Higher Education Tax Benefits

Tax Credits, Tuition and Fees Deduction, and Employer-Provided Educational Assistance

In addition to direct investments in workforce development, the federal government also provides billions of dollars in indirect support for education and training through the U.S. tax code. Education tax benefits—including credits and deductions for higher education expenses and preferential treatment of qualifying employer expenditures on training—have proven increasingly popular with lawmakers and taxpayers. The number of tax returns claiming education credits increased by more than 150 percent between 2008 and 2009, and it is likely that demand will continue to grow as federal funding for other workforce programs declines.

While tax benefits can make it easier and more affordable for some individuals to participate in postsecondary education and training, Congress should take steps to strengthen current policies by ensuring that tax credits are available to participants regardless of enrollment status, tax liability or program type, and by creating incentives for businesses to more effectively target their investments in employee education and training.

Higher Education Tax Credits

Background

In 1997, Congress enacted the Hope and the Lifelong Learning Tax Credits which were designed to cover college tuition and other postsecondary expenses.1 Under the American Recovery and Reinvestment Act (Recovery Act),2 for tax years 2009 and 2010, Congress largely replaced the Hope Credit with the partially refundable American Opportunity Tax Credit (AOTC).3 Congress extended the AOTC for tax years 2011 and 2012 under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.4 Unless extended, the AOTC will revert to the Hope Credit in tax year 2013.

Current Legislative Status

The Hope and Lifetime Learning Credits are permanent and do not require reauthorization. The Hope Credit has been temporarily modified by the AOTC, which is currently set to expire in 2012. If Congress fails to extend the AOTC, the Hope Credit would be restored in tax year 2013.

The Obama Administration has proposed making the AOTC permanent; however, political debates in Washington about the rising costs of federal education benefits and U.S. tax policy may complicate such efforts.5 Fiscal conservatives in Congress have already signaled a growing willingness to target postsecondary assistance programs—the final Fiscal Year (FY) 2012 omnibus appropriations bill reduced Pell Grant funding by an estimated $11 billion over ten years—and the rising costs of education tax credits may draw scrutiny from lawmakers seeking deficit savings. In addition, because authorization for the AOTC is due to expire at the same time as other major tax provisions, including the 2001 and 2003 Bush-era income tax cuts, it is likely that any AOTC extension would be part of a broader—and politically contentious—tax package.
## Higher Education Tax Benefits At-A-Glance

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<th>American Opportunity Tax Credit</th>
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<th>Employer-Provided Educational Assistance (Sec. 127)</th>
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<tr>
<td><strong>Legislative Status</strong></td>
<td>Authorized through the 2012 tax year.</td>
<td>Does not expire. Will apply for 2013 tax year if AOTC not extended.</td>
<td>Does not expire.</td>
<td>Authorized through the 2011 tax year.</td>
<td>Authorized through the 2012 tax year.</td>
</tr>
<tr>
<td><strong>Amount of Benefit</strong></td>
<td>Up to $2,500 per student, per year. 40 percent refundable.</td>
<td>Up to $1,500 per student.* Non-refundable.</td>
<td>Up to $2,000 per tax return, per year. Can cover multiple students up to annual limit. Non-refundable.</td>
<td>Up to $4,000 per year.</td>
<td>Up to $5,250 per year.</td>
</tr>
<tr>
<td><strong>Qualifying Expenses</strong></td>
<td>Tuition and related expenses. Related expenses can include fees (if paid directly to school); books, supplies, or equipment (do not have to be paid directly to school).</td>
<td>Tuition and related expenses (fees, books, supplies, equipment). Related expenses must be paid directly to school.</td>
<td>Tuition and related expenses (fees, books, supplies, equipment). Related expenses must be paid directly to school.</td>
<td>Tuition and fees; books, supplies, and equipment if paid directly to school as condition of enrollment.</td>
<td>Tuition, fees, and related materials. Related materials do not need to be paid directly to school.</td>
</tr>
<tr>
<td><strong>Eligibility</strong></td>
<td>May only be for the first four years of a student’s postsecondary education. Must be enrolled in program leading to degree, certificate, or other recognized credential. Must be enrolled at least half-time.</td>
<td>May only be used for the first two years of a student’s postsecondary education. Must be enrolled in program leading to degree, certificate, or other recognized credential. Must be enrolled at least half-time.</td>
<td>May be claimed in any year in which qualifying expenses are incurred for a student. Must be enrolled in an eligible educational institution. May be enrolled less-than-half-time.</td>
<td>May be used for any postsecondary education used to improve job skills. Students must have at least a high school diploma or equivalent.</td>
<td>Must be provided under written plan. Can cover any employee, but plan cannot discriminate in favor of highly compensated employees, and there are limits on amount of funds that may be used for owners.</td>
</tr>
</tbody>
</table>

* For the 2009 tax year only, the Hope credit remained available to taxpayers with at least one student attending an institution in a Midwestern disaster area. The credit was limited to $3,600 for students attending such institutions, and $1,800 for any other students claimed on the return but not attending such institutions.
Structure of Higher Education Tax Credits

Amount of Benefit

The AOTC provides up to a maximum $2,500 per student per year for qualifying expenses incurred during the first four years of a student’s postsecondary education. Taxpayers are allowed to claim 100 percent of the first $2,000 of qualifying expenses, plus 25 percent of the next $2,000 of qualifying expenses. The AOTC is partially refundable; taxpayers who are eligible for a credit that exceeds their tax liability for the year can receive a refund equal to 40 percent of the credit, up to a maximum of $1,000. This makes the credit more accessible for low- and moderate-income individuals, who are likely to have lower tax liabilities.

The Hope Credit provides $1,500 per eligible student per year, and is only for students enrolled in their first two years of postsecondary education. The Hope credit is not refundable.

The Lifetime Learning Credit provides up to a maximum of $2,000 per tax return, meaning a taxpayer may apply the credit to qualifying expenses for multiple students so long as the credit claimed remains below the limit. Unlike the AOTC, which is limited to the first four years of postsecondary education for any given student, the Lifetime Learning Credit may be claimed for any year in which the taxpayer incurs qualifying expenses. Taxpayers are eligible to claim 20 percent of the first $10,000 of qualifying expenses per year. The Lifetime Learning Credit is nonrefundable, meaning a taxpayer must have a tax liability in order to benefit from the credit.

Qualifying Expenses

The AOTC may be used for tuition and related expenses required for enrollment or attendance at an eligible institution. Related expenses can include student fees if paid directly to the institution, and expenses for books, supplies or equipment regardless of whether these items are purchased from the institution. This differs from the Hope Credit, under which expenses for books, supplies, or equipment could only qualify if purchased from the school. The Lifetime Learning Credit can be used for expenses for tuition, as well as for related expenses paid directly to the institution. Room and board, insurance, medical assistance, transportation, and other nonacademic costs are not qualifying expenses under the AOTC, Hope Credit, or the Lifetime Learning Credit.

Eligibility

The AOTC, Hope Credit, and Lifetime Learning Credit may be claimed by taxpayers for qualifying expenses incurred on behalf of the taxpayer themselves, their spouse, or their dependents.

The AOTC may only be claimed for expenses incurred for a student during their first four years of postsecondary education, and may not be claimed for more than four tax years for any given student. The student must be enrolled in a program leading to a degree, certificate, or other recognized educational credential, and must be enrolled at least half-time during at least one academic period (such as a semester or quarter) during the taxable year. These restrictions limit accessibility of the credit for working adults and other individuals who may be unable to complete their studies within the four-year limit, or who enroll in courses that do not lead to a postsecondary credential but may provide skills that enhance employment prospects.

The Lifetime Learning Credit may be claimed during any tax year in which qualifying expenses are incurred for a student, with no cap on the number of years the credit may be claimed. The Lifetime Learning Credit is also less restrictive than the AOTC in that it is available for any postsecondary education
that improves job skills. Students claiming the Lifetime Learning Credit must enroll in at least one course at an eligible educational institution, but do not need be enrolled in a degree or other credential program.

The AOTC cannot be claimed for individuals with a felony drug conviction. There is no such restriction on the Lifetime Learning Credit.

All higher education tax credits are subject to income eligibility restrictions. For the AOTC, benefits are limited to single filers with modified adjusted gross incomes (MAGI) of less than $90,000 and for joint filers with MAGI of less than $180,000. For the Lifetime Learning Credit, the benefits are limited to single filers with MAGI of less than $60,000, and joint filers with MAGI of less than $120,000. Both credits are gradually reduced for filers at the upper ends of the income eligibility scale.

**Funding**

Tax incentives differ from many other federal investments in training because funding is not annually appropriated; instead, they offer reduced tax liability automatically to any taxpayers who qualify. While this means that the availability of the credits is not subject to annual debates over funding levels, this also means that in order to control costs, Congress must limit eligibility (rather than simply reduce funding).

The number of tax returns claiming an education tax credit jumped from 7.7 million to 12.3 million between 2008 and 2009, while the dollar amount claimed increased by more than 140 percent, from $7.6 billion to $18.3 billion. Much of this growth was driven by the availability of the AOTC; approximately 8.9 million AOTCs were claimed in 2009 for a total of $15.5 billion in tax savings.

The Treasury Department estimates that in 2009, 4.5 million students and families who would not have qualified for tax relief in 2008 received tax refunds under the AOTC. While this suggests that AOTC has significantly expanded access to education credits for lower-income households, there are indications that higher-income households still disproportionately benefit from the credit. One estimate suggests that more than half of all savings under AOTC in 2009 went to taxpayers with AGIs above $50,000, compared to only 27 percent for households with AGIs below $30,000. Another estimate suggests that similar distributions are likely for the 2011 tax year, with households above $50,000 AGI claiming about 49 percent of total benefits.

**Relationship to Other Programs/Benefits**

Other tax-free educational assistance—such as scholarships, Pell Grants, or employer-provided educational assistance—must be subtracted from a student’s qualifying education expenses before calculating the AOTC, Hope, or Lifetime Learning Credits. Taxpayers claiming any of these credits may not take the tuition and fees deduction (see below) for the same student in the same tax year.

**Tuition and Fees Tax Deduction**

**Background**

While credits are the primary tax benefit for postsecondary educational expenses, taxpayers can also take advantage of a tuition and fees deduction. Unlike a tax credit, which is applied against individual tax liability (the amount of taxes owed), the deduction is used to reduce the taxpayer’s adjusted gross income (AGI), which is the portion of income subject to taxation. While credits are generally better than deductions, the tuition and fees deduction can be valuable for individuals who might otherwise not qualify for a tax credit.
Current Legislative Status

The tuition and fees tax deduction was originally created as part of the 2001 Economic Growth and Tax Relief Reconciliation Act.\textsuperscript{14} Originally set to expire in December 2005, the deduction has been extended several times, most recently under the Tax Relief Act of 2010.\textsuperscript{15} The deduction is currently extended only through the 2011 tax year, and it is unclear whether Congress will take up legislation to renew the deduction for 2012.

Structure of Higher Education Tax Deduction

Amount of Benefit

The tuition and fees deduction allows taxpayers to deduct up to $4,000 of qualified education and training expenses from taxable income. The deduction may be claimed even if a taxpayer does not itemize deductions.

Qualifying Expenses

Qualifying expenses consist of tuition and fees related to enrollment or attendance at any college, university, vocational school, or other institution that is eligible to participate in a student aid program under the 2008 Higher Education Opportunity Act (HEOA).\textsuperscript{16} These expenses may also include the cost of books, supplies, and equipment, but only if they are paid directly to the institution as a condition of enrollment.

Eligibility

The tuition and fees deduction is available to taxpayers on behalf of themselves, their spouse, or their dependents. Like the Lifetime Learning Credit, the benefit is available for any postsecondary education, including non-credit courses, used to improve job skills. Students do not have to pursue a recognized credential and need only be enrolled in one course. The student must have either a high school diploma or a GED.

As with the higher education tax credits, the tuition and fees deduction is also subject to income eligibility restrictions. Benefits are limited to individual filers with a MAGI of $80,000, and joint filers with an MAGI of $160,000. Similarly, the amount of the allowable deduction is phased out for filers at the upper end of the income eligibility scale.

Funding

As with the education tax credits, funding for the tuition and fees deduction does not depend on annual appropriations; anyone who meets the qualifications may claim the deduction. The number of taxpayers claiming the tuition and fees deduction declined sharply between 2008 and 2009, from around 4.6 million to 2.4 million (47 percent), while the amount claimed dropped from $11 billion to about $5.5 billion (50 percent).\textsuperscript{17} It seems likely that this was due to the availability of the more generous benefits under the AOTC and Hope Credit in 2009 (tax filers are prohibited from claiming both a higher education tax credit and the tuition and fees deduction).

Relationship to Other Programs

Tax filers who claim the AOTC or Lifetime Learning Credit are not eligible to claim the tuition and fees deduction for the same expenses. In addition, taxpayers must deduct any tax-free educational assistance—including Pell Grants, scholarships, or employer-provided educational assistance—used to pay for tuition and fees.
Employer-Provided Educational Assistance

Background

It is estimated that U.S. businesses spent nearly $126 billion on employee education and training in 2009, of which nearly 11 percent was for tuition reimbursements for courses at educational institutions. Under Section 127 of the U.S. tax code, employees may receive up to $5,250 of tuition reimbursement and other qualifying employer-provided assistance without paying taxes on that assistance.

Because Section 127 allows individuals to shift at least some of the costs of education to employers—who benefit from the skills and knowledge acquired by employees—it has potential to be a powerful tool for increasing postsecondary attainment of working-age adults, particularly low-income individuals who might not otherwise be able to afford higher education. However, as with other educational tax benefits, Section 127 is of greater value to individuals with higher incomes and higher potential tax liability. The relatively limited tax benefit for employers means the provision creates little direct incentive for businesses to invest in education and training for their employees. As a result, there is some concern that the tax benefit is not changing employers’ behavior—that is, getting employers to make investments in education and training they wouldn’t otherwise make—but rather is simply used to help offset the cost of investments employers would make anyway.

Current Legislative Status

Originally passed in 1978, Section 127 was most recently extended through tax year 2012 as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Structure of Employer-Provided Educational Assistance

Amount of Benefit

Individuals may exclude up to $5,250 per year of employer-provided educational assistance from their gross income. Employers do not need to include benefits up to this amount on the W-2 wage form for their employees, and do not pay FICA and other payroll taxes on those benefits.

Qualifying Expenses

Educational assistance can include tuition, fees and related materials—including books, supplies, and equipment—regardless of whether the related materials are purchased from the educational institution. Costs for meals, lodging, transportation, and any tools or supplies (other than books) that are retained by the individual after completing the course are not qualifying expenses.

Eligibility

Educational assistance under Section 127 may be provided for “undergraduate or graduate” level education, though the law does not define eligible institutions, and places relatively few restrictions on the types of workers or educational activities that may be covered under a plan. The education or training does not have to be work-related in order to qualify for Section 127 coverage, although employers can make this a requirement under their plans. Educational assistance must be provided under a separate written educational assistance plan administered by the employer. Programs must not discriminate in favor of highly compensated employees, and no more than 5 percent of the amounts paid or incurred can be provided for more than 5 percent of the company’s owners. Because benefits offered to employees...
under Section 127 are structured by individual employers, they may require a minimum grade point average or other criteria before reimbursing employees for their education expenses.

While there are no direct restrictions on the use of Section 127 for lower skilled workers, employer-provided education assistance tends to be utilized by high-earning, higher skilled employees. In the 2007-2008 school year, of independent undergraduate students who were receiving Section 127 assistance while working full time (at least 35 hours per week), nearly 55 percent had family incomes of $50,000 or above, while only 16 percent had family incomes below $30,000.22

About 42 percent of Section 127 recipients in 2007-2008 were enrolled in graduate level courses, with an average benefit of $3,701. Undergraduates received an average benefit of $1,849. 18 percent of Section 127 recipients were enrolled in baccalaureate level programs, 26 percent were enrolled in associate’s degree programs, and another 14 percent were enrolled in non-degree programs.23

**Funding**

Overall, federal revenues foregone under Section 127 have remained fairly steady: the Joint Committee on Taxation estimated that federal revenues foregone in FY 2010 were approximately $900 million, up from about $800 million in FY 2007.24 More than 900,000 individuals received Section 127 benefits during the 2007-2008 academic year, compared to about 431,000 in the 1992-1993 school year.

**Relationship to Other Programs**

Individuals may not use any of the tax-free education expenses paid for by their employer as the basis for any other tax deduction or credit, including the AOTC or Lifetime Learning credits.
**Policy Recommendations**

**Consolidate Current Education Credits into Permanent, Refundable Credit for All Students**

The AOTC and the Lifetime Learning Credit have features that can benefit low-income and nontraditional students: the AOTC’s refundability means that low-income individuals without tax liability can still benefit from the credit, while the Lifetime Learning Credit’s availability for non-credit and less-than-half-time studies means working adults seeking postsecondary education to enhance their career prospects can benefit from the credit. However, under current law students must choose between the two credits, and the AOTC is due to expire after 2012 if not renewed. Congress should combine the two credits into a single credit that retains the refundability of the AOTC and the flexibility of the Lifetime Learning Credit, and make the new credit permanent.

**Create Stronger Incentives for Employers to Invest in Low-Skilled Workers**

The current Section 127 provides limited tax relief for businesses, which means employers have little incentive to expand usage of educational assistance plans, particularly for low-skilled employees who may require prerequisite or remedial education prior to enrolling in degree programs. To ensure that Section 127 benefits are better targeted to support the needs of all workers—not just highly skilled employees—Congress should consider strengthening the incentives available to employers through or in conjunction with Section 127, including providing additional tax benefits (through credits or deductions) to employers who support training for low-skilled, lower wage employees.

**Reauthorize the Tuition and Fees Deduction**

While usage of the tuition and fees deduction has declined since the introduction of the AOTC, it is still a valuable option for certain students, particularly those who are enrolled in non-degree programs or on a less-than-half-time basis. Given the uncertain fate of AOTC after 2012, Congress should reauthorize the tuition and fees deduction to ensure that U.S. workers have the broadest possible range of tax benefits to support educational attainment.
References

1 Under the Taxpayer Relief Act of 1997 (P.L. 105-34).
2 P.L. 111-5.
3 For the 2009 tax year only, the Hope credit remained available to taxpayers with at least one student attending an institution in a Midwestern disaster area. The credit was limited to $3,600 for students attending such institutions, and $1,800 for any other students claimed on the return but not attending such institutions. Taxpayers electing the Hope credit could not claim the AOTC for any student. See http://www.irs.gov/pub/irs-prior/p970--2009.pdf.
4 P.L. 111-312.
6 Individuals who are under the age of 24 and meet certain other conditions relating to income and family support are not eligible to claim the refundable portion of the credit.
7 For the AOTC, Hope Credit, and Lifetime Learning Credit, "eligible institutions" include any college, university, vocational school, or other postsecondary educational institution eligible to participate in a U.S. Department of Education student aid program. See http://www.irs.gov/pub/irs-pdf/p970.pdf.
9 2008 data drawn from http://www.irs.gov/pub/irs-soi/08in02ar.xls, includes Hope and Lifetime Learning Credits. 2009 data includes AOTC, Lifetime Learning, and Hope Credits used at institutions in Midwestern disaster areas; totals drawn from the Treasury Inspector General for Tax Administration’s September 2011 report, “Billions of Dollars in Education Credits Appear to be Erroneous.” http://www.treasury.gov/tigta/auditreports/2011reports/201141083fr.pdf. It is important to note that the TIGTA report indicated that as many as 2.1 million taxpayers received AOTCs for which they did not qualify, totaling $3.2 billion in 2009.
10 Ibid.
14 P.L. 107-16.
15 P.L. 111-312.
16 P.L. 110-315.
19 P.L. 111-312.
21 Under section 127(c)(1), “educational assistance” can include both payments incurred on behalf of the employer for the employee, or the provision, by an employer, of courses of instruction for such employee. The law prohibits educational assistance for courses involving sports, games, and hobbies, unless they are related to the business of the employer or are required as part of a degree program.