CENTER for POSTSECONDARY and ECONOMIC SUCCESS at CLASP

Education Tax Credits: Refundability Critical to Making Credits Helpful to Low-Income Students and Families

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Half of all non-loan federal student aid is now offered as tax benefits for educational costs in the form of credits, deductions, and college savings accounts. These benefits help students and families offset the costs of their postsecondary education with tax savings. Yet, as explained in our 2013 report, Reforming Student Aid: How to Simplify Tax Aid and Use Performance Metrics to Improve College Choices and Completion[i], under current law, the benefits of these tax incentives overwhelmingly go to students from higher-income families who are already most likely to attend higher education institutions. Moreover, the multiple overlapping tax benefits for higher education add to the complexity of the tax code, and can result in taxpayers not claiming the benefits for which they are eligible. In both our initial report, and a follow-up report from The Reimagining Aid Design and Delivery (RADD) Consortium for Higher Education Tax Reform, we recommended a set of changes that would both simplify the package of education tax benefits and increase the extent to which they assist students in low- and moderate-income families.

With the increased need to make college more affordable for low-income students and their families, policymakers are rightfully paying attention to this issue. In the previous Congress, Representatives Diane Black (R-TN) and Danny K. Davis (D-IL) introduced H.R. 3393, the Student and Family Tax Simplification Act, which combined several tax provisions into an enhanced American Opportunity Tax Credit (AOTC). President Obama's proposed budget for 2016, released in February, contains a proposal that builds on this bill. And in March, Representative Lloyd Doggett (D-TX) introduced H.R. 1260, The American Opportunity Tax Credit Act of 2015 and Senator Charles Schumer (D-NY) introduced S. 699, The American Opportunity Tax Credit Permanence and Consolidation Act of 2015 that takes the current AOTC one step further by increasing and expanding current eligibility limits. While all of these proposals are designed to make the AOTC permanent, to simplify the tax code by consolidating benefits, and to increase the extent to which students and their families who do not have federal income tax liability can benefit, they vary in the details.

This brief explains the tax provisions that would be affected by these proposals, compares them all, and examines how different types of students would be affected under each proposal.

Current Education Tax Benefits

Students paying for postsecondary education (or their parents, if the students can be claimed as tax dependents) may qualify for the American Opportunity Tax Credit (AOTC), the Lifetime Learning Credit (LLC) or the tuition and fees deduction (See table 1). Only one of these can be claimed for an individual student in a given year.

- **The American Opportunity Tax Credit:** For those who qualify for the AOTC, it provides the largest benefit (up to $2,500 per student for the first four years of postsecondary education), and it is the only one that is partially refundable, meaning that taxpayers can receive a benefit (up to $1,000) even if they do not have federal income tax liability. However, some students--such as those who attend graduate school, those who attend less than half-time, and those who have already claimed the AOTC (or the Hope Credit) for four years--are ineligible for the AOTC. The AOTC was created in 2009 under the American Recovery and Reinvestment Act and expanded the previous **Hope Credit**. The AOTC is currently scheduled to expire after 2017, when it will revert to the Hope Credit, which is not refundable, and is limited to two years.

- **The Lifetime Learning Credit:** The LLC is a non-refundable credit that helps undergraduates, graduates, and those taking courses to improve their job skills pay for their courses regardless of the number of years in their program. Because it is available without time limit--and for part-time and graduate study--it reaches students who are not eligible for the AOTC. However, because the LLC is non-refundable, it does not benefit lower-income taxpayers. The LLC has a maximum value of $2,000 but students must have at least $10,000 in qualified expenses to receive the full amount, so students who attend institutions with relatively low tuition, fees, and expenses cannot benefit from the full credit.

- **The tuition and fees deduction** reduces the amount of taxable income by the amount of tuition and fees paid, up to $4,000 per year. It is one of the most regressive tax benefits for education, with nearly half of the benefit going to taxpayers with incomes above $100,000. This is because it phases out at higher income ranges than the other credits and is also more valuable for taxpayers with higher marginal tax rates (e.g. it is worth $400 for a family in the 10 percent tax bracket but $1,120 for a family in the 28 percent tax bracket).

Note that for all of these credits, tuition and fees are countable educational expenses, but living expenses are not, even though they are part of the cost of attendance under financial aid formulas. Students who receive Pell Grants or other scholarships that can be used to cover living expenses may opt to do so and use other funds (including loans) to pay for tuition in order to qualify for the tax benefits. However, under current law, scholarships used for educational fees and expenses besides tuition must be reported as taxable income. In many cases, students are still better off claiming the educational tax credits, but each student must examine his or her individual tax situation to determine the optimal way to allocate expenses.[ii]

Table 1: Current Law Provisions of Each Credit

Main Features of Key Education Tax Credits

	AOTC (2009-2017)	Hope Credit (2008)	Lifetime Learning Credit (LLC)	Tuition and Fees Deduction
Maximum Credit Value	$2,500 per student *100 percent of the first $2,000 of qualifying expenses, plus 25 percent of the next $2,000 in qualifying expenses*	$1,800* per student *100 percent of the first $1,200 of qualifying expenses, plus 50 percent of the next $1,200 in qualifying expenses**	$2,000 per return *20 percent of the first $10,000 of qualifying expenses.*	Can reduce the amount of income subject to tax by up to $4,000
Refundability	40 percent refundable; maximum cash refund of $1,000	Nonrefundable	Nonrefundable	Does not apply
Income Phase-Out	Single and Head of Household: $80,000-$90,000 Married Filing Jointly: $160,000-$180,000	Single and Head of Household: $48,000-$58,000* Married Filing Jointly: $96,000-$116,000*	Single and Head of Household: $54,000-$64,000** Married Filing Jointly: $108,000-$128,000**	Single and Head of Household: $65,000- $80,000 Married Filing Jointly: $130,000-$160,000
Indexing for Inflation	Neither the value of the credit nor the phase-out limits are indexed.	Both the value of the credit and the phase-out limits are indexed.	The phase-out limits are indexed, but the value of the credit is not.	Neither the value of the credit nor the phase-out limits are indexed.
Qualifying Expenses	Tuition, fees, and required course materials	Tuition and fees	Tuition and fees	Tuition and fees
Miscellaneous	The credit may only be claimed for four years, and is available for the first four years of postsecondary education (including any years the Hope Credit was claimed). Students must be enrolled at least half time for at least one academic period that begins during the tax year, and they must be working toward an undergraduate degree, certificate, or other recognized education credential.	The credit may only be claimed for two years and is available for the first two years of postsecondary education. Students must be enrolled at least half time for at least one academic period that begins during the tax year, and they must be working toward an undergraduate degree, certificate, or other recognized education credential.	The LLC is available for any for-credit postsecondary education (excluding certain hobby and sport –related classes). It is therefore available for students who are not eligible for the AOTC, including students attending less than half-time, students who have exceeded the four-year limit, and graduate students.	This deduction can be claimed for an unlimited number of years during a student's enrolment in postsecondary education. It is available while enrolled in one or more courses at an eligible institution.

* *The Hope parameters correspond to 2008 levels. If AOTC expires and the law reverts to the Hope Credit, these amounts will be adjusted for inflation. Note that the Lifetime Learning Credit phase-out levels shown are what the Hope parameters would have been if it were in effect in 2014.* ****** *As of 2014 these income thresholds took effect.*

Sources: *Joint Committee on Taxation 2014, Crandall-Hollick 2014, IRS Service 2015.*

Proposals

To reduce the ineffectiveness of these credits in promoting college access and completion, a number of proposals have been suggested to reform the education tax systems in order to simplify the tax codes so students and families can more easily afford the costs of higher education. In 2013, Reps. Diane Black (R-TN) and Danny Davis (D-IL) proposed the *Student And Family Tax Simplification Act*, in his 2015 State of the Union, President Obama outlined his plan to reform our complex tax codes, and earlier this year, Rep. Lloyd Doggett (D-TX) unveiled the *American Opportunity Tax Credit Act of 2015*.

All of the proposals would eliminate the LLC and the tuition and fees deduction and, in turn, would make permanent and enhance the AOTC by increasing and frontloading the refundability.[iii] All of these proposals would also improve coordination between the AOTC and Pell Grants. They differ in their phase-out ranges, their treatment of students who take more than four years to attend or who attend less than half-time, and in how they are paid for.

Elements of each proposal are as follows:

Table 2: Comparison of the Proposals

	Black-Davis	Obama	Doggett	Schumer
Maximum Value of Enhanced AOTC	Up to $2,500 credit per eligible student	Up to $2,500 credit per eligible student	Up to $2,500 credit per eligible student	Up to $3,000 credit per eligible student
Refundability	Maximum of $1,500	Maximum of $1,500	Maximum of $1,500	Maximum of $1,500
Time Limit on Claiming	Credit available for first four years	Extends the credit to five years for all students	Replaces current limits on the number of years a student can use the AOTC with a $15,000 lifetime cap	Replaces current limits on the number of years a student can use the AOTC with a $15,000 lifetime cap
Eligibility of Students Attending Less than Half-time	Students must attend at least half-time to qualify	Eligibility is expanded to students attending part-time	Eligibility is expanded to students attending part-time	Eligibility is expanded to students attending part-time
Eligibility of Graduate Students	Do not qualify	Do not qualify	Qualify, subject to lifetime limit	Do not qualify
Income Phase-Out	Changes current income phase-out limits:* Single and Head of Household: $43,000 -$63,000 Married Filing Jointly: $86,000 -$126,000	Maintains current income phase-out limits: Single and Head of Household: $80,000-$90,000 Married Filing Jointly: $160,000-$180,000	Maintains current income phase-out limits: Single and Head of Household: $80,000-$90,000 Married Filing Jointly: $160,000-$180,000	Raises income phase-out limits: Single and Head of Household: $80,000-$100,000 Married Filing Jointly: $160,000-$200,000
Extension	Makes permanent	Makes permanent	Makes permanent	Makes permanent

Indexing for Inflation	Indexes the value of the AOTC to inflation, starting 2018	Indexes the value of the AOTC to inflation	Indexes the value of the AOTC to inflation	Indexes the value of the AOTC to inflation
Qualifying Expenses	Tuition, fees, and required course materials	Tuition, fees, and required course materials	Tuition, fees, and required course materials	Tuition, fees, and required course materials
Coordination of Pell and AOTC	Improves the coordination between Pell Grants and the AOTC and ensures that Pell Grants are never counted as taxable income, even when used for educational costs other than tuition	Improves the coordination between Pell Grants and AOTC by exempting Pell Grants from taxable income	Improves the coordination between Pell Grant and the AOTC by exempting Pell Grants from taxable income	Improves the coordination between Pell Grant and the AOTC by exempting Pell Grants from taxable income
LLC and Tuition and Fees Deduction	Eliminates the Hope and Lifetime Learning Credits and the tuition deduction	Eliminates other tax preferences for higher education such as the LLC and the tuition and fees deduction	Eliminates the Hope and Lifetime Learning Credits and the tuition deduction	Eliminates the Hope and Lifetime Learning Credits and the tuition deduction
How It's Funded	As introduced, changes to education tax credits were revenue neutral.	Being paid for out of the overall tax proposal	No offsets identified	No offsets identified

Note: The change in the current income phase-out limit was reversed in the version of the Black-Davis bill that was ultimately passed by the House Ways and Means Committee in 2014.

Several of the proposals suggested by all four bills particularly benefit the fifty-one percent of students who are independent and non-traditional students. Consolidating the various educational benefits into an improved AOTC was among the recommendations made by CLASP and our partners in our Reimagining Aid Delivery and Design (RADD) white paper, Higher Education Tax Reforms: A Shared Agenda for Increasing College Affordability, Access, and Success. Increasing the refundable portion of the AOTC to $1,500 benefits students who attend low-cost institutions, such as community colleges, and are not eligible to receive the full $1,000 refundable credit if they have less than $4,000 in qualified expenses. Additionally, improving the coordination between the Pell Grant and AOTC by exempting Pell from taxable income and the AOTC calculation would make it easier for the nine million Pell Grant recipients to claim the tax benefit already available to them.

How Students Fare Under the Proposals

The best way to understand the changes that the proposals would make compared to current law, and the differences among them, is to look at how students at different institutions and in different years of study would be affected. For this purpose, we use the College Board's estimated in-state tuition and fees of $3,347 for public two-year colleges and $9,139 for public four-year state colleges.[iv] We also assume that students apply any Pell Grants received to room and board expenses so that they can qualify for the maximum education tax credits. For this analysis, we assume that all of the students have income under the levels at which the tax credits phase out. We do not take into account the tuition and fees deduction, as only some high-income families will be better off taking it rather than the credits.

Table 3: Student in third year of college, attending full-time: Currently eligible for AOTC

	Current policy	After AOTC expires (current law after 2017)	Black/Davis and Obama	Doggett	Schumer
Tuition of $9,139, has income tax liability	$2,500 (from AOTC)	$1,828 (from LLC)	$2,500 (from AOTC)	$2,500 (from AOTC)	$3,000 (from AOTC)
Tuition of $9,139, no income tax liability	$1,000 (from AOTC)	0 (not eligible for Hope, LLC is not refundable)	$1,500 (from AOTC)	$1,500 (from AOTC)	$1,500 (from AOTC)
Tuition of $3,347, has income tax liability	$2,337 (from AOTC)	$669 (from LLC)	$2,337 (from AOTC)	$2,337 (from AOTC)	$2,337 (from AOTC)
Tuition of $3,347, has no income tax liability	$935 (from AOTC)	0 (not eligible for Hope, LLC is not refundable)	$1,500 (from AOTC)	$1,500 (from AOTC)	$1,500 (from AOTC)

All of these proposals provide significant improvements for students, or their families, who do not have federal income tax liability. They both increase the total amount of the credit that is refundable and frontload it so that individuals attending lower-cost institutions can still benefit. This is important both for targeting and for making tax credits more effective at supporting postsecondary education attendance. Families with income tax liability also benefit, particularly after 2017 when the AOTC would otherwise expire. The proposals, however, diverge for students after their fourth year of college.

Table 4: Student in 5th year of college, attending full-time: Currently ineligible for AOTC, eligible for LLC

	Current policy	Black-Davis	Obama	Doggett	Schumer
Tuition of $9,139, has income tax liability	$1,828 (from LLC)	0	$2,500 (from AOTC)	$2,500 (from AOTC)	$3,000 (from AOTC
Tuition of $9,139, no income tax liability	0 (not eligible for AOTC, LLC is not refundable)	0	$1,500 (from AOTC)	$1,500 (from AOTC)	$1,500 (from AOTC)
Tuition of $3,347, has income tax liability	$669 (from LLC)	0	$2,337 (from AOTC)	$2,337 (from AOTC)	$2,337 (from AOTC)
Tuition of $3,347, has no income tax liability	0 (not eligible for AOTC, LLC is not refundable)	0	$1,500 (from AOTC)	$1,500 (from AOTC)	$1,500 (from AOTC)

Table 5: Student in 6th year of college, attending full-time: Currently ineligible for AOTC, eligible for LLC

	Current policy	Black-Davis	Obama	Doggett	Schumer
Tuition of $9,139, has income tax liability	$1,828 (from LLC)	0	0	$2,500 (from AOTC	$3,000 (from AOTC
Tuition of $9,139, no income tax liability	0 (not eligible for AOTC, LLC is not refundable)	0	0	$1,500 (from AOTC)	$1,500 (from AOTC)
Tuition of $3,347, has income tax liability	$669 (from LLC)	0	0	$2,337 (from AOTC)	$2,337 (from AOTC)
Tuition of $3,347, has no income tax liability	0 (LLC is not refundable)	0	0	$1,500 (from AOTC)	$1,500 (from AOTC)

Unlike current policy, which limits the AOTC to four years or Obama's budget proposal that caps AOTC after five years, Doggett and Schumer's proposals would eliminate the current limits on the number of years a student can receive the AOTC receipt and, instead, would establish a $15,000 lifetime limit cap. Students receiving the maximum credit each year would reach this limit in five or six years, but students receiving less than the maximum amount would be able to claim the credit for additional years.

Table 6: Student in 4th year of college, attending less than half-time: Currently ineligible for AOTC, eligible for LLC
(Note: Tuition is assumed to be 1/3 the cost of full tuition)

	Current policy	Black-Davis	Obama*	Doggett	Schumer
Tuition of $3,050, has income tax liability	$610 (from LLC)	0	$1,250 (from AOTC)	$763 (from AOTC	$915 (from AOTC)
Tuition of $3,050, no income tax liability	0 (not eligible for AOTC, LLC is not refundable)	0	$750 (from AOTC)	$763 (from AOTC	$915 (from AOTC)
Tuition of $1,110, has income tax liability	$222 (from LLC)	0	$1,110 (from AOTC)	$277 (from AOTC)	$333 (from AOTC)
Tuition of $1,110 , has no income tax liability	0 (LLC is not refundable)	0	$750 (from AOTC)	$277 (from AOTC)	$333 (from AOTC)

* *Assumes that the credit for less-than-half-time students is calculated the same as the regular AOTC, except with lower limits -- details are not fully available.*

Under current law, students attending school less than half-time, and graduate students, can only benefit from the LLC, not the AOTC. But, low-income families without federal income tax liability do not benefit from the LLC because it is not refundable. The Obama, Doggett and Schumer proposals all address this issue by allowing such students to claim a partial AOTC. However, because even a partial AOTC uses up a year of eligibility in the Obama proposal, students who anticipate moving between full- and part-time status may wish not to claim the AOTC in a year in which they attend part-time in order to preserve their future eligibility. As the Doggett and Schumer proposals rely on a dollar cap rather than a number of years, students would have no reason not to claim a partial benefit when they attend part-time.

Discussion

While all of these proposals are designed to simplify education tax benefits and make them more useful to low-income students and their families, there are important differences.

The Black-Davis bill, as introduced, was designed to be revenue neutral, with the expansions fully offset by cuts elsewhere, and it would result in losers as well as winners. Specifically, it would have made the AOTC much more targeted, by lowering the income level at which eligibility begins to phase out by almost 50 percent. For example, under current law, a single taxpayer is eligible for the full AOTC until income exceeds $80,000; this bill would have reduced the income threshold to $43,000. This change would *significantly* reduce the number of students and families who would be eligible for the benefit. However, this change was reversed in the amended version of the Black-Davis bill that was ultimately passed by the House Ways and Means Committee in 2014.

By contrast, the Obama, Doggett and Schumer proposals would all add significantly to the cost of educational tax benefits. The Obama and the Doggett proposals would not change the income limits, while the Schumer proposal would actually raise the phase-out limits, allowing higher-income families to benefit. In the Obama budget, the improved AOTC proposal is one of several tax provisions for middle-class families that would be offset by increased taxation of trust funds, dividends, and capital gains.[v] The Schumer and Doggett proposals do not contain offsets.

Even with the proposed reforms, it is important to remember that direct student aid, such as Pell Grants, is a more effective way of targeting federal educational assistance to lower income students. Moreover, financial aid is paid out to schools when tuition is due, while education tax credits cannot be claimed until the following year. But as long as we choose to use the tax code to subsidize higher education, it is important that we do so in a manner that does not exclude low- and moderate-income students who are disproportionately likely to attend low-cost institutions and to take more than four years to complete a degree.

Tax-based student aid is long overdue for reform. The current system of education tax credits and deductions is complex. We are thus pleased that policymakers are taking up our ideas and continue to encourage them to improve the targeting of tax-based student aid to low- and moderate-income undergraduate students, and to simplify the system, making it easier for students and families to understand and claim the benefits available.

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[i] P. Reimherr, T. Harmon, J. Strawn, and V. Choitz, *Reforming Student Aid: How to Simply Tax Aid and Use Performance Metrics to Improve College Choices and Completion*, CLASP, February 2013. http://www.clasp.org/resources-and-publications/publication-1/Final-RADD-Exec-Summ-Feb-2013.pdf

[ii] Department of the Treasury, *Interaction of Pell Grants and Tax Credits: Students May Be Foregoing Tax Benefits by Mistake*, 2014, http://www.treasury.gov/connect/blog/Documents/Pell%20AOTC%204%20pager.pdf.

[iii] Frontloading refundability means that the limited amount of refundable credit is not further reduced for students who qualify for less than the maximum possible credit. For further details, see discussion on pages 25-27 of the RADD white paper, *Higher Education Tax Reform: A Shared Agenda for Increasing College Affordability, Access, and Success*. http://www.clasp.org/resources-and-publications/publication-1/Nov2013RADD_TaxAid.pdf

[iv] College Board, *Average Published Undergraduate Charges by Sector, 2014-2015*, http://trends.collegeboard.org/college-pricing/figures-tables/average-published-undergraduate-charges-sector-2014-15

[v] The White House, Office of the Press Secretary, "Fact Sheet: A Simpler, Fairer Tax Code That Responsibly Invests in Middle Class Families," January 17, 2015, https://www.whitehouse.gov/the-press-office/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-fami.