

**TAX INCENTIVES FOR HIGHER
EDUCATION IN THE INTERNAL REVENUE
CODE: EDUCATION TAX EXPENDITURE
REFORM AND THE INCLUSION OF
REFUNDABLE TAX CREDITS**

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“LAWS for the liberal education of youth, especially of the lower classes of people, are so extremely wise and useful, that to a humane and generous mind, no expence for this purpose would be thought extravagant.”

– John Adams (1735-1826)¹

I. INTRODUCTION

In addition to its function as a system of facilitating government revenue collection, the Internal Revenue Code (“Code”)² was established and is maintained as a means of encouraging socially desirable and efficient behavior through government tax policy.³ The Code provides numerous tax incentives for implementing such behavior and policy through a multitude of deductions, credits, exemptions and exclusions.⁴ Because the income tax system is essentially a self-determining, self-reporting and self-assessing

1. JOHN ADAMS, THOUGHTS ON GOVERNMENT (1776) *reprinted in* 4 PAPERS OF JOHN ADAMS 86, 91 (Robert J. Taylor ed., Massachusetts Historical Society 1979).

2. Unless the context indicates otherwise, all references to the “Code,” “I.R.C.,” “section,” or “§” are to the Internal Revenue Code of 1986 as amended, and the Treasury regulations promulgated thereunder.

3. See Frank Sammartino, Eric Toder & Elaine Maag, *Providing Federal Assistance for Low-Income Families through the Tax System: A Primer* 4 URBAN-BROOKINGS TAX POLICY CTR., (Discussion Paper No.4) available at <http://www.urban.org/UploadedPDF/410526.pdf> [hereinafter Frank Sammartino et al.] (stating that “the federal income tax system has always been more than just a means of collecting . . . [l]egislators have used the income tax system to promote favored forms of consumption and investment and to help selected groups of taxpayers.”); Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 42 (2006) (“Policymakers currently attempt to enhance economic efficiency through tax provisions that promote a wide variety of behavior that they deem socially beneficial.”); see also Kenneth M. Sokoloff & Eric M. Zolt, *Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions*, 59 TAX L. REV. 167, 167-68 (2006).

4. Examples of such provisions include the following: home ownership is encouraged through sections 121 (exclusion from gross income for up to \$250,000 of gain from the sale of principal residence (\$500,000 for joint returns)), I.R.C. § 121, and 163 (home mortgage interest deduction), I.R.C. § 163; medical treatment is encouraged through sections 223 (health savings accounts), I.R.C. § 223 and 213 (itemized deduction for medical expenses), I.R.C. § 213; charitable giving is encouraged through section 170 (deduction for charitable contributions), I.R.C. § 170; purchasing energy efficient vehicles is encouraged through section 30B (tax credit for purchasers of selected energy efficient vehicles, including qualified hybrid automobiles), I.R.C. § 30B; and education is encouraged through sections 117 (exclusion of qualified scholarships from gross income), I.R.C. § 117, and 25A (Hope and Lifetime Learning Credits for education expenses), I.R.C. § 25A. Although the Code contains many provisions providing tax benefits directly to educational organizations (e.g., tax-exempt status and exempt bond financing), this paper solely focuses on the tax incentives provided to individuals.

system, taxpayers typically bear the burden of obtaining their tax benefits through the Code and the government can, in theory, expend less on administrative costs.⁵

One such policy is the encouragement of the nation's citizens to achieve higher education.⁶ The notion that a well-educated society is in our country's national interest is seemingly beyond question.⁷ Tax expenditures⁸ for higher education serve the valuable purpose of encouraging taxpayers to obtain the education and training necessary for our economy to remain globally and domestically competitive in such areas as mathematics, engineering, the sciences and technology generally.⁹ Additionally, ensuring that higher education is an opportunity afforded to all who seek it, regardless of wealth, race, or gender, is a concept that enjoys widespread support.¹⁰

5. See U.S. GOV'T ACCOUNTABILITY OFFICE, POSTSECONDARY EDUCATION: MULTIPLE TAX PREFERENCES AND TITLE IV STUDENT AID PROGRAMS CREATE A COMPLEX EDUCATION FINANCING ENVIRONMENT BEFORE THE S. COMM. ON FINANCE 10 (2006) (statement of Michael Brostek before the S. Comm. on Finance), [hereinafter GAO Testimony on Postsecondary Education Report] available at <http://www.senate.gov/~finance/hearings/testimony/2005test/120506mbtest.pdf>.

6. Some commentators argue that educational incentives should not be delivered through the tax system in any way but are instead better suited for delivery as direct government expenditures (for example, through the government's financial aid system in the form of grants and loans). See, e.g., Natasha Mulleneaux, *The Failure to Provide Adequate Higher Education Tax Incentives for Lower-Income Individuals*, 14 AKRON TAX J. 27, 41 (1999); Cynthia E. Garabedian, Note, *Tax Breaks for Higher Education: Tax Policy or Tax Pandering?*, 18 VA. TAX REV. 217, 236 (1998). This paper operates on the assumption that educational incentives will continue to exist as tax expenditures delivered through the Code, and as such, provides suggestions as to how they should be reformed and structured.

7. See, e.g., Donna Desrochers, *Higher Education's Contribution to the Knowledge Economy*, AMERICAN COUNCIL ON EDUC., [http://www.solutionsforourfuture.org/site/PageServer?pagename=knowledge_economy_wp & printer_friendly=1](http://www.solutionsforourfuture.org/site/PageServer?pagename=knowledge_economy_wp&printer_friendly=1) (stating that, "[t]o maintain our economic competitiveness, higher education must continue to play the lead role in educating our workforce," and that "if the growth of the college-educated labor force slows, as is expected in the coming decades, U.S. productivity growth will also increase more slowly.").

8. For purposes of this paper, the term "tax expenditures" refers to "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." 2 U.S.C.A. § 622(3) (West, 2007).

9. See GAO Testimony on Postsecondary Education Report, *supra* note 5; see also U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2008 REVENUE PROPOSALS 1 (2007) (stating that, "[t]he tax system should promote the competitiveness of American workers and businesses in the global economy.").

10. See, e.g., U.S. DEP'T OF EDUC., A TEST OF LEADERSHIP: CHARTING THE FUTURE OF U.S. HIGHER EDUCATION 16 (2006) [hereinafter U.S. DEP'T OF EDUC., A TEST OF LEADERSHIP] (stating that, "[e]very student in the nation should have the opportunity to pursue postsecondary education."); see also Steve Gunderson, *Investing in America's Future: The Case for Higher Education*, AMERICAN COUNCIL ON EDUC. (2006),

The notion of improving access to – and affordability of – higher education is a theory long transfused into American politics and social policy.¹¹ In the 2006 Congressional elections, Democratic candidates advocated improved access to higher education through tax reform as a pivotal point in their campaigns.¹² However, as this paper attempts to demonstrate, more fundamental measures for reform are needed to improve access to higher education, especially for those lower income taxpayers who stand to gain the greatest marginal benefits from improved incentives. The focus in reforming education tax incentives in the Code should be on those students not otherwise likely to attend institutions of higher learning. In other words, instead of focusing on easing the burden of those who will attend college regardless of a tax benefit, tax expenditures should be designed with those students in mind who may ultimately be persuaded to pursue post-secondary education by the availability of the tax benefit.¹³

Government subsidies for post-secondary education are highly desirable because they promote domestic and global economic efficiencies and economic equity.¹⁴ Given the fact that college tuition is now rising

<http://www.solutionsforourfuture.org/site/DocServer/09-Investment-Infrastructure.pdf?docID=104> (generally stating that access to higher education should be granted to every citizen of the United States in order to invest efficiently in the nation's future); *Education and Training Tax Provisions of the Administration's Fiscal Year 1998 Budget Proposal: Hearings Before the H. Comm. on Labor & Human Res.*, 105th Cong. 37 (1997) (statement of James B. Appleberry).

11. See, e.g., Abraham Lincoln, Communication to the People of Sangamo County (Mar. 9, 1832), in 1 THE COLLECTED WORKS OF ABRAHAM LINCOLN 5, 8 (Roy P. Basler ed., Rutgers University Press 1953), available at <http://quod.lib.umich.edu/l/lincoln/> (“Upon the subject of education, not presuming to dictate any plan or system respecting it, I can only say that I view it as the most important subject which we as a people can be engaged in.”); John Godfrey, *Clinton and Dole Share Some Common Themes, Kies Says*, 72 TAX NOTES 1583 (1996) (stating that during the presidential campaign, “[w]hile Dole and Clinton may not agree on specific proposals, the idea of targeting tax breaks to education is attractive.”); 152 CONG. REC. S9631-01 (2006) (statement of Sen. Max Baucus) (generally stating that one of the major purposes of the learning credit he introduced is to “grant greater access to education” through reformed tax provisions).

12. See, e.g., Anne Marie Chaker, *What's on the Agenda For Student Aid – How the New Congressional Leadership Hopes to Make College More Affordable; Battle Over Rates*, WALL ST. J., Nov. 15, 2006, at D1 (stating that college affordability is one of the stated top priorities in the Democratic-led Congress); Charles Hurt, *Democrats to Offer Permanent Tax Cut; Plan Makes College Tuition Deductible*, WASH. TIMES, Dec. 1, 2006, at A4, (stating that Democrats promised to make college tuition deductible as part of their “Six for ‘06” platform that enabled them to win both the House and Senate majorities); Stephen Burd, *Democrats Focus on Student Aid, but Questions Remain About Details and Costs*, CHRONICLE OF HIGHER EDUCATION, Nov. 1, 2006.

13. See STAFF OF J. ECONOMIC COMM., COLLEGE AFFORDABILITY: TUITION TAX CREDITS VS. SAVING INCENTIVES 3 (1997) (stating that despite government efforts to improve affordable access to college, “[t]he prospect of incurring large debts has discouraged many low-income students from attending college altogether.”).

14. See STAFF OF J. COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO TAX EXEMPTIONS AND INCENTIVES FOR HIGHER EDUCATION 29-30 (Comm. Print 2006); see also U.S. DEP’T OF EDUC., A TEST OF LEADERSHIP, *supra* note 10, at vii (Preamble) (stating that many

more rapidly than inflation,¹⁵ government subsidies through refundable credits, scholarships, loan forgiveness programs and similar tax incentives are invaluable in encouraging potential students to seek higher education in the United States. However, though the United States was once considered the world leader in educational attainment, recent studies show that it is now ranked twelfth among major industrialized countries in this category.¹⁶

In addition to making educational tax incentives more widely available to those who stand to benefit most, any reform must address the daunting multitude of education tax incentives currently available to taxpayers.¹⁷ As the GAO noted in 2006, the currently existing tax incentives are so numerous, overlapping and complicated that they impose a significant burden on students and families to “identify applicable tax preferences, understand complex rules concerning their use, and correctly calculate and claim credits or deductions.”¹⁸

Unless otherwise noted, this paper operates on the assumption that all recommendations for Code and tax expenditure reform are to be revenue-neutral. Part II of this paper briefly discusses the various tax benefits for education expenses of individuals currently existing in the Code. The current tax incentives are analyzed according to when the tax benefit is realized by the taxpayer, either for current expenses, previously incurred expenses, or saving for future expenses. Part III provides an analysis and

of the world’s countries other than the United States are beginning to educate more of their citizens to more advanced levels than the United States, and that these countries are passing the United States “at a time when education is more important to our collective prosperity than ever”); see also Alisa Cunningham, *The Broader Societal Benefits of Higher Education*, AMERICAN COUNCIL ON EDUC., http://www.solutionsforourfuture.org/site/PageServer?pagename=societal_benefits_of_higher_education_revised (generally stating that in addition to the individual benefits obtained from higher education, society as a whole benefits from an increased number of college-educated citizens).

15. See *Report Card on Tax Exemptions and Incentives for Higher Education: Pass, Fail, or Need Improvement?: Hearing Before the S. Comm. on Finance*, 109th Cong. (2006) [hereinafter Grassley, Opening Statement] (opening statement of Sen. Chuck Grassley, Chairman, S. Comm. on Finance) (noting that, since “1976 college tuition and fees have risen by more than twice the economy’s overall price level.”); AMERICAN COUNCIL ON EDUC., *RIISING PRICES: COLLEGE TUITION INCREASES* (2001), http://www.solutionsforourfuture.org/site/PageServer?pagename=riising_increases_r (stating that the average cost of college tuition has increased by more than 65% over the past decade in comparison to median family income, which has only increased by 5% over the same period). However, it should be noted that at least a partial justification for this rapid increase in tuition may be due to the fact that college tuition charges generally lagged behind inflation during the 1970s. See STAFF OF J. COMM. ON TAXATION, 109TH CONG., *PRESENT LAW AND BACKGROUND RELATING TO TAX EXEMPTIONS AND INCENTIVES FOR HIGHER EDUCATION* 25 (Comm. Print 2006).

16. U.S. DEP’T OF EDUC., *A TEST OF LEADERSHIP*, *supra* note 10, at ix (Preamble).

17. See GAO Testimony on Postsecondary Education Report, *supra* note 5.

18. GAO Testimony on Postsecondary Education Report, *supra* note 5. See also discussion *infra* Part III.A.

critique of the current tax incentives, with a special focus on their complexity and inability to reach target taxpayers effectively. Part IV of this paper proposes use of a refundable credit as the most effective means of structuring an incentive through the Code, both from an economic and from a policy standpoint. This Part goes on to discuss potential arguments against the use of refundable tax credits and concludes with a discussion about ways to structure a refundable higher education tax credit.

II. CURRENT EDUCATION TAX INCENTIVES FOR INDIVIDUALS

Current tax benefits in the Code for education expenses are best understood when arranged in three separate categories: (1) incentives for current expenses, (2) benefits for expenses previously incurred via student loans, and (3) incentives for saving for future educational expenditures. Although the Code contains other provisions, such as section 162, that may occasionally provide education related benefits,¹⁹ this paper limits its discussion to those tax incentives specifically created for tax-favored treatment of higher education expenses.

A. *Tax Incentives for Current Education Expenses*

1. Hope Scholarship Credit

The HOPE Scholarship Credit is one of two nonrefundable education tax credits found in section 25A of the Code.²⁰ An individual may claim the Hope Scholarship Credit for qualified payments to an “eligible educational institution”²¹ for the first two years of post-secondary education for an “eligible student.”²² Qualified payments include tuition and fees required for the enrollment of the taxpayer, her spouse, or any qualified

19. Section 162 may allow a taxpayer to deduct certain education expenses, but this section has the broader purpose of allowing deductions for education expenses only if they first qualify as trade or business expenses. *See* I.R.C. § 162; Treas. Reg. § 1.162-5(b).

20. I.R.C. § 25A(b); Treas. Reg. § 1.25A-3.

21. For purposes of section 25A, “eligible educational institution” is defined as an institution described in section 481 of the Higher Education Act of 1965 and eligible to participate in a Title IV program of the same Act. I.R.C. § 25A(f)(2); Treas. Reg. § 1.25A-2(b) (“eligible educational institutions” generally include accredited educational institutions offering post-secondary degrees, such as colleges, universities, or vocational schools).

22. For purposes of section 25A, “eligible student” is defined as a student who meets the requirements of section 484(a)(1) of the Higher Education Act of 1965 and is enrolled in a degree program on at least a one-half time basis. I.R.C. § 25A(b)(3); Treas. Reg. § 1.25A-3(d).

dependent of the taxpayer at an eligible post-secondary educational institution.²³

The maximum amount of the Hope Scholarship Credit prior to any phase-out is \$1,650 annually for the 2006 and 2007 taxable years.²⁴ For the 2006 taxable year, the Hope Scholarship Credit is ratably phased-out (but not below zero) for individual taxpayers with modified adjusted gross income between \$45,000 and \$55,000.²⁵ For the 2007 taxable year, the credit is ratably phased-out (but not below zero) for individual taxpayers with modified adjusted gross income between \$47,000 and \$57,000.²⁶ Although a taxpayer may claim both the Hope Scholarship and the Lifetime Learning Credit for separate eligible students during the same taxable year, a taxpayer may not claim both credits for the same student during the same taxable year.²⁷

2. Lifetime Learning Credit

The Lifetime Learning Credit is the second nonrefundable education tax credit found in section 25A of the Code.²⁸ For taxable years beginning after 2002, a taxpayer may receive a nonrefundable credit of up to 20% of \$10,000 of qualified tuition and related expenses.²⁹ The Lifetime Learning Credit is subject to the same modified adjusted gross income phase-out limitations that apply to the Hope Scholarship Credit.³⁰ As mentioned above, a taxpayer may not claim the Lifetime Learning Credit and the Hope Scholarship Credit for the same student in the same taxable year.³¹

23. I.R.C. § 25A(f)(1); Treas. Reg. § 1.25A-2(d) (qualified tuition and related expenses generally include fees required for enrollment, books, supplies and equipment used in a course of study, but do not include expenses of a personal nature, such as room and board, insurance, medical expenses and transportation, regardless of whether these personal expenses are required for enrollment).

24. The amount of the Hope Scholarship Credit equals 100% of qualified tuition and related expenses not exceeding \$1100 plus 50% of the excess up to \$2200. I.R.C. § 25A(b)(1), (4); Treas. Reg. § 1.25A-3(a); Rev. Proc. 05-70, 2005-47 I.R.B. 979, 981 (cost of living adjustments for 2006); Rev. Proc. 06-53, 2006-48 I.R.B. 996, 999 (cost of living adjustments for 2007).

25. I.R.C. § 25A(h)(1) (between \$90,000 and \$110,000 for married taxpayers filing a joint return); Rev. Proc. 05-70, 2005-47 I.R.B. 979, 982 (cost of living adjustments for 2006).

26. I.R.C. § 25A(h)(1) (between \$94,000 and \$114,000 for married taxpayers filing a joint return); Rev. Proc. 06-53, 2006-48 I.R.B. 996, 999 (cost of living adjustments for 2007).

27. I.R.C. § 25A(a); Treas. Reg. § 1.25A-1(b)(1).

28. I.R.C. § 25A(c); Treas. Reg. § 1.25A-4.

29. I.R.C. § 25A(c)(1); Treas. Reg. § 1.25A-4(a).

30. I.R.C. § 25A(d). *See supra* Part II.A.1 discussing the Hope Scholarship Credit and applicable phase-out limitations.

31. I.R.C. § 25A(a); Treas. Reg. § 1.25A-1(b)(1).

Although the Hope Scholarship and Lifetime Learning Credits are subject to the same phase-out limitations, the two credits have important differences. Unlike the Hope Scholarship Credit, the Lifetime Learning Credit is not indexed for inflation³² and the Lifetime Learning Credit is applied on a per-return basis instead of a per-student basis.³³ In addition to qualified tuition and related fees at an eligible educational institution, the Lifetime Learning Credit also covers amounts paid for courses to acquire or improve job skills, even if the courses are not part of a post-secondary degree program and regardless of whether the student is enrolled on less than a half-time basis.³⁴ Finally, the Lifetime Learning Credit can be claimed for any number of years for a specific student and is not limited to the student's first two years in post-secondary education.³⁵

3. Above-the-Line Deduction

Subject to income and eligibility limitations, an individual is allowed an above-the-line deduction for qualified tuition and related expenses.³⁶ Allowance of the deduction is subject to an income limitation based on adjusted gross income.³⁷ The deduction applies to tuition and fees related to enrollment of the taxpayer, her spouse, or any qualified dependent of the taxpayer at an institution of higher education.³⁸ The above-the-line deduction is not available for expenses claimed by the taxpayer with respect to the same individual in the same taxable year under either the Hope Scholarship or the Lifetime Learning Credit, or for expenses allocated to the exclusions from income under section 529 plans, Coverdell education

32. Section 25A(h)(1) generally states that the amount of the credit under subsection (b)(1) (the Hope Scholarship Credit) is to be adjusted by the cost-of-living adjustment under section 1(f)(3) each calendar year, but specifically fails to mention such an adjustment for the Lifetime Learning Credit. I.R.C. § 25A(h)(1).

33. I.R.C. § 25A(c)(1); Treas. Reg. § 1.25A-4(a).

34. I.R.C. § 25A(c)(2)(B); Treas. Reg. § 1.25A-4(c)(1) (the Lifetime Learning Credit does not have the same "eligible student" requirement found in section 25A(b)(3) that applies to the Hope Scholarship Credit).

35. Treas. Reg. § 1.25A-4(b).

36. I.R.C. §§ 62(a)(18), 222(a).

37. For taxable years beginning in 2006 and 2007, a \$4000 maximum deduction is allowed for taxpayers with adjusted gross income not exceeding \$65,000 (\$130,000 for married taxpayers filing a joint return) and \$2000 for taxpayers with adjusted gross income not exceeding \$80,000 (\$160,000 for married taxpayers filing a joint return). I.R.C. § 222(b) (*amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933 (2007) to retroactively extend the expiration date by two years from December 31, 2005 to December 31, 2007).

38. I.R.C. § 222(d)(1) (using the definition of "qualified tuition and related expenses" found in section 25A(f) of the Code).

savings accounts, or U.S. education savings bonds.³⁹ More generally, section 222(c) provides that the above-the-line deduction is not allowed for any expense that would result in a “double benefit” from any other provision in the Code.⁴⁰

4. Qualified Scholarships and Qualified Tuition Reduction

An individual who receives a qualified scholarship may exclude the amount of the scholarship from her gross income provided she uses the scholarship for qualified tuition and related expenses and is a candidate for a degree at an educational institution.⁴¹ The Code defines “qualified tuition and related expenses” as tuition, fees, books, supplies and equipment required for enrollment or courses of instruction at an “educational organization.”⁴²

Additionally, a qualified tuition reduction for employees of an educational organization (and their spouses and dependents) is excluded from the employee’s gross income provided that the tuition reduction does not discriminate in favor of highly compensated employees.⁴³ Neither the qualified scholarship nor the qualified tuition reduction exclusions apply to any portion of the amount received that represents compensation for services performed by the student, such as teaching or research.⁴⁴

5. Employer-Provided Educational Assistance Programs

An individual employee may exclude from her gross income annually up to \$5250 of employer-provided educational assistance paid on her behalf by her employer provided certain requirements are met.⁴⁵ “Educational

39. I.R.C. § 222(c)(2). *See infra* Part II.C for discussion of section 529 plans, Coverdell education savings accounts and U.S. savings bonds for higher education.

40. I.R.C. § 222(c)(1) (generally stating that no deduction is allowed under section 222 if it would result in a “double benefit” to the taxpayer).

41. I.R.C. § 117(a), (b); Treas. Reg. § 1.117-1(a).

42. I.R.C. § 117(b)(2); Treas. Reg. § 1.117-3(b). “Educational organization” is defined in section 170(b)(1)(A)(ii) of the Code as “an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.” I.R.C. § 170(b)(1)(A)(ii).

43. I.R.C. § 117(d).

44. I.R.C. § 117(c); Treas. Reg. § 117-2(a)(2).

45. I.R.C. § 127(a). The section 127 exclusion is set to expire after 2010 pursuant to the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150. To qualify as a section 127 “educational assistance program,”

assistance” includes amounts paid by the employer for the employee’s tuition, fees, books, supplies and equipment, but does not include payments for meals, lodging, transportation, tools or supplies that the employee may keep after completion of the course, or for any payment related to education involving sports, games, or hobbies.⁴⁶

B. Tax Benefits for Previously Incurred Education Expenses

1. Student Loan Interest Deduction

An individual taxpayer is allowed an above-the-line deduction for interest paid on qualified educational loans during the taxable year.⁴⁷ The maximum amount of the deduction is \$2500 annually, subject to the applicable phase-out limitations and inflation adjustments.⁴⁸ For the 2006 taxable year, the \$2500 deduction is ratably phased-out (but not below zero) for individual taxpayers with modified adjusted gross income between \$50,000 and \$65,000.⁴⁹ For taxable years beginning in 2007, the \$2500 deduction is ratably phased-out (but not below zero) for individual taxpayers with modified adjusted gross income between \$55,000 and \$70,000.⁵⁰ These phase-out ranges are different from those applicable to the Hope Scholarship Credit and the Lifetime Learning Credit.⁵¹

2. Discharge of Student Loan Indebtedness

Although gross income generally includes income from discharge of indebtedness,⁵² it does not include the amount of income arising from the

such program must be documented in a separate written plan, must be made for the exclusive benefit of eligible employees, must not discriminate with regards to eligibility, and must meet reasonable notification requirements to all eligible employees. I.R.C. § 127(b).

46. I.R.C. § 127(c)(1).

47. I.R.C. §§ 62(a)(17), 221(a).

48. I.R.C. § 221(b), (f).

49. I.R.C. § 221(b)(2) (between \$105,000 and \$135,000 for married taxpayers filing a joint return); Rev. Proc. 2005-70, 2005-47 C.B. 984 (cost of living adjustments for 2006).

50. I.R.C. § 221(b)(2) (between \$110,000 and \$140,000 for married taxpayers filing a joint return); Rev. Proc. 2006-53, 2006-48 I.R.B. 1002 (cost of living adjustments for 2007).

51. For 2006, both the Hope Scholarship and the Lifetime Learning Credits are ratably phased-out (but not below zero) for individual taxpayers with modified adjusted gross income between \$45,000 and \$55,000. For 2007, the credits are ratably phased-out for individual taxpayers with modified adjusted gross income between \$47,000 and \$57,000. See *supra* notes 25, 26, 30 and accompanying text.

52. I.R.C. § 61(a)(12).

discharge of student loan indebtedness, in whole or in part, provided certain requirements are met.⁵³ To qualify for the income exclusion, the individual must work “for a certain period of time in certain professions for any of a broad class of employers.”⁵⁴ The loan must have originated from specified sources – generally, from a governmental entity or educational lender – in order for the discharge to be eligible for exclusion.⁵⁵ As a condition for the exclusion to apply, the loan discharge must not be made in consideration of the student’s performing services for the organization that made the loan or refinanced the existing loan.⁵⁶ Finally, the discharge of the loan indebtedness or refinancing of the loan must be made pursuant to a program that “is designed to encourage . . . students to serve in occupations with unmet needs or in areas with unmet needs” and the services must be performed for or under the control of either a governmental unit or a charitable organization exempt from tax under section 501(c)(3) of the Code.⁵⁷

C. *Tax Incentives to Save for Education*

1. Section 529 Plans

A section 529 plan (“qualified tuition program”) is a program established and maintained by either a State or by an eligible education institution.⁵⁸ Under an eligible education institution tuition program, the contributor may purchase tuition credits (prepaid tuition) on behalf of a beneficiary for the beneficiary’s “qualified higher education expenses.”⁵⁹

53. I.R.C. § 108(f).

54. I.R.C. § 108(f)(1).

55. Qualifying lenders include: (1) the United States (or its instrumentality or agency), (2) a State (or its political subdivision), (3) a tax-exempt public benefit corporation that controls a state, county, or municipal hospital, or (4) an educational organization that originally received the funds from one of the three aforementioned sources. I.R.C. § 108(f)(2). The section 108(f) exclusion also applies to the forgiveness of loans from educational organizations wherein the loan funds originated from a private, nongovernmental source, provided that the individual uses the loan proceeds to attend an educational organization or to refinance existing student loans. I.R.C. § 108(f)(2)(D) (flush language).

56. I.R.C. § 108(f)(3).

57. I.R.C. § 108(f)(2)(D) (flush language).

58. I.R.C. § 529(b)(1); Prop. Treas. Reg. § 1.529-2(a), 63 Fed. Reg. 45019, 45026 (Aug. 24, 1998). An “eligible education institution” is defined as an institution described in section 481 of the Higher Education Act of 1965 and eligible to participate in a Title IV program of the same Act. I.R.C. § 529(e)(5); Prop. Treas. Reg. § 1.529-1(c), 63 Fed. Reg. 45019, 45026 (Aug. 24, 1998).

59. I.R.C. § 529(b)(1)(A)(i). “Qualified higher education expenses” include tuition, fees,

Under a State qualified tuition program, the program can be either a prepaid tuition program or a savings account for qualified higher education expenses.⁶⁰ Although contributions to a qualified tuition program are not tax deductible, earnings in the account accumulate tax-free and distributions both of principal and earnings are tax-free to the beneficiary so long as they are used for qualified higher education expenses.⁶¹ Any distributions that exceed the beneficiary's amount of qualified higher education expenses are includable in the beneficiary's gross income and may be subject to an additional ten percent tax.⁶²

Although contributions to a qualified tuition program are essentially unlimited, the statute provides that a program will not be treated as a section 529 qualified tuition program unless it contains adequate safeguards to prevent contributions that exceed the amount necessary for the beneficiary's qualified higher education expenses.⁶³ Section 529 programs also provide for favorable estate, gift, and generation-skipping tax treatment.⁶⁴ In determining whether a distribution from a qualified tuition program exceeds the beneficiary's qualified higher education expenses, the distribution must be coordinated with the Hope and Lifetime Learning Credits and the Coverdell education savings account provisions by reducing the section 529 plan's qualified expenses by the amount of expenses already claimed under the aforementioned provisions.⁶⁵ Essentially, this coordination provision is meant to prohibit taxpayers from receiving a "double benefit," as Congress also sought to do in the case of the above-

books, supplies, equipment required for enrollment at an eligible educational institution, and room and board if the student is enrolled on at least a one-half time basis. I.R.C. § 529(e)(3); Prop. Treas. Reg. § 1.529-1(c), 63 Fed. Reg. 45019, 45026 (Aug. 24, 1998). The prepaid tuition program essentially allows taxpayers to pay upfront an agreed upon price for tuition no matter what the cost is when the beneficiary ultimately attends. This allows the taxpayer to lock in a future tuition expense at today's prices. See Albert B. Crenshaw, *No Quick Fix for Section 529 Plans*, WASH. POST, June 6, 2004, at F4, available at <http://proquest.umi.com/pqdweb?did=6470244661&sid=1&Fmt=3&clientId=13322&RQT=309&VName=PQD>.

60. I.R.C. § 529(b)(1)(A)(ii); Prop. Treas. Reg. § 1.529-2(a), 63 Fed. Reg. 45019, 45027 (August 24, 1998).

61. I.R.C. § 529(a), (c)(3); Prop. Treas. Reg. § 1.529-1(a), 63 Fed. Reg. 45019, 45025 (August 24, 1998).

62. I.R.C. § 529(c)(3)(A), (c)(6); Prop. Treas. Reg. § 1.529-2(e), 63 Fed. Reg. 45019, 45027 (August 24, 1998).

63. I.R.C. § 529(b)(6); Prop. Treas. Reg. § 1.529-2(h)(i), 63 Fed. Reg. 45019, 45028 (August 24, 1998).

64. See I.R.C. § 529(c)(2), (c)(4), (c)(5); Prop. Treas. Reg. § 1.529-5, 63 Fed. Reg. 45019, 45032 (August 24, 1998).

65. I.R.C. § 529(c)(3)(B)(v), (vi).

the-line tuition deduction under section 222.⁶⁶

2. Coverdell Education Savings Account

A Coverdell education savings account is a United States trust created exclusively for the purposes of paying the “qualified education expenses” of a designated beneficiary.⁶⁷ Although contributions to a Coverdell account are not deductible for federal tax purposes, all appreciation in the account accumulates on a tax-free basis.⁶⁸ The maximum annual contribution amount is \$2000,⁶⁹ and the permissible amount of the contribution is subject to an applicable phase-out based on the contributor’s modified adjusted gross income.⁷⁰ Distributions from the Coverdell account are tax-free to the beneficiary to the extent the distributions are used for qualified education expenses.⁷¹ Any distributions in excess of the beneficiary’s qualified education expenses are includable in the beneficiary’s gross income and may be subject to an additional ten percent tax.⁷²

In determining whether a distribution exceeds the beneficiary’s qualified education expenses, the amount of the beneficiary’s qualified expenses must be coordinated with the Hope and Lifetime Learning Credit provisions and the section 529 plan provisions so as to prevent the taxpayer from receiving a “double benefit.”⁷³

3. Income From United States Savings Bonds for Higher Education

Interest earned on a “qualified United States savings bond”⁷⁴ is excludable from a taxpayer’s gross income if the redemption amount of the

66. *See supra* notes 39-40 and accompanying text.

67. I.R.C. § 530(b). “Qualified education expenses” for higher education include tuition, fees, books, supplies, equipment required for enrollment at an eligible educational institution, room and board if the student is enrolled on at least a one-half time basis, and contributions to a qualified tuition program (as defined in section 529(b)). I.R.C. § 530(b)(2).

68. I.R.C. § 530(a).

69. I.R.C. § 530(b)(1)(A)(iii).

70. The maximum \$2000 contribution ratably phases-out for individual contributors with modified gross adjusted income between \$95,000 and \$110,000 (between \$190,000 and \$220,000 for married taxpayers filing a joint return). I.R.C. § 530(c).

71. I.R.C. § 530(d)(2)(A).

72. I.R.C. § 530(d)(2)(B), (d)(4).

73. I.R.C. § 530(d)(2)(C). *See supra* notes 39, 40, 66 and accompanying text for discussion of “double benefit” concerns.

74. A “qualified United States savings bond” is defined as a United States savings bond issued at a discount under section 3105 of title 31 of the United States Code after December 31, 1989 to an individual who is at least 24 years old. I.R.C. § 135(c)(1).

bond is used to pay the “qualified higher education expenses”⁷⁵ of the taxpayer during the year.⁷⁶ Any proceeds from the redemption exceeding the qualified higher education expenses of the taxpayer may be includable in gross income, depending on the result of applying a formula to the proceeds and interest amounts.⁷⁷ Additionally, the redemption amount excluded from taxpayer’s gross income is subject to an applicable phase-out, which is adjusted for inflation.⁷⁸

In determining the amount of qualified higher education expenses under this section, the taxpayer must account for expenses already taken into account so as to prevent a “double benefit.”⁷⁹ This essentially requires that the amount of qualified expenses excludable under this section be reduced by the tax-free amount of any scholarship under section 117, as well as by the amount of any expenses claimed by a taxpayer (with respect to an individual) in determining the amount of the Hope or Lifetime Learning Credits, the above-the-line tuition deduction, and the exclusion amounts from a section 529 plan or Coverdell savings account.⁸⁰

4. Traditional and Roth IRAs

Although not specifically intended to aid in saving for education expenses, the Code contains several savings vehicles that a taxpayer can utilize in a tax-favored manner.⁸¹ Two of these savings vehicles –

75. “Qualified higher education expenses” include tuition and fees of the taxpayer, her spouse, or her dependent to an eligible education institution (as defined in section 529(e)(5)). I.R.C. § 135(c)(2), (3).

76. I.R.C. § 135(a).

77. I.R.C. § 135(b)(1). If the total amount that taxpayer receives upon redemption of the bond does not exceed the amount of qualified higher education expenses for the year, the entire amount of interest on the bond is tax-free. However, if the total amount received upon redemption of the bond exceeds the amount of qualified higher education expenses, only a portion of the interest on the bond may be tax-free. The tax-free amount of the bond proceeds is determined by the following equation: amount of interest in the bond proceeds x (adjusted qualified higher education expenses paid during the year/total bond proceeds during the year) = amount of tax-free interest on the bond. Any remaining interest is subject to tax. I.R.C. § 135(b). *See also* INTERNAL REVENUE SERV. DEP’T OF TREASURY, PUBL’N NO. 970, TAX BENEFITS FOR EDUCATION, available at <http://www.irs.gov/pub/irs-pdf/p970.pdf>.

78. For 2006, the exclusion amount ratably phases out for taxpayers with modified gross adjusted gross income between \$63,100 and \$78,100 (between \$94,700 and \$124,700 for married taxpayers filing a joint return). For 2007, the exclusion amount ratably phases out for taxpayers with modified gross adjusted income between \$65,600 and \$80,600 (between \$98,400 and \$128,400 for married taxpayers filing a joint return). I.R.C. § 135(b)(2).

79. *See supra* notes 39, 40, 66 and accompanying text for discussion of a “double benefit.”

80. I.R.C. § 135(d)(1), (2).

81. *See generally* STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND

Traditional⁸² and Roth IRAs⁸³ – can provide tax benefits for education expenses. Each type of IRA has its own set of rules for determining when a taxpayer will receive tax-favored treatment, but benefits generally include penalty-free early withdrawals and exclusion from gross income of such withdrawals when the amounts are used for qualified education expenses.⁸⁴

III. ANALYSIS AND CRITIQUE OF CURRENT TAX INCENTIVES FOR HIGHER EDUCATION

During the 2005 fiscal year, the federal government incurred well in excess of \$9.15 billion in tax expenditures on account of post-secondary educational tax incentives currently in the Code.⁸⁵ Using a broader gauge of higher education-related expenditures, the Joint Committee on Taxation estimates that such tax expenditures will amount to almost \$49 billion for fiscal years 2006-2010.⁸⁶ Given that these amounts represent lost federal tax revenue, both the government and taxpayers have compelling reasons to ensure that the foregone revenue is allocated as efficiently and effectively as possible.⁸⁷ For such allocation goals to be achieved, it is important that

ANALYSIS RELATING TO TAX BENEFITS FOR HIGHER EDUCATION 22 (Comm. Print 2004).

82. See I.R.C. § 408(a), (d)(1) (generally providing that early withdrawals are excluded from gross income to the extent attributable to a return of nondeductible contributions and are not subject to an early withdrawal penalty tax if used for qualified higher education expenses).

83. See I.R.C. § 408A(a), (d)(5) (generally providing that early withdrawals are excluded from gross income to the extent not attributable to earnings and are not subject to an early withdrawal penalty tax if used for qualified higher education expenses).

84. For a more complete discussion of these various savings vehicles as they relate to expenses for higher education, see STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX BENEFITS FOR HIGHER EDUCATION 22-25 (Comm. Print 2004).

85. GAO Testimony on Post-secondary Education Report, *supra* note 5, at 5. Tax expenditures accounted for in the GAO report include the Hope and Lifetime Learning Credits, the student loan interest deduction, the tuition and fees deduction, section 529 plans, and Coverdell Education Savings Accounts, but do not include exclusions for qualified scholarships, discharge of student loan debt, and exclusions for employer-provided education assistance and tuition reductions.

86. STAFF OF J. COMM. ON TAXATION, 109TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2006-2010 37 (Comm. Print 2006). Tax expenditures counted in the Joint Committee's estimate include the Hope and Lifetime Learning Credits, student loan interest deductions, section 529 plans, Coverdell savings accounts, scholarship exclusions, exclusions for discharge of certain student loan debt, and exclusions for employer-provided education assistance and tuition reductions. *Id.*

87. See GAO Testimony on Post-secondary Education Report, *supra* note 5, at 1 (“The fact that we face large and growing structural deficits in the future – primarily driven by demographics and rising health care costs – emphasizes the need to consider how the government allocates resources.”).

the expenditures actually reach the target taxpayers intended to benefit most from these incentives: potential students on the margin of pursuing higher education and in need of an incentive to do so. Analysis of the current education tax incentives in the Code reveals two fundamental problems: (1) the current system is confusing, especially to lower-income taxpayers who are most in need of educational assistance; and (2) the existing structure does not effectively reach these target taxpayers.

A. The Complexity of Current Education Tax Incentives Leads to Taxpayer Confusion

One of the most commonly cited shortcomings of the current system is that the complexity of the existing education tax incentives leads to confusion among taxpayers.⁸⁸ In particular, the ideal target student for education tax incentives – the low-income potential student on the margin of entering college – likely has the greatest difficulty understanding these complicated provisions.⁸⁹ The inherent difficulty in attempting to understand and balance the Code’s various education tax benefits is evidenced by the Service’s detailed 80-page publication on the subject, which is intended to assist taxpayers in sorting through the provisions.⁹⁰

Although the multitude of tax incentives for education might seem to provide taxpayers with a beneficial variety of tax-favored choices, the confusion created by these overlapping incentives and their differing

88. See, e.g., Grassley, Opening Statement, *supra* note 15 (noting that, “[i]t is very discouraging that many students and their families are not taking full advantage of the tax incentives [the government] has provided because of confusion and uncertainty.”); STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX BENEFITS FOR HIGHER EDUCATION 44 (Comm. Print 2004); *Educational Tax Proposals: Hearing Before the S. Comm. on Finance*, 105th Cong. (1997) (statement of John S. Barry, Economic Policy Analyst, The Heritage Foundation) (stating that Americans widely regard the complexity of the income tax system as a “major concern” and that the “costs of this complexity are enormous”); Gerald Prante, *Tax Confusion Has Become a Nightmare for Students*, TAX FOUNDATION, Aug. 30, 2005, <http://www.taxfoundation.org/blog/show/1036.html> (“Instead of an IRS public awareness campaign on how to best maneuver through the current complex tax code that frustrates millions every year, why not overhaul the tax code and make it fair and simple for everyone? This way, everyone could do their own taxes, and the benefits received from government educational assistance would not vary depending upon who had the money to hire their own accountant.”).

89. *Hearing Before the S. Comm. on Finance*, 109th Cong. 4 (2006) (statement of Susan Dynarski, Associate Professor of Public Policy, Harvard University & National Bureau of Economic Research) available at <http://www.senate.gov/~finance/hearings/testimony/2005test/120506sdttest.pdf>. [hereinafter Dynarski, Senate Finance Hearings].

90. See INTERNAL REVENUE SERV. DEP’T OF TREASURY, PUBL’N NO. 970, TAX BENEFITS FOR EDUCATION, available at <http://www.irs.gov/pub/irs=pdf/p970.pdf>.

requirements may actually outweigh any benefits gained.⁹¹ Because our income tax system is essentially one of self-assessment, taxpayers themselves must navigate these provisions' highly complex eligibility requirements.⁹² In order to do so, taxpayers must consider and analyze the following: the interaction among the various provisions,⁹³ the expiring nature of some of the incentives,⁹⁴ which incentives will provide the greatest benefit,⁹⁵ different definitions for similar concepts throughout the provisions,⁹⁶ different income limitations,⁹⁷ and the various recordkeeping requirements.⁹⁸ This complexity likely results in many taxpayers' making

91. See A.B.A. Section of Taxation, AICPA Tax Division & Tax Executives Institute, *Tax Simplification Recommendations*, A.B.A. SEC. TAX'N 6-7 (2001), available at <http://www.abanet.org/tax/pubpolicy/2001/0102simpl.pdf> (stating that, "[f]or many taxpayers, analysis and application of the intended incentives are too cumbersome to deal with compared with the benefits received.") [hereinafter A.B.A. Section of Taxation et al.].

92. See U.S. GOV'T ACCOUNTABILITY OFFICE, STUDENT AID AND POST-SECONDARY TAX PREFERENCES: LIMITED RESEARCH EXISTS ON EFFECTIVENESS OF TOOLS TO ASSIST STUDENTS AND FAMILIES THROUGH TITLE IV STUDENT AID AND TAX PREFERENCES 19-20 (2005).

93. For example, section 222 (relating to the tuition deduction) generally states that no deduction is allowed under section 222 if it would result in a "double benefit" to the taxpayer. I.R.C. § 222. The deduction is not available if the taxpayer claims either the Hope Scholarship or Lifetime Learning Credit under section 25A with respect to an individual in the same taxable year. I.R.C. § 25A. Also, in determining whether a distribution from a section 529 qualified tuition program is tax-free to the beneficiary, the distribution must be coordinated with the Hope and Lifetime Learning Credits and the Coverdell education savings account provisions. I.R.C. § 529. See *supra* Part II.A-C for a discussion of the various provisions.

94. For example, the tuition deduction under section 222 was recently extended through 2007, but its future beyond this point is uncertain. I.R.C. § 222. See *supra* note 37.

95. For example, although a taxpayer may claim both the Hope Scholarship and the Lifetime Learning Credit for separate eligible students during the same taxable year, both credits may not be claimed for the same student during the same taxable year. See *supra* Part II.A.1. Also, in determining whether to use a tax-favored savings vehicle (such as a section 529 plan, a Coverdell account, or a U.S. savings bond), the taxpayer must analyze whether distributions will be more favorable from these accounts or whether she wants to claim a nonrefundable education credit, since her qualified expenses cannot be applied to both a savings vehicle and an education credit. See *supra* Part II.C for a discussion of the various provisions.

96. For example, the definition of an "eligible student" is not the same under the HOPE and Lifetime Learning Credits. See *supra* note 34.

97. Consider the following 2006 income limitations for some of the education tax incentives: the Hope Scholarship and Lifetime Learning Credits both phase-out individual taxpayers with modified adjusted gross income between \$45,000 and \$55,000; the \$4000 above-the-line tuition deduction is available to taxpayers with adjusted gross income not exceeding \$65,000 and \$2000 for taxpayers with adjusted gross income not exceeding \$80,000 (not subject to a phase-out); the \$2500 student loan interest deduction is ratably phased-out for individual taxpayers with modified adjusted gross income between \$50,000 and \$65,000; contributions to section 529 qualified tuition program are essentially unlimited, but are subject to "adequate safeguards"; and the maximum \$2000 contribution to a Coverdell account ratably phases-out for individual contributors with modified gross adjusted income between \$95,000 and \$110,000. See *supra* Part II.A-C for a discussion of the various provisions.

98. STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND

suboptimal choices on their returns, and thus not taking full advantage of the tax benefits available to them.⁹⁹

B. Some Current Education Tax Incentives Fail to Reach Target Taxpayers

From a practicality standpoint, this paper presumes that for purposes of feasibility of enactment, any and all suggestions for tax reform are to operate on a revenue-neutral basis. Consistent with revenue neutrality, this paper contends that reform of the current system should advance two goals: reducing taxpayer confusion from overlapping and inconsistent incentives, and providing incentives that actually reach the target taxpayers. To satisfy these goals, this paper recommends that certain current tax incentives for higher education should be eliminated and their expenditure amounts be allocated to a more efficient system. For reasons discussed in further detail below, a more efficient system of tax incentives for higher education would include a uniform refundable tax credit for higher education.¹⁰⁰

1. Beneficial Current Tax Incentives

Although the existing system of education tax incentives is in need of reform, some of the current provisions provide a substantial benefit to target taxpayers without causing confusion stemming from inconsistency and overlap with other provisions. Accordingly, the following provisions are not in need of reform and should endure so as to continue providing an efficient tax incentive to target taxpayers.

RELATING TO TAX EXEMPTIONS AND INCENTIVES FOR HIGHER EDUCATION 40 (Comm. Print 2006). In describing how complicated the current education tax incentives can be, one commentator noted that a taxpayer may need “Forms 1098-E, 1098-T, 1099-Q, 1099-4, 2106, 2106-EZ, 5329, 8815, 8863 and W/9S” when figuring which education tax incentives she can claim. Gerald Prante, *Tax Confusion Has Become a Nightmare for Students*, TAX FOUNDATION, Aug. 30, 2005, <http://www.taxfoundation.org/blog/show/1036.html>. The commentator further notes that, “[o]n the bright side, it’s a great time to be an accountant.”

99. GAO Testimony on Post-secondary Education Report, *supra* note 5, at 10-12. The GAO report states that for the 2002 tax year, approximately 27% of the returns eligible to claim the Hope Credit, the Lifetime Learning Credit, or the tuition deduction, approximately 374,000 failed to claim any of these benefits. Notably, the GAO report states that approximately 50% of all analyzed returns failing to make optimal education-related tax choices were prepared by paid tax return preparers.

100. See *infra* Part IV.

a. *Qualified scholarship exclusion*

The author firmly believes that the qualified scholarship exclusion under section 117 is the ultimate incentive for students to excel in higher education.¹⁰¹ Without the exclusion, students would incur a “success penalty” in the form of additional taxable income when they receive a scholarship intended to reward them for their achievements, whether their scholarship is on account of academics, athletics, or financial need. In its fiscal year 2008 budget, the U.S. government estimates that for fiscal years 2006-2012, the exclusions of scholarship and fellowship income will result in approximately \$14.42 billion in federal tax expenditures.¹⁰² This expenditure amount is properly allocated and should remain unchanged, since the tax benefit directly advances the policy goal of encouraging the pursuit of higher education.

b. *Discharge of student loan indebtedness*

The section 108(f) loan forgiveness exclusion is desirable from a public policy standpoint and should remain unchanged.¹⁰³ Given the increasingly large debt loads that many students carry following post-secondary school, graduates with a “charitable mindset” wishing to work in a public interest job may be swayed to enter the private sector purely out of necessity.¹⁰⁴ According to the American Bar Association, law school graduates are leaving law school with an average debt load (combining law school and undergraduate debts) in excess of \$80,000, while careers in the public interest sector average an annual salary \$36,000.¹⁰⁵ The loan forgiveness exclusion may provide that much needed incentive to pull these potential advocates back into the noble work of public interest, since the graduate’s overwhelming debt is no longer a barrier to entering the lower-paying field.¹⁰⁶

101. See *supra* Part II.A.4 for discussion of the qualified scholarship exclusion.

102. OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2008 288 (2007), available at <http://www.whitehouse.gov/omb/budget/fy2008/pdf/apers/receipts.pdf>.

103. See *supra* Part II.B.2 for discussion of the exclusion for a discharge of student loan indebtedness.

104. See Diane Curtis, *Encouraging Law Students to Pursue Public Interest Careers*, CAL. BAR J., Jan. 2007, at 1-7.

105. *Id.*

106. For a recent discussion on why the section 108(f) exclusion should apply to law school public interest loan forgiveness programs, see Letter from Ellen P. April, Associate Dean for Academic Programs, Loyola Law School (Los Angeles), to Donna Welch, Internal Revenue Service et al., (Feb. 16, 2007), available at

The U.S. government estimates that for fiscal years 2006-2012, the exclusion for discharge of student loan indebtedness will result in approximately \$140 million in federal tax expenditures – a relatively small sum in budgetary terms.¹⁰⁷ This expenditure amount may increase in the future because law schools, the American Bar Association, and the Association of American Law Schools are advocating for increased availability of loan forgiveness programs.¹⁰⁸ The University of California at Berkeley School of Law recently commenced a new “loan repayment assistance program” in which eligible candidates (graduates employed in public interest or government jobs earning less than \$58,000 annually and making substantial use of their law degrees) can have up to \$100,000 of their loans paid by Berkeley over a 10-year period.¹⁰⁹ Berkeley is one of 100 law schools offering a loan repayment assistance program to its graduates in 2006, as compared to only 47 schools in 2000.¹¹⁰

Because the loan forgiveness exclusion effectively encourages graduates to work in areas that provide a substantial social benefit, the relatively small tax expenditure attributable to this provision is being well spent. Moreover, because this program is unique it is not confusing to taxpayers or difficult to administer.

c. Coverdell education savings account

Encouraging taxpayers to save for higher education expenses is undoubtedly a form of socially desirable behavior worthy of some form of a tax benefit.¹¹¹ Coverdell education savings accounts allow taxpayers to

http://taxprof.typepad.com/taxprof_blog/files/aprill_108f_letter.pdf (last visited Apr. 8, 2007). The letter discusses a recent Tax Court Summary Opinion (*Moloney v. Comm’r*, 53 T.C. (2006) (Summary Opinion)) in which the Tax Court questioned whether law school loan forgiveness programs fall under the definition of “certain professions” in section 108(f)(1) based on the statute’s legislative history. The author argues that if the section 108(f) exclusion does not apply to law school loan forgiveness programs, the unfortunate result for the recipient is that the forgiven amount will constitute taxable gross income and may also subject the recipient to payroll taxes. *Id.* at 7-8.

107. OFFICE OF MGMT. & BUDGET, *supra* note 102 (note that the government estimated \$20 million per year across the six-year span without variation, suggesting that the \$20 million is a true estimate).

108. *See* Curtis, *supra* note 104.

109. Press Release, Janet Gilmore, U.C. Berkeley, Law school establishes new loan forgiveness program (Oct. 19, 2006), *available at* http://www.berkeley.edu/news/media/releases/2006/10/19_lrap.shtml.

110. American Bar Association, *Law School LRAP Information*, <http://www.abanet.org/legalservices/sclaid/lrap/lawschoollraps.html> (last visited on Aug. 19, 2007).

111. The President’s Advisory Panel on Tax Reform recommended replacement of all current savings accounts under the Code (including section 529 plans and Coverdell savings accounts)

save for education expenses with distributions that are ultimately tax-free and have the added feature of imposing an annual contribution limit on these accounts.¹¹² These contribution limits – along with a reasonable income limitation – assist in limiting the amount of federal tax expenditures allocated to these tax-favored savings vehicles, thereby allowing an allocation of a greater amount to more targeted incentives, such as the refundable education tax credit. Accordingly, the Coverdell account is a preferred savings vehicle for education expenses and should remain as is.

2. Current Tax Incentives that Fail to Reach Target Taxpayers

The education tax incentives discussed below are prime candidates for elimination, since they do not provide incentives that are targeted to taxpayers most in need of them. The tax expenditures attributable to these provisions would be better spent if allocated to other, more effective provisions, such as a single refundable credit.

a. Hope and Lifetime Learning Credits

The Code currently contains two nonrefundable tax credits for educational expenses: the Hope Scholarship and Lifetime Learning Credits.¹¹³ Both credits are meant to subsidize the cost of attending post-secondary school by offsetting a portion of an eligible student's expenses, thereby encouraging more taxpayers to pursue higher education.¹¹⁴ Recent studies show that middle and higher income taxpayers are benefiting disproportionately, at the expense of lower income taxpayers, from the

with a "Save for Family" account, which allows for after-tax contributions of up to \$10,000 with tax-free treatment on the appreciation. Withdrawals from the account are tax-free, provided that it is for qualified expenditures relating to education, health, or home purchasing expenditures. PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR & PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM, REPORT OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM 120 (Nov. 2005) [hereinafter PRESIDENT'S ADVISORY PANEL REPORT], available at www.taxreformpanel.gov/final-report/. In 2007, the Administration proposed allowance of the Saver's Credit for contributions to section 529 plans as a means of encouraging lower income taxpayers to save for the expenses of higher education. U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2008 REVENUE PROPOSALS 43 (2007).

112. See *supra* Part II.C.2 for discussion of the Coverdell education savings account.

113. See *supra* Part II.A.1-2 for discussion of the Hope and Lifetime Learning Credits.

114. Katie Fitzpatrick & Elaine M. Maag, *Subsidizing Higher Education Through the Federal Income Tax Code*, 100 TAX NOTES 95 (Jul. 7, 2003), available at http://www.urban.org/UploadedPDF/1000507_TaxFacts_070703.pdf.

Hope and Lifetime Learning Credits.¹¹⁵ According to a U.S. Department of Education study, middle-income taxpayers earning between \$32,000 and \$60,000 saved an average of \$900, and taxpayers earning between \$60,000 and \$92,000 saved an average of \$1,100, as a result of claiming the nonrefundable credits, whereas families earning less than \$32,000 are saving an average of \$600.¹¹⁶ This result comes as no surprise to some commentators, who have argued that enactment of the Hope Credit and similar tax benefits represents a shift from the original intent of federal education assistance programs – to increase access to higher education for those students from low-income families who might not otherwise attend college – to instead provide benefits almost exclusively for middle income families.¹¹⁷ Because the Hope and Lifetime Learning Credits are nonrefundable and regressive, taxpayers are benefited more as their incomes increase. This may create a windfall for those taxpayers who would seek higher education regardless of the availability of a credit.¹¹⁸

The U.S. government estimates that, for fiscal years 2006-2012, the Hope and Lifetime Learning Credits alone will result in approximately

115. See Gerald Prante, *Who Benefits from College Education Tax Credits?*, TAX FOUNDATION, Aug. 28, 2006, <http://www.taxfoundation.org/news/show/1779.html>; see also Katie Fitzpatrick & Elaine M. Maag, *Tax Credits and Grants for Undergraduates*, 103 TAX NOTES 1183 (May 18, 2004) (stating that the largest average credits during 1999-2000 went to families of students with income between \$50,000 and \$100,000).

116. *Study finds tuition tax breaks help poor least*, BOSTON GLOBE, Aug. 25, 2006, available at http://www.boston.com/business/personalfinance/articles/2006/08/25/study_finds_tuition_tax_breaks_help_poor_least/. Families earning \$92,000 or more per year are saving an average of \$700 in taxes from the credits. *Id.* See also STAFF OF J. ECON. COMM., 105TH CONG., COLLEGE AFFORDABILITY: TUITION TAX CREDITS VS. SAVING INCENTIVES at 9 (1997) (stating that the Hope Scholarship Credit “is designed to primarily benefit middle- and upper-income families since the credit is not available to financially disadvantaged families with no income tax liability.”).

117. Thomas R. Wolanin, *Rhetoric and Reality: Effects and Consequences of the Hope Scholarship 2* (April 2001) (Inst. for Higher Educ., Working Paper, 2001), available at <http://www.ihep.org/Pubs/PDF/Hope.pdf>. Wolanin states that the primary goal of federal assistance for students during the Nixon administration “was to increase access to higher education for students from low-income families who would not otherwise have the opportunity to attend.” *Id.* Wolanin ultimately argues that the Hope Credit was enacted purely for political reasons, stating that its enactment “is a clear case of good politics trumping good policy.” *Id.* at 26.

118. *Id.* (stating that the Hope Credit provides a windfall to taxpayers who would attend college anyway, and therefore “compromises the fairness of the tax system.”); see Beth Macy, *Working class-zero*, SALON.COM, Feb. 16, 2000, <http://archive.salon.com/books/it/2000/02/16/tax/index.html> (stating that President Clinton’s College Opportunity Tax Cut Plan (which included the Hope and Lifetime Learning Credits, qualified tuition programs and student loan interest deductions) only benefited those already in college, and that, “[t]he plan won’t increase by one student the number of kids attending college; it will just make it easier for the kids who are already going.”).

\$44.35 billion in federal tax expenditures.¹¹⁹ The estimated tax expenditures for these credits – which were intended to encourage taxpayers to attain higher education¹²⁰ – certainly represents a substantial amount of foregone federal revenue.¹²¹ Accordingly, to ensure that these tax expenditures are not misdirected or diluted in their effectiveness, they should be allocated in the most efficient manner possible. As discussed below, the Hope and Lifetime Learning Credits should be repealed and replaced with a single refundable education tax credit, since these nonrefundable credits are currently inefficient in reaching the target taxpayers.¹²² For the aforementioned reasons, these tax expenditures are better allocated to the single refundable education tax credit, which will help ensure that the refundable credit is implemented on a revenue-neutral basis.

b. Section 529 plans

Because of its inability to direct substantial tax benefits to lower income taxpayers, the section 529 plan is a tax expenditure in need of reform or, better yet, elimination.¹²³ Maintaining the premise that educational tax incentives should be designed with a primary focus on the target taxpayer – the potential student on the margin of pursuing higher education and in need of an incentive to do so – tax expenditures from section 529 plans are not effective in promoting the desired behavior, since the benefits from these tax-favored savings vehicles largely accrue to higher income taxpayers.¹²⁴ In fact, it is estimated that only three percent of all

119. OFFICE OF MGMT. & BUDGET, *supra* note 102.

120. H.R. REP. NO. 105-148, at 316 (1997), *as reprinted in* 1997 U.S.C.C.A.N. 678, 724 (stating that the purpose for enacting the Hope Credit was “[t]o assist low- and middle-income families and students in paying for the costs of post-secondary education.”).

121. It should be noted that although tax expenditures essentially represent foregone revenue to the federal government, it does not follow that an elimination of a tax expenditure results in a corresponding increase in federal revenue, since: (1) the elimination of a tax expenditure may have a resulting incentive effect that alters the economic behavior of taxpayers, and (2) tax expenditures may be interdependent, so the repeal of one may lead to either a decrease or increase in the prevalence of another. *Id.* at 286. *See* 2 U.S.C. §622(3) (2000) (defining “tax expenditures.”).

122. *See infra* Part IV.C.1.

123. *See supra* Part II.C.1 for discussion of section 529 plans.

124. U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 92, at 18-19 stating:

Although many families are eligible to participate in tax-exempt savings programs, the programs are more advantageous to those with higher incomes and tax liabilities. Families with higher than average incomes are more likely to use tax-exempt savings opportunities for a range of reasons, including, among others, that (1) these families hold greater assets to invest in these vehicles; (2) these families have a higher marginal tax rate, and thus benefit the most from the use of these

American households actually use an education savings account.¹²⁵ Furthermore, nearly one-third of all American households lack any financial assets available for investment purposes and one-fifth have a negligible amount of assets for investment.¹²⁶ Accordingly, the target taxpayer on the margin of deciding whether to incur substantial postsecondary costs likely does not have the financial ability to contribute to a savings vehicle.¹²⁷

The U.S. government estimates that, for fiscal years 2006-2012, section 529 state prepaid tuition plans alone¹²⁸ will result in approximately \$9.02 billion in federal tax expenditures.¹²⁹ This is a substantial amount to allocate to a tax-favored program that mainly benefits those taxpayers who are likely to attend college even in absence of the tax benefit. Permitting middle and higher income taxpayers to shift their savings into tax-free vehicles is a tax subsidy for investment that creates little or no educational incentive, since taxpayers that are financially able to contribute to these tax-favored vehicles (and their dependents) would likely incur the educational costs in the absence of a tax incentive. Essentially, these expenditures come at the cost of lower income taxpayers who fail to receive any benefit from this incentive.¹³⁰ Accordingly, the tax expenditures allocated to these programs would be better allocated to a more efficient system of tax incentives for higher education, such as a system of refundable tax credits

vehicles; and (3) higher-income families may gain a reduction in tax liability even if withdrawals are not used for post-secondary expenses.

See also Batchelder, et al., *supra* note 3, at 23, 24 (“[P]roviding a larger incentive to higher-income households is economically inefficient unless policymakers have specific knowledge that such households are more responsive to the incentive or that their engaging in the behavior generates larger social benefits.”); Paperwight’s Fair Shot, *Saving for Education: Counterintuitive, Byzantine, and Regressive*, May 3, 2004, http://fairshot.typepad.com/fairshot/2004/05/saving_for_educ.html (“If you’re so poor that you can’t really save at all, then you’ve got a whole set of problems revolving around paying for your child’s education, and no tax-advantaged savings account is going to help.”).

125. PRESIDENT’S ADVISORY PANEL REPORT, *supra* note 111, at 92 (“Not surprisingly, only three percent of all households actually use an education savings account. Amount households that do take advantage of the accounts, the benefits go mostly to higher-income families.”).

126. U.S. DEP’T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2008 REVENUE PROPOSALS 1 (2007) at 43.

127. *Id.* (“Many Americans are kept from entering the economic mainstream because they lack the financial resources to invest for long-term goals.”).

128. Note that the estimate is based on state prepaid tuition plans only under section 529 and does not account for education institution tuition programs. A state qualified tuition program can be either a prepaid tuition program or a savings account for qualified higher education expenses, whereas an education institution tuition program is limited to prepaid tuition and is administered by the institution itself. See *supra* Part.II.C.1 for a discussion of section 529 plans.

129. OFFICE OF MGMT. & BUDGET, *supra* note 102.

130. See Wolanin, *supra* note 117, at 25.

for higher education.¹³¹

c. Student loan interest deduction

Because of its failure to provide a direct and effective incentive for taxpayers on the margin of attending college to make the decision to do so, the student loan interest deduction is the next candidate for reform.¹³² The stated reason for initially enacting the deduction for student loan interest was to “help ease the financial burden that such obligations represent.”¹³³ However, keeping the target taxpayer in mind, the prospect of an interest deduction at some point in the distant future is not as likely to motivate the taxpayer to incur the costs of higher education as is a refundable tax credit, which puts money into her pocket during the present year when the funds are needed most.

The U.S. government estimates that, for fiscal years 2006-2012, the student loan interest deduction alone will result in approximately \$5.41 billion in federal tax expenditures.¹³⁴ This substantial tax expenditure – similar in magnitude to the Hope and Lifetime Learning Credits and the section 529 plans – would be better allocated to a refundable education tax credit if the goal is to bring those potential students on the margin into post-secondary institutions. Instead of allocating tax expenditures towards helping taxpayers manage their debt following post-secondary education, we should instead focus these expenditures towards ensuring that needy students enter the institutions in the first place by targeting the financial subsidy to them.¹³⁵

131. An interesting argument in favor of tax-favored savings vehicles (including section 529 plans) is that they may indirectly subsidize lower income taxpayers despite the clear direct benefit they confer on higher income taxpayers. By allowing taxpayers to utilize tax-favored savings vehicles, they are less likely to rely on government sources for education financing, which, in turn, reduces government costs, thereby freeing up additional federal education grants that can be diverted to lower income taxpayers. STAFF OF J. ECON. COMM., 105TH CONG., COLLEGE AFFORDABILITY: TUITION TAX CREDITS VS. SAVING INCENTIVES at 10-11, (although the article directly refers to education IRAs, the logic equally applies to section 529 savings vehicles). Because this argument relies on an indirect subsidy to lower income taxpayers through a direct subsidy to higher income taxpayers, it runs afoul of this paper’s underlying premise: educational tax incentives should *directly* target taxpayers most in need of the incentive. Accordingly, this argument merits no further discussion.

132. See *supra* Part II.B.1 for discussion of the student loan interest deduction.

133. S. REP. NO. 105-33, at 20 (1997).

134. OFFICE OF MGMT. & BUDGET, *supra* note 102.

135. In January of 2007, Congress passed a bill that will cut the interest rates on subsidized Stafford loans in half (from 6.8% to 3.4%) over a five-year period. *House OKs bill that cuts student loan rates*, USA TODAY, Jan. 17, 2007, available at http://www.usatoday.com/money/perfi/college/2007-01-17-house-student-loans_x.htm. The

IV. PROPOSAL FOR TAX EXPENDITURE REFORM: REFUNDABLE HIGHER EDUCATION TAX CREDITS

The need for serious reform of the tax Code generally is a common political and social theme.¹³⁶ This paper contends that reform of the education tax incentives currently contained in the Code should likewise be a high priority and that, in effecting such reform, the government must not lose sight of those taxpayers most responsive to these incentives. For many lower income taxpayers, a properly structured education tax incentive is not a mere tax benefit, but in many cases it may be the deciding factor when choosing whether to pursue higher education at all.¹³⁷ In structuring an education tax incentive system, the most efficient means of reaching and influencing these target taxpayers is through a refundable education tax credit. Although refundable tax credits in general have been criticized by some commentators,¹³⁸ this paper demonstrates that a properly structured refundable tax credit for higher education can withstand these objections. A refundable tax credit tied to specific education expenditures by the taxpayer is a highly efficient form of a tax incentive that contains adequate safeguards against taxpayer fraud and abuse.

controversial bill had the stated purpose of making college more affordable and accessible for low-income families, but critics of the bill assert that this does nothing to help achieve this goal. Instead, the reduction in rates is “about expanding federal subsidies for college grads, including millions of middle-class men and women who will go on to do very well in life and hardly need such a government handout.” Editorial, *Educating Democrats*, WALL ST. J., Jan. 17, 2007, at A18 (the author also states that, “[t]he interest rate doesn’t affect whether a student can pay his or her tuition bill.”).

136. See PRESIDENT’S ADVISORY PANEL REPORT, *supra* note 111, at 9 (“In short, the tax code presents an obvious target for change. . . . Reform is the only thing that works.”); NEAL BOORTZ & JOHN LINDER, *THE FAIR TAX BOOK 3* (Harper Collins 2005) (“Any progress we can make to rid ourselves of our current income tax code – a code that is dragging down our economy, discouraging achievement, and sometimes destroying families – will be an improvement.”); Grassley, Opening Statement, *supra* note 15 (stating that, “[w]e need to make simplification in [the] area [of confusion and uncertainty arising from education tax incentives] a priority”); Gerald Prante, *Tax Confusion Has Become a Nightmare for Students*, TAX FOUNDATION, Aug. 30, 2005, <http://www.taxfoundation.org/blog/show/1036.html> (“Instead of an IRS public awareness campaign on how to best maneuver through the current complex tax code that frustrates millions every year, why not overhaul the tax code and make it fair and simple for everyone?”); Francine J. Lipman, *Taxing Undocumented Immigrants: Separate, Unequal, and Without Representation*, 59 TAX LAW. 813, 866 (2006) (“As Congress and President George W. Bush work to fulfill their promise to reform and simplify our federal income tax system, we must encourage them to support a tax system that is fair for all families”).

137. In a recent hearing before the Senate Finance Committee regarding the education tax incentives, one commentator stated that, in regard to the need for reformation of the current education incentives in the Code, “[w]e need to cut the price of college for those who would not go to college in the absence of the incentive.” Dynarski, Senate Finance Hearings, *supra* note 89, at 2.

138. See *infra* Part IV.B.

A. *Refundable Tax Credits: Efficient Tax Expenditures for Higher Education Incentives*

As a general proposition, many commentators and policy makers agree that if the Code is to be used as a means of facilitating socially desirable behavior through tax expenditures, the ideal form of expenditure is a refundable credit rather than a deduction or nonrefundable credit.¹³⁹ As three commentators noted in their recent article, “if policymakers want to create incentives through the individual income tax for all or most [individuals] . . . to engage in certain behavior each year, such as saving or obtaining education for themselves or their children, refundability should not only be considered an acceptable instrument of tax policy – it is imperative.”¹⁴⁰ A refundable credit consists of four elements for purposes of this discussion: it is a tax credit that is (1) found in the Code, (2) administered through the tax system, (3) meant to encourage a certain type of behavior, and (4) designed to provide a cash benefit when the taxpayer has no income tax liability to offset.¹⁴¹

1. Nonrefundable Credits Provide a Lesser Benefit to Lower Income Taxpayers Than to Higher Income Taxpayers

Although the Code currently contains three major refundable tax credits, none of these relates to education expenditures.¹⁴² Because the current education tax incentives found in the Code consist of nonrefundable credits, deductions, and exclusions, taxpayers cease benefiting from these

139. See, e.g., JASON FURMAN, CTR. ON BUDGET & POLICY PRIORITIES IF YOU'RE GOING TO DO SOCIAL POLICY THROUGH THE TAX CODE, DO IT RIGHT, (2007), <http://www.cbpp.org/1-24-07tax.pdf>; Education Competitiveness Act of 2006, S. 3902, 109th Cong. § 801 (2006) (the Education Competitiveness Act, introduced by Senator Baucus, provided for a \$2000 “refundable higher education credit,” which sought to repeal and replace both the Hope and Lifetime Learning Credits); Personal Access to Continued Education Act of 2003, H.R. 3251, 108th Cong. (2003) (the Act sought to increase the Hope Credit to \$2500 and to make it refundable); LEONARD E. BURMAN & JEFFREY ROHALY, TAX POLICY CENTER, SENATOR KERRY'S TAX PROPOSALS, (2004), http://www.taxpolicycenter.org/UploadedPDF/1000634_KerryPlan.pdf (stating that as part of Senator Kerry's presidential campaign he proposed a refundable “College Opportunity Tax Credit,” which would replace the Hope Scholarship Credit).

140. Batchelder et al., *supra* note 3, at 54.

141. Batchelder et al., *supra* note 3, at 33 (identifying these four elements as comprising the refundable tax credit).

142. The three major refundable tax credits are the Earned Income Tax Credit, I.R.C. § 32, the Child Tax Credit, I.R.C. § 24 and a Health Insurance Cost Credit, I.R.C. § 35. The Code also contains various refundable credits related to correction of incorrect withholdings, certain uses of gasoline and special fuels, and overpayments of tax. See I.R.C. §§ 31, 33, 34, 36.

incentives once they reach the point of zero positive income tax liability.¹⁴³ If we assume that the primary goal in structuring tax incentives for education is to enable those potential students who may not otherwise attend college in fact to attend (as this paper does assume), refundable credits are the most effective, because they target the benefit to lower-income taxpayers, who are most in need of, and most likely to derive the greatest marginal benefit from, the incentive. More than 35% of all American households have no current tax liability, and nearly half of all American children come from these households.¹⁴⁴ Thus, taxpayers who make up a large portion of potential college-bound individuals cannot derive any possible benefit from the Code's current education tax incentives. A uniform refundable credit is a more efficient tax expenditure than a nonrefundable credit, since a refundable credit can uniformly lower the cost of education independent of whether the taxpayer has positive income tax liability.¹⁴⁵

2. Refundable Tax Credits Provide Economic Efficiency at a Socially Optimal Level For Attainment of Higher Education

a. *Uniform refundable credits properly subsidize positive externalities*

Uniform refundable tax credits offer the most efficient and effective means of encouraging higher education through tax policy, since refundable credits more adequately subsidize the positive externalities generated from a taxpayer's attainment of higher education than do nonrefundable credits. A positive externality occurs when one person is made better off by some act of another person, but the second person does not account for this external benefit when deciding whether to engage in the act.¹⁴⁶ For example, the attainment of higher education by one person can be thought

143. Because deductions, exclusions and nonrefundable credits permit a taxpayer to reduce her positive income tax liability to zero with no further reduction, any excess deductions, exclusions, nonrefundable credits are essentially lost. Furthermore, if the incentive is structured as a below-the-line itemized deduction, taxpayers claiming the standard deduction will likewise forego any benefit from the deduction. Considering that approximately 65% of all taxpayers filing returns claim the standard deduction, tax incentives formed as itemized deductions are lost on many taxpayers. Batchelder et al., *supra* note 3, at 53-54.

144. Batchelder et al., *supra* note 3 at 28-29.

145. See Batchelder et al., *supra* note 3 at 49.

146. See STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO TAX EXEMPTIONS AND INCENTIVES FOR HIGHER EDUCATION 29 (Comm. Print 2006).

to confer a positive externality on the rest of society, since an educated population is generally considered desirable and beneficial to the nation as a whole.¹⁴⁷ Although Adam Smith would defer to the market's invisible hand to correct the uncompensated externality, direct subsidies through government tax expenditures can better compensate for these positive externalities, since no market exists for the broad positive effects these externalities generate.¹⁴⁸

By directly subsidizing the desired behavior (attainment of higher education) through a government subsidy (the uniform refundable tax credit), the taxpayer seeking higher education will – in addition to accounting for her personal benefits – fully internalize the benefits she will ultimately cast upon society when deciding whether to incur the costs of education. Accordingly, lower income taxpayers with zero income tax liability who are on the margin of deciding whether to incur higher education costs will be more inclined to do so than if the credit were nonrefundable, since the taxpayer is able to internalize the benefits of obtaining higher education through the availability of a refund. Therefore, from an economic perspective the most efficient form of a tax expenditure intended to promote the attainment of higher education is through a uniform refundable credit, since nonrefundable credits do not adequately subsidize the positive externalities generated into society at large when individuals obtain higher education.

b. Refundable credits provide for an even lifetime distribution of the incentive

From an economic perspective, refundable credits are the most efficient means of providing an incentive over the span of a student's education, since adherence to the annual accounting system can lead to distortions in a taxpayer's ability to fully realize nonrefundable tax

147. See Mulleneaux, *supra* note 6, at 28-29 (stating that the promotion of higher education is in the national interest, since "higher education (1) increases the nation's productivity and wealth, (2) assists in social progress and (3) increases the prosperity of individuals."). An educated society also provides valuable non-market benefits that are not always quantifiable in economic terms, such as enhanced democratic participation, aversion to criminal activity, decreased reliance on public welfare, and enhanced family values. STAFF OF J. ECON. COMM., 106TH CONG., INVESTMENT IN EDUCATION: PRIVATE AND PUBLIC RETURNS 10-11 (2000).

148. See Batchelder et al., *supra* note 3, at 44. In economic terms, this type of subsidy is known as a "Pigouvian subsidy," which compensates for the positive externality "by subsidizing the desired behavior so that the market price reflects the social value of the good, which is defined as its private value to consumers plus the value of the positive externalities it generates."

incentives.¹⁴⁹ Because a family's income typically varies from year to year, the combination of nonrefundable tax incentives and the annual accounting system may lead to "fluctuation penalties" that result in an additional "lifetime tax" on these taxpayers.¹⁵⁰ In the context of nonrefundable credits for education, it is possible for a taxpayer to realize the full benefit of the credit in one year but only a portion of the credit in a subsequent year due to variable income over the two years, despite the fact that the average income earned over the two years would permit the taxpayer to receive the full credit if earned each year.¹⁵¹

A tax incentive structured as a refundable credit softens the harshness of the annual accounting system, since a student or her family is able to realize the full benefits of each credit claimed when viewed across the spectrum of the student's education.¹⁵² This ability to neutralize income over the span of the student's postsecondary years is especially advantageous to lower-income taxpayers – who are typically more susceptible to having volatile income – since it adds stability to their financial planning. The decision to pursue higher education has a strong element of financial planning, since the family can expect to incur a minimum of two to four years of education expenses. If the family feels confident that their average income over the upcoming years will provide them with adequate funds to absorb the costs and that they will not be penalized for having volatile income, they are more likely to make the initial decision to commit to the costs of pursuing higher education. Use of

149. See *infra* Part III.A.

150. See Batchelder et al., *supra* note 3, at 55. "Fluctuation penalties" occur as a result of a taxpayer's income being variable from year to year, since an increase in the taxpayer's marginal tax rate during one year (higher income year) may not be fully offset by a reduction in her marginal rate during another year (lower income year).

151. Consider the following example based on a fictional nonrefundable tax credit for education expenses. Suppose there is a \$2000 nonrefundable tax credit for higher education expenses that phases out at \$80,000. Additionally, a taxpayer must have \$20,000 of income to be subject to tax liability. Taxpayer earns \$25,000 in each of years one and two and is able to claim and realize the full amount of the nonrefundable credit in each year, since she is not phased-out and still has positive income tax liability. However, if she earns \$15,000 in year one because she lost her job halfway through the year, she is unable to claim the credit. If in year two she earns \$35,000 because she started a new job, she can claim the full amount of the credit. Although her average income over the two years is \$25,000 (an amount allowing her to realize the full \$2000 credit amount), she is unable to claim the credit in year one as a result of the annual accounting system. Had the credit been refundable, taxpayer would have been able to utilize the entire amount of the credit for each year.

152. See Batchelder et al., *supra* note 3, at 56-57. The article states that the above analysis applies equally to deductions and exclusions, since a taxpayer with zero positive income tax liability for a given year loses the benefit of any deduction or exclusion for that year but may realize the full benefit in a subsequent year with higher income, whereas a refundable credit permits her to realize the full benefit of each credit across the years.

a refundable credit in lieu of nonrefundable credits, deductions, or exclusions ensures that the family receives the full benefit of each credit over the years.

3. Advance Receipt of the Refundable Education Tax Credit

Although a refundable education tax credit is the most efficient means of incentivizing target taxpayers to attain higher education, the *timing* of when the taxpayer actually realizes this subsidy presents an issue. A commonly cited problem with providing education incentives through the tax system is that the taxpayer does not receive the much-needed subsidy until *after* she has already incurred the expenses during the year (that is, not until after she has filed her return for the year).¹⁵³ In the case of higher education, taxpayers eligible for a refund will not receive it until after they are required to pay their tuition and expenses,¹⁵⁴ and furthermore may not have adequate outside funds to pay the fees at the time tuition is actually due. This may be the deciding factor for taxpayers on the margin of deciding whether to attend – the lack of immediate liquidity necessary to pay tuition and expenses may persuade some taxpayers to forgo the pursuit of higher education.

Providing taxpayers with an advance payment of the amount of their refundable credit may be enough to solve this issue of timing and the taxpayer's need for liquidity. The Earned Income Tax Credit (EITC), a refundable tax credit currently in the Code, is subject to a system of advance receipt for qualifying taxpayers.¹⁵⁵ The Service permits a taxpayer who expects to be eligible for the EITC at the end of the year to receive a portion of the overall credit in her paycheck throughout the year.¹⁵⁶ After filling out the necessary form, the taxpayer gives the form to her employer, who then adds the amount of the advance receipt to the taxpayer's net income on each paycheck.¹⁵⁷ The employer then subtracts the amount of the advance EITC payment from its payroll taxes.¹⁵⁸ Advance receipt of the

153. See Dynarski, Senate Finance Hearings, *supra* note 89, at 5 (“Families need the credit when tuition is due, not a year or more later when taxes are filed.”).

154. See *supra* Part II.A.

155. I.R.C. § 32.

156. U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERVICE, EARNED INCOME CREDIT (EIC) 30, <http://www.irs.gov/pub/irs-pdf/p596>. (Publication No. 956); see also Advance Earned Income Tax Credit Questions and Answers, Dep't of Treasury, Internal Revenue Service, <http://www.irs.gov/individuals/article/0,,id =96515,00.html#QA4> (last visited Aug. 22, 2007) [hereinafter Advanced Earned Income Tax Credit Questions and Answers].

157. Advance Earned Income Tax Credit Questions and Answers, *supra* note 156.

158. Would you like to help your employees increase their take-home pay at no cost to you?,

EITC is contingent on the taxpayer's remaining eligible throughout the year,¹⁵⁹ and in the event she becomes ineligible after having received advance payments she is required to return all amounts received with her return at the end of the year.¹⁶⁰

A refundable higher education tax credit can be structured in a manner similar to the EITC advance receipt program, preferably with the credit amount being distributed to the taxpayer (or credited to the student's account) by the education institution.¹⁶¹ Akin to the EITC program, taxpayers seeking advance receipt of their refundable tax credit would be required to submit an application form through the university, which in turn would have to coordinate with the Service. Additionally, taxpayers claiming an advance credit would have to remain eligible throughout the year, satisfying the requirements for enrollment status, eligible expenses and income limitations. An alternative approach to this "wait and see" method for determining eligibility is to base eligibility for the credit on the previous tax year's income.¹⁶² This method would provide the target taxpayer with certainty of the amount she is ultimately entitled to receive and apply towards her education expenses, a factor that is likely to influence positively her decision to attend.¹⁶³

A lump sum payment for the entire credit refund at the beginning of the academic year is likely a more desirable approach for the taxpayer – as opposed to incremental payments throughout the year – since tuition and

Dep't of Treasury, Internal Revenue Service,
<http://www.irs.gov/individuals/article/0,,id=129062,00.html> (last visited Aug. 26, 2007).

159. See I.R.C. § 32.

160. Advance Earned Income Tax Credit Questions and Answers, *supra* note 156.

161. Advance receipt through paychecks is not a feasible option in the education context for advance receipt of credits, since many full-time students are not regularly employed throughout their academic years to ensure consistent receipt of the payments. One commentator suggested that, in regards to planning for receipt of the benefit of the Hope Credit, taxpayers who need the money immediately to pay for tuition and expenses could adjust their wage withholdings in anticipation of the tuition and expenses they had to pay and the amount of the credit they expected to receive. Theoretically, this would permit the taxpayer to segregate this amount from her paychecks in order to have actual cash to pay for tuition and fees. The author admitted that, "[t]his sophisticated level of financial and tax planning is probably beyond a realistic expectation for the behavior of most families." Wolanin, *supra* note 117, at 13 n.35.

162. See Frank Sammartino et al., *supra* note 3 (stating that in the area of refundable health credits, President Bush's fiscal year 2003 budget proposed to determine the taxpayer's refundable credit amount based on the previous year's income); Dynarski, Senate Finance Hearings, *supra* note 89, at 5.

163. A commentator noted that one reason many taxpayers fail to request an advance EITC is because the amount that they are ultimately entitled to receive is uncertain until the end of the tax year and they fear that a change in circumstances throughout the year may leave them with a larger tax bill than expected. Frank Sammartino et al., *supra* note 3, at 15

most expenses are likely to become due at this time.¹⁶⁴ An advance lump sum payment of the refundable amount should not be difficult to administer, since other government financial aid is currently issued upfront at the time the student needs the money for tuition and expenses.¹⁶⁵ The advance payment of a refundable education tax credit can be similarly administered through the university (in coordination with the Service), thus providing the target taxpayer with an incentive – and the financial ability – to enroll in an institution of higher education.¹⁶⁶

B. Arguments Against the Use of Refundable Credits

1. Equivalent to a Welfare System

Critics of refundable credits often claim that these credits are undesirable because they are essentially equivalent to a welfare system administered through the Code.¹⁶⁷ In a recent hearing before the House Ways and Means Subcommittee on Oversight regarding an increase in taxpayer awareness of the EITC, one commentator stated that the refundable credit “is one of the abuses within the outdated Tax Code that removes any incentive for lower income citizens to better themselves by giving them someone else’s hard-earned money.”¹⁶⁸ Stemming from this

164. See Frank Sammartino et al., *supra* note 3, at 15 (offering as a reason for some taxpayers’ failure to claim the advance EITC that, “[s]ome families [would] prefer to receive the [advance EITC] payment as a lump sum rather than staggered over the course of the year, using it as a way to save . . .”).

165. See Dynarski, Senate Finance Hearings, *supra* note 89, at 5 (stating that the Department of Education currently makes all forms of financial aid (grants and loans) available to the students at the time of enrollment).

166. In regards to early receipt of grant money, one commentator noted that, “[f]or a lower-income student, receiving grant dollars before expenses must be paid may mean the difference between attending college or not.” Mulleneaux, *supra* note 6, at 41. For the reasons discussed above, the same principle holds true for advance receipt of the entire refundable credit amount prior to the taxpayer’s enrollment.

167. See, e.g., Press Release, Republican Study Comm., House Conservatives: “Tax Code Should Not Be The Place for Welfare,” Urge Changes in EITC & Refundable Child Tax Credit (June 11, 2003), available at <http://www.house.gov/hensarling/rsc/doc/PR61103.pdf> (quoting Rep. Sue Myrick as stating that, “[t]he debate over the ‘refundable child tax credit’ isn’t a debate about a tax issue; it’s a welfare issue.”).

168. *Hearing on Earned Income Tax Credit Outreach: Hearing Before the H. Comm. on Ways & Means and S. Comm. on Oversight*, 110th Cong. (2007) [hereinafter Williamson, Statement on the EITC] (statement of Donald Williamson, Americans for Fair Taxation), available at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=5627>. The commentator went on to label the refundable credit as a “handout,” which he regards as a “form of socialism.” *Id.*

position is the argument that all Americans, regardless of financial status, should be obligated to pay *some* form of income tax as a civic duty so as to feel some meaningful participation in the governmental process.¹⁶⁹

The argument that a refundable credit represents a welfare system seems somewhat arbitrary, since the Code contains many provisions other than refundable credits enabling taxpayers to decrease their overall tax liability – sometimes to zero – when they act in what is determined to be a socially desirable manner.¹⁷⁰ Indeed, many taxpayers receive tax refunds that are attributable to their response to various tax incentives; it is not clear why the line between “welfare” and “responsible civic behavior” should be zero taxable income.¹⁷¹ Society (through the government) has determined that certain acts are so desirable and beneficial to the general population – such as higher education – that they are worthy of a government subsidy. Labeling a refundable credit a form of welfare is to make a “false distinction between taxes paid and the benefits flowing from government,” since a refundable credit is essentially a vehicle for indirectly delivering a government subsidy.¹⁷² Moreover, the argument that all taxpayers, regardless of financial status, should pay some amount of tax is essentially circular, since it “arbitrarily supports taxing one dollar and then immediately transferring it back through a spending program, while opposing the elimination of the tax in the first place.”¹⁷³

In any event, a refundable higher education tax credit is less subject to a “welfare” charge than is the EITC, owing to differences in how the two credits are claimed and administered. The EITC gives the taxpayer unfettered use of a cash refund, which can be used by the taxpayer for virtually any purpose.¹⁷⁴ A refundable credit tied to education expenses merely reimburses the taxpayer’s cost of education – the credit cannot be used for general welfare purposes. Because it is likely that any credit amount will be absorbed entirely by the costs of tuition and related expenses, a taxpayer claiming the refundable education credit will not have the opportunity to receive any net accretion to wealth.¹⁷⁵ Additionally,

169. See Batchelder et al., *supra* note 3, at 66-67.

170. See *supra* note 4 and accompanying text for examples of deductions, credits, exemptions and exclusions meant to encourage socially desirable behavior.

171. See Batchelder et al., *supra* note 3, at 66.

172. Batchelder et al., *supra* note 3, at 67.

173. Batchelder et al., *supra* note 3, at 67. The authors state that if society has determined to subsidize a certain behavior through a refundable tax credit, “requiring every American to pay some income tax needlessly entails ‘taking with one hand in order to give back with the other.’” (quoting CHARLES FRANCIS BASTABLE, PUBLIC FINANCE 319 (MacMillan 1903) (1892)).

174. See Lipman, *supra* note 136, at 847.

175. See *infra* Part IV.B.2 for discussion of methods to prevent fraudulent use of the education

whereas low-income taxpayers potentially can receive the EITC in perpetuity so long as they qualify, a taxpayer claiming the refundable education tax credit will only be able to do so during the period in which higher education expenses are actually incurred (that is, for an average of four years). Accordingly, a refundable education tax credit certainly does not resemble a welfare system.

2. Subject to Taxpayer Fraud and Abuse

A common concern with the use of refundable credits is the presumption that they are particularly subject to fraud and abuse. Some critics argue that a subsidy delivered through the tax system as a refundable credit is especially prone to fraud because the credit is obtained through a self-assessment system, and that the Service lacks the ability to audit each and every overstatement.¹⁷⁶ In particular, the EITC has been the subject of criticism due to the large frequency of overpayments to taxpayers.¹⁷⁷ Based on this historical presumption, skeptics of refundable credits in general may be hostile to a refundable education tax credit.

The argument that refundable credits are particularly susceptible to abuse, like the “welfare” charge, seems arbitrary because there is no reason to assume that fraudulent behavior begins to exist at the exact point at which tax liability is no longer positive.¹⁷⁸ “If anything, fraud may be easier to hide when it comes in the form of a reduction of taxable income as opposed to an increase in refundable credits.”¹⁷⁹ Furthermore, much of the

tax credit amount.

176. See Press Release, Republican Study Comm., *supra* note 167 (“By filing a form with the IRS, which is not designed or equipped to make advance decisions on eligibility, individuals are guaranteed that they will be sent a government check [for the EITC or Child Tax Credit]. Only if they are audited is an effort then made to recover wrongful payments, using bulky IRS procedures.”);

177. See Jeffrey M. Jones, *Welfare: The Mother of All Tax Credits*, 2 HOOVER DIGEST, available at <http://www.hoover.org/publications/digest/3042856.html> (stating that EITC errors resulted in \$8.5 to \$9.9 billion in overpayments for the 1999 tax year and was subject to a 30% error rate); ROBERT GREENSTEIN, CTR. ON BUDGET & POLICY PRIORITIES, THE NEW PROCEDURES FOR THE EARNED INCOME TAX CREDIT 5 (2003), <http://www.cbpp.org/5-20-03eitc2.pdf> (stating that, as a result of new Service procedures initiated in 2003, “the rates at which EITC filers will be subject either to audit or to other documentation requirements and verification procedures will be sharply higher than the rates at which other filers are subject to scrutiny.”).

178. Batchelder et al., *supra* note 3, at 30 (“With respect to fraud, there is no reason in theory, and no empirical reason in practice, why there should be a “cliff effect” precisely at the point of positive income tax liability.”).

179. Batchelder et al., *supra* note 3, at 70. The authors state that “over 80% of individual misreporting is attributable to understated income, not overstated deductions.” See Batchelder et

complication associated with the EITC is said to flow from taxpayer confusion,¹⁸⁰ and as this paper has attempted to demonstrate, simplification of the education tax incentives in Code will alleviate much taxpayer confusion.¹⁸¹

Administrative solutions exist to minimize the risk of fraud and abuse in connection with a refundable education tax credit. First and foremost, any taxpayer claiming a refundable education credit would be required to provide a valid social security number for every student on whose behalf qualifying education expenses have been made. The identification requirement is a common and basic means of preventing fraud – since 1996, it has been required for all EITC claims¹⁸² – and it is currently a requirement for Code sections that provide an education tax benefit, such as the Hope and Lifetime Learning Credits.¹⁸³

Another means of preventing taxpayer fraud and abuse in administering a refundable education tax credit is to maintain a “receipt” system similar to that used for charitable contributions, as to which the Code was recently amended to provide increased accountability. Under the amended law, in the case of charitable contributions of money, regardless of the amount, in order to receive a charitable deduction the donor is required to maintain a bank record, cancelled check, or receipt from the donee detailing the amount of the donation, the donee’s name and the date of the

al., *supra* note 3, at 70 n.186 (citing *The Causes of and Solutions to the Federal Tax Gap: Hearing Before the S. Comm. on the Budget*, 109th Cong. 3 (2006) (statement of Nina Olson, National Taxpayer Advocate)).

180. In response to the accusations against the EITC the credit’s supporters point out that many instances of noncompliance are inadvertent and are merely the result of a benefit that is overly complicated. See Batchelder et al., *supra* note 3, at 70 (stating that “EITC noncompliance is largely driven by the complexity of the credit . . .”); Frank Sammartino et al., *supra* note 3 at 23 (“The difference in the definition of a qualifying child for different tax benefits contributes to taxpayer confusion [for EITC claims.]”); ROBERT GREENSTEIN, CTR. ON BUDGET & POLICY PRIORITIES, THE EARNED INCOME TAX CREDIT: BOOSTING EMPLOYMENT, AIDING THE WORKING POOR (2005), available at <http://www.cbpp.org/7-19-05eic.htm> (describing the EITC as too complex, which leads to tax-filing errors).

181. See *supra* Part III.A.

182. In response to its problems with noncompliance, the EITC was amended in 1996 to include a social security number requirement for any eligible individual, her spouse, and for a qualifying child. Lipman, *supra* note 136, at 850. See I.R.C. § 32(c)(1)(E), (3)(D) (taxpayer claiming the EITC must provide taxpayer identification numbers for herself, her spouse and any qualifying child).

183. See, e.g., I.R.C. § 25A(g)(1) (stating that neither the Hope Scholarship nor the Lifetime Learning Credit will be allowed for the qualified tuition and related expenses of an individual unless *that individual’s* taxpayer identification number is included on the return); I.R.C. § 222(d)(2) (stating that the qualified tuition deduction will not be allowed for the qualified tuition and related expenses of an individual unless *that individual’s* taxpayer identification number is included on the return).

contribution.¹⁸⁴ Additionally, for any contribution of \$250 or more (cash or property), the donor must have a contemporaneous written acknowledgment from the charity detailing the name of the charity, the amount of cash or a description of any property given, and either a statement that no goods or services were provided by the charity in return for the contribution, or, if they were, an estimate of the value of such goods or services.¹⁸⁵

Similarly, in order to receive a refundable credit for qualified education expenses, the taxpayer would be required to provide documentation supporting eligibility. The taxpayer would be required to provide proof of enrollment in a qualified educational institution and also to provide reliable proof of the amount of tuition and fees paid to that institution. Additionally, in the event that qualified higher education expenses under a refundable credit were to include supplies and equipment, the taxpayer would be required to provide receipts detailing these purchases.¹⁸⁶ With a valid social security number matching the taxpayer's tax return, coupled with proof of enrollment and tuition paid, the risk of fraudulent claims of the refundable education credit should be kept to a minimum.

Maintaining the premise that any reform of the Code's educational tax incentives should reduce taxpayer confusion through simplification of its provisions and requirements, an effective means of ensuring that the refundable education tax credit is free from taxpayer fraud and abuse is to funnel the credit through the educational institution itself. Not only would this system reduce the compliance burden imposed on the taxpayer, it would also provide an additional level of security against fraud and abuse, since the taxpayer would be unable to manipulate the tax return in an effort to receive an undeserved refund.

Similar to the advance EITC system – which allows the taxpayer to receive her refundable credit through her employer throughout the year – a refundable education credit could be administered to the taxpayer through the educational institution at the beginning of the academic year.¹⁸⁷ The added level of security from administering the refundable education tax credit through the university in a manner similar to the advance EITC would help ensure that the refundable credit is applied directly to qualified

184. I.R.C. § 170(f)(17), *amended by* Pension Protection Act of 2006, Pub. L. No. 109-280, § 1217(a), 120 Stat. 780.

185. DEP'T OF TREASURY, INTERNAL REVENUE SERVICE PUBLICATION NO. 1771, CHARITABLE CONTRIBUTIONS—SUBSTANTIATION AND DISCLOSURE REQUIREMENTS 3 (2005), *available at* <http://www.irs.gov/pub/irs-pdf/p1771.pdf>.

186. However, as noted directly below, qualified education expenses would likely be defined to exclude supplies and equipment out of concerns for potential fraud and abuse.

187. *See supra* Part IV.A.3 for a further discussion regarding advance receipt of the EITC in the context of a refundable education tax credit.

educational expenses such as tuition, fees, books, and room and board provided by the university.

As noted above, it is unlikely that a refundable education tax credit would extend to equipment and supplies, since the cost of tuition alone would typically be enough to fully absorb the credit amount.¹⁸⁸ By limiting the qualified education expenses to those that can be efficiently administered through the educational institution – such as tuition and related fees, room and board and on-campus books – the potential for fraud and abuse would be greatly reduced, since the taxpayer in that event would not receive an actual cash refund, but would have the credit applied by the university to reduce otherwise-payable fees and expenses. Although universities may resist additional administrative work, in all likelihood the additional burden imposed on the universities will be minimal considering that federal financial aid is already administered through the university system.¹⁸⁹

In the event the above-mentioned solutions to taxpayer fraud and abuse of the refundable education tax credit should prove less than 100% effective, the credit can provide a preemptive enforcement threat through a provision similar to that used in the EITC, which prohibits a taxpayer from claiming the EITC for ten taxable years following a determination that the taxpayer's claim was fraudulent.¹⁹⁰ A fraudulent claim under an educational credit would be triggered for situations such as knowingly using the refund for something other than qualified educational expenses, claiming the credit for a nonqualified dependent, or knowingly claiming the credit when the taxpayer does not qualify within the income limitations. Similar to the EITC, a taxpayer in violation of these rules would be prohibited from claiming the credit for a certain period of time following the violation.¹⁹¹

188. See *supra* note 186 and accompanying text.

189. The federal government and education institutions have the primary responsibility for assisting taxpayers with their federal aid under Title IV programs. In order to receive Title IV aid, a taxpayer must simply fill out and submit a FAFSA form. At this point, the taxpayer's efforts are complete and the Department of Education and the post-secondary institutions must complete the process, including calculating, determining and delivering eligible aid amounts. See GAO Testimony on Post-secondary Education Report, *supra* note 5, at 9-10.

190. I.R.C. § 32(k)(1)(A), (B)(i). If the taxpayer's improper credit claim was due to "reckless or intentional disregard of rules and regulations (but not due to fraud)" the disallowance period for claiming the credit is two taxable years. I.R.C. § 32(k)(1)(A), (B)(ii).

191. Similar to the EITC rules under section 32, a taxpayer would be penalized under the educational credit rule for acts amounting to reckless or intentional disregard. See I.R.C. § 32(k)(1)(A), (B)(ii).

3. Increased Administrative and Compliance Cost

A third major objection to the use of refundable credits is that their availability will generate an increase in administrative and compliance costs stemming from a surge in the number of taxpayers suddenly deciding to file returns.¹⁹² The Service will then have the burden of processing additional returns, whereas the taxpayers themselves will have the burden of requesting another tax benefit, or in some cases the burden of beginning to file returns at all. Undoubtedly, the creation of a refundable education tax credit would result in some actual administrative and compliance costs for both the Service and taxpayers.¹⁹³ However, these additional costs are likely to be insubstantial in relation to the benefits, since “non-filers represent a relatively small share of the households that stand to gain from structuring tax incentives as uniform refundable credits.”¹⁹⁴ Although this paper presumes that any and all suggested reforms of educational tax expenditures are to be revenue-neutral, an insubstantial increase in costs is an acceptable consequence, especially in light of the overall increase in societal benefits resulting from increased education.

It is important to note that, as previously discussed, reform of the current education tax incentives in the Code should be performed with the goal of overall simplification in order to reduce taxpayer confusion and error.¹⁹⁵ This simplification is likely to reduce administrative and compliance costs to some degree, thus offsetting some of the potential increase in costs as a result of increased filings for a refundable credit, which allows reform of the current education tax incentives to remain revenue-neutral.¹⁹⁶

192. See Batchelder et al., *supra* note 3, at 69.

193. On average, it currently costs the Service approximately \$2 in direct processing costs for a paper return, and approximately \$243 for an individual taxpayer to have her return professionally prepared. See Batchelder et al., *supra* note 3, at 71.

194. See Batchelder et al., *supra* note 3, at 71 (stating that approximately “13% of tax units are non-filers in any given year, while close to 40% have no federal income tax liability and are thus excluded altogether from non-refundable tax incentives.”). See also Jones, *supra* note 177 (stating that, “the EITC is probably the most cost-effective anti-poverty program the federal government operates. . . . the EITC is inexpensive to administer [o]ne of the benefits of a system based largely on self-assessment (such as the EITC) is lower administrative costs.”).

195. See *supra* Part III.A.

196. As the Code becomes increasingly complex, compliance costs for taxpayers also increase, since taxpayers must spend additional time maintaining their records and staying current with the law, and must hire accountants and attorneys to assist them with the preparation of their returns and sending them to the Service. See Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 688-89 (2003). Additionally, as the Code becomes increasingly complex, administrative costs likely increase for the Service, since it must educate its employees, stay current with forms, publications and software, and issue guidance to assist taxpayers in their understanding of the law. *Id.* at 696-97.

However, in the unlikely event that overhaul of the current system into a refundable credit were to substantially increase the net *administrative* and compliance costs associated with educational tax incentives, this is a cost that the government should be willing to absorb, since the large efficiency gains from the subsidized behavior likely outweigh these costs. Based on the efficiency arguments set forth above, society as a whole stands to benefit from increased participation in higher education.¹⁹⁷ Moreover, encouraging taxpayers to file returns represents sound government policy, both from a tax collection aspect as well as from a democratic participation aspect, since our entire tax system is based upon self-assessment and voluntary compliance.¹⁹⁸ A government tax incentive that delivers tax benefits to subsidize socially beneficial behavior while simultaneously encouraging taxpayers to engage in voluntary compliance is representative of sound federal income tax policy.¹⁹⁹

C. Possible Alternatives to Refundable Credits

1. Allocate Inefficient Expenditures to a Refundable Tax Credit

As discussed above, some of the current education tax expenditures in the Code fail to reach target taxpayers and should instead be allocated to a more efficient system of tax incentives.²⁰⁰ Allocating current expenditures that are inefficient in reaching target taxpayers not only provides greater efficiency in use of the expenditures, but also provides for greater overall simplification of the education tax incentive system. Furthermore, in

197. See *supra* Part IV.A for a discussion of the efficiency benefits from a refundable education tax credit.

198. *Flora v. U.S.*, 362 U.S. 145, 176 (1960) (stating that the income tax system is “based upon voluntary assessment”); Shirley D. Peterson, *IRS Vision: Changing With America*, 13 VA. TAX. REV. 187, 189 (1993) (generally stating that voluntary compliance is considered “to be the very heart of our tax system”); Donaldson, *supra* note 196, at 693 (“Voluntary assessment is an important feature of the federal income tax.”).

199. In one of the seminal articles on designing effective federal income tax policy, the author lists seven criteria for measuring an effective income tax structure: “(1) to supply *adequate* revenue, (2) to achieve a *practical* and workable income tax system, (3) to impose *equal* taxes upon those who enjoy equal incomes, (4) to assist in achieving economic *stability*, (5) to *reduce economic inequality*, (6) to avoid impairment of the operation of the *market-oriented economy* and (7) to accomplish a high degree of harmony between the income tax and the sought-for *political order*.” Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 568 (1965). A refundable education tax credit fits within these criteria, since the credit targets a socially-beneficial activity, is meant to compensate for market inequality (relating to positive externalities), and intends to subsidize it as a means of reducing economic inequality.

200. See *supra* Part III.B.2.

implementing a system of education tax incentives that utilizes a refundable tax credit, this paper contends that such a system can be achieved on a revenue-neutral basis by allocating existing expenditures to the refundable credit.

The Hope and Lifetime Learning Credits are inefficient because of their inability to fully incentivize target taxpayers²⁰¹ and because of the confusion associated with their application.²⁰² Accordingly, the tax expenditures currently allocated to these nonrefundable credits would be more effective if allocated to a refundable education tax credit, since a refundable credit is able to target and fully benefit those who need the incentive most – lower income taxpayers on the margin of attending college. Converting the Hope and Lifetime Learning Credits into a uniform refundable credit permits the lower marginal bracket taxpayer to realize the full benefit intended by the credit, since the taxpayer with zero income tax liability will receive the same dollar benefit as a higher-income taxpayer with the same educational expenses.²⁰³ In implementing a system of refundable education tax credits on a revenue-neutral basis, the estimated \$44.35 billion in expenditures from the Hope and Lifetime Learning Credits during fiscal years 2006-2012 would therefore be more effective if instead allocated to a refundable education tax credit.²⁰⁴

In addition to the Hope and Lifetime Learning Credits, the tax expenditures currently associated with section 529 plans and the student loan interest deduction would be more efficient if allocated to a refundable education tax credit. Due to their inability to reach target taxpayers for reasons mentioned above, the section 529 plan and the student loan interest deduction are not ideal tax incentives for incentivizing the target taxpayer on the margin of pursuing higher education.²⁰⁵ Accordingly, the estimated \$14.43 billion in tax expenditures allocated to these incentives over fiscal years 2006-2012 would be more effective if instead allocated to a refundable education tax credit.²⁰⁶

201. See Dynarski, Senate Finance Hearings, *supra* note 89, at 3 (stating that “nearly half of families with college students do not get the full [education tax] credit because their income is too low”) (internal citation omitted).

202. See Dynarski, Senate Finance Hearings, *supra* note 89, at 4. The Hope and Lifetime Learning Credits are also often criticized because of the perception that they may ultimately cause tuition rates to rise, since universities account for availability of the credits as enabling students to pay more for college. See Wolanin, *supra* note 117, at 17-18.

203. See Frank Sammartino et al., *supra* note 3, at 8 (stating that one rationale supporting a refundable credit is to use the income tax system as an administrative means of providing cash subsidies to low-income families).

204. See *supra* Part III.B.

205. See *supra* Part III.B.2.b-c.

206. See OFFICE OF MGMT. & BUDGET, *supra* note 102.

2. Simplification of Education-Related Tax Incentives

Although this paper contends that the most efficient form of an education tax incentive is a refundable tax credit, alternative proposals for education tax reform may exist. Alternatives include consolidation of the existing education tax incentives, uniform definitions and eligibility requirements, and a carryback or carryforward provision for existing education tax credits.

a. Simplification through consolidation

As discussed above, the current system of education tax incentives is complex and confusing, especially for lower income taxpayers, who should be the targets of these incentives.²⁰⁷ The straightforward and obvious response to the complexity surrounding these provisions is to simplify them.²⁰⁸ One of the most common proposals for simplification in the area of education tax incentives is the merger of the Hope and Lifetime Learning Credits into a single credit.²⁰⁹ Combining the two credits – and making the new credit refundable as discussed above – would be a significant improvement, since taxpayers would no longer have to run the gauntlet of comparing and contrasting the two credits.²¹⁰ Additionally, this simplification would allow taxpayers to estimate their credit in advance of receipt with greater ease than under the current system.²¹¹

207. See *supra* Part III.A.

208. See PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 111, at 51 ("Complexity in our current code arises from a number of sources. . . . [r]ecognizing the importance of simplicity, the Panel determined to make simplification a priority.").

209. See, e.g., A.B.A. Section of Taxation et al., *supra* note 91 (proposing to combine the Hope and Lifetime Learning Credits into a single credit, but not stating whether it should be refundable or nonrefundable); STAFF OF J. COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, VOLUME II 126-30 (Comm. Print 2001); Education Competitiveness Act of 2006, S. 3902, 109th Cong. § 801 (2006) (the Act provided for a \$2000 "refundable higher education credit," which sought to repeal and replace both the Hope and Lifetime Learning Credits); Personal Access to Continued Education Act of 2003, H.R. 3251, 108th Cong. (2003) (the Act sought to increase the Hope Credit to \$2000 and to make it refundable); Dynarski, Senate Finance Hearings, *supra* note 89, at 4.

210. Currently, taxpayers claiming the Hope and Lifetime Learning Credits must complete a four-page form with their annual return. See INTERNAL REVENUE SERV. DEP'T OF TREASURY, FORM 8863, *Education Credits (Hope and Lifetime Learning Credits)*, available at <http://www.irs.gov/pub/irs-pdf/f8863.pdf>. A merging of the two education credits into a single refundable credit would require less effort on the part of taxpayers seeking an education tax credit.

211. See Dynarski, Senate Finance Hearings, *supra* note 89, at 4.

As a means of simplifying the myriad of current educational tax incentives on a broader scale, the American Bar Association Section of Taxation proposed to eliminate *all* current education tax incentives in favor of a “universal deduction or credit.”²¹² Although this measure would undoubtedly simplify the current system, it would throw out the baby with the bath water by eliminating certain current incentives – such as the exclusions for qualified scholarships and forgiveness of student loan indebtedness – that represent desirable policy, cause no taxpayer confusion, and should endure.²¹³ The President’s Advisory Panel on Federal Tax Reform recommended simplification by replacing all current education credits and deductions with a full “Family Credit” worth \$1500, as well as by giving all taxpayers the ability to save for future education expenses on a tax-free basis through a “Save for Family” account.²¹⁴ However, this “Save for Family” account may suffer from the same flaws as the section 529 plans discussed above, since these savings vehicles primarily provide benefits to middle and higher income taxpayers who have the financial ability to allocate income to a tax-advantaged investment account.²¹⁵ Although replacing all current education credits and deductions with a single “Family Credit” would simplify the current system, this single credit would only be effective if implemented as a *refundable* tax credit for the reasons mentioned above.

b. Uniform definitions and qualifications for eligibility

A less comprehensive means of simplification would be the reformation of current incentives to provide uniform definitions of “qualifying educational expenses”²¹⁶ and “students,”²¹⁷ and to provide uniform income eligibility limitations and phase-out amounts.²¹⁸ Although

212. A.B.A. Section of Taxation et al., *supra* note 91, at 7.

213. *See supra* Part III.B.1 for further discussion.

214. PRESIDENT’S ADVISORY PANEL REPORT, *supra* note 111, at 84, 120.

215. *See supra* Part III.B.2.b.

216. Under the current Code provisions, section 529 qualified tuition plans and Coverdell savings accounts include room and board in qualifying expenses, whereas the Hope and Lifetime Learning Credits do not include room and board. *See supra* notes 23, 34, 59, 75 and accompanying text.

217. Currently, an “eligible student” under the Hope Credit only includes a student in her first two years of post-secondary education whereas the Lifetime Learning Credit includes a student for any number of years of post-secondary education. *See supra* notes 22, 34-35 and accompanying text.

218. *See supra* discussion in note 97. *See also* A.B.A. Section of Taxation et al., *supra* note 91, at 7 (proposed these as possible measures to simplify education tax incentives in the Code); *see also* Dynarski, Senate Finance Hearings, *supra* note 89, at 4 (stating that simplification of the

this alternative would not reduce the current number of incentives for taxpayers to choose from, this simplification would take some of the guesswork out of the process. For example, taxpayers wishing to claim an education tax credit or use a distribution from a savings vehicle would no longer have to determine whether they qualify as an eligible student, which expenses qualify, under which incentive they qualify, and which income limitation they are subject to.

Similarly, the current system could be improved by adopting uniform definitions of “qualified educational expenses,” since some of the current incentives are limited to tuition, fees and expenses whereas others include items such as room and board, equipment and supplies.²¹⁹ This paper has discussed that qualifying educational expenses should be limited to tuition, related fees and room and board.²²⁰ In addition to simplifying the current system’s multitude of varying definitions, this limitation would act as a safeguard against taxpayer fraud and abuse, since qualifying expenses would be limited to those that can be funneled through the university itself.²²¹

3. Carryback or Carryforward of a Nonrefundable Education Tax Credit

An alternative to the use of a uniform refundable credit as an efficient tax incentive is the use of a non-refundable credit with a carryback or carryforward provision. This would allow a taxpayer with an unused portion of the credit in a given year to either carry it back to a previous year or carry it forward to a later year. The amount carried forward or back would apply on top of the full amount of the non-refundable credit applicable in the current tax year. Because this type of credit would apply on a per-student basis (as opposed to a per-return basis), the duration of the carryback or carryforward can be easily determined based on the length of time the student is to be enrolled in a post-secondary institution.²²²

current incentives should include the consideration of “tuition, fees, room and board as eligible expenses for the purposes of the [single refundable] credit . . . [which] matches the definition used for the 529 and Coverdell accounts.”).

219. *See supra* note 216.

220. *See generally supra* Part IV.B.2. Although this paper discussed including equipment and supplies through use of a receipt system, the fact that tuition, fees, and room and board will likely exceed any applicable credit amount suggests that there is no need to address the inclusion of equipment and supplies as qualified expenses.

221. *See supra* Part IV.B.2 for discussion of limiting taxpayer fraud and abuse through a simplified definition of qualifying educational expenses.

222. For example, if the eligible student is enrolled in a four-year institution, the carryback

However, this type of a credit has the economic consequence of creating a “fluctuating penalty,”²²³ since the full amount of the credit carryforward is subject to a time value of money discount.²²⁴ Furthermore, a more severe penalty exists if the credit carryback or carryforward ultimately goes unused, which would occur in the event the student completes school during years of higher income in which the unused portion may not be used.²²⁵

In comparison to a refundable education tax credit, a nonrefundable credit with a carryback or carryforward provision would not alleviate taxpayer confusion in applying education tax incentives, but would instead increase confusion. Instead of claiming the simple refundable credit each year and figuring out the refund, taxpayers claiming a nonrefundable credit with a carryback or carryforward provision would be forced to track their educational expenses throughout the years and attempt to apply any excess credit amount back or forward, as appropriate. This process would be especially difficult for lower-income taxpayers, who are the target taxpayers and stand to benefit most from a simplified tax incentive system. Accordingly, a refundable credit is the preferred form of an education incentive as compared to a nonrefundable credit with a carryback and carryforward provision, since the refundable credit results in greater efficiency and alleviation of taxpayer confusion.

V. CONCLUSION AND REFLECTION

This paper has attempted to demonstrate the importance and necessity of encouraging the advancement of higher education in today’s knowledge-driven and increasingly global American society. More importantly, the opportunity for attaining higher education should be made available to all who seek it, regardless of economic barriers. Although the Code is not the single and exclusive solution to this goal, the Code has been and remains a powerful tool for implementing and encouraging beneficial social policy. As such, the Code’s provisions should strive for efficiency and effectiveness through well reasoned and soundly structured provisions, all with the uniform goal of directing its benefits toward those who stand to

and carryforward amount of any unused nonrefundable credit can only be applied during those four years.

223. See *supra* note 150 and accompanying text for discussion of “fluctuating penalties.”

224. See Batchelder et al., *supra* note 3, at 57 n.139 (stating that a deduction or exclusion with a carryback or carryforward provision is subject to a fluctuation penalty in the form of a time value of money discount).

225. See Batchelder et al., *supra* note 3, at 56-57.

benefit most. In the case of higher education tax incentives in the Code, the target taxpayer is the potential student on the verge of seeking higher education and in need of an incentive to compensate for her lack of financial ability.

Although the Code's current education tax incentive provisions were intended to increase access to higher education for all, the reality is that the convoluted structure of these provisions not only leads to intense taxpayer confusion, but also results in the intended benefits straying from their desired course. The Code is in need of major reform, and its current tax incentives for higher education clearly evidence this need. A refundable tax credit for the expenses of higher education in lieu of some of the Code's current provisions provides both economic efficiency and certainty that target taxpayers will realize the full benefit of the tax incentive. Furthermore, by reforming and consolidating the Code's current education tax incentives in favor of a single, uniform refundable credit, the goal of improving access to higher education for the target taxpayer can be achieved on a revenue-neutral basis.

The following simple words of a late President speak of both timeless wisdom and a sense of national urgency, as they serve as perpetual reminders of where our priorities for the future of our nation ought exist:

Our progress as a nation can be no swifter than our progress in education. Our requirements for world leadership, our Hopes for economic growth, and the demands of citizenship itself in an era such as this all require the maximum development of every young American's capacity.

The human mind is our fundamental resource.²²⁶

226. John F. Kennedy, President's Special Message to the Congress on Education, THE AMERICAN PRESIDENCY PROJECT (Feb. 20, 1961), available at <http://www.presidency.ucsb.edu/ws/index.php?pid=8433&st=&st1=>.