



American Institute of Certified Public Accountants

Written Testimony for the Record

Senate Finance Committee Hearing on

Education Tax Incentives and Tax Reform

July 25, 2012

The American Institute of Certified Public Accountants (AICPA) has long been an advocate for sound tax policy that promotes simplification and fairness of the tax law, as well as ease in compliance with and administration of that law. We appreciate the importance and the role that education tax incentives play for families seeking to pay for higher education costs. Thank you for the opportunity to submit our statement on behalf of the members of the AICPA for the hearing record.

Present Law

Included in the Internal Revenue Code are education incentives that may be divided into two general categories: (1) those that are intended to help taxpayers meet current higher education expenses and (2) those that encourage taxpayers to save for future higher education expenses.

The first category includes provisions that may be divided into three main subcategories: (1) exclusions from taxable income such as scholarships (section 117) and employer-provided education assistance (section 127); (2) deductions including the student loan interest deduction (section 221) and the tuition and fees deduction (section 222) and (3) credits including the Hope Credit (for tax years 2009 through 2012, referred to as the American Opportunity Tax Credit) and Lifetime Learning Credit (section 25A). Changes to some of these provisions have already occurred while other provisions will see changes on January 1, 2013 unless Congress takes action to extend the current provisions.

The second category, intended to fund future education, includes educational savings bonds (section 135), qualified tuition programs or QTPs (section 529), and Coverdell Education Savings Accounts or ESAs (section 530).

The various provisions contain numerous and differing eligibility rules summarized in the accompanying table.

Background and Analysis

Tax incentives are meant to encourage certain types of economic behavior, but taxpayers will only respond if they are aware of and understand those incentives. Few, if any, taxpayers are both aware of all the education tax incentives and familiar with their details. Fewer still, can perform the analysis to determine which incentive is most advantageous to them.

The Internal Revenue Code (IRC) contains at least 14 complex incentives to encourage saving for and spending on education.¹ Requirements, eligibility rules, definitions, and income phase-outs vary from incentive to incentive. For example, eligibility for one of the two education credits depends on numerous factors including the academic year in which the child is in school, the timing of tuition payments, the nature and timing of other eligible expenditures, and the adjusted gross income ("AGI") level of the parents (or possibly the student). Further, in a given year a parent may be entitled to different credits for different children, while in subsequent years credits may be available for one child but not another.

Another complication is that some of the provisions, such as section 222, *qualified tuition and related expenses*, are temporary provisions that are sometimes renewed retroactively, making it difficult for taxpayers to plan for optimal usage of the education provisions. Section 222, qualified tuition and related expenses expired on December 3, 2011 unless Congress acts to extend the provision.

Further complicating the statutory scheme, the Code precludes use of the Lifetime or Hope (American Opportunity Tax) Credit if the child also receives tax benefits from a Coverdell Education Savings Account. Although the child can elect out of such benefits, this decision also entails additional analysis. The IRS publication to explain the income tax rules on education incentives (Publication 970) is 87 pages long.

For many taxpayers, analysis and application of the intended incentives are too cumbersome to deal with compared with the benefits received. The U.S.

Government Accountability Office ("GAO") estimated that for tax year that for 2009 returns, about 14% of eligible taxpayers failed to claim education incentives resulting in an average lost tax benefit of \$466.² Further, according to GAO research, although the number of taxpayers using the educational tax credits is growing quickly, the complexity of the tax provisions prevents hundreds of thousands of taxpayers from claiming tax benefits to which they are entitled or which would be most advantageous to them.³ Finally, there is evidence that the regressive nature of the provisions prevents low-income taxpayers from getting the tax benefit that Congress envisioned.⁴

Furthermore, there is evidence from government studies that erroneous application of the Hope Credit contributes significantly to the "Tax Gap." A 2009 U.S. Treasury Inspector General for Tax Administration ("TIGTA") report identified approximately 203,000 taxpayers who claimed the Hope Credit for the same student for the three consecutive years ending in Tax Year (TY) 2006 (TYs 2004, 2005, and 2006).⁵ The TIGTA report explained that the amounts of the credits inappropriately claimed in TY 2006 averaged close to \$1,500 and totaled just over \$300 million.⁶ Further, over 58,000 of these taxpayers claimed the credit for the same student for four consecutive tax years (TYs 2004 through 2007).⁷ The amounts of the credits inappropriately claimed for a fourth year totaled almost \$80 million.⁸ In a separate report, more than 169,000 taxpayers were identified who claimed the Hope Credit for the same student for the three consecutive tax years ending in TY 2007 (TYs 2005, 2006, and 2007).⁹ The amounts of the credits inappropriately claimed averaged close to \$1,400 and totaled just over \$232 million.¹⁰

In terms of tax policy, the numerous tax incentives to assist with college expenses are not the only way the federal government provides assistance to college students and their families. Through the Department of Education, the federal government assists low-income individuals through various scholarship and grant programs. We encourage Congress to consider all of these programs together to determine if the desired goals are being met in an effective and efficient manner. The current tax provisions do not always meet the goal of helping low to middle-income families with college expenses. Consideration should be given to where assistance can best be provided through the tax law (such as incentives to save for future college expenses) versus grant and scholarship programs while the student is in college (where assistance is needed at the start of the school year rather than when the tax return is filed). Consideration should also be given to identifying the targeted income group that the federal government should be providing financial

assistance to for higher education expenses. When assessing whether this goal is met, aid distributed through scholarships, grants or tax provisions should be considered.

AICPA Proposals

1. Replace tax incentives (i.e., Hope Credit, American Opportunity Tax Credit, Lifetime Learning Credit and the tuition and fees deduction) intended to help taxpayers meet current higher education expenses with one new or revised credit. Combining features of these into one credit would simplify the tax benefits and remove duplicative provisions relating to higher education expenses.

a. The credit should be on a "per student" rather than a "per taxpayer" basis, offering a potentially larger tax benefit per family.

b. The credit should be available for any year of postsecondary education, including graduate-level and professional degree courses.

c. The credit should only be available to students meeting the definition of "student" under section 25A(b)(3).

d. The credit should have a lifetime limit rather than an annual limit.

e. The tax return reporting requirement should continue including the SSN of the student associated with the expenses claimed with respect to the credit taken for the tax year. Accordingly, amounts claimed over time could be tracked by the student's SSN. These changes may result in improved compliance and enforcement.

f. The credit should be 100% refundable and phased-out for high income taxpayers. The phase-out limitations should be consistent with any other education-related incentive.

g. The credit should be claimed on the parents' return as long as the child is a qualifying dependent of the parent.

2. Create a uniform definition of "qualified higher education expenses" (QHEE) for all education-related tax provisions. Specifically, QHEE should include tuition, books,

fees, supplies and equipment. Also, the terms "special needs services" and "special needs beneficiary" should be clearly defined.

3. Coordinate the phase-out amounts for the student loan interest deduction and the educational savings bonds and Coverdell Education Savings Accounts exclusions with the new or revised tax credit intended to help taxpayers meet current higher education expenses. All education-related tax provisions should have the same AGI limitations. The concern for excessively high marginal rates resulting from coordinating phase-out provisions should be alleviated by substituting one credit for the several benefits that exist today. In addition, any remaining concerns could be addressed by widening the phase-out range which would still permit coordination that could simplify matters for taxpayers and improve their understanding of eligibility. A single definition of modified AGI should be used for the phase-out determination of any education provision.

Summary of Select Education Tax Incentives

Exclusions

Code §

117

Provision

Exclusion for scholarships

Summary

Excludes scholarship from income to the extent it covers qualified education expenses for degree-seeking undergraduate student

Qualified Education Expenses Defined As

Tuition, books, supplies, equipment; but not room and board

AGI Phase-Out

None

Code §

127

Provision

Exclusion for employer-provided education

Summary

For tax years beginning before 2013 Employee excludes from income up to \$5,250 of employer-provided qualified education expenses under educational assistance program

Qualified Education Expenses Defined As

Tuition and fees for undergraduate and graduate courses; books, supplies, equipment; but not room and board

Does not have to be for work-related courses.

AGI Phase-Out

None

Deductions

Code §

221

Provision

Student loan interest deduction

Summary

For AGI deduction of \$2,500 for interest paid on qualifying student loan

Qualified Education Expenses Defined As

Tuition, fees, books, supplies, equipment, room and board, transportation, other necessary expenses

AGI Phase-Out

S: \$60,000 - \$75,000 MAGI

MFJ: \$125,000 - \$155,000 MAGI

MFS: No deduction

After 12/31/12 the thresholds and phase outs return to levels of:

S: \$40,000 - \$55,000 MAGI

MFJ: \$60,000 - \$75,000 Indexed for inflation.

Code §

222

Provision

Qualified tuition and fees deduction

Expired 12/31/11

Summary

For AGI deduction of up to \$4,000

Qualified Education Expenses Defined As

Tuition, fees; but not room and board

Student-activity fees and expenses for course-related books, supplies, and equipment are included in QHEE only if the fees and expenses must be paid to the institution as a condition of enrollment. Cannot include room & board.

AGI Phase-Out

S, HOH: If AGI is not more than \$65,000, may deduct \$4,000; if between \$65,000 and \$80,000, may deduct \$2,000

MFJ: If AGI is not more than \$130,000, may deduct \$4,000; if between \$130,000 and \$160,000, may deduct \$2,000

MFS: No deduction

Education Incentives -- Credits

Code §

25A

Provision

Hope credit

(For tax years 2009 through 2012, the American Opportunity Tax Credit as described in 25A(i))

Summary

Credit of up to \$2,500 *per eligible student*: 100% of first \$2,000; plus 25% of next \$2,000.

Must be enrolled at least half-time

40 percent of modified credit is refundable (but not for child subject to section 1(g) Kiddie tax)

If parent pays the expenses, must be able to claim exemption for student on tax return

No felony drug conviction

New regulations explain who gets credit in special circumstances

Qualified Education Expenses Defined As

Tuition, fees, and course materials including books, during first four years of post-secondary education; but not room and board.

Courses must be associated with degree program or recognized education credential

Athletic fees, insurance, activity fees are not eligible unless required as a condition of enrollment and paid directly to the institution

AGI Phase-Out

S: \$80,000 - \$90,000

MFJ: \$160,000 - \$180,000

MFS: No credit

Code §

25A

Provision

Lifetime Learning credit

Summary

Credit of up to \$2,000 *per return*: 20% on up to \$10,000. The credit is not per child but per taxpayer.

A non-refundable elective credit

If parent pays the expenses, must be able to claim exemption for student on tax return

New Regulations explain who gets credit in special circumstances

Qualified Education Expenses Defined As

Tuition and fees including for graduate courses/continuing education; but not room and board

Available for all post-secondary education not necessarily associated with degree

AGI Phase-Out

S: \$52,000 - \$62,000

MFJ: \$104,000 - \$124,000

MFS: No credit

Education Incentives -- Planning for College

Code §

135

Provision

Educational Savings Bonds

Summary

Allows for partial or total exclusion of interest income on redemption of qualified U.S. savings bonds used for qualifying purposes

Qualified Education Expenses Defined As

Tuition and fees but not for courses involving sports, games, or hobbies that are not part of degree or certificate granting program; not room and board

AGI Phase-Out

S: \$72,860-\$87,850 for 2012; MFJ: \$109,250-\$139,250 for 2012, MFS: No exclusion

Code §

529

Provision

Qualified Tuition Plans

Summary

For College Savings Plan, account owner contributes cash to a plan account for a beneficiary and the contribution is invested according to the terms of the plan.

For Prepaid Tuition Plan, account owner contributes cash to a plan account and the contribution purchases tuition credits or credit hours based on then-current tuition rates.

Contributions qualify for the annual gift tax exclusion.

Earnings are not taxed and funds may be withdrawn tax free if used for qualifying purposes.

Qualified Education Expenses Defined As

Tuition and fees, books, computers, technology and other expenses for vocational schools, 2-year and 4-year colleges as well as graduate and professional education; room and board if the beneficiary attends school at least half-time; expenses of special needs beneficiary necessary for his/her enrollment at eligible educational institutions

AGI Phase-Out

None

Code §

530

Provision

Coverdell Education Savings Account

Summary

Non-deductible contribution of up to \$2,000 per year for a beneficiary under age 18. Except for special needs beneficiaries, contributions must end at age 18 and assets must be withdrawn by age 30.

Distributions non-taxable to extent funds used for QHEE or qualified elementary and secondary education expenses

Qualified Education Expenses Defined As

Tuition, books, fees, supplies, equipment, tutoring, computer equipment and software, uniforms for both higher education and elementary and secondary education at public, private, and religious schools; room and board for student enrolled at least half-time

AGI Phase-Out

S: \$95,000 and \$110,000

MFJ: \$190,000 and \$220,000

MFS: \$95,000 and \$110,000

FOOTNOTES

¹ The 14 education tax incentives are (1) non-itemized tuition deduction; (2) non-itemized college loan interest; (3) itemized deduction for work related education; (4) HOPE (American Opportunity Tax) Credit; (5) Lifetime Learning Credit; (6) tax-free treatment of student loans canceled; (7) tax-free student loan repayment assistance; (8) tax exemption for scholarships used for tuition, fees, and books; (9) Coverdell Education Savings Accounts; (10) penalty-free withdrawal from IRAs to pay for education; (11) interest exclusion for savings bonds used to finance college education; (12) Section 529 qualified tuition plans; (13) tax-free education benefits provided by employer plans; and (14) additional dependent exemption for students age 19-23. There is also one disincentive for saving outside these programs: income from savings of fulltime students age 19-23 can be taxed at their parents' marginal tax rate.

² U.S. Government Accountability Office, Testimony Before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, *Higher Education Multiple Higher Education Tax Incentives Create Opportunities for Taxpayers to Make Costly Mistakes*, May 1, 2008, GAO-08-717T. A May 2012 report from GAO indicated that for 2009 returns, about 14% of eligible taxpayers failed to claim education incentives resulting in an average lost tax benefit of \$466. GAO, *Higher Education: Improved Tax Information Could Help Families Pay for College*, GAO-12-560, May 2012.

³*Ibid.*

⁴*Ibid.*

⁵ Treasury Inspector General for Tax Administration (2009). *Improvements Are Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions*; September 30, 2009, Ref. No. 2009-30-141.

⁶*ibid.*

⁷*ibid.*

⁸*ibid.*

⁹*ibid.*

¹⁰*ibid.*