What tax incentives exist to help families pay for college?

Rapidly rising college expenses in the 1990s spurred the 1997 enactment of tax incentives for higher education, which included the Hope credit, the lifetime learning credit, and deductions for tuition and fees and for student loan interest. The Hope credit was subsequently supplanted by the more generous (but temporary) American opportunity tax credit enacted as part of the fiscal stimulus package and then extended through 2017.

AMERICAN OPPORTUNITY TAX CREDIT

The American opportunity tax credit (AOTC) provides a credit up to $2,500 per student during the first four years of postsecondary school (up from the two years allowed by the Hope credit). Students receive a credit of 100 percent against the first $2,000 of tuition, fees, and books, and a 25 percent credit against the next $2,000 (eligible Hope expenses did not include books). Up to $1,000 of the AOTC is refundable (the Hope was not at all refundable). AOTC credits, it should be noted, are not indexed for inflation, though Hope credits were. For 2014 tax returns, the maximum benefit for the AOTC phases out between adjusted gross incomes (AGIs) of $80,000 and $90,000 (between $160,000 and $180,000 for married couples).

LIFETIME LEARNING CREDIT

The lifetime learning credit (LLC) equals 20 percent of tuition and fees for any postsecondary education expense, up to a maximum annual credit of $2,000 per taxpayer. That maximum applies to the combined expenses of all students in the household claiming the credit and is reached when total qualifying expenses equal $10,000. The maximum benefit for the LLC phases out between 2014 AGIs of $54,000 and $64,000 for single taxpayers ($108,000 and $128,000 for married couples). The LLC is nonrefundable, so only people who owe income tax can benefit.

TUITION AND FEES DEDUCTION

The deduction for tuition and fees allows taxpayers (parents or students, whoever pays) to reduce taxable incomes by up to $4,000. To qualify, a family's adjusted gross income may not exceed $65,000 for single filers or $130,000 for married filers. Single filers with AGIs between $65,000 and $80,000 or married filers with AGIs between $130,000 and $160,000 can deduct up to $2,000 of expenses. After that, a family is no longer eligible for the deduction. Since the provision is a deduction, it has value only to students and their families with taxable income. The tuition and fees deduction was retroactively extended for 2014; it is set to expire again in 2015 unless extended.

STUDENT LOAN INTEREST DEDUCTION

The student loan interest deduction allows taxpayers with qualified student loans (loans taken out solely to pay qualified higher education expenses) to reduce taxable income by $2,500 or the interest paid during the year, whichever is less. The loan cannot be from a relative or made under a qualified employer plan, and the student must be a taxpayer, a spouse, or a dependent; only those enrolled at least half time in a degree program qualify.

Qualified expenses include tuition and fees, room and board, books, supplies and equipment, and other necessary expenses such as transportation. To qualify for 2014, a taxpayer's AGI may not exceed $80,000 for single, head of household, or qualifying widower filers, or $160,000 for married filers. After that, a family is no longer eligible for the deduction. The deduction is, of course, only valuable to people with taxable income.

HOW THESE TAX INCENTIVES AFFECT STUDENTS

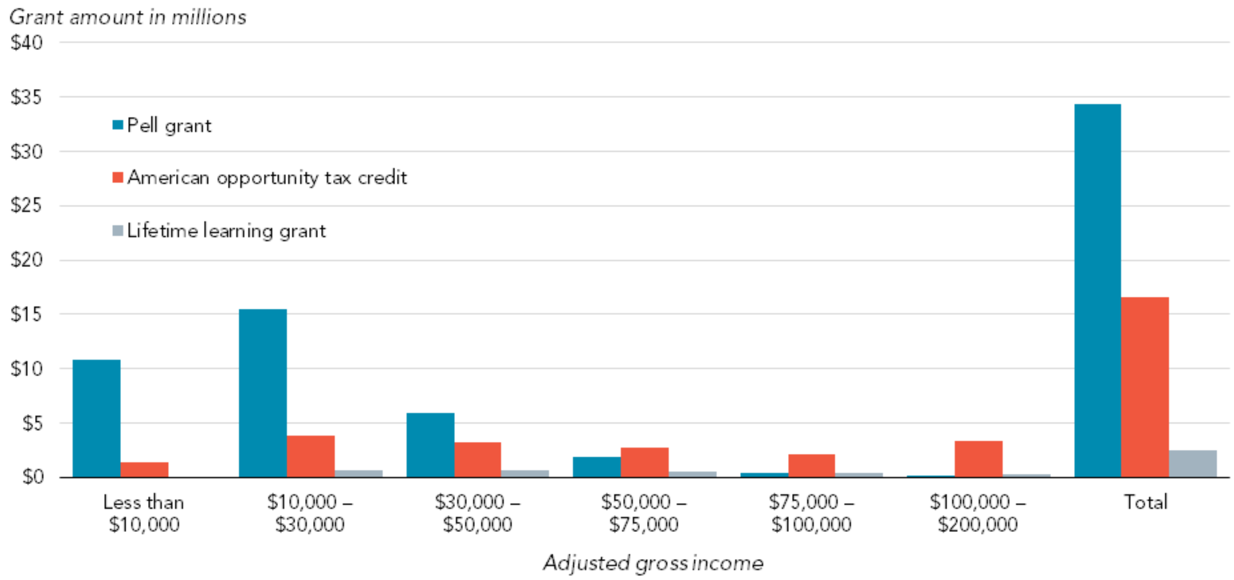
Before Congress created the AOTC, many observers argued that existing tax subsidies had minimal impact on college enrollment because those subsidies went mostly to people who would have attended college even without the additional aid. Many low-income students who might have been the most influenced by reduced college costs received little or no benefit from the Hope and LLC credits because they were nonrefundable and thus could only offset income taxes owed.

In response, the AOTC was made refundable, allowing lower-income families to receive the credit. Even so, students with incomes below $50,000 receive more aid from the Pell grant than from the tax credits. And even with the changes to the tax credits, it remains unclear whether tax credits increase college enrollment (figure 1).

FIGURE 1

Amount of Pell Grants and Education Tax Incentives

All students, 2015



Source: Tax Policy Center, Table T15-0155, 2015.

Using the tax system to subsidize higher education has two primary advantages over using traditional spending programs: (1) Students don't have to fill out the daunting Free Application for Federal Student Aid (FAFSA) form to receive benefits; and (2) Every student who qualifies receives the full benefit for which they appear entitled. However, providing aid through the tax system also has disadvantages— notably, the delay in funds being received (up to 15 months after tuition was paid).

OPTIONS FOR REFORM

- Even though some books are eligible expenses under the American opportunity tax credit, additional assistance could be provided by broadening coverage to include other expenses such as room and board.

- Providing benefits directly to schools when students enroll—not months later when their families file tax returns—could help students cover college costs when they are obliged to make payments. Benefit amounts would be based on estimates of the previous year's taxes.

- Consolidating the credits into a single credit would make the process more transparent for students.

- Rather than offering a deduction for student loan interest, providing incentives for students to enroll in income-contingent repayment programs would reduce hardship in student debt repayment.

DATA SOURCES

Urban-Brookings Tax Policy Center. T15-0137. "Tax Benefit of Education credits and Student Loan Interest Deduction."

———. T15-0155. "Current Law Distribution of Tax Units Receiving Pell Grants, AOTC, and LLC."

FURTHER READING

Baum, Sandy and Martha Johnson. 2015. "Student Debt: Who Borrows Most? What Lies Ahead?" Washington, DC: Urban Institute.

Bulman, George B., and Caroline M. Hoxby. 2015. "The Returns to the Federal Tax Credits for Higher Education." NBER Working Paper No. 20833. Cambridge, MA: National Bureau of Economic Research.

Dynarski, Susan, and Judith E. Scott-Clayton. 2007. "College Grants on a Postcard: A Proposal for Simple and Predictable Federal Student Aid." Hamilton Project Discussion Paper. Washington, DC: Brookings Institution.

Dynarski, Susan, Judith Scott-Clayton, and Mark Wiederspan. 2013. "Simplifying Tax Incentives and Aid for College: Progress and Prospects." NBER Working Paper No. 18707. Cambridge, MA: National Bureau of Economic Research.

Internal Revenue Service. 2015. "Tax Benefits for Education (For Use in Preparing 2014 Returns)." Publication 970. Washington, DC: Internal Revenue Service.

New America Atlas. 2015. "Higher Education Tax Benefits Overview." Updated May 15, 2015.

Rueben, Kim, and Sandy Baum. 2015. "Obama Would Improve Tax Subsidies for Higher Education." *Tax Vox* (blog). January 26.