript{169} In addition, the President proposes to coordinate the tax treatment of Pell Grants with the AOTC in a manner similar to the Congressional proposals.\textsuperscript{170} The White House further proposes to eliminate the deduction of student loan interest because of administrative complexity and low utilization.\textsuperscript{171} Currently, the federal government taxes student loan forgiveness after twenty to twenty-five years under the income based repayment plan.\textsuperscript{172} Since this plan is available to those who have low-paying


\textsuperscript{168} This proposal would limit Pell Grants for individuals who repeatedly enroll in programs but do not earn academic credit. It also would strengthen academic progress requirements and provide bonus grants to encourage students to graduate on time. Further, it would provide bonus grants to colleges that successfully enroll and graduate low-income students. \textit{Id.}


\textsuperscript{170} In one important respect, Pell Grants receive different treatment under the Congressional and Executive proposals. The Schumer bill would consider Pell Grants directed to non-tuition and fees, to the extent paid by the student, as well as any amount of grant paid in excess of qualified tuition and fees to be applied to reduce qualified tuition and fees paid for purposes of the AOTC. The President’s proposal would extend tax-exempt status to Pell Grants, regardless of any excess amount over qualified expenses. As the Senate Finance Committee Working Group noted, however, “at current Pell levels, this may be a difference without a consequence, as generally an individual’s living expenses in any given year are estimated to exceed the maximum Pell Grant amount.” S. COMM. ON FIN., 113TH CONG., \textit{THE INDIVIDUAL INCOME TAX, BIPARTISAN TAX WORKING GROUP REPORT} 29 n.48 (2015), http://www.finance.senate.gov/download/the-individual-tax-bipartisan-tax-working-group-report.


\textsuperscript{172} \textit{See} I.R.C. § 61(a)(12) (including income from discharge of indebtedness in the definition of gross income). Under the William D. Ford Direct Loan Program (also called the “Obama Student Loan Forgiveness Program”), loan payments may be contingent on the borrower’s income, family size, loan balance, and/or interest rate. \textit{Standard Plan, FED. STUDENT AID}, https://studentaid.ed.gov/sa/repay-loans/understand/plans/standard (last visited Oct. 31, 2016). The federal government would forgive any outstanding balance on these loans at the end of a twenty-five year period. For new loans, Congress already reduced the period before forgiveness to twenty years. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 2213, 124 Stat. 1029, 1081. For those working in public service, a ten-
Reforming Higher Education Tax Incentives

jobs and/or large families relative to their earned income, the President proposes to make this forgiveness tax-free.\(^\text{173}\)

The President had proposed to tax earnings on new contributions to QTPs on the basis that the current exemption inures primarily to the benefit of higher-income families.\(^\text{174}\) He subsequently withdrew this proposal, however, because of strong bipartisan opposition.\(^\text{175}\)

The President also proposes to permanently expand Pell Grants in two new programs. The first is the “Second Chance Pell Program,” which would apply to prisoners eligible for release, to facilitate their future assimilation into society and assist them in obtaining employment.\(^\text{176}\) The second program is the “On Track Pell Program” in which grants would be awarded to students who stay on course to graduate on time.\(^\text{177}\)

The centerpiece of the Obama proposal, however, is the “America’s College Promise” program, which authorizes the Department of Education to award grants to cover tuition at community colleges.\(^\text{178}\)

\(^\text{173}\) Currently, there are three income contingent repayment plans available for Direct Loans, but under the President’s proposal, the PAYE plan (Pay-As-You-Earn) would be the only one available for new loans originating after July 1, 2016. The payments would be capped at 10% of the borrower’s discretionary income and would allow forgiveness after twenty years. The proposal would cap the amount of public service forgiveness at $57,500. See Allesandra Lanza, What Obama’s 2016 Budget Proposal Means for Student Borrowers, U.S. NEWS & WORLD REP. (Feb. 11, 2015, 10:00 AM), http://www.usnews.com/education/blogs/student-loan-ranger/2015/02/11/what-obamas-2016-budget-proposal-means-for-student-borrowers.

\(^\text{174}\) The Administration notes that approximately 80% of the tax benefits of QTPs inure to the benefit of families earning more than $250,000. Stratford, supra note 171.


\(^\text{177}\) Those students taking at least fifteen credit hours per semester and who are set to graduate on time will receive an extra $300 “on-track Pell bonus” added to their grant. College Affordability and Completion: Assuring a Pathway to Opportunity, U.S. Dep’t Educ., http://www.ed.gov/college (last visited Oct. 31, 2016).

\(^\text{178}\) The House introduced the America’s College Promise Act, H.R. 2962, 114th Cong. (2015), to implement this program, but no identified funding source exists, so presently enactment remains unlikely. The bill was referred to the House Subcommittee on Higher
that the proposal represents a fundamental cultural shift in higher education policy.\footnote{Michael Stratford, \emph{Middle-Class Economics for Tuition}, \emph{INSIDE HIGHER ED} (Jan. 21, 2015), http://www.insidehighered.com/news/2015/01/21/obama-pitches-free-community-college-higher-education-tax-credits-state-union.} This program would provide free community college tuition funded by the federal government, in partnership with the states.\footnote{The states would cover 25% of the cost and the federal government would cover the remainder. The federal government will require community colleges to pass federal eligibility requirements. In addition, some of the legislation pending in other states would impose other restrictions, such as requiring students to maintain a certain GPA and to remain in the state for a certain period of time after graduation. See, e.g., \textsc{Or. Rev. Stat.} § 341.522(3)(e) (2016) (requiring a cumulative grade point average of 2.5 or better in high school to receive a waiver of tuition for community colleges). Most of the pending legislation would cover only tuition and fees. Washington state’s legislation, however, the Washington Promise Program, offers a stipend of up to $1500 for books and other related expenses for needy students. \textit{Compare S. 6481, 64th Leg., Reg. Sess. § 3(7)(b) (Wash. 2016), with H.R. 2820, 64th Leg., Reg. Sess. § 3(7)(b) (Wash. 2016). See also \textit{Washington Promise Comparison}, LEAGUE EDUC. VOTERS (Jan. 2016), http://educationvoters.org/wp-content/uploads/2016/01/Washington-Promise-Comparison.pdf.}\footnote{See supra text accompanying note 166.}\footnote{Cong. Research Serv., \textit{Bill Summary & Status} H.R. 2962, 114th Cong. (2015), https://www.congress.gov/bill/114th-congress/house-bill/2962. Congress will allocate approximately $10 billion of this amount to grants for historically black colleges, universities, and other minority-serving institutions that enroll at least 35% low-income students, helping to improve completion rates and student outcomes.\footnote{Stratford, \textit{supra} note 171. The President asked for $60 billion to cover the initial basic cost of the program. \textit{Id.}}.\footnote{Stratford, \textit{supra} note 171. The President asked for $60 billion to cover the initial basic cost of the program. \textit{Id.}}} The federal government would make the program available to students who meet certain requirements.\footnote{Congress estimates the program to cost almost $80 billion over ten years,\footnote{Stratford, \textit{supra} note 171. The President asked for $60 billion to cover the initial basic cost of the program. \textit{Id.}} which the President proposes to pay by raising taxes on wealthy Americans and financial institutions.\footnote{Stratford, \textit{supra} note 171. The President asked for $60 billion to cover the initial basic cost of the program. \textit{Id.}}

Over forty percent of students attending community colleges are minorities and over half of community college students attend part-time
while working to support their families.\textsuperscript{184} Free tuition for the first two years of postsecondary education will not only give the underprivileged a start toward obtaining a college degree, but it will also likely reduce student borrowing and defaults in the long run. This is because postsecondary enrollment eventually will reach an optimal point, since not everyone has an interest in or aptitude for higher education. Those who realize this after enrolling, incurring student loans and dropping out, have unusually high rates of student loan defaults.\textsuperscript{185} Providing the first two years of college free, with conditions to keep grades at a certain level, would help cull those who might otherwise drop out. Thus, a program of free community college may pay for itself simply by reducing the rate of student loan defaults.\textsuperscript{186}

\textbf{D. The Education Consortium Proposal}

The Consortium Report recommends reforming the tax incentives and redirecting the savings to the Pell Grant program.\textsuperscript{187} Similar to the other proposals, the Report recommends coordinating AOTC benefits with Pell Grants and eliminating the tax on Pell Grants.\textsuperscript{188} The Report focuses heavily on reforming the AOTC. Like the other proposals, it would eliminate the Hope and Lifetime Learning Credits,\textsuperscript{189} although unlike the other proposals, the Report recommends making the AOTC fully refundable.\textsuperscript{190} The proposal would replace the four-year limit on the use of the AOTC with a $10,000 lifetime cap;\textsuperscript{191} the four-year limitation creates confusion, whereas a lifetime

\textsuperscript{184} See Exec. Office Report, supra note 178, at 11–12.

\textsuperscript{185} See James, supra note 72 (noting that students who drop out default on their loans at a much higher rate than those who graduate, even if the balance is much lower comparatively). See also 2012 S.Hrg., supra note 14, at 44 (testimony of Dr. Susan Dynarski, Professor, University of Michigan, Faculty Research Associate, National Bureau of Economic Research, and Research Associate, Center for Analysis of Postsecondary Education and Employment) (finding that students at for-profit colleges drop out, borrow, and default on loans at an unusually high rate).

\textsuperscript{186} It also would pay for itself by producing a more educated workforce and a more robust economy with a larger number of taxpayers. See discussion of positive externalities, supra notes 30–33 and accompanying text.

\textsuperscript{187} See Consortium Report, supra note 110, at 25. The Report consists of four parts. The main part is a “set of consensus policy recommendations” of the Consortium, entitled Higher Education Tax Reform: A Shared Agenda for Increasing College Affordability, Access, and Success. There are also four issue briefs exploring in greater depth specific aspects of the consensus report. These reports focus on strengthening outreach of the AOTC, the timing mismatch between the payment of tuition and the receipt of the tax benefit, standards to encourage institutional improvement, and tax-exempt borrowing by postsecondary institutions. Id.

\textsuperscript{188} Id. at 17, 22.

\textsuperscript{189} Id. at 20.

\textsuperscript{190} Id. at 17.

\textsuperscript{191} Id. at 21.
cap would treat taxpayers fairly and more uniformly.\textsuperscript{192} This recommendation is similar to that of the Schumer bill and susceptible to the same criticisms.\textsuperscript{193} In addition, the proposal would double the phase-out ranges by raising the upper limits of the income limitations.\textsuperscript{194} The limitations would adjust for inflation beginning in 2018.\textsuperscript{195}

The current AOTC adopts the provision of the former Hope Credit that bans its use by individuals convicted of a felony drug offense.\textsuperscript{196} The Consortium’s recommendation would eliminate this lifetime ban on the grounds of fairness and increasing access for the economically disadvantaged.\textsuperscript{197} The Consortium also recommends the creation of some mechanism, such as advance payment of the credit, to address the timing problem of the mismatch between the AOTC refund and the due date of tuition payments.\textsuperscript{198}

The Consortium places great emphasis on outreach and awareness of the AOTC, suggesting that all stakeholders engage in publicizing the credit and encouraging participation, particularly by low- and lower-middle income

\textsuperscript{192} Id. The four-year limitation created problems because some taxpayers thought the credit was available for only one of the past four years. Commentators attribute this to a confusing sentence on the IRS Form 8863. See Troy Onink, \textit{IRS Confirms, American Opportunity Tax Credit Good for 4 Years}, FORBES (Feb. 26, 2013, 10:09 AM), http://www.forbes.com/sites/troyonink/2013/02/26/irs-confirms-american-opportunity-tax-credit-good-for-4-years/#1e044f6920e8. Also, the credit is available for four taxable years (generally a calendar year) but is attributable to four full years of postsecondary education. This creates particular confusion for students who alternate between full-time and part-time status. See CONSORTIUM REPORT, supra note 110, at 21.

\textsuperscript{193} See supra notes 158, 161–163 and accompanying text.

\textsuperscript{194} So, for single filers the proposal would reduce the credit for modified AGI between $40,000 and $60,000, instead of between $40,000 and $50,000, as it currently stands. For joint filers, the phase-out range would begin with modified AGI of $80,000 and would completely phase out when the modified AGI reaches $120,000, instead of phasing out between $80,000 and $100,000, as it does currently. CONSORTIUM REPORT, supra note 110, at 14 tbl.2.

\textsuperscript{195} Id. at 21.

\textsuperscript{196} I.R.C. § 25A(b)(2)(D). This provision applies to any student who “has been convicted of a Federal or State felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year with or within which such period ends.” Id. The provision does not apply to the Lifetime Learning Credit. See id. at § 25A(c).

\textsuperscript{197} The Consortium reasons that not only do the drug laws vary widely from state to state, but studies have shown that the ban does not deter the commission of drug offenses. On the other hand, it does deter those convicted of such offenses from pursuing higher education. This disproportionately impacts the economically disadvantaged and those who are first generation college attendees. See CONSORTIUM REPORT, supra note 110, at 22. This makes it much more likely that these individuals will continue on a path to criminality.

\textsuperscript{198} Id. at 22. The Report was vague as to how this would be accomplished, but the Consortium promised to study the problem to try to discern a feasible solution. Id. at 23.
Reforming Higher Education Tax Incentives

In addition, the Consortium recommends eliminating the tuition and fees deduction and Coverdell accounts because both are regressive benefits used primarily by higher-income taxpayers. It also recommends phasing out, under the same income limitations as the AOTC, the student loan interest deduction and the parental exemption for dependent students, which it refers to as "the worst-targeted of all the higher education tax benefits." It further recommends limiting the exclusion of employer-provided educational assistance to undergraduate certificates and degrees and imposing income limits and other reforms on QTPs.

IV. ALTERNATIVE SUGGESTIONS FOR REFORM

A more educated populace not only would strengthen the national economy, but it also would make the United States more competitive in the global economy. Thus, the federal government's goal for education should be twofold: (1) to expand educational opportunities for the economically disadvantaged, minorities, and those who are the first in their families to attend college, as well as for those who otherwise would not have enrolled in college, and (2) to encourage the retention of this group to make it more likely that they will complete their degrees. The federal government should fund this goal with equity, efficiency, and simplicity in mind.

A. Direct Benefits

For many lower- and middle-income individuals, the spiraling costs of higher education may seem insurmountable. The considerable benefits of a college education may be outweighed by missed opportunity costs and the prospect of staggering debt. For these individuals, tax incentives will not be a decisive factor in whether or not to pursue higher education. Thus, targeted benefits such as grants, scholarships, and fellowships that do not have to be repaid, or low-interest, subsidized loans with flexible payment plans are

199 Id. at 23. These stakeholders include the secondary and postsecondary educational institutions, the U.S. Department of the Treasury, the U.S. Department of Education, community organizations, and volunteer and commercial tax preparation entities. Id.

200 Id. at 20-21. In addition, the Report notes that Coverdell accounts "are becoming a subsidy for private elementary and secondary schools, rather than a way to pay for college." Id. at 21.

201 Id. at 18.

202 Id. at 17-18.

203 Id. at 18-19.

204 Id. at 18. Other suggestions for reforming QTPs include imposing limits on contributions and "changing the treatment of these assets in the Expected Family Contribution calculation" for the determination of federal financial assistance. Id.
much more likely to be persuasive. This phenomenon aptly illustrates the fact that tax benefits and subsidies are not substitutes for one another. Thus, any meaningful reform of federal funding for higher education must be done in a holistic manner in which direct benefits are the cornerstone and tax incentives fill in the gaps.

In fiscal year 2015, the federal government spent approximately $130 billion on direct benefits such as grants, loans, and work-study programs. The second largest of these was the Pell Grant program. The average Pell Grant today, however, covers only approximately one-third of the total cost of a public four-year, in-state college. This is down from around half in the 1980s and around seventy percent in the 1970s.

In examining enrollment trends since the 1960s, the cost of tuition and

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205 See supra note 6; see also supra note 35.
206 In fiscal year 2015, the government spent approximately $30.3 billion on Pell Grants awarded to nearly 8.2 million students, $95.6 billion on student loans, $1 billion on the federal work-study program, and $15.2 billion on veterans’ educational assistance. See Coll. Bd., supra note 8, at 10 tbl.1.
207 THE INST. FOR COLL. ACCESS & SUCCESS, PELL GRANTS HELP KEEP COLLEGE AFFORDABLE FOR MILLIONS OF AMERICANS 1 (2016), http://ticas.org/sites/default/files/pub_files/overall_pell_one-pager.pdf. The maximum Pell Grant for 2015-2016 was $5775. Federal Pell Grant Program, U.S. Dep’t Educ. (June 4, 2015), http://www2.ed.gov/programs/fpg/index.html. For academic year 2016-2017, it will increase to $5815. See Federal Pell Grants, Fed. Student Aid, https://studentaid.ed.gov/sa/types/grants-scholarships/pell#how-much-money (last visited Nov., 2, 2016). The federal government determine this amount by (1) the amount the federal government expects the student’s family to contribute (EFC) (including the amount of the student’s income, the value of his or her assets (if the student is independent), and the number of family members, with emphasis on those members attending postsecondary institutions), (2) the cost of attendance at the institution in which the student plans to enroll, (3) the student’s enrollment status (full-time or part-time), and (4) whether the student attends for a full academic year or less. See id. Since they are grants rather than loans, the recipient does not have to be repay them. Congress established the first version of the program under Title IV of the Higher Education Act of 1965, Pub. L. No. 89-329, 79 Stat. 1219, 1232 (codified as amended at 20 U.S.C. § 1070), under the Johnson administration as Basic Educational Opportunity Grants, and renamed for U.S. Senator Claiborne Pell in 1988 to commemorate his work on education. Pell Grants, Pell Inst. (2016), http://www.pellinstitute.org/pell_grants.shtml.
Reforming Higher Education Tax Incentives

fees remains a paramount factor influencing the decision by lower- and middle-income individuals to enroll in college, particularly the concomitant issues of the debt they face at the end and their ability to repay that debt. The availability of adequate federal aid and the certainty of benefits, including low-interest loans, should positively affect enrollment by these individuals.

Since the financial crisis of 2008, however, student debt has more than doubled, leading to speculation that it represents the next housing bubble. Today, forty million Americans remain saddled with student loans and twenty-five percent of borrowers are either delinquent or in default on those loans. A number of reasons explain this crisis. First, states cut support for higher education, causing a vicious cycle that forces colleges to raise tuition. Federal assistance has not kept pace with the rising cost of financial assistance has contributed to college enrollment.

Questions remain as to whether the education tax incentives encourage students to assume more debt than they feasibly might repay. See 2014 S.Hrg., supra note 30, at 4 (statement of Sen. Orrin G. Hatch, Member of S. Comm. on Fin.). Other factors, however, such as the economy, influence college enrollment. In a robust economy, more disposable income and the ability to get a better paying job may persuade some to continue their education. In an economic downturn, the inability to find jobs combined with the availability of financial assistance has contributed to college enrollment. Clifton B. Parker, The Great Recession Spurred Student Interest in Higher Education, Stanford Expert Says, STANFORD NEWS (Mar. 6, 2015), http://news.stanford.edu/2015/03/06/higher-ed-hoxby-030615/.

The financial crisis caused not only the value of homes to plummet, but also the value of retirement accounts to nosedive. This, combined with the scarcity of jobs and the flat salaries of middle-class taxpayers, has led more and more students to consider higher education and to borrow to pay for that education, resulting in a record $1.3 trillion in student debt by the end of 2015. See Financing Higher Education: Exploring Current Challenges and Potential Alternatives: Hearing Before the J. Econ. Comm., 114th Cong. 60 (2015) [hereinafter J. Econ. Comm. Hrg.] (testimony of Rohit Chopra, Senior Fellow, Center for American Progress, formerly assistant director of the Consumer Financial Protection Bureau) https://www.gpo.gov/fdsys/pkg/CHRG-114shrg97328/pdf/CHRG-114shrg97328.pdf. This amount does not include other forms of debt that families may have incurred to pay the costs of education, such as tapping credit cards, retirement plans, home equity, and draining their savings. Id.

See 2014 S.Hrg., supra note 30, at 4 (opening statement of Sen. Orrin G. Hatch, Member, S. Comm. on Fin.).

See Jillian Berman, America’s Growing Student-Loan-Debt Crisis, MARKETWATCH (Jan. 19, 2016, 2:11 PM), http://www.marketwatch.com/story/americas-growing-student-loan-debt-crisis-2016-01-15. However, the cohort default rate for Stafford Loans declined in late 2015, attributable to the income-based repayment plans in which the Department of Education reported a 50% increase in the number of borrowers taking advantage of these options. See Betsy Mayotte, Falling Student Loan Default Rates Still Challenge Borrowers, U.S. NEWS & WORLD REP. (Oct. 7, 2015, 10:00 AM), http://www.usnews.com/education/blogs/student-loan-ranger/2015/10/07/falling-student-loan-default-rates-still-challenge-borrowers (stating that the default rate increased from 13.7% in 2014 to 11.8% in 2015).

See Michael Mitchell et al., Funding Down, Tuition Up: State Cuts to Higher Education Threaten Quality and Affordability at Public Colleges, CTR. ON BUDGET & POL’Y PRIORITIES (Aug. 15, 2016), http://www.cbpp.org/research/state-budget-and-tax/funding-
this tuition, forcing students to borrow more money for their education.\textsuperscript{214} Second, government policies do not serve these borrowers well. Paying for these loans through income-based repayment plans provides some relief, but many borrowers fail to realize that they must timely renew these loans each year. If not, dire consequences can make repayment of the loans even more difficult.\textsuperscript{215} Consolidation of loans also can provide some relief, but the fact that this is complicated by the fact that the borrower must be cognizant of the type of loan involved. In some cases, the interest rate may increase; in others, special benefits, such as loan forgiveness, to which the borrower may have been entitled, may be terminated.\textsuperscript{216}

The federal government profits from student loans because it charges far higher interest rates than it must pay to borrow the funds to lend to students. This is particularly true with PLUS loans to parents and graduate students, which carry higher interest rates than other types of student loans and offer minimal opportunities for debt relief.\textsuperscript{217} These loans have been called “classic predatory lending,”\textsuperscript{218} but there is little optimism that the federal government will reform these loans, as they remain “a cash cow for the government.”\textsuperscript{219}

down-tuition-up.

\textsuperscript{214} Id.

\textsuperscript{215} Disturbingly, sixty percent of these borrowers failed to timely renew their repayment plans and nearly a third of these ended up in forbearance or deferment. Mayotte, supra note 212. Since many borrowers pay through automatic deduction from their bank accounts, they may fail to open a notice from their lender, thinking that it is a bill they can disregard. See Betsy Mayotte, \textit{Follow 4 Tips to Stay on Top of an Income-Driven Repayment Plan}, U.S. NEWS & WORLD REP. (Sept. 23, 2015, 10:00 AM), http://www.usnews.com/education/blogs/student-loan-ranger/2015/09/23/follow-4-tips-to-stay-on-top-of-an-income-driven-repayment-plan. This can result in drastic consequences for these borrowers, such as increasing monthly payments, increasing loan principal because of additional accrued interest, and terminating interest subsidies. \textit{Id.}

\textsuperscript{216} This is especially the case with Perkins Loans, which provide for forgiveness after a certain period for those working in certain areas, such as full-time firefighters, nurses, law enforcement or corrections officers, VISTA or Peace Corps volunteers, and attorneys working as federal or community public defenders. See \textit{Forgiveness, Cancellation and Discharge Charts}, FED. STUDENT AID, https://studentaid.ed.gov/sa/repay-loans/forgiveness-cancellation/charts (last visited Oct. 31, 2016).


\textsuperscript{219} \textit{Id.} (quoting same). In 2002, the government set interest rates for both subsidized and unsubsidized Stafford Loans at 6.8% for loans originating after July 1, 2006. Rachel Rowan, \textit{Is Congress to Blame for Student Loan Crisis?}, TUITION.IO (June 17, 2014), https://www.
In addition, the federal government’s track record in overseeing the management of student loans has been poor, subjecting Sallie Mae and other government contractors to multiple large penalties for unfair lending practices.220

Although an in-depth examination of the federal government’s actions in relation to student loans is beyond the scope of this article,221 clearly the federal government must exert greater oversight and control on behalf of student borrowers. Congress should consider this issue in a holistic review of the problems of funding higher education. The federal government must enforce the student consumer protection laws, help borrowers manage their payments, and provide better opportunities to refinance student debt.222

B. Indirect Benefits

The myriad problems that the current education tax incentives present demonstrate that they are neither equitable, efficient, nor fair. Thus, many of them should be repealed, as the current proposals suggest. This article makes alternative suggestions to reform the tax incentives, which share some

tuition.io/blog/2013/04/is-congress-to-blame-for-student-loan-crisistwin/. Because of the events of September 11, 2001, however, the Federal Reserve cut interest rates several times in an effort to boost the economy. Id. This made the 6.8% fixed rate much higher than the variable rate. Id. It also meant that the federal government made a large profit from student loans because it could borrow the money for these loans at the much lower rate. Id. Congress, so far, has failed to provide relief for this cohort of borrowers.

220 These contractors, Sallie Mae, Citibank, JPMorgan Chase, Wachovia, Bank of America, Nelnet, Wells Fargo, and College Loan Corporation, all agreed to stiff penalties in 2007 to avoid charges of wrongdoing in connection with these practices. See J. Econ. Comm. Hrg., supra note 210, at 61 (testimony of Rohit Chopra, Senior Fellow, Center for American Progress, formerly assistant director of the Consumer Financial Protection Bureau). Some also accuse the federal government itself of engaging in predatory lending practices on education loans. See Grunwald, supra note 218. In 2014, federal regulators ordered Sallie Mae to pay a fine of $96.6 million to military student loan borrowers for unfair lending practices involving the student loans of more than 60,000 active duty service members. See Chris Hicks, Federal Regulators Fine Sallie Mae for Overcharging and Discriminating Against Borrowers, JOBS WITH JUST. (May 13, 2014), http://www.jwj.org/victory-federal-regulators-fine-sallie-mae-for-overcharging-and-discriminating-against-borrowers.

221 The author will examine this in more depth in Follow the Money: The Evolution and Inefficiency of Federal Funding for Higher Education (in progress). See supra note 22.

222 See J. Econ. Comm. Hrg., supra note 210, at 66 (testimony of Rohit Chopra, Senior Fellow, Center for American Progress, formerly assistant director of the Consumer Financial Protection Bureau). The federal government should also provide greater oversight for educational institutions. Those that do not provide quality education and have an inordinate number of dropouts and/or defaulters should not be eligible for federal funding. See Rooney Columbus, A Crisis of Value, U.S. NEWS & WORLD REP. (Nov. 17, 2015, 11:45 AM), http://www.usnews.com/opinion/knowledge-bank/2015/11/17/the-student-loan-crisis-is-really-a-crisis-of-educational-value.
common features with the current proposals. There are some important
differences, however, that could have a larger impact on college enrollment
and retention.

1. Savings Incentives

There are three current tax incentives designed to encourage savings for
higher education: education savings bonds, qualified tuition plans and
Coverdell educational savings accounts. Less than three percent of
families, however, use qualified tuition plans and Coverdell accounts, and
these families tend to fall in the higher-income ranges. Thus, these
incentives neither influence the decisions nor behavior of the lower-income
target group, nor do they affect overall college enrollment and retention
because individuals in the higher-income ranges generally enroll in college
without the incentives.

All of the current proposals would repeal Coverdell accounts. As the
Education Consortium stated in its report, not only do a relatively small
number of taxpayers use Coverdell accounts, but they also tend to use them
to offset the cost of private secondary education. Since taxpayers subsidize
these accounts, as with all tax incentives, this is an inefficient result.

Although President Obama proposed to eliminate QTPs by taxing
interest accumulation on new contributions, he succumbed to political
pressure and withdrew this proposal. The Ways and Means bill would
repeal all of the savings devices except QTPs. For lower-income families,
however, QTPs and Coverdell accounts usually will remain out of reach,
because these families generally will not have much disposable income to
contribute to these accounts. QTPs are more complicated than either
Coverdell accounts or educational savings bonds. For one thing, investment
in a QTP generally requires some financial sophistication because banks

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223 I.R.C. § 135.
224 Id. § 529.
225 Id. § 530.
227 See Schenk & Grossman, supra note 9, at 324–25.
228 See supra Consortium Report, supra note 110, at 21.
229 See Stratford, supra note 171; McKinnon, supra note 175.
usually charge fees that may vary with the individual plans. If an individual can make only small contributions, these fees will have a noticeable effect. Another issue is that QTPs remain subject to market risk, unlike Coverdell accounts and savings bonds. If the value of a QTP declines, this disproportionately affects a lower-income contributor. On the other hand, if the value of the plan increases, it is considered an asset of the contributor, which may affect the family's qualification for certain types of public assistance. Moreover, if the family remains in the lower-income tax brackets, it may become eligible for federal or institutional educational assistance, so a tax-favored educational savings device is not a feasible

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232 Id. at 22–24. The Coverdell account also may charge fees if the contributor invests in a mutual fund, although no-load funds remain available.

233 States differ in their approach to investing these funds. For example, during the economic crisis of 2008, QTPs in North Carolina, Maryland, and Virginia lost up to 30% of their value. See Saving For College: 529 Plans, NAT’L CONF. ST. LEGISLATURES (May 22, 2014), http://www.ncsl.org/research/education/saving-for-college-529-plans.aspx. In Florida, though, QTP assets were invested more conservatively and the value of these assets did not decline during 2008. Id. Even prepaid tuition plans, which remain less susceptible to market risks, depend upon the state operating the plan to maintain its solvency. Id. Some states experienced shortfalls that necessitated their taking action to ensure the solvency of their plans.

234 The federal government addressed this issue with respect to the Supplemental Nutrition Assistance Program (SNAP) and Temporary Assistance to Needy Families (TANF), so that savings in a QTP would not disqualify the family for SNAP or TANF benefits. See Rourke O’Brien, 529s and Public Assistance, NEW AM. (Nov. 10, 2009), https://www.newamerica.org/asset-building/policy-papers/529s-and-public-assistance/. The states, however, impose their own asset limits on SNAP, TANF, and Medicaid benefits, where some are more generous than others. Thirty-four states, plus the District of Columbia, eliminated the asset test for SNAP benefits, while eight states eliminated the asset test for TANF benefits. Corp. for Econ. Dev., Asset Limits in Public Benefit Programs, ASSET & OPPORTUNITY SCORECARD (2016), http://scorecard.assetsandopportunity.org/latest/measure/asset-limits-in-public-benefit-programs. Furthermore, among those states with limits, the amount of the limit may vary. Both the federal government and the states should address the asset limits issue across the board, so that they do not remain a disincentive to saving for education or retirement. Currently, in states that apply an assets test for federal benefit eligibility, a QTP remains a “countable asset.” Thus, in order to remain eligible for benefits in those states, the contributor must spend the assets in the QTP, which triggers not only a tax liability, but also the 10% penalty on any disqualified distribution. If the contributor transfers the QTP to another family member, this may be considered a transfer of assets that could trigger a penalty under the Medicaid rules. Note that the federal government has not addressed any of these issues with respect to savings bonds.

The QTP assets are considered owned by the contributor and will count toward the expected family contribution (EFC) for the determination of federal educational assistance. In calculating the EFC, however, the federal government considers parents’ assets at a level of 5.64% as opposed to student-owned assets, which the federal government considers at a level of 20%. See Does a 529 Plan Affect Financial Aid?, SAVINGFORCOLLEGE.COM (July 29, 2016), http://www.savingforcollege.com/intro_to_529s/does-a-529-plan-affect-financial-aid.php.
alternative for those in the lower-income tax brackets.

Those in the higher income tax brackets, however, can better afford to save for higher education and likely do not need a tax benefit to encourage them to do so.235 Thus, QTPs and Coverdell accounts remain very inefficient savings vehicles if the goal is to encourage those who otherwise would not have continued their education. Because of this inefficiency, Congress should repeal these incentives, with the benefits of current plans grandfathered into the program.236

The Ways and Means bill repeals the tax benefits of educational savings bonds, and the other proposals do not address them at all, probably because taxpayers seldom use them compared to the other incentives.237 Several advantages of educational savings bonds, however, make them a much more secure and equitable savings device for higher education. First, they remain a more secure investment because they are backed by the full faith and credit of the federal government. Moreover, they represent an investment in the federal government, whereas QTPs are state-controlled devices. Since the federal government provides significant funding for higher education, why not invest in the federal government in return? Second, these bonds are less complicated than either QTPs or Coverdell accounts. They do not require establishing a separate account, they charge no fees (unlike QTPs and Coverdell accounts), they do not fluctuate in value (like QTPs), and they are easy to purchase.238 Third, they may be purchased in small increments of $25, up to a maximum single purchase of $10,000.239 Because of this feature,

235 See Schenk & Grossman, supra note 9, at 324–25.

236 When President Obama proposed repealing the favorable tax benefits of QTPs, severe blowback from both political parties resulted. Thus, this proposal will not be politically feasible because this incentive remains popular with higher-income constituents. See Stratford, supra note 171; McKinnon, supra note 175; see also discussion supra notes 174–175 and accompanying text.

237 The OMB projects their cost at around $30 million in fiscal year 2016. See 2017 BUDGET PERSPECTIVES, supra note 25, at 230 tbl.14–1. This is approximately the same as the cost of Coverdell accounts. Id. These two incentives have the lowest revenue cost of any of the education tax incentives.

238 They may be purchased online or automatically through a payroll savings plan. See BUREAU OF FISCAL SERV., U.S. DEP’T OF THE TREASURY, U.S. SAVINGS BONDS FOR EDUCATION, FS PUBLICATION 0051 (2015), https://www.treasurydirect.gov/forms/savpdp0051.pdf (addressing questions about the savings bonds in general, including how to purchase and who may purchase).

Reforming Higher Education Tax Incentives

individuals of all income levels may purchase the bonds.

So why do taxpayers seldom use them? The answer is that they have some severe statutory drawbacks. First, like most of the tax incentives, the interest is excludable only if the taxpayer uses the bonds for a qualified educational expense, which in the case of educational savings bonds only includes tuition and related fees.²⁴⁰ This provision remains the most restrictive definition of any of the educational savings tax incentives. It also presents the same catch-22 as Pell Grants: if the bonds are not used for a qualified education expense, they become taxable,²⁴¹ but payment of qualified tuition and fees with the bonds reduces the ability to use any other available tax incentive, such as the AOTC, that might produce a greater benefit to the taxpayer.²⁴²

A second (and bigger) problem is the restrictive income limitations, the most restrictive of any of the three tax incentive savings devices.²⁴³ The problem is that these limitations apply to the mAGI of the bondholder in the year of the redemption of the bond.²⁴⁴ This makes long-term planning very difficult. Young parents thinking ahead and purchasing bonds for their children’s education usually have no idea what their mAGI might be in ten to fifteen years or more when their children become ready for college. Nor do they have any idea what the statutory phase-out limitation might be at that point.²⁴⁵ These circumstances create a dilemma for young parents. If their mAGI is greater than the income limitation when their children begin college, the deferred interest on the bond becomes taxable, which makes the bonds a very poor investment. On the other hand, if their mAGI is below the income limitation, their children may qualify for federal assistance and they may not need the bonds. Thus, the bonds involve very speculative decisions at the time of purchase. Parents cannot avoid the income limitations by transferring the bonds to the child because someone over age 24 must purchase and hold them.²⁴⁶

²⁴⁰ I.R.C. § 135(a), (c)(2)(A).
²⁴¹ See id. § 135(a).
²⁴² See, e.g., id. § 25A(g)(2)(c), (g)(5); see also supra note 76 and accompanying text.
²⁴³ This limitation applies to single filers with mAGIs in excess of $40,000 and to joint filers with mAGIs in excess of $60,000. Id. § 135(b)(2)(A). QTPs have no phase-out limitations and Coverdell accounts phase out when the contributor’s mAGI exceeds $95,000 for single taxpayers and $190,000 for joint filers. Id. §§ 529, 530(c).
²⁴⁴ Id. § 135(a). Congress obviously intended this provision for grandparents and other older family members living on fixed incomes.
²⁴⁵ Many young parents may not purchase the bonds because they might remain optimistic and assume that their incomes will be above the phase-out limit when they redeem the bonds.
²⁴⁶ Id. § 135(c)(1). This provision exists to alleviate the problem of a child purchasing the bonds to avoid the phase-out limitations.
Any tax-deferred savings device with associated fees will not serve as a useful device for lower- and lower-middle income families. This makes the savings bonds a superior savings device in terms of aiding the target group. Also, the simplicity and ease of purchase, combined with the fact that taxpayers may purchase the bonds in small increments, make them more likely to appeal to lower- and middle-income families than either Coverdell accounts or QTPs. Still, the statutory drawbacks to these bonds remain daunting and illogical. The bonds will become a much more attractive savings device if Congress amends the authorizing statute to remove the income limitations altogether. Then, anyone could purchase the bonds, and as long as the purchaser used them for qualified higher education expenses, they would remain tax-free. Also, Congress should revise the current restrictive definition of qualified education expense to a more liberal definition, such as that which currently applies to QTPs and Coverdell accounts. This would make education savings bonds a much more efficient and equitable savings vehicle.

2. Current Cost Incentives

Both the Ways and Means bill and the Education Consortium advocate repealing the above-the-line deduction for qualified tuition and related expenses. Critics note that this remains a confusing deduction with limited value relative to the other incentives. Both proposals also would repeal the exemption for dependent students because, as the Consortium noted, it remains the most poorly targeted of all the tax incentives. The Ways and Means bill further eliminates the penalty relief provision for early distributions from IRAs used for the purpose of education, because, as the

247 Congress must also address the asset limitation to qualify for other federal assistance. While it addressed this to some extent with QTPs, it has not addressed it with savings bonds. See O'Brien, supra note 234.

248 If Congress eliminated the income limitations, the restrictive age limit on purchase would become unnecessary. Thus, anyone, including teenagers, would become eligible to purchase the bonds. This is important for the psychological commitment of taking the first step toward investing for higher education.

249 This definition covers not only tuition and fees, but also books, supplies, equipment, special education needs, and, generally, room and board. It also includes elementary and secondary educational expenses. See I.R.C. §§ 529(e)(3), 530(b)(2)(A).


252 See CONSORTIUM REPORT, supra note 110, at 17–18.

253 Tax Reform Act of 2014, H.R. 1, 113th Cong. § 1210 (2014) (proposing to repeal
Ways and Means Committee noted, retirement accounts should be used for retirement.254

The proposal proffered by this article differs in some important respects from the current proposals with respect to tax incentives to defray the current costs of higher education. First, it advocates repealing the education tax credits. The Ways and Means bill, the Schumer bill, President Obama, and the Education Consortium all recommend repealing the Lifetime Learning Credit and substituting a modified AOTC with an enhanced refund feature to provide greater equity to those in the lower-income levels who may have little or no tax liability.255 The refund feature allows them to benefit from the credit. Still, two problems with these proposals persist. First, in order to claim the refund, lower-income individuals must file a return when one otherwise may not have been required. Thus, the proposals involve compliance costs. Second, there remains a mismatch in timing between the refund and the tuition payment.256 The Education Consortium’s proposal suggests an advance or third-party payment of the credit, and the group promises to work on a timely delivery mechanism.257

In addition, there are other problems with the AOTC that none of the current proposals is likely to solve. First and foremost, at a cost of over $13 billion, it remains the largest education tax expenditure.258 Yet, it has had a negligible effect on college enrollment, retention, and the type of institution in which students enroll.259 Since the 2009 amendment to the AOTC under

I.R.C. § 72(t)(2)(E) and amending confirming provisions).

254 See STAFF OF H. COMM. ON WAYS AND MEANS, 113TH CONG., TAX REFORM ACT OF 2014: DISCUSSION DRAFT, SECTION-BY-SECTION SUMMARY 12 (Comm. Print 2014).

255 See Tax Reform Act of 2014, H.R. 1, 113th Cong. § 1201 (2014) (proposing to amend I.R.C. § 25A(a), (c), and proposing a new § 25A(b) that would increase the refundable amount from forty percent to sixty percent (from $1000 to $1500)); American Opportunity Tax Credit Permanence and Consolidation Act of 2013, S. 835, 113th Cong. § 2 (2013) (proposing a new I.R.C. § 25A(g)); Press Release, The White House, supra note 169 (seeking to consolidate the Lifetime Learning Credit into a modified AOTC with an increased refundable portion of $1500); CONSORTIUM REPORT, supra note 110, at 17, 20 (seeking to repeal the Lifetime Learning Credit and make the AOTC fully refundable).

256 See Schenk & Grossman, supra note 9, at 353–54; Long, supra note 5, at 132.


259 See NCES DIGEST, supra note 1, at 426 tbl.303.10. Like the effect on tuition increases, some evidence indicates that the tax incentives may affect both college choice (four-year versus two-year and private versus public institutions) for students from middle-income families and the initial decision to pursue post-baccalaureate education. See MICHELLE ASHA COOPER, COLLEGE ACCESS AND TAX CREDITS, NAT’L ASS’N. OF STUDENT FIN. AID ADM’RS. 8–10 (2005), http://files.eric.ed.gov/fulltext/ED543302.pdf. Other studies, however, refute this
the American Recovery and Reinvestment Act,\textsuperscript{260} which transformed it into a partially refundable credit, the bottom twenty percent of households now receive a greater share of the credit than any other type of tax incentive for higher education.\textsuperscript{261} The college enrollment rate by lower-income individuals, however, has not noticeably increased since 2009.\textsuperscript{262}

All of the proposals to modify the AOTC fail to consider the needs of current students. The majority of college students today are non-traditional students. They are older and attend school part-time because they have jobs and families to support.\textsuperscript{263} On average, they take over six years to finish college, if they finish at all.\textsuperscript{264} Neither the Ways and Means bill nor the Schumer bill considers these students, because neither bill extends the eligibility of the AOTC beyond its current four-year period. Even the President’s proposal, which extends the credit to five years,\textsuperscript{265} does not go far enough to help these students, and neither does the Consortium’s proposal to substitute the four-year limitation with a lifetime benefit cap of $10,000.\textsuperscript{266}

All of the current proposals eliminate the Lifetime Learning Credit, which students may use for any year of postsecondary education, meaning that currently those in graduate or professional school may use this credit.\textsuperscript{267} None of the proposals offers any relief to these students. Moreover, the Ways


\textsuperscript{261} See GREER & LEVIN, supra note 9, at 5.

\textsuperscript{262} NCES DIGEST, supra note 1, at 422 tbl.302.30.


\textsuperscript{264} See id. (“While the median time to degree for all bachelor’s degree recipients is 4.3 years, for adult learners (between ages 24–29), the median time to degree is 6.6 years.”).

\textsuperscript{265} See Press Release, The White House, supra note 169.

\textsuperscript{266} CONSORTIUM REPORT, supra note 110, at 14, 21.

\textsuperscript{267} The Lifetime Learning Credit, unlike the AOTC, is not limited in the number of years in which taxpayers may use it. Thus, graduate and professional students may use it. See I.R.C. § 25A(c). Since it is a “per taxpayer” credit, however, rather than a “per student” credit, it remains less advantageous for taxpayers with more than one child in graduate school. Id. at § 25A(c)(1).
Reforming Higher Education Tax Incentives

and Means bill reduces the phase-out limits of its modified AOTC, making the new credit available to fewer taxpayers.\(^{268}\) Yet, overall, this bill would increase spending, reduce revenues, and add to the federal budget deficit.\(^{269}\) As the dissenting opinion to the bill notes, it makes no sense for Congress to consolidate these credits at a cost to graduate and professional students, nontraditional students, and those currently unable to use the AOTC, benefitting fewer students while adding to the budget deficit.\(^{270}\)

Another problem with the Ways and Means proposal is that it retains the AOTC’s lifetime ban on use by those convicted of a state or federal felony drug offense, which the proposal defines as an offense “consisting of the possession or distribution of a controlled substance” before the end of the taxable year in which the credit otherwise would apply.\(^{271}\) There are two problems with this provision. First, it is arbitrary. No similar lifetime ban exists for other felons, such as rapists, murderers, and thieves. Second, it fails to take into account the nature of the controlled substance, where it falls within the controlled substances schedule, how much of the controlled substance the student possessed, and whether or not this is the student’s first offense. Also, criminal possession laws vary widely from state to state, and in some cases state law and federal law may vary. For instance, marijuana remains controversial because it has some medicinal effects, and while federal law considers it an illegal substance, some states do not criminalize its possession or sale.\(^{272}\) Also, whether the offense constitutes a felony or a

\(^{268}\) The proposal would phase out the modified AOTC between $43,000 and $64,000 for single filers and between $86,000 and $126,000 for joint filers. H.R. 1 § 1201 (proposed I.R.C. § 25A(c)). The current AOTC phases out between $80,000 to $90,000 for single filers and between $160,000 and $180,000 for joint filers. I.R.C. § 25A(i)(4).

\(^{269}\) See H.R. REP. No. 113-526, at 15 (2014) (stating that staff of the Joint Committee on Taxation estimates that over a 10-year period, the bill would increase direct spending by approximately $73.7 billion, reduce revenues over this same period by approximately $22.7 billion, and would increase federal budget deficits by approximately $96.5 billion during this period).

\(^{270}\) See id. at 38 (dissenting views).


\(^{272}\) States vary widely in views on marijuana. See generally Marijuana Resource Center: State Laws Related to Marijuana, WHITE HOUSE, https://www.whitehouse.gov/ondcp/state-laws-related-to-marijuana (last visited Nov. 2, 2016). For instance, it is legal to sell, possess, and use marijuana in Washington, Oregon, Colorado, and Alaska, and in the cities of Portland and South Portland, Maine, and Keego Harbor, Michigan, and in the District of Columbia (although Congress currently bans commercial sales in D.C.). See id.; see also State Medical
misdemeanor may depend on the amount of the substance possessed, which varies from state to state. Further, whether an individual is convicted of a misdemeanor or a felony drug offense often depends too heavily on the vagaries of prosecutors and plea-bargains on the one hand, and inadequate representation on the other hand. Because of these inherent problems, Congress should repeal the felony drug conviction ban. Of the four proposals mentioned, however, only the Consortium’s proposal affirmatively repeals this provision.

Income limitations also create another problem inherent in the AOTC and some of the other tax incentives. As mentioned previously, these limitations are arbitrary and they contain a built-in cliff effect that may reduce or eliminate the benefit. In addition, the definition of mAGI remains a problem, as it does not allow consideration of certain expenses over which the taxpayer may have no control but which may affect his or her ability to pay for higher education, such as extraordinary medical expenses, casualty losses, and pre-existing student loans. Thus, some taxpayers—considered higher income under the tax code for purposes of the AOTC phase-out—may not actually possess the means to afford the cost of higher education. For

Marijuana Laws, Nat’rel Conf. St. Legislatures tbl.1 (Sept. 29, 2016), http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx#4; Patrick May, Patients May Soon Be Able to Use Pot at Marin Hospital, Mercury News (Sept. 12, 2016, 2:21 PM), http://www.mercurynews.com/2016/09/12/patients-may-soon-be-able-to-use-pot-at-marin-hospital/. There are, however, differences among these states as to the amount that individuals may legally possess, sell, and grow. In twenty-one states, the possession and use of marijuana is legal for medicinal use only (e.g., Arizona, California, Nevada, New Mexico, Rhode Island, and Vermont). See State Medical Marijuana Laws, supra.

For instance, in some states, possession of marijuana is merely a civil infraction (e.g., Delaware, Connecticut, New York, Ohio, Rhode Island), in others it is a misdemeanor (e.g., Arkansas, Florida, Iowa, Texas, Wyoming), and in still others it is a felony. See State Laws, Nat’l Org. for Reform Marijuana Laws (2016), http://norml.org/laws. Also, in some states, it is a misdemeanor to sell marijuana (Indiana, Kentucky, and New York), while in others it is a felony (e.g., Alabama, Florida, Kansas, Tennessee, Texas, Utah). See id.

Note that this provision only applies to the Hope Scholarship Credit and the AOTC. It does not apply to the Lifetime Learning Credit. See I.R.C. § 25A(b)(2)(D), (i).

CONSORTIUM REPORT, supra note 110, at 14, 22. One of the other pending House bills, however, the Student and Family Tax Simplification Act, proposes to repeal the provision. See H.R. 3393, 113th Cong. § 2 (2014). This bill addresses only the AOTC, Pell Grants, and the section 222 deduction for qualified tuition and fees. It proposes amendments to the first two and a repeal of the latter. Id.

See Schenk & Grossman, supra note 9, at 325 (noting the arbitrariness of the income limitations). “A taxpayer with $160,000 of AGI could receive a $2000 deduction for education expenses, which in a 25% tax bracket would produce tax savings of $500. If, however, he had $160,001 AGI, he would receive no deduction. Thus, the additional dollar in income produces a loss of $499.” Id. at 301.

See discussion supra Section II.B.2.
instance, a taxpayer with extraordinary medical expenses from long-term dependent care or extraordinary casualty losses because of a natural disaster, may have high adjusted gross income but low taxable and disposable income. Since these deductions are not reflected in adjusted gross income, they do not affect mAGI. Further, since the deduction for medical expenses is subject to a high floor,\textsuperscript{278} taxable income also may not accurately reflect the taxpayer's disposable income.

The elimination of the education tax credits would free around $15–$16 billion per year that could be redirected to Pell Grants and subsidized loans. These direct benefits do not present the timing problems or the inequities of the tax credits. All of the current proposals address the problem of taxing Pell Grants used for living expenses,\textsuperscript{279} but none address the exclusion of scholarships and fellowships from income. This exclusion has been in the tax code since 1954\textsuperscript{280} and should remain because it is equitable, since most scholarships and fellowships are granted on the basis of merit and/or need. The current law excluding scholarships and fellowships from income, however, provides that the scholarship or fellowship remains tax-exempt only to the extent the taxpayer uses it for “qualified tuition and related expenses.”\textsuperscript{281} This includes tuition and related fees required for college enrollment or attendance, plus expenses for fees, books, supplies, and equipment required for course instruction.\textsuperscript{282}

"Qualified tuition and related expenses" does not include expenses for room and board, which presents three problems. First, room, board, and other living expenses remain necessary expenses for most students, either because there is no college within a feasible commuting distance or the most suitable college is not within a feasible commute. These costs may equal or exceed the cost of tuition and related fees. The government should allow students the flexibility to attend the college of their choice. Some scholarships may cover the cost of living expenses, but if so, the portion used for living expenses becomes taxable to the student. This means that the scholarship or fellowship does not inure solely to the benefit of the recipient because the government claims a portion as tax.\textsuperscript{283} This is neither fair nor efficient. Thus, Congress

\textsuperscript{278} See I.R.C. § 213. These expenses are first itemized, below-the-line deductions, so taxpayers may take them only if they have sufficient deductions to itemize, as opposed to taking the standard deduction. Medical expenses under I.R.C. § 213 also are subject to a floor of 10\% of adjusted gross income, the highest floor of any of the itemized deductions. Id. § 213(a). Finally, they may be phased out (reduced) at certain income levels. See id. § 68 (limiting itemized deductions).

\textsuperscript{279} See supra notes 135–39, 143–144, 160, 170 and accompanying text.

\textsuperscript{280} See I.R.C. § 117 (1954).

\textsuperscript{281} I.R.C. § 117(b)(1).

\textsuperscript{282} Id. § 117(b)(2).

\textsuperscript{283} Initially, Congress made room and board qualified educational expenses under I.R.C.
should amend the law to take into account that reasonable living expenses are a necessary part of higher education for all scholarship and fellowship recipients, not just Pell Grant recipients.

The second problem is that, as in the case of Pell Grants, to the extent the student uses a scholarship or fellowship for tuition and related fees, it reduces the amount of "qualified educational expenses" for purposes of the other education tax incentives. Thus, the amount of those incentives will be reduced or eliminated for scholarship students and Pell Grant recipients, while those who receive tax-free gifts neither have to account for the amount of the gift spent on qualified education expenses, nor reduce the amount of qualified education expenses for purposes of the tax incentives. Since the income levels of Pell Grant recipients and familial gift recipients likely vary widely, this results in disproportionate treatment between the two groups, which is inherently unfair. Thus, the law should alleviate this inequity by amending the definition of qualified educational expense to cover any legitimate expense of obtaining a higher education, including living expenses. Scholarship or fellowship recipients and Pell Grant recipients could then use their awards for living expenses and also take advantage of any educational tax incentives in the same manner as students from higher-income families, whose family members pay their tuition and fees with tax-free gifts.

A third problem under the current law is that if students use tax-exempt scholarships or fellowships for eligible education expenses (tuition and fees), the amount so used may reduce the recipient's eligibility for need-based federal student aid. This makes the room and board issue more pronounced, because students might otherwise spend need-based loans and grants on room and board.

While the current proposals all advocate solving this problem with respect to Pell Grants, none suggest extending this "fix" to other scholarship or fellowship recipients. Spiraling costs, however, make it more and more difficult for middle-income families to afford higher education. By taxing a portion of the scholarship or fellowship used to pay legitimate costs of higher education, the government makes it more difficult for the brightest and/or

§ 117, but in 1986, Congress changed this on the grounds that room, board, and other living expenses constitute "nondeductible personal expenses." H.R. REP. NO. 99-426, at 100-01 (1985). As Bittker, McMahon, and Zelenak have noted about the taxation of living expenses under I.R.C. § 117, "[t]o the extent that the exclusion of tuition scholarships grows out of a legislative intent to foster the pursuit of education, it is not a very rational way of achieving this objective." BORIS I. BITTKER, MARTIN J. McMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS § 5.06[1] (3d ed. 2002).

284 See supra note 76 and accompanying text.

285 See supra notes 96-99 and accompanying text.

286 See supra note 234.
Reforming Higher Education Tax Incentives

neediest students to afford higher education. This is both counterproductive and inefficient.

Prior to 1986, Congress excluded student earnings from income if the student was required to teach, research, or perform other services as a condition of receiving the scholarship or fellowship, and the same work was required of all students as part of their regular course of study, regardless of whether they were scholarship or fellowship recipients.\(^{287}\) In the base-broadening quest of the massive 1986 Tax Reform Act,\(^{288}\) however, these amounts became taxable.\(^{289}\) Taxing these earnings is shortsighted, though, because it reduces the value of the scholarship or fellowship. Furthermore, encouraging students to pay their way to the extent feasible results in less borrowing for student loans. Therefore, for fairness and efficiency reasons, Congress should exclude from income the value of work required of students in order to receive a scholarship, fellowship, or grant.\(^{290}\)

Currently, "qualified tuition reduction[s]" also remain excluded from gross income.\(^{291}\) These are tuition reductions that apply to employees of educational institutions and to employees' spouses and dependents.\(^{292}\) The Ways and Means bill repeals the exclusion for qualified tuition reductions in full.\(^{293}\) This article suggests a partial repeal.

While an educational institution has an interest in employees furthering their education, it has less interest in the employees' spouses and dependents furthering their education, except as employee incentives. Instead of


\(^{289}\) I.R.C. § 117(c)(1). Congress provided a limited exception for work required under the National Health Service Corps Scholarship Program and under the Armed Forces Health Professions Scholarship and Financial Assistance program. Id. § 117(c)(2). These programs require recipients to perform certain services in the public interest. Recipients of the National Health Service Scholarship must perform medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. 42 U.S.C. § 2541 (2002). Armed Forces Scholarship recipients must serve for a certain number of years in the military at an armed forces medical facility. 10 U.S.C. § 2122.

\(^{290}\) This would include free or reduced tuition at work/study colleges like Berea College in Berea, Kentucky, and College of the Ozarks in Point Lookout, Missouri, as well as those required to perform services (such as teaching) as part of their program of study. See Katy Hopkins, Save Money by Attending Tuition-Free Colleges, U.S. NEWS & WORLD REP. (June 12, 2012, 10:00 AM), http://www.usnews.com/education/best-colleges/paying-for-college/articles/2012/06/12/save-money-by-attending-tuition-free-colleges (discussing tuition/work exchanges at Berea College and College of the Ozarks).

\(^{291}\) I.R.C. § 117(d)(1).

\(^{292}\) Id. § 117(d)(2). This also includes graduate students who work as teaching or research assistants. Id. § 117(d)(5).

\(^{293}\) Tax Reform Act of 2014, H.R. 1, 113th Cong. § 1208 (2014) (proposing to repeal I.R.C. § 117(d) and amending conforming provisions).
excluding this provision entirely, the exclusion of tuition reduction for employees should remain. If an employee's spouse or dependent works toward a degree, the amount of the tuition reduction should be included in income, but only for those employees with mAGI above a certain amount. This will ensure that lower-paid employees will benefit from the exclusion while higher-paid employees will not. There should be a grandfather provision, however, to accommodate employees who have children about to enter college or who are within a few years of entering college. This accommodation is fair because those employees likely relied upon this benefit and made career choices and college savings decisions based upon it.

Similarly, Congress should retain the exclusion of tuition reduction for graduate students who serve as teaching or research assistants because it is common practice to require graduate students to engage in teaching or research assistance. If Congress taxed the tuition reduction, these students would not have the cash flow to pay the tax liability. Thus, as a matter of basic fairness and efficiency, Congress should enable graduate students to continue to exclude tuition reductions or waivers.

The Ways and Means bill repeals the exclusion for employer-provided educational assistance. This also is shortsighted because this incentive enables many employees to further their education and obtain critical skills when they otherwise might not possess the means to do so without a decrease in their pay. If Congress repeals this provision, employer assistance payments will be considered compensation income, which will subject the benefit not only to federal income tax, but also to employment taxes, without a corresponding income receipt with which to pay these taxes. This will likely discourage many employees from taking advantage of employer-provided educational assistance, unless the employer pays more to compensate the employee for the tax cost, which will make the program less attractive to employers. The current exclusion is efficient because it stands to affect the economy directly and positively by promoting a more educated workforce, more efficient businesses, and by providing an incentive for third parties other than the federal government to assume some of the burden of funding higher education. Congress apparently has been conflicted about this

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294 Id. § 1209.
295 See I.R.C. § 127. This exclusion applies to both graduate and undergraduate courses. Initially, the exclusion did not apply to graduate courses, but Congress changed this in 2001. See infra note 299.
296 These include not only income tax withholding, but also deductions for the Federal Insurance Contributions Act (Social Security and Medicare taxes, plus an additional Medicare tax for income in excess of a threshold amount), as well as unemployment taxes. See Understanding Employment Taxes, I.R.S. (June 21, 2016), https://www.irs.gov/businesses/small-businesses-self-employed/understanding-employment-taxes.
benefit for some time. Initially, when it first enacted the provision in 1978, it was temporary. Congress then extended it ten times, sometimes at the eleventh hour, before finally enacting it as a permanent benefit in 2013. The temporary nature of this provision had made it difficult for employers and employees to plan ahead.

A further problem with this provision is that since Congress enacted it in 1978, it has not been indexed for inflation. Thus, an employee may exclude no more than $5250 of employer-provided educational assistance. Congress should increase this cap to reflect the cost of education in today’s dollars. While any amount of employer-provided educational assistance above the current cap might be excludable as a working condition fringe benefit (provided the expense relates directly to the employee’s current job), Congress tied the fringe benefit exclusion to the business expense deduction, which imposes some severe limitations on the deduction of education expenses.

3. After College – Repaying Student Loans

The House Ways and Means Committee, the President, and the Education Consortium all would repeal the deduction for interest on student loans because, as President Obama noted, it is complicated, poorly targeted, and “provides very limited assistance to a broad group of borrowers, rather than targeting more meaningful assistance to those who need it most.”

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298 See Sammer, supra note 86.
300 I.R.C. § 127(a)(2).
301 See id. § 132(a)(3).
302 See id. § 162. For instance, the employee cannot work toward a first degree, the education cannot qualify the employee for a new trade or business, and the individual must already work in that trade or business. See also Treas. Reg. § 1.162-5 (as amended in 1967) (discussing deductibility of education expenses as business expenses).
While this deduction is complicated to compute and few taxpayers apparently use it, an immediate repeal is unfair to those who consistently repay their loans and claim this deduction, because it would immediately and unexpectedly increase the cost of their loans. Because of this reliance factor, Congress should phase out any repeal of this deduction over a period of years or repeal it only for new loans for undergraduates.\footnote{\textsuperscript{304}}

The interest deduction should remain, however, for graduate and professional students, who do not enjoy as many federal education incentives as undergraduates. For instance, graduate and professional students are not eligible for Pell Grants, do not get the benefit of subsidized Stafford loans, may not defer the interest on their student loans, so the interest accrues while they pursue their degrees, and do not get the benefit of the six-month grace period before repayment when they graduate.\footnote{\textsuperscript{305}} Since graduate students generally end up paying more interest over the lives of their loans than their undergraduate counterparts, the interest deduction should remain for graduate and professional students. The Ways and Means bill further recommends repealing the current exclusion for forgiveness of student loans for students who agree to work in public service occupations or in underserved geographical areas.\footnote{\textsuperscript{306}} This again is very shortsighted. Those who work in public service occupations or underserved areas often remain undercompensated compared to their cohorts working in the private sector and in urban areas. It is equitable and efficient to exclude such forgiveness from gross income because it directly serves a public purpose. It provides some financial parity for those who work in these areas and serves as an incentive to encourage work in the public interest. Moreover, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005\footnote{\textsuperscript{307}} provides that student loans are no longer dischargeable in bankruptcy, so these debts remain forever unless the debtor can establish "undue hardship," which is a difficult hurdle to clear.\footnote{\textsuperscript{308}} A default on student loans also means that Social

\textsuperscript{304} The Obama Administration has proposed a repeal of this incentive, but only for new borrowers. See Press Release, The White House, supra note 169. The Administration also has proposed expanded income-based repayment options (PAYE), which, if enacted, will compensate at least somewhat for the loss of the interest deduction. See Lanza, supra note 173 (explaining income based repayment options).

\textsuperscript{305} See 2014 S.Hrg., supra note 30, at 128–129 (testimony of Dr. Debra W. Stewart, President, Council of Graduate Schools).

\textsuperscript{306} Tax Reform Act of 2014, H.R. 1, 113th Cong. § 1207 (2014).


\textsuperscript{308} Id. § 220(a)(8) (codified at 11 U.S.C. § 523(a)(8)). This nondischargeability applies to both government and private student loans. For problems in meeting the undue hardship test, see Quixada Moore-Vissing, Inconsistency in Judicial Interpretations of Undue Hardship, PELL INST. FOR STUDY OPPORTUNITY HIGHER EDUC., http://www.pellinstitute.org/
Reforming Higher Education Tax Incentives

Security benefits may be subject to garnishment.\footnote{See \textit{H. Budget Comm., 113th Cong., Expanding Opportunity in America, Discussion Draft} 46 (July 24, 2014) (citing Annamaria Andriotis, \textit{Grandma's New Worry: Student Debt}, MSN Money, Aug. 7, 2012).} For an individual working in the public interest whose salary may be relatively meager, there is much at stake.

\section*{C. Increased Awareness of Benefits}

Finally, the federal government could do a better job of increasing awareness of federal resources for higher education. The federal government has communicated ineffectively with prospective students about financial aid and tax incentives,\footnote{Student financial aid letters do not typically mention the tax benefits that may be available. \textit{See 2014 S.Hrg., supra} note 30, at 40 (testimony of Jayne Caflin Fonash, Director of School Counseling, Loudoun Academy of Science).} so that those most in need of these resources may be unaware of them or may not understand them if they are aware.\footnote{\textit{See, e.g., I.R.S. Pub. 970, Tax Benefits For Education} (2016), \url{https://www.irs.gov/pub/irs-pdf/p970.pdf} (explaining the education tax incentives for taxpayers). This publication currently stands at an eye-glazing ninety-seven pages long.} If these resources were simpler to understand and information about them was more easily accessible, this alone could increase college enrollment by those in the target group.

The IRS recently modified its Form 1098-T (Tuition Statement) to require educational institutions to report the amount of tuition and related fees that scholarship and fellowship recipients paid, in addition to the amounts billed. This will enable students to better determine the tax benefits for which they might be eligible and also will allow the IRS to better monitor compliance.\footnote{Mark J. Mazur suggested this during the 2014 Senate Hearing. \textit{See 2014 S.Hrg., supra} note 28, at 10 (statement of Hon. Mark J. Mazur, Assistant Secretary for Tax Policy, U.S. Department of the Treasury).} Still, although this modification applies in 2016, its implementation will lag because the IRS will not impose penalties until 2017 for failure to report the amount paid rather than the amount billed.\footnote{\textit{See I.R.S., U.S. Dep't of the Treasury, 2016 Instructions for Forms 1098-E and 1098-T} (2016), \url{https://www.irs.gov/pub/irs-pdf/i1098et.pdf} (outlining student loan interest statement and tuition statement).}

Students also lack adequate information about the real cost of college. Many students do not pay the full sticker price but instead pay a discounted price because of need- or merit-based financial assistance.\footnote{\textit{See Tuition Discounts at Private Colleges Continue to Climb}, \textit{supra} note 67.} Often, students do not know at the time of application what price they will have to pay for a particular institution, much less be able to compare prices among institutions.

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This makes it very difficult for students to make informed choices. While the government has taken steps to address some of these issues, critics complain that these steps do not go far enough.

D. Feasibility of the Proposal

The Joint Committee on Taxation estimates that the budgetary impact of the tax incentives for higher education over four years, from 2015 through 2019, will be $84 billion for the AOTC and Lifetime Learning credits, $24.7 billion for the parental personal exemption for students aged nineteen to twenty-three, $11.1 billion for the deduction for student loan interest, $5.8 billion for the exclusion of earnings in QTPs, $0.9 billion for the deduction for tuition and fees, and $0.5 billion for the exclusion of earnings on Coverdell accounts.

According to the Obama administration’s projections, the cost of free community college for two years is estimated at around $80 billion over ten years, which the administration proposes to fund by imposing a tax on higher-income individuals and financial institutions. If one relies on the Joint Committee’s estimate, however, simply eliminating the education tax credits alone would pay for this benefit in four years. Eliminating the remaining incentives would save an additional $43 billion, much of which could be redirected to the Pell Grant program and other direct assistance.

The Joint Committee estimates the current revenue loss from the exclusion of interest on education savings bonds to be de minimus, defined as less than $50 million. This amount would be greater under this article’s proposal and probably somewhat similar to the current revenue cost of QTPs and Coverdells. The exclusions of scholarships and fellowships, tuition

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316 For instance, critics complain that the data lacks sophistication, particularly because it generally covers only one year and does not cover the full program. Thus, the student lacks the full picture of what the total cost of the program will be. Critics also complain that the government’s net price calculators are cumbersome to use. See SMOLE, supra note 9, at 3.


318 See Cong. Research Serv., Bill Summary & Status H.R. 2962, 114th Cong. (2015), https://www.congress.gov/bill/114th-congress/house-bill/2962; Stratford, supra note 171 (noting that the President estimated the initial basic cost of the program to be $60 billion, which the federal government would fund by raising taxes on wealthy Americans and financial institutions).


320 This amount totaled $1.71 billion in 2015. See 2017 BUDGET PERSPECTIVES, supra
reforming higher education tax incentives, and certain discharge of student loans are projected to cost $23.8 billion over the four-year period from 2015–2019.\textsuperscript{321} That amount also would increase under this proposal, but the amount of that increase remains difficult to project.

V. CONCLUSION

As the American Council on Education stated in its comments to the Senate Finance Committee, "because the opportunity to reform these provisions does not come along very often, it is critically important that any reforms address the needs and circumstances of the broad range of students in higher education."\textsuperscript{322} It is also critical that Congress undertakes the reform with a goal of increasing college enrollment and retention, especially for minorities, first generation college students, and the economically disadvantaged.

The proposal proffered by this article primarily addresses reform of the education tax incentives, but meaningful reform must address all aspects of federal funding for higher education. This proposal shares some features in common with the current proposals, but it also differs significantly. Like the comprehensive Ways and Means bill, this proposal would repeal Coverdell accounts, the Lifetime Learning Credit, the deduction for qualified tuition and related fees, the exemption for students aged eighteen to twenty-four, and the ten percent penalty for early withdrawals from retirement accounts.

Like the President's proposal, this one would tax interest accumulation on new contributions to QTPs, essentially eliminating the tax benefit of that tax-favored college savings device. Unlike any of the current proposals, however, this one would greatly expand the benefits of educational savings bonds to make them a more important college savings incentive. This would allow greater participation by individuals in lower-income levels and encourage them to make the important psychological commitment to save toward a better future for their children.

Unlike any of the current proposals, this one would repeal the AOTC because it remains expensive and ineffective. The proposal would make modifications to the exclusion from tax of scholarships, fellowships, and tuition reductions in order to make the tax treatment of those incentives fairer and more consistent with the goal of encouraging greater college enrollment and retention by the economically and socially disadvantaged. This also should result in less student debt in the long run. The proposal also would

\textsuperscript{322} ACE Comments to S. Finance Comm., supra note 263, at 4.
expand the exclusion of employer-provided educational assistance and gradually phase out the student loan interest deduction. The remaining six tax incentives would be retained without change.\footnote{323}

The elimination of some of the tax incentives and the modification of others should result in a significant revenue savings that can be redirected to make federal spending for higher education much more efficient. This can be done by increasing the amount of Pell Grants so that they become more meaningful and by providing free community college, as the President has proposed. Both of these would result in less borrowing for college and less student debt in the long run. It could help control some of the costs of higher education, at least in the short term, by reducing some of the regulatory burden on educational institutions.\footnote{324}

Inadequate funding for education and poor funding policies create a vicious circle in which the opportunity costs of higher education seem overwhelming for many low- and middle-income individuals, so they either do not enroll or they drop out, student borrowers find it difficult to repay their loans, and the economy suffers. The federal government’s expenditure for higher education remains inefficient because it is too high compared to the benefit that it receives, especially with respect to the tax incentives. The current system, which requires students to commit a large portion of their future income to obtain an education, remains counterproductive because it eradicates the positive externalities of higher education and undermines not only the federal investment in education, but the entire American dream.

The problem of funding education remains an enormous and multifaceted one. This article has addressed only the federal financial commitment to higher education. In order to reach the desired goal of equal educational opportunities for all and to generate the maximum positive external benefits, improvements must be made in every level of education. Further, the states must assume their proper role in funding education. The federal government also has an important role, however, because it has undertaken the funding of education, and if it does not continue this role in a thoughtful manner, the results could be dire. On the other hand, if done

\footnote{323} These are (1) the deduction for education expenses related to current employment under I.R.C. § 162; (2) the corresponding exclusion for education expenses paid by an employer that do not fall under § 127, but may be considered a working condition fringe benefit under § 132(a)(3); (3) the definition of “qualifying child” for purposes of the earned income credit, which includes a student under age twenty-four, § 32(c)(3)(A) & § 152(c)(3)(A); (4) the exclusion for loan forgiveness for those working in the public interest under § 108(f); (5) the exclusion from gift tax of payments of tuition and related fees made directly to an educational institution under § 2503; and (6) the exclusion of educational assistance to members of the military under § 134. See supra note 23.

\footnote{324} See H. Oversight Hrg., supra note 53, at 6 (statement of Terry W. Hartle, Senior Vice President, American Council on Education); supra notes 64–65 and accompanying text.
properly, this investment could pay tremendous dividends to the country for many years to come.

The current education tax incentives do not work well and their cost remains high. It is important that Congress not squander this opportunity to reform these incentives. It is time for drastic reform of the incentives, reinvesting the revenue savings from that reform in education through direct funding. For this to occur, however, the federal government needs a steady commitment to education and a clear, workable goal.