Key Elements of the U.S. Tax System

Q. What tax incentives exist for higher education?

Federal tax incentives for higher education include tax benefits for saving, tax benefits for tuition and related expenses, and tax benefits for student loans—in other words, benefits before, during, and after college attendance. These incentives mostly target middle-class households who do not benefit from traditional student aid.

The federal government provides individuals with financial assistance for higher education expenses in two major ways: traditional student aid (through loans, grants, and work study) and tax benefits. In 2017, 14 tax benefits were available for college students and their parents. These include three broad classes—special tax treatment for education savings plans, tax credits for tuition and related expenses, and tax deductions for student loan payments The Joint Committee of Taxation estimates these tax benefits will cost the federal government $144.7 billion between 2017 and 2021. These estimates account for recent tax law changes made by the 2017 Tax Cuts and Jobs Act (P.L. 115-97) and the extension of certain expiring tax provisions as part of budget reconciliation (P.L. 115-123).

Tax benefits for higher education are frequently oriented toward the middle class rather than the poorest households, who benefit more from traditional student aid (table 1). The largest benefits are tax credits: the American opportunity tax credit (AOTC) and the lifetime learning credit (LLC). Although the AOTC is refundable, both credits largely accrue to middle-class households, as these households typically have larger out-of-pocket expenses for higher education than lower-income households, who receive traditional aid. Allowing parents to claim a personal exemption for students ages 19 to 23 (before 2018) also helped middle-class households more than poor households, as the value of exemptions is tied to tax rates and middle-class households face higher tax rates. The Congressional Budget Office estimates that nearly all other tax benefits for higher education similarly benefit middle- and upper-class families. The one exception: allowing college dependents to qualify as children for the refundable earned income tax credit.

The Tax Cuts and Jobs Act (TCJA) did not dramatically change tax benefits for higher education savings or loan repayment. It also avoided changes to the AOTC and LLC. However, the legislation did significantly change the structure of tax benefits for those claiming a dependent college student. In prior years, taxpayers could only claim dependents over 18 if the dependent's gross income was below a modest amount. However, parents could claim full time students ages 19 to 23 without regard to the gross income test. In 2017, taxpayers received an additional $4,050 personal exemption for each 19 to 23 year old college student claimed as a dependent.

Key Elements of the U.S. Tax System

What tax incentives exist for higher education?

The Tax Cuts and Jobs Act eliminated all personal exemptions but it also expanded the child tax credit to include a $500 nonrefundable credit for dependents not eligible for the regular child tax credit, including 19- to 23-year-old dependent college students. This change transformed the tax saving for claiming a college student dependent from one which depended on the parents' tax rate to a credit where all taxpayers get an equivalent benefit regardless of their tax rate (up to the limit of their total income tax liability). This shifts more of the value of the benefit from higher-income taxpayers to lower-income taxpayers. However, because the new credit is nonrefundable, it still does not reach the lowest-income taxpayers.

In addition to the benefits discussed in more detail below, tax benefits for education include a business deduction for work-related education expenses; an exclusion from taxable income of scholarships, grants, tuition reductions, and employer-provided educational assistance; and penalty-free early withdrawals from individual retirement accounts if the funds are used for educational expenses.

TABLE 1

Distribution of Higher Education Tax Expenditures

by income before transfers and taxes, under current law, 2016

Tax Expenditure	Dollars (billions)	Shares (Percent)				
		Lowest quintile	Second quintile	Third quintile	Fourth quintile	Highest quintile
Credits for education (AOTC and LLC)	18.8	12	23	28	28	9
Preferential treatment for students 19 to 23						
Dependent exemption	4.4	5	15	20	33	27
Higher Age Limit for Earned Income Tax Credit	3.3	52	29	5	3	2
All Preferential Treatment	7.7	25	21	16	21	17
Exclusions from taxable income						
Scholarships and fellowship income	3.6	9	16	17	28	30
Employer-provided education benefits and tuition reduction	2.9	12	18	20	25	25
Earnings of qualified education savings plans	0.9	*	*	1	3	97
Certain discharged student loan debt	0.2	3	5	11	28	56
All exclusions	7.7	9	15	16	24	37
Deductions						
Student loan interest	2.2	2	14	30	39	15
Tuition and fees	0.3	7	14	12	36	31
All deductions	2.5	3	14	28	39	17
All Tax Expenditures	36.6	13	20	23	26	17

Source: Congressional Budget Office (2018).

Notes: AOTC = American Opportunity Tax Credit; LLC = Lifetime Learning Credit

* = between zero and 0.5 percent

Key Elements of the U.S. Tax System

What tax incentives exist for higher education?

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US Department of the Treasury. 2016. "Tax Expenditures—FY 2018." Washington, DC: US Department of the Treasury. (table 1)

Q. What tax incentives exist to help families pay for college?

A. Rapidly rising college expenses in the 1990s spurred the 1997 enactment of tax incentives for higher education, which currently include the American opportunity tax credit, the lifetime learning credit, and deductions for tuition and fees and for student loan interest.

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 undergraduate postsecondary school. 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. Up to $1,000 of the AOTC is refundable; to qualify for the credit, students must be enrolled at least half time for one or more academic periods during the year. AOTC credits, it should be noted, are not indexed for inflation. The AOTC was enacted as part of the fiscal stimulus package and then made permanent in 2015 under the Protecting Americans from Tax Hikes Act. The AOTC replaced the Hope credit and is available for more years of schooling (four versus two years), covers more expenses, and is partly refundable.

The maximum benefit for the AOTC begins to phase out when modified adjusted gross income (MAGI) reaches $80,000 and is completely phased out at MAGI of $90,000. For married couples, the phaseout range begins at MAGI of $160,000 and the credit is completely phased out at MAGI of $180,000. The phaseout thresholds are not indexed for inflation.

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 for MAGI between $57,000 and $67,000 in 2018 (and between $114,000 and $134,000 for married couples). The phaseout thresholds for the lifetime learning credit are adjusted annually for inflation. 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, students, or spouses—whoever pays) to reduce taxable incomes by up to $4,000 per return. Single, head of household, or qualifying widower filers with MAGIs between $65,000 and $80,000 or married filers with MAGIs 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. Because the provision is a deduction, it has value only to students and their families with taxable income. Congress retroactively extended the tuition and fees deduction for 2017, but it will not be available in 2018 unless Congress extends it again.

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 in 2018, a taxpayer's AGI may not exceed $80,000 for single, head of household, or qualifying widower filers, or $165,000 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. The student loan interest deduction will cost an estimated $2.1 billion in 2018.

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 credit and the LLC 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).

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 form to receive benefits, and (2) every student who qualifies receives the full benefit for which he or she appears 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), a lack of transparency about why taxes went down, and potential mismatches in that the person receiving the credit or deduction is often not the student.

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.

Key Elements of the U.S. Tax System

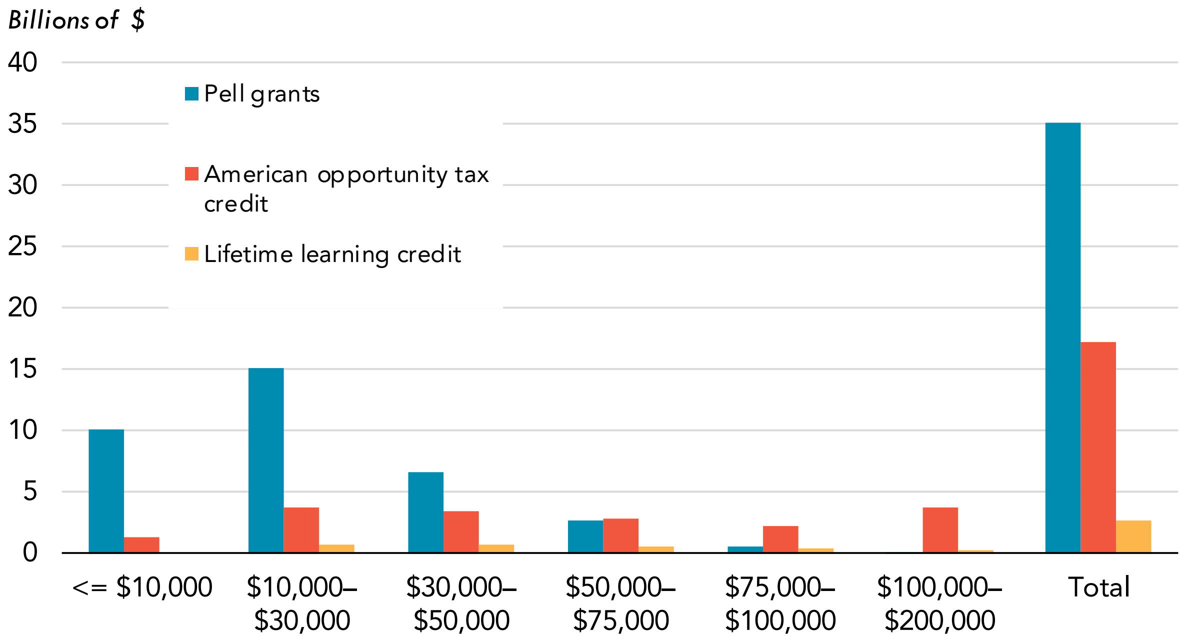
What tax incentives exist to help families pay for college?

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

FIGURE 1

Amount of Pell Grants, AOTC, and LLC

All students, 2017



Source: Tax Policy Center, Table T16-0246, 2016.

Key Elements of the U.S. Tax System

What tax incentives exist to help families pay for college?

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Q. What tax incentives exist to help families save for education expenses?

A. Three tax-favored saving instruments encourage families to save for education expenses: Coverdell savings accounts, qualified tuition programs (commonly known as 529 plans), and the education savings bond program. The first two can be used for elementary, secondary, and postsecondary education. In contrast the much smaller education savings bond program is limited to postsecondary education.

Tax-favored accounts encourage families to save for education expenses by reducing or eliminating the tax normally owed. But there's a catch: to reap significant benefits, families who use these accounts to save for college must invest in sheltered savings accounts years before they know whether their children will attend college. While these funds can be redirected toward another person's educational expenses if the child does not go to college, savers must pay penalties to divert the money for noneducation purposes. The resulting uncertainty is greatest for low-income families because their children are least likely to attend college.

Recent law changes allow families to make nontaxable withdrawals from 529 plans to pay for qualified expenses at public or private K–12 schools—an existing feature of Coverdell savings accounts.

Higher-income families benefit more from tax-favored accounts because they avoid more taxes for each dollar contributed to a sheltered account. All families must pay income tax and a 10 percent penalty on money withdrawn from an account if the funds are used for purposes other than permitted educational expenses. However, even after paying the penalties, high-income families can still come out ahead because of the size of their tax savings and because the accounts let them shift ownership to their children, who typically face lower income tax rates. That benefit, of course, does not extend to low-income families, who are likely to be in the same tax bracket as their children. Tax-free accounts hold no benefit for families whose incomes are too low to require them to pay income taxes, but they are still subject to the penalty for using the funds for other purposes.

COVERDELL ACCOUNTS

In 2018 families with adjusted gross income (AGI) below $110,000 ($220,000 if filing a joint return) can deposit up to $2,000 per beneficiary in a Coverdell account on an after-tax basis. Funds grow untaxed and may be withdrawn tax free if used to pay educational expenses. Coverdell account funds can be used for K–12 expenses as well as higher education.

Key Elements of the U.S. Tax System

What tax incentives exist to help families save for education expenses?

QUALIFIED TUITION PROGRAMS (529 PLANS)

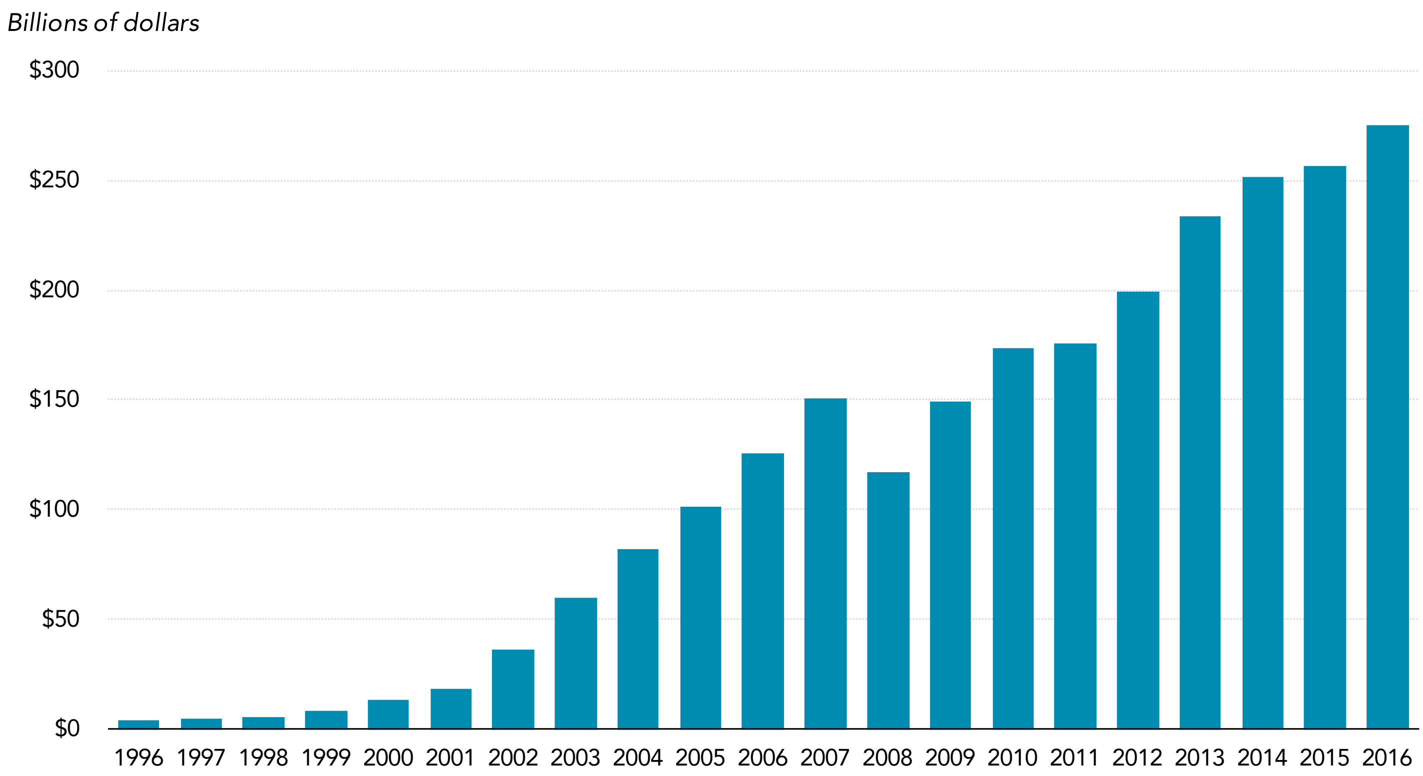
Anyone, regardless of income, may contribute to a 529 plan for a designated beneficiary. As of 2018, a donor may contribute up to $15,000 annually for each beneficiary without triggering a gift tax, with the option of making up to five years of contributions in a single payment as long as no additional gifts are made during the five-year period. Income in 529 plans accumulates untaxed.

Since passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, funds are not taxed when withdrawn from 529s, provided they are used to pay qualified expenses for postsecondary education (tuition, room and board, books and supplies, and technology). Donors retain ownership of the accounts but may use the funds to pay educational expenses only for the named beneficiary. The donor may, however, change beneficiaries if the new beneficiary is a member of the same family as the old beneficiary.

FIGURE 1

Growth of 529 College Savings Plan Account Assets

1996–2016



Source: College Savings Plans Network (CSPN), *529 Report: An Exclusive Year-End Review of 529 Plan Activity*, March 2017.

What tax incentives exist to help families save for education expenses?

The 2017 Tax Cuts and Jobs Act expanded the qualified uses for tax- and penalty-free withdrawals from 529 plans to also cover K–12 elementary and secondary school tuition for public, private, and religious schools. Assets in 529 plans have grown considerably in the last two decades. In 1996, only 500,000 accounts existed and contained only $2.4 billion in assets. As of December 2016, there were 12.9 million 529 plan accounts containing $275 billion in assets (figure 1).

Every state except Wyoming sponsors a 529 plan (but Wyoming residents receive preferred treatment in the Colorado 529 plan). In states with a personal income tax, residents investing in their state-sponsored 529 plans often receive a state tax break for at least part of their investment. Families can choose to invest in plans from other states, which may be the best option for them—especially when contributions are not tax deductible. Some states, moreover, provide matching funds for contributions to 529 accounts. Beyond the state plans, there is also a separate private college 529 plan.

States that offer income tax credits or deductions for contributions to 529 college saving plans and exempt qualified distributions from 529 plans from state income taxes must decide whether they will follow the recent changes in federal rules for qualified withdrawals. Some states have decided to allow qualified withdrawals for K–12 tuition while others have not. For example, New York and Nebraska have issued public statements saying that only higher education expenses would qualify. In contrast, Pennsylvania will allow payment for K–12 tuition expenses to be processed through the PA 529 College Savings Program.

EDUCATION SAVINGS BOND PROGRAM

The federal government allows buyers to exclude interest on designated government bonds from income tax if the money is used to pay for postsecondary education. In 2018, however, families can only cash in these bonds tax free if their modified AGI (MAGI) is less than certain limits. The tax exclusion phases out for MAGI between $79,700 and $94,700 in 2018 (and between $119,550 and $149,550 for married couples). The income limits are indexed for inflation. This program is substantially smaller than the Coverdell and 529 programs.

What tax incentives exist to help families save for education expenses?

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Q. What is the tax treatment of college and university endowments?

A. A small number of colleges and universities in the United States have accumulated significant wealth in the form of endowments. Because these institutions are public and private nonprofit charitable enterprises, donations to their endowments are not taxed and the assets grow free of taxes. The 2017 tax legislation created an exception to this practice, imposing a tax on the endowment earnings of a small number of private nonprofit colleges and universities.

The 2017 Tax Cuts and Jobs Act (TCJA), imposes a new tax on a small group of private nonprofit colleges and universities. Institutions enrolling at least 500 students that have endowment assets exceeding $500,000 per student (other than those assets which are used directly in carrying out the institution's exempt purpose) will pay a tax of 1.4 percent on their net investment income. The $500,000 threshold is not indexed for inflation. A precise understanding of the tax awaits Internal Revenue Service guidance, but only 25 to 30 institutions meet these criteria.

CURRENT TAX TREATMENT OF ENDOWMENTS

Most private nonprofit colleges and universities are exempt from taxes because of their status as 501(c)(3) organizations and their educational mission. Many of these institutions attempt to accumulate endowments—financial assets that generate income to supplement budgets and provide long-term fiscal stability. Endowments support a wide range of activities. At doctoral universities, these include graduate education and research in addition to undergraduate education.

The tax treatment of private nonprofit college and university endowments differs from the treatment of private foundations. Private foundations are tax-exempt organizations established by an individual, family, or company for charitable purposes. Unlike college and university endowments, which accrue from multiple sources over time, foundations must pay an excise tax on their net investment income (generally 2 percent but reduced to 1 percent if their distributions are growing over time). Nonoperating foundations, which are funded by a single or small group of donors and distribute money to others rather than engage themselves in charitable activities, are required to pay out at least 5 percent of their funds each year. In contrast, operating foundations can receive donations from many donors and primarily operate charitable activities themselves rather than distribute grants. They, like college and university endowments, do not have payout requirements.

Key Elements of the U.S. Tax System

What is the excise tax on university endowments?

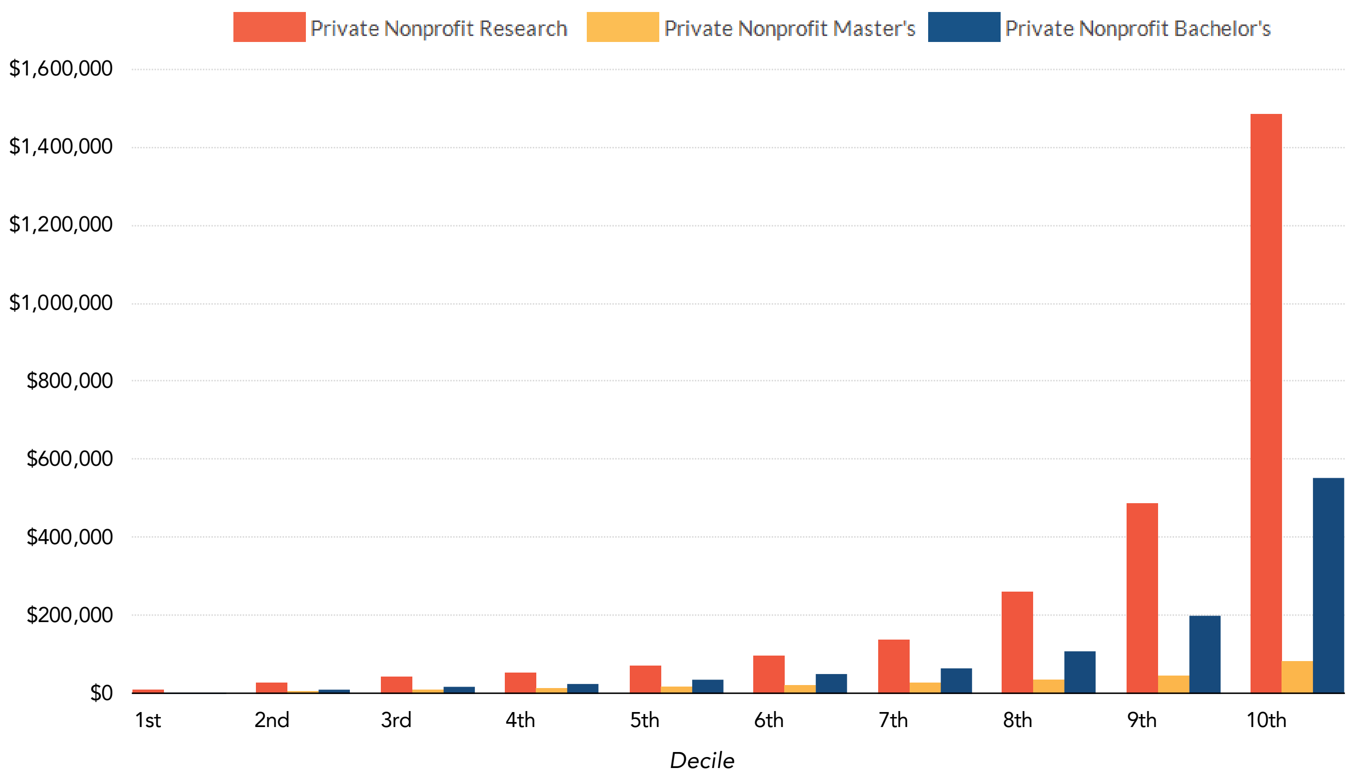
SIZE OF ENDOWMENTS

Public and private colleges and universities collectively hold over $500 billion in endowment wealth, but just 23 of these institutions hold approximately 50 percent of the assets. (There are about 1,600 private nonprofit and more than 700 public four-year institutions in the United States.)

Endowments provide income that supplements tuition and fees, state appropriations, and other funding sources to support the education of undergraduate and graduate students, as well as research, public service, and other institutional activities. Endowments provide a cushion that protects institutional budgets from cyclical pressures, unanticipated changes in enrollments, and other temporary revenue disruptions.

When measuring institutional strength, it is best to examine endowment per student rather than total endowment dollars (figure 1). These figures must be interpreted with caution because they do not distinguish between undergraduate and graduate students, and differences across institutions may be misleading given the differences in institutional missions. Undergraduate colleges use almost all draw (the funds added to their annual budgets from endowments) to support undergraduate education, whereas research universities use the funds to support a broader range of activities.

FIGURE 1
Endowment per Full-Time Equivalent Student
Private nonprofit colleges and universities, 2015–16



Source: Urban Institute analysis of Integrated Postsecondary Education Data System data.
Notes: Institutions ranked by endowment per student. Each decile contains approximately 10 percent of the students in that sector.

Key Elements of the U.S. Tax System

What is the excise tax on university endowments?

The endowments of the wealthiest private research universities enrolling 10 percent of students in the sector average about $1.5 million per student. The average combined endowment ($486,000 per student) for the wealthiest institutions enrolling half the students in this sector is more than 10 times the average endowment ($43,000 per student) of the institutions with the lowest endowments where the other half of this sector's students are enrolled. Endowment wealth at private bachelor's colleges is similarly skewed. At the master's universities, where there is much less wealth and the gaps are smaller, the average endowment for the top half is still almost five times the average for the bottom half.

THE EFFECT OF THE NEW TAX

The new tax is not expected to generate a significant amount of revenue for the federal government, an estimated $200 million per year, but it could set a precedent for imposing further taxes on these nonprofit entities. Some members of Congress have questioned whether these wealthy institutions actually use their resources to further society's educational goals in a meaningful way, largely because few low-income students enroll at institutions with large endowments, which tend to have very selective admissions. In both the public and private nonprofit sectors, the higher the endowment income per student at a college or university, the lower the share of its student body receiving federal Pell grants for low- and moderate-income students.

However, the high-endowment schools do use some of their wealth to reduce the prices they charge low-income students. Low-income students who attend the best-endowed institutions benefit both from the opportunities offered and from considerably lower net tuition prices than they would pay elsewhere. Financial aid is already so generous at these institutions that the tax will not likely lower prices. Moreover, these wealthy institutions enroll fewer than 150,000 of the 4 million students in the private nonprofit sector, and 20 million postsecondary students overall.

The new endowment tax is controversial. There are bipartisan efforts in Congress to repeal the tax, which is, unsurprisingly, unpopular among the higher education community. Some earlier proposals for taxing colleges and universities involved providing incentives for institutions to spend their endowments in certain ways or to modify their pricing structures. Whether it is feasible or advisable for the federal government to effect such changes, the current legislation makes no such effort, nor does it use revenues generated by the tax to further the nation's educational goals.

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