

Key Elements of the U.S. Tax System

What tax incentives exist for higher education?

TAXES AND EDUCATION

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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.

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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

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