

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The top bulb is filled with a dark blue color, and the bottom bulb is filled with a light blue color. The globe is centered in the narrow neck of the hourglass.

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Education Tax Benefits: Are They Permanent or Temporary?

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Abstract. This report describes the postsecondary education tax benefits available to individuals and highlights their temporary-versus-permanent features. It discusses legislation that would remove the applicability of EGTRRA's sunset provision to these education tax benefits and H.R. 1424, the Emergency Economic Stabilization Act of 2008, which the House and Senate passed in early October 2008; in Division C of the bill, the Tax Extenders and Alternative Minimum Relief Act of 2008, the Higher Education Deduction is extended from its expiration on December 31, 2007, to December 31, 2009.

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CRS Report for Congress

Education Tax Benefits: Are They Permanent or Temporary?

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Summary

Federal income tax benefits available to individuals to mitigate escalating costs associated with postsecondary education have multiplied within the past decade. Some of these benefits are authorized temporarily (e.g., the Higher Education Deduction), while others are authorized permanently (e.g., the Hope Scholarship Credit, Lifetime Learning Credit, Coverdell Education Savings Account, and Section 529 Program). But complicating this distinction is the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), in which Congress enhanced temporarily aspects of permanent education tax benefits and authorized temporarily the Higher Education Deduction. This report very briefly describes the postsecondary education tax benefits available to individuals and highlights their temporary-versus-permanent features. It discusses legislation that would remove the applicability of EGTRRA's sunset provision to these education tax benefits and H.R. 1424, the Emergency Economic Stabilization Act of 2008, which the House and Senate passed in early October 2008; in Division C of the bill, the Tax Extenders and Alternative Minimum Relief Act of 2008, the Higher Education Deduction is extended from its expiration on December 31, 2007, to December 31, 2009.

Temporarily Authorized Education Tax Provisions

The Higher Education Deduction originated in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16). It authorized the deduction for tuition and related fees for tax years 2002 through 2005. In December 2006, Congress reauthorized the deduction retroactive to its expiration date and extended it to December 31, 2007, in the Tax Relief and Health Care Act of 2006 (P.L. 109-432). H.R. 1424, the Emergency Economic Stabilization Act of 2008, passed the House and Senate in early October 2008; in Division C of the bill, the Tax Extenders and Alternative Minimum

Relief Act of 2008, the Higher Education Deduction is extended from its expiration on December 31, 2007, to December 31, 2009.

The tax provision allows both itemizers and non-itemizers to claim it (i.e., the deduction is “above-the-line”). It is meant to assist the same student population as the permanently authorized Lifetime Learning credit (discussed below), but the deduction extends to taxpayers with higher incomes: a deduction capped at \$4,000 per return is available to taxpayers whose modified adjusted gross income (AGI) does not exceed \$65,000 for a single filer/\$130,000 for a joint filer; a deduction capped at \$2,000 per return is available to taxpayers whose AGI does not exceed \$80,000 for a single filer/\$160,000 for a joint filer. The deduction cannot be taken for the same student for whom a Hope Scholarship or Lifetime Learning credit is claimed. Neither the amount of the deduction nor the AGI limits are adjusted for inflation, and the amount of the deduction is not phased out as AGI increases.¹

EGTRRA also extended through December 31, 2010, the temporary exclusion for employer-provided educational assistance, which was set to expire for courses beginning after December 31, 2001. The act allowed the \$5,250 annual limit on education assistance to again cover graduate as well as undergraduate courses. The income exclusion originated with enactment of the Revenue Act of 1978 (P.L. 95-600).²

Although the above-the-line deduction for classroom expenses of elementary and secondary (K-12) school educators often is included in conversations about education tax benefits, its purpose differs from that of the other provisions. The educator deduction, initially authorized in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), is intended to help elementary and secondary school teachers among other school personnel defray expenditures for classroom materials they voluntarily make to enhance the quality of students’ education. Like the Higher Education Deduction, it most recently was reauthorized retroactive to its expiration date and extended to December 31, 2009, in H.R. 1424. The classroom expense deduction is available to teachers, instructors, counselors, principals, and aides employed at least 900 hours in a school year at public and private K-12 schools. It is limited to \$250 for purchases of certain items (e.g., books and supplies) used by educators in the classroom.³

¹ For additional information, see CRS Report RL31129, *Higher Education Tax Credits and Deduction: An Overview of the Benefits and Their Relationship to Traditional Student Aid*, by Linda Levine and Charmaine Mercer. (Hereafter cited as CRS Report RL31129, *Higher Education Tax Credits and Deduction*.)

² For additional information, see CRS Report RS22911, *Tax Treatment of Employer Educational Assistance for the Benefit of Employees*, by Linda Levine.

³ For additional information, see CRS Report RS21682, *The Tax Deduction for Classroom Expenses of Elementary and Secondary School Teachers*, by Linda Levine. (Hereafter cited as CRS Report RS21682, *The Tax Deduction for Classroom Expenses of Elementary and Secondary School Teachers*.)

Permanently Authorized Education Tax Provisions

The Taxpayer Relief Act of 1997 (P.L. 105-34) established two permanent federal income tax credits — the Hope Scholarship and Lifetime Learning Credits — for qualified postsecondary education expenses. Since tax year 1998, persons with income tax liabilities⁴ may subtract from them the tuition and related fees paid on behalf of students (e.g., a child, spouse, or themselves) claimed as exemptions on their returns. Before determining the amount of the tuition and fees for which the credits can be claimed, qualified expenses must be reduced by any tax-free scholarships and financial aid (e.g., Pell Grants) awarded to the student. The two credits are intended to aid different student populations: for the Hope credit, students enrolled at least half-time in a program leading to an educational credential who are in their first two years of postsecondary school; and for the Lifetime credit, students enrolled in one or more courses at the undergraduate or graduate level who need not be pursuing an educational credential. The Hope credit was capped at \$1,650 per student in tax year 2007; the Lifetime credit, at \$2,000 per return. Only one of the credits may be claimed for a given student. In 2007, the amount of the credits was gradually reduced for a single return tax filer with AGI between \$47,000 and \$57,000 (a joint filer, between \$94,000 and \$114,000). AGI limits may be adjusted annually for inflation.⁵

The Education Savings Bond program, which became effective in 1990 pursuant to Section 6009 of the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647), is permanent as well. Bond owners who apply the principal and interest of Series EE and I bonds toward tuition and related fees on behalf of a dependent student at the undergraduate or graduate level in the same year in which the bonds are redeemed may be eligible to exclude the interest from their taxable income. The bond must be registered in the taxpayer's and/or spouse's name rather than the dependent's name. The taxpayer must claim an exemption for the student and must meet AGI limits in the year in which bond proceeds are used toward tuition and related fees. In 2007, the exclusion began to phase out at an AGI above \$65,600 for a single filer and above \$98,400 for a joint filer. The exclusion cannot be taken by single filers whose AGI is at least \$80,600 (for joint filers, \$128,400). AGI limits may be adjusted annually for inflation.⁶

EGTRRA changed temporarily, typically for tax years 2002 through 2010, certain aspects of three other permanently authorized education tax benefits. Two of the benefits are meant to encourage individuals to save toward future educational expenses (i.e., the

⁴ To take advantage of nonrefundable credits, taxpayers must have income tax liabilities remaining after they have taken personal/dependency exemptions, standard or itemized deductions, and other personal credits.

⁵ For additional information, see CRS Report RL31129, *Higher Education Tax Credits and Deduction*.

⁶ For additional information, see CRS Report RL32155, *Tax-Favored Higher Education Savings Benefits and Their Relationship to Traditional Federal Student Aid*, by Linda Levine and Charmaine Mercer. (Hereafter cited as CRS Report RL32155, *Tax-Favored Higher Education Savings Benefits*.)

Coverdell Education Savings Accounts and Section 529 Programs). The third is the Student Loan Interest Deduction.

The Coverdell Education Savings Account (CESA) is a trust or custodial account that originated as the Education IRA in P.L. 105-34 for the purpose of providing a tax-free savings vehicle for higher education expenses. The account became available in 1998. The appeal of the permanently authorized CESA was enhanced in EGTRRA starting in tax year 2002, but on January 1, 2011, absent congressional action, the following modifications will be supplanted by their prior versions:⁷

- The annual limit on an individual's after-tax contributions to a beneficiary's account was quadrupled to \$2,000 from \$500.
- The "marriage penalty" was eliminated as well, such that a joint filer with an AGI below \$220,000 is now eligible to make contributions to CESAs compared to prior law when their AGI had to be below \$160,000.
- Tax-free CESA withdrawals were extended from payment of qualified higher education expenses (e.g., tuition, books, and supplies) to payment of qualified K-12 expenses (e.g., tuition, tutoring, and uniforms).
- Higher education expenses were expanded to include, for example, special needs services for special needs beneficiaries.⁸ For special needs beneficiaries, the under-18 age limit for contributions to CESAs was eliminated, as was the requirement that funds in CESAs generally be distributed to beneficiaries by age 30.
- The date by which contributions to CESAs can be made was extended to the tax filing date for that year. The length of time for corrective withdrawals of excess contributions and associated earnings to avoid a 6% excise tax was extended to June 1 from the due date of the beneficiary's tax return for the contribution year.
- The definition of a beneficiary's family members was extended to first cousins into whose accounts funds may be rolled over tax-free from existing accounts and who may be named as new beneficiaries of existing accounts. This too is the case for Section 529 Plans, discussed below.
- Before determining the qualified expenses that CESA withdrawals can offset, expenses must be reduced by the amount of tax-free scholarships and financial aid (e.g., Pell Grants). Taxpayers then can claim a Hope or Lifetime Credit or a Higher Education Deduction for the remaining tuition and fees of a given student and make tax-free withdrawals from CESAs if the withdrawals do not go toward the same expenses for which the other benefits are claimed. (Before January 1, 2002, taxpayers could not claim the credits unless they waived the tax-free treatment of CESA withdrawals.) If, through December 31, 2010, CESA withdrawals become taxable because of receipt of tax-free assistance and of education credits or deductions, the withdrawals will not be subject to the 10% tax penalty usually assessed nonqualified distributions.

⁷ Ibid.

⁸ Definitional changes were made to room and board as well. The changes similarly apply to Section 529 Programs.

Few states sponsored a Qualified Tuition Program before its federal tax treatment was clarified at Section 529 of the Internal Revenue Code by the Small Business Job Protection Act of 1996 (P.L. 104-188). Two types fall within the permanently authorized Section 529 Program: prepaid tuition plans and college savings plans. After-tax contributions to beneficiaries' 529 college savings plans are invested by account owners in one of many portfolios predetermined by state sponsors, and withdrawals from the accounts can pay for a variety of postsecondary expenses. After-tax contributions to prepaid tuition plans on behalf of beneficiaries are collectively invested by plan sponsors to serve as a hedge against tuition inflation. EGTRRA extended sponsorship of prepaid tuition plans from states to institutions of higher education effective through December 31, 2010. The Pension Protection Act of 2006 (P.L. 109-280) made permanent this and other temporary amendments to 529 plans included in EGTRRA. For example, P.L. 109-280 made permanent the tax-free treatment of 529 withdrawals used to pay qualified education expenses and the ability of taxpayers to contribute to a 529 Plan and a CESA in the same year for the same beneficiary without incurring a penalty; to take an education credit or deduction for tuition and fees in the same year that tax-free withdrawals are made from a 529 plan, provided that the distributions are not used toward the same expenses for which the credit or deduction is claimed; and to make one tax-free same-beneficiary rollover in a 12-month period.⁹

An above-the-line deduction from taxable income of up to \$2,500 in annual interest payments on student loans was permanently authorized as of 1998 in the Taxpayer Relief Act of 1997. The loans must have been used toward the cost of attendance for students enrolled at least half-time in undergraduate and graduate programs leading to an educational credential. From 2002 through 2010, the student loan interest deduction no longer is restricted to interest paid within the first 60 months during which interest payments are required. Unlike under prior law, EGTRRA also allows voluntary payments of interest to be deducted over the period. In addition, the act raises the AGI of a taxpayer who may claim the tax benefit (from \$55,000 to \$65,000 for a single filer and from \$75,000 to \$130,000 for a joint filer), effective in 2002. From 2003 through 2010, the income limits may be adjusted annually for inflation; thereafter, absent congressional action, AGI will revert to pre-EGTRRA levels.

Legislation Related to the Relationship Between EGTRRA and Education Tax Benefits

The 110th Congress did not actively consider the application of EGTRRA's sunset provision (Title IX) to the act's "Affordable Education Provisions" (Title IV) generally. Title IV is composed of Subtitle A — Education Savings Incentives; Subtitle B — Educational Assistance; Subtitle C — Liberalization of Tax-Exempt Financing Rules for Public School Construction; and Subtitle D — Other Provisions (i.e., section 431's establishment of the Higher Education Deduction). Rather, the 110th Congress concerned itself specifically with the Higher Education Deduction that EGTRRA had authorized in Title IV, Subtitle D.

⁹ For additional information, see CRS Report RL32155, *Tax-Favored Higher Education Savings Benefits*; and CRS Report RL31214, *Saving for College Through Qualified Tuition (Section 529) Programs*, both by Linda Levine.

Some Members supported retaining the Higher Education Deduction as evidenced by legislation to expand the tax provision, extend it, or make it permanent (e.g., H.R. 193, H.R. 411, H.R. 686, H.R. 1407, H.R. 1437, H.R. 2411, H.R. 2734, H.R. 2782, H.R. 3388, H.R. 3630, H.R. 3879, H.R. 3906, H.R. 4086, H.R. 6049). S. 359 would have removed applicability of EGTRRA's sunset provision to the Higher Education Deduction and enhanced it, while also amending the deduction's definition of an eligible student to conform to that of the Hope credit (i.e., carrying at least half the normal full-time work load for the course of study being pursued).

Members also appeared to favor simplifying use of the federal tax code to help individuals better afford college.¹⁰ For example, H.R. 2902, S. 614 and S. 2763 would have replaced the Higher Education Deduction and the two education credits with one credit. Proposals to eliminate the Higher Education Deduction and Lifetime Learning Credit or to retain them but substitute the Hope Credit's definition of an eligible student would curtail people's access to tax benefits that reduce the cost of taking courses during one's working life to acquire or improve job skills.

Only one of the bills noted above went beyond committee referral, namely, H.R. 6049, the Renewable Energy and Job Creation Act of 2008. The House passed the bill on May 21, 2008. Among its many provisions was a one-year extension of the Higher Education Deduction. The Senate attached its version of H.R. 6049 to a financial rescue bill (H.R. 1424) that it passed on October 1, 2008. The Senate substitute language extends the Higher Education Deduction from December 31, 2007, to December 31, 2009. On October 3, 2008, the House voted favorably on H.R. 1424, which includes the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 at Division C. The JCT estimates the extension of the deduction might cost \$3.1 million in FY2009 and \$2.2 million in FY2010.

¹⁰ For examples of the complexity that families face choosing between the three tax provisions, see CRS Report RL31129, *Higher Education Tax Credits and Deduction*.