Higher Education Tax Reform

A Shared Agenda for Increasing College Affordability, Access, and Success

The Reimagining Aid Design and Delivery (RADD)
Consortium for Higher Education Tax Reform
November 2013

CLASP
policy solutions that work for low-income people

YOUNGINVINCIBLES

NEW AMERICA FOUNDATION

The Education Trust

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About the Consortium

The **Consortium for Higher Education Tax Reform** is a partnership of four organizations concerned with college affordability, access, and completion for low- and modest-income individuals: the Center for Postsecondary and Economic Success at CLASP, Young Invincibles, the New America Foundation's Education Policy Program, and The Education Trust. Over the next year, this consortium will address a variety of issues related to reform of federal higher education tax policy. The Consortium is funded by the Bill & Melinda Gates Foundation as part of its Reimagining Aid Design and Delivery initiative.

This publication represents our shared agreement on initial proposals for reforming higher education tax benefits. It builds on previous work under Reimagining Aid Design and Delivery grants, as well as other research and analysis. Our Shared Agenda is a work-in-progress. Several of the ideas included in the reform agenda will be more fully developed over the coming months and new ideas may be added.

Consortium Partners

The Center for Postsecondary and Economic Success at CLASP advances policies and investments designed to increase the number of low-income adults and youth who earn marketable postsecondary and industry credentials, opening doors to good jobs, career advancement, and economic mobility. CLASP develops and advocates for policies at the federal, state, and local levels that strengthen families and create pathways to education and work. (www.clasp.org)

Young Invincibles is a national organization committed to amplifying the voices of young Americans, ages 18 to 34, and expanding economic opportunity for our generation. Young Invincibles ensures that young Americans are represented in today's most pressing societal debates through cutting-edge policy research and analysis, and innovative campaigns designed to educate, inform and mobilize our generation to change the status quo. (www.younginvincibles.org)

The New America Foundation's Education Policy Program is a nonprofit, nonpartisan public policy institute. It develops ideas that advance equity, access, and excellence in education, from early childhood through elementary and secondary schools, college, and the workforce. (www.education.newamerica.net)

The Education Trust is a national nonprofit that promotes high academic achievement for all students at all levels, pre-K through college. Its goal is to close the gaps in educational opportunity and academic achievement that consign far too many young people—especially those from low-income families or who are black, Latino, or American Indian—to lives on the margins of the American mainstream. (www.edtrust.org)

Higher Education Tax Reform:

A Shared Agenda for Increasing College Affordability, Access, and Success

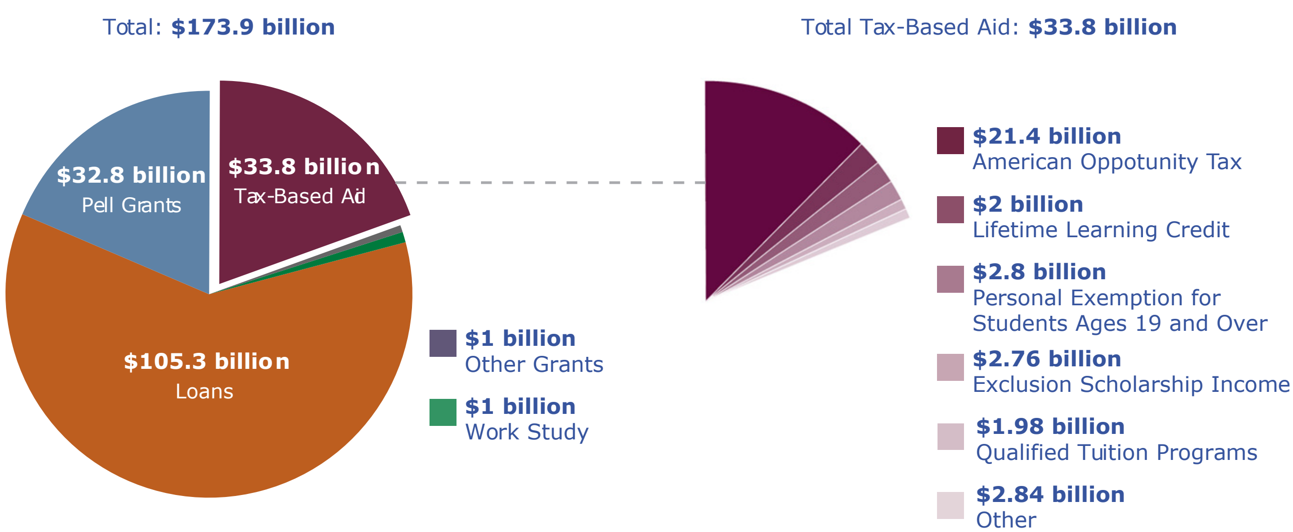
If asked, what would you say is the largest form of federal student aid, excluding loans?

If you guessed Pell Grants, you'd be wrong; it's student aid delivered through the tax system. Since its inception in the late nineties, tax-based student aid has more than quadrupled and now represents more than half of all non-loan federal aid. In 2012, the federal government spent nearly $34 billion on tax-based student aid—a billion more than it spent on Pell Grants (Figure 1).[i] Despite this rapid growth, policymakers haven't scrutinized this aid to determine whether it improves college affordability, access, and success.

Given rising college costs and tight federal budgets, Congress should take action to maximize the impact of federal higher education spending. That means ensuring tax-based student aid goes to low- and modest-income students striving to reach the middle class rather than higher-income individuals who are already very likely to attend college. Reforms should also make it easier for families to understand and claim tax-based student aid and ensure aid is delivered when college bills are due. Further, institutions of higher education that do not meet minimum thresholds for advancing college access and completion goals should not receive federal tax subsidies. Finally, we should reinvest any potential savings from our reforms into students. Every dollar should be used to improve college access, affordability, and success, including through funding for the Pell Grant program.

Figure 1. Tax-Based Aid Now the Largest Source of Federal Student Aid, Excluding Loans

Federal Student Aid by Type in Billions. FY 2012



Source: CLASP, based on estimates from the President's FY14 Budget and the Department of Education's FY14 Budget Summary and Background Information.

Why Reform Is Needed

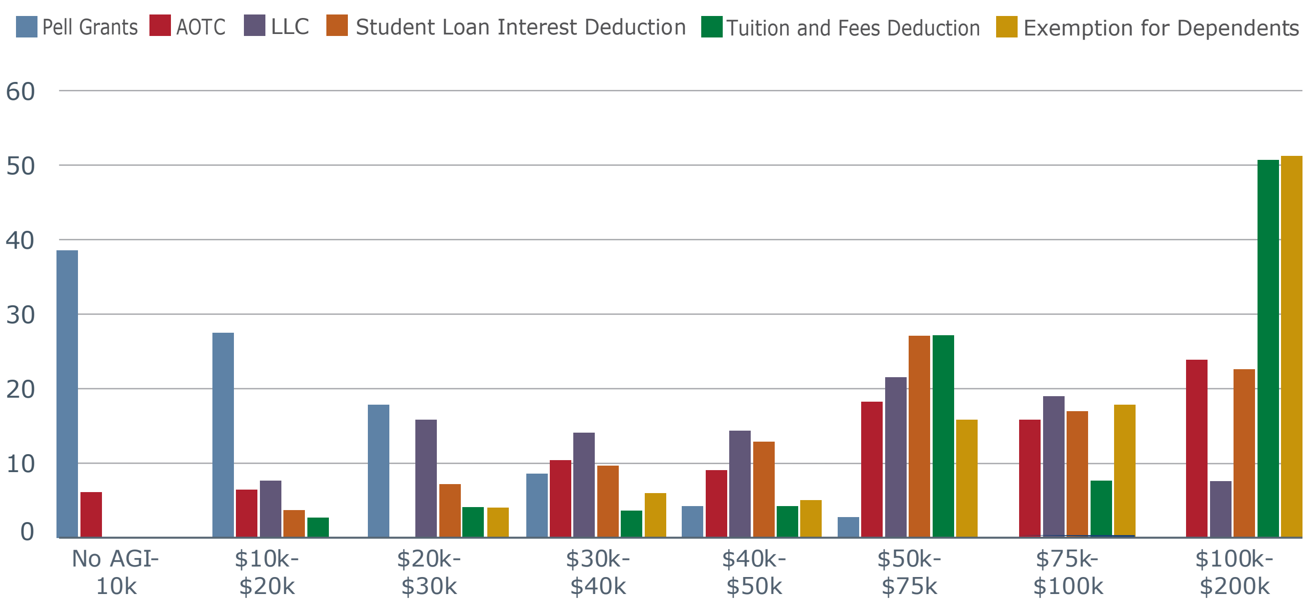
Currently tax-based student aid suffers from four critical flaws that limit its impact on college affordability, access, and completion:[ii]

1) Tax-based aid is poorly targeted.

Despite extensive research showing that low- and modest-income families are more likely to respond to changes in college costs and student aid, tax-based aid provides substantial support to higher-income families who are well beyond middle class (Figure 2).[iii] In 2013, the Tax Policy Center estimates that more than half of the benefits of the Tuition and Fees Deduction and the Exemption for Dependent Students will go to households with annual incomes of $100,000 or more. Nearly a quarter of American Opportunity Tax Credit (AOTC) benefits (24 percent) and Student Loan Interest Deduction benefits (23 percent) will go to families making more than $100,000 per year.[iv] (In 2012, most American

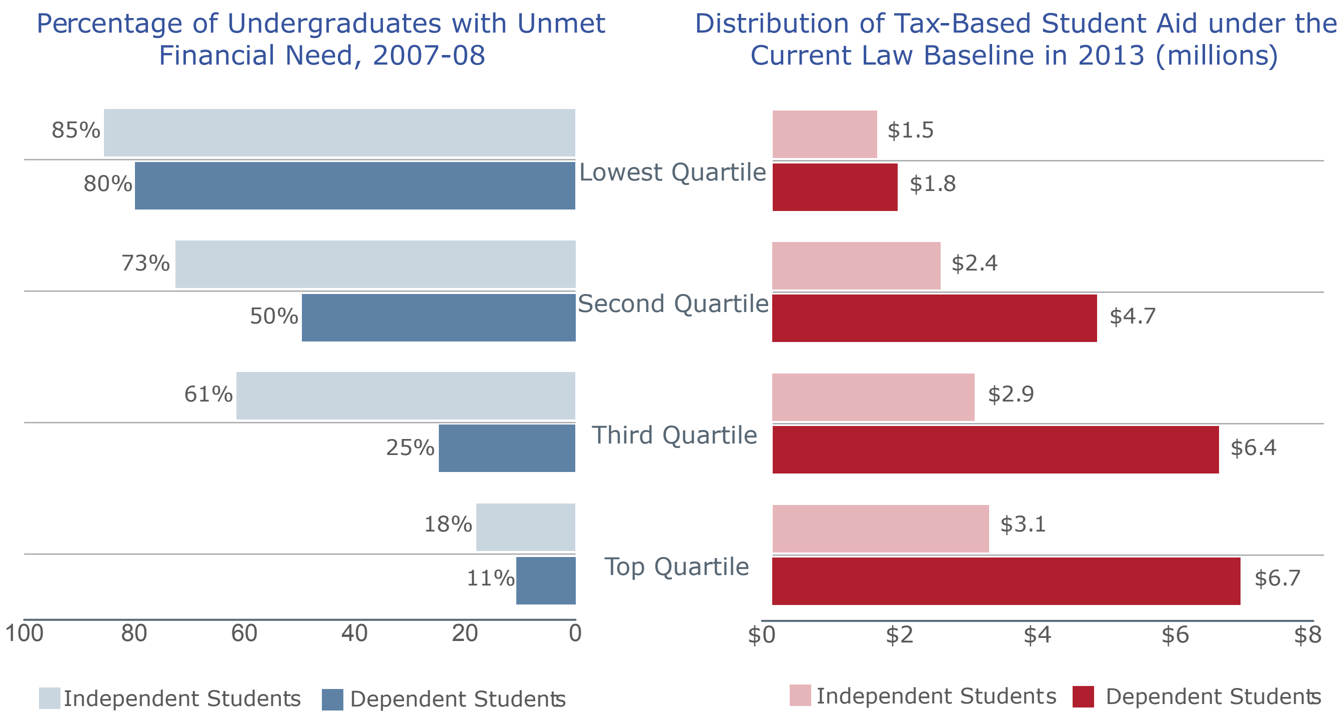
Figure 2. Tax-Based Student Aid is Poorly Targeted

Percentage of Benefit by Type and Income Category in 2013



Source: CLASP, based on data from the Tax Policy Center.

Figure 3. Students with Least Amount of Need Receive the Most Tax-Based Aid



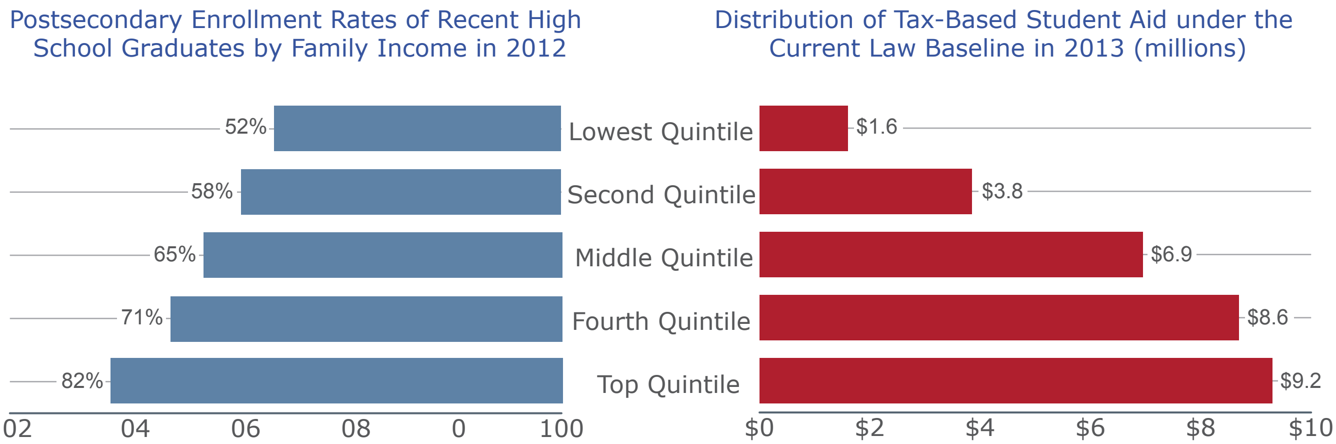
Source: CLASP, based on data from the U.S. Department of Education (NPSAS:08) and from the Tax Policy Center. The unmet financial need data is the most recent available from the federal government and will be updated when the relevant NPSAS:12 data is released in late 2013 or 2014.

households—almost 80 percent—had incomes below $100,000.[v]) Moreover, there are no income participation limits of any kind on federally-subsidized 529 college savings plans. As a result of this poor targeting, students from families with the least financial need receive the most tax-based aid (Figure 3).

We must urgently address the college affordability, access, and completion issues facing low-income families. Despite some progress, low-income students still attend college at lower rates than high-income students did 40 years ago.[vi] Further, the lowest-income students are only one-seventh as likely as their highest-income peers to attain a bachelor's degree by age 24.[vii] Not only does poor targeting blunt the impact of tax-based aid on socioeconomic mobility, it is also an extraordinarily inefficient way to promote college affordability and access because higher-income individuals are already very likely to attend college (Figure 4). One study found, for example, that for each student motivated to attend college (or enroll in more courses) by federal tax-based aid, as many as 13 other students receive tax subsidies without that aid changing their enrollment decisions.[viii]

There is also another dimension to poor targeting: currently, federal tax breaks for institutions of higher education—such as their ability to receive tax-deductible charitable donations and access tax-exempt bond financing— benefit a significant number of

Figure 4. Tax-Based Aid Largely Benefits Individuals Already Highly Likely to Attend College



Source: CLASP, based on data from Education Pays 2013 (the College Board) and the Tax Policy Center

institutions that perform especially poorly in enrolling low-income students or in helping students succeed. This includes over 100 four-year institutions with graduation rates below 20 percent.[ix] Students who attend these institutions often find themselves in worse financial positions following enrollment, because of out-of-pocket expenses and student loan debt incurred outside receipt of grant- and tax-based aid. In fact, students who leave higher education with debt but no degree are four times more likely to default on their student loans.[x]

2) Tax-based aid programs are complex and difficult to use.

Student aid provisions in the tax code include multiple tax credits, a variety of deductions, and numerous exclusions (Table 1). The IRS publication that explains the rules for education tax benefits is almost 90 pages long.[xi] Current tax benefits sometimes overlap, and taxpayers often do not choose the provision that would benefit them most. The Government Accountability Office (GAO) found, for example, that 40 percent of those who claimed the Tuition and Fees Deduction in 2009 would have been better off claiming the Lifetime Learning Credit.[xii] In addition, student aid experts agree that complexity reduces the effectiveness of aid by making it harder for students and parents to understand what help is available and how to apply for it.[xiii]

3) Tax-based aid does not reach students at the time college expenses are incurred.

The power of tax-based aid to provide incentives for enrollment, persistence, and completion is further diluted by the separation between action and benefit. Students and parents only receive this aid after filing their taxes, not when college bills are due. This greatly limits its usefulness to families who simply cannot afford to pay college costs up-front and wait for as long as 15 months for tax-based aid to arrive. The time lag makes it exceptionally difficult for students and families to determine whether they can afford college; undermines the likelihood they will enroll in the college that is best for them; and adds complexity to the higher education financing process by delivering tax aid on a different

Table 1. Current Tax-Based Student Aid Provisions

Aid Before College	Aid During College	Aid After College
• Exclusion of Coverdell ESA Earnings • Qualified Tuition Programs (Prepaid Plans and 529 Plans) • Education Exception to Additional Tax on Early IRA Distributions • Exclusion of Education Savings Bond Interest	• Exclusion of Scholarship, Fellowship, Grant Aid • American Opportunity Tax Credit (formerly the Hope Credit) • Lifetime Learning Credit • Tuition and Fees Deduction • Exemption for Dependent Students (Age 19-23) • Gift Tax Exemption for Tuition Payments • Exclusion of Employer-Provided Educational Assistance	• Student Loan Interest Deduction • Student Loan Forgiveness for Certain Professions

schedule than other forms of financial aid.

4) Lack of awareness limits the impact of tax-based aid.

Lack of awareness limits the reach of higher education tax benefits, as well as their ability to influence individual decisions about whether to enroll or persist in college. Many individuals receiving tax-based aid are not aware of it. According to one study, almost 60 percent of individuals who claim a higher education tax credit do not realize they have received help from the government to pay for college.[xiv] Others fail to claim benefits for which they are eligible. For example, a GAO study found that one in seven taxpayers—or 1.5 million tax filers—who were eligible for either the Tuition and Fees Deduction or the Lifetime Learning Credit in 2009 failed to claim those benefits.[xv] And unlike outreach around the Earned Income Tax Credit, there has been no concerted effort to make low-income families aware of and help them claim the refundable AOTC.

A Shared Agenda for Reform

Our reforms would ensure that tax-based student aid goes to low- and modest-income students who struggle most with college costs, rather than higher-income individuals who are already very likely to attend college without a tax incentive.

Poor targeting, complexity, delayed payment, and pervasive confusion among families about what help they can expect with college costs are serious shortcomings that can only be addressed through bold action, not incremental change. We have developed comprehensive recommendations that would go a long way toward fixing current problems with tax-based aid. Our reforms would ensure that tax-based student aid goes to low- and modest-income students who struggle most with college costs, rather than higher-income individuals who are already very likely to attend college without a tax incentive. We would eliminate overlapping tax benefits, make it easier for families to understand and claim tax-based student aid, and deliver aid when college bills are due. Further, we propose linking tax breaks for higher education institutions to their performance on college access and completion. Finally, we would reinvest any potential savings from our reforms into students. Every dollar should be used to improve college access, affordability, and success, including through funding for the Pell Grant program.

We hope this Shared Agenda can inform the efforts of Congress and the Obama Administration as they tackle comprehensive tax reform. Because it has been 27 years since the last overhaul of the tax code, we cannot afford to miss this rare opportunity to fix tax-based student aid. In addition, administrative action could be taken to improve these benefits. Even within the constraints of current law, much more can be done to help eligible students and parents become aware of and use tax-based student aid.

Table 2 summarizes our package of proposals, with revenue estimates from the Tax Policy Center where possible, and shows that our Shared Agenda can be accomplished in a fiscally responsible way.

Table 2. Summary of Shared Agenda for Reform

Consortium Proposals, By Goal of Reforms

Better Targeting

1. Make the AOTC permanent.
2. Phase out the AOTC between $80-120,000 for joint filers and $40-60,000 for single filers.
3. Make the AOTC fully refundable.
4. Coordinate AOTC benefits with Pell Grants.[1]
5. Phase out the Exemption for Dependent Students at the same income levels as the AOTC.[2]
6. Phase out the Student Loan Interest Deduction at the same income levels as the AOTC.
7. Better target the tax benefits of Qualified Tuition Programs (529s) through income limits and other reforms.
8. Limit the Exclusion for Employer Provided Educational Assistance to undergraduate certificates and degrees only.
9. Adopt a new institutional eligibility threshold for higher education tax benefits to colleges and universities.
10. Limit the tax exemption for interest earned on qualified 501(c)(3) bonds for private higher education institutions.
11. Improve transparency around institutional receipt of tax benefits through expanded reporting.

Simplification

12. Eliminate Lifetime Learning Credit.
13. Eliminate Tuition and Fees Deduction.
14. Eliminate Coverdell Education Savings Accounts.
15. Adjust the AOTC for inflation starting in 2018.
16. Replace the four-year limit on the AOTC with an equivalent lifetime dollar cap.
17. Eliminate taxation of Pell Grants.
18. Remove the lifetime ban on the AOTC for individuals convicted of a drug felony.

Timely Delivery of Tax Aid

19. Create a mechanism for delivering the AOTC at the time that college expenses are incurred, not just at tax time.

Outreach

20. Increase take-up and awareness of the AOTC through expanded outreach and increased collaboration by the Departments of Education and Treasury.

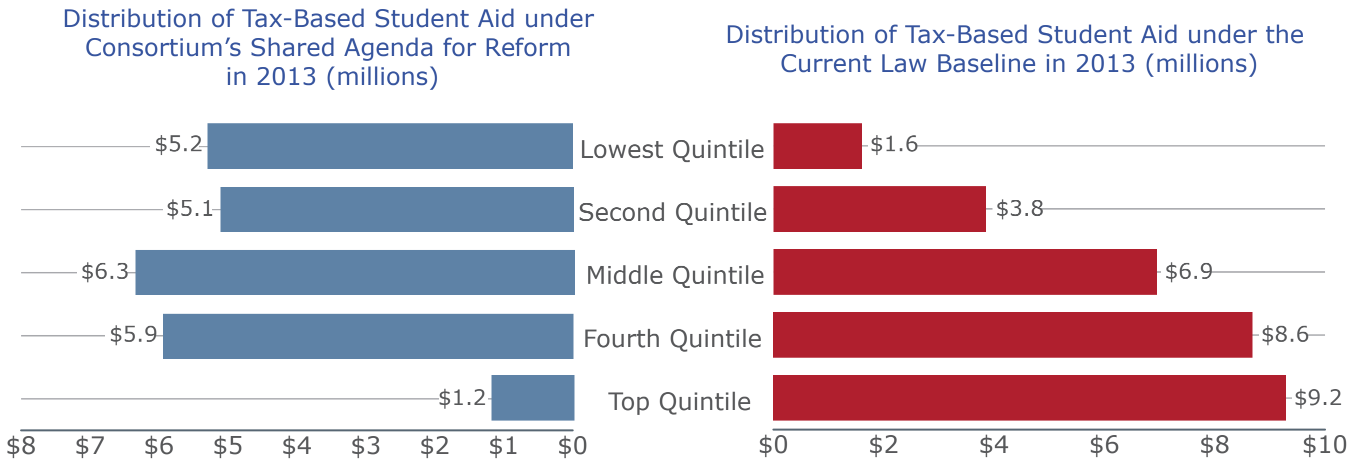
Revenue Impact of Consortium Proposals

Where possible, we have obtained Tax Policy Center estimates of the revenue impact of our proposals against the current law baseline. As shown below, our Shared Agenda results in substantial revenue savings which should be reinvested in students, including through funding for the Pell Grant program. These Tax Policy Center estimates cover the impact of recommendations numbered 1-3, 5-6, 12-13, and 15:

2013 to 2022	2014 to 2023
$24.3 billion in savings	**$16.2 billion in savings**[3]

The Tax Policy Center is unable to estimate the revenue impacts of our other proposals. However, in 2010, the Congressional Joint Committee on Taxation estimated the cost of the two Pell Grant provisions combined as $168 million over ten years (2011-2020).

Figure 5. Shared Agenda for Reform Shifts Aid toward Low- and Modest-Income Families



Source: CLASP, based on data from the Tax Policy Center

Our Shared Agenda would substantially realign the federal investment in tax-based student aid to maximize its impact on affordability, access, and completion, in contrast to the current misalignment of these tax expenditures. Under our proposals, tax-based student aid would go primarily to the low- and modest-income families and individuals who most struggle with college costs (Figure 5).

Goals and Recommendations

Our Shared Agenda is organized around four goals: better targeting, simplification, more timely delivery, and increased take-up and awareness.

BETTER TARGETING

Goal: Target tax-based student aid to low- and modest-income undergraduate students.

Proposed reforms should shift tax-based aid toward families in the bottom 80 percent of the income distribution, as measured by the Census Bureau. Target higher education tax breaks to institutions that meet at least a minimum responsibility threshold for enrolling low-income students and helping students persist and complete.

Discussion

As discussed above, the current structure of tax-based aid mainly helps higher-income families who require no financial incentive for college attendance. In our tax system, deductions and exemptions are worth more to those who earn more (they reduce taxable income and so have a higher value to those in higher tax brackets). Tax credits can be more useful to low- and modest-income families if they are made refundable. Of the two higher education credits currently available, the LLC is not refundable and the AOTC is only partially refundable (40 percent of the credit value).

[1] Pell Grants would be applied first to costs of attendance (such as room and board) that are not qualified expenses for the AOTC. Any remaining Pell Grant would continue to reduce the qualified expenses used to calculate the AOTC.
[2] Proposal to phase out exemption for dependent students above AOTC income thresholds does not affect the classification of full-time students age 19 to 23 as qualifying child dependents for other purposes such as head of household filing status and the EITC.
[3] Urban-Brookings Tax Policy Center Microsimulation Model (version 0613-1).

A second factor limiting tax-based aid to low- and modest-income students is that qualified expenses for credits and deductions include only tuition, fees, and in some cases course materials. For students attending lower-cost institutions, these qualified expenses comprise a small portion of their overall cost of attendance; other necessary expenses, such as room and board, transportation, and child care are larger factors. In fact, for academic year 2007-2008 (the most recent federal data available), tuition and fees on average accounted for only 19 percent of the cost of attendance for full-time students attending public two-year institutions.[xvi] After subtracting other grant aid, such as Pell Grants, from the calculation of qualified expenses (as is required currently), students may not have enough qualified expenses remaining to claim a credit, despite having high levels of unmet financial need.[xvii] Students at public two-year institutions had average unmet financial need of $4,500 in 2007-08.[xviii] This high unmet need has serious consequences for the ability of students to succeed in college. For example, two-thirds of young community college students work more than 20 hours per week to cover college and family costs, a level of work which research shows puts them at risk for not completing.[xix]

A third targeting issue is that some forms of tax-based aid largely benefit graduate students. For example, 64 percent of LLC benefits flow to graduate students, as do 40 percent of Exclusion for Employer-Provided Educational Assistance benefits. Given that individuals with a graduate degree earn, on average, at least twice as much as those with only a high school diploma,[xx] we believe we should prioritize helping those without a college degree before assisting those who have already completed at least an undergraduate education.

A fourth targeting issue centers on institutional accountability for higher education tax breaks. Institutions can benefit from various tax breaks—such as tax-exempt status and access to tax-exempt bond financing and the charitable deduction for their donors—even if they graduate very few of their students or enroll very few low-income students. This is contrary to the federal government's higher education investment goals of increasing college affordability, access, and completion.

Recommendations for Reform

Recommendation 1: Preserve the AOTC as the primary vehicle for tax-based student aid by making it permanent rather than allowing it to expire after 2017.

- The AOTC has many design advantages compared to the LLC or any of the deductions. It is focused on undergraduate education, is partially refundable, has a slightly more expansive definition of qualified expenses, and is available for four years. The AOTC is not perfect, but as a tax incentive to improve affordability, access, and completion, it is far superior to other tax-based aid. And the improvements we recommend would strengthen it further.

Recommendation 2: Lower income eligibility for the AOTC and double the length of the phase-out range.

Begin phasing out the credit at $80,000 for those who are married and filing jointly, which is approximately the median income level for such households.[xxi] End eligibility for the credit at $120,000 for individuals who are married filing jointly. Phase out the credit for single tax filers between $40,000 and $60,000.

- Lowering the AOTC's income phase-out ranges would focus its benefits on low- and modest-income families, making the federal investment more effective by concentrating it on individuals whose college enrollment and persistence decisions are most sensitive to cost. We note that even with our proposed lower phase-outs, more than 80 percent of families would continue to be eligible for the AOTC. Adjusting the phase-out range would also provide substantial revenue to fund improvements to the AOTC, such as greater refundability.

- Doubling the phase-out range for the AOTC from the current $20,000 to $40,000 (and from $10,000 to $20,000 for single filers) would reduce the effective marginal tax rate associated with the phase-out of tax benefits. A longer phase-out range reduces benefits more gradually as income increases. The effect of this more gradual phase-out for AOTC would be amplified if, as we propose, the same phase-out schedule were to be used for other higher education tax benefits as well.

Recommendation 3: Make the AOTC fully refundable.

- Currently, households can receive up to 40 percent of the AOTC as a refundable credit. Receipt of the remaining 60 percent is tied to the amount of their income tax liability. Making the AOTC fully refundable would ensure that the credit is worth the same to every individual with a given amount of qualified college expenses. Currently, a low-income family with, for example, $1,000 of qualified college expenses can receive only a $400 AOTC, whereas a higher-income family with $1,000 of expenses receives a $1,000 AOTC. Making the AOTC fully refundable would ensure that all students with similar expenses receive equal help from the AOTC in paying for college.
- Making the full credit refundable would help low-income students and parents better understand how big a credit they can expect to help them pay for college, since the credit value will be based solely on their qualified expenses up to the same maximum credit available to all students.

Recommendation 4: Coordinate AOTC benefits with Pell Grants, so that students can combine them to address unmet financial need and cover expenses up to the total cost of attendance.

Federal Pell Grants would first be applied to Pell-allowable expenses that are not eligible for the AOTC (e.g., room and board); after those expenses are paid for, any remaining grant amount would then reduce qualified tuition expenses for purposes of the AOTC.

- Currently, many Pell Grant recipients at lower-cost institutions receive little or no benefit from the AOTC because they must subtract other grant aid, such as Pell Grants, from the calculation of qualified expenses, leaving them with few or no qualified expenses remaining to claim the credit despite often having high levels of unmet financial need.
- Pell Grants are intended to address the total cost of attendance—not just tuition, fees, and books. Coordinating this grant aid with the AOTC would mean students could use the tax credit to cover tuition, fees, and books and use Pell Grants to cover remaining necessary costs—such as room and board, transportation, and child care—included in the total cost of attendance calculated under the federal need analysis. The portion of Pell Grants being applied to other Pell-qualified attendance costs would be exempt when calculating AOTC reductions.

Recommendation 5: Apply the same income limits and phase-outs to the Exemption for Dependent Students as we recommend for the AOTC.

- Currently, parents can claim full-time students ages 19 to 23 as dependents under the qualifying child rules. The Exemption for Dependent Students reduces 2013 taxable income by $3,900 for taxpayers with incomes below $300,000 ($250,000 for single filers). This is the worst-targeted of all the large higher education tax benefits. In 2013, more than half of the benefits from this exemption will go to tax filers with incomes of more than $100,000.[xxii]
- Phasing out the Exemption for Dependent Students at the same levels we propose

[The Exemption for Dependent Students] is the worst-targeted of all the large higher education tax benefits. In 2013, more than half of the benefits from this exemption will go to tax filers with incomes of more than $100,000.[xxii]

for the AOTC would substantially improve the targeting of this benefit and also save revenues that can be reinvested in improving the AOTC for low- and modest-income students and in Pell Grants. All parents would retain the ability to claim a full-time dependent student as a qualifying child for other tax purposes.

Recommendation 6: Apply the same income limits and phase-outs to the Student Loan Interest Deduction as we recommend for the AOTC.

- Even benefits for student loan borrowers are poorly targeted. Those who enter high-earning fields are disproportionately able to take advantage of the deduction—and benefit even more from it since they face higher marginal tax rates. Currently, tax filers with incomes of up to $155,000 per year can use the Student Loan Interest Deduction. According to estimates from the Tax Policy Center, 40 percent of the benefit of the Student Loan Interest Deduction in 2013 will go to individuals with incomes of more than $75,000 per year, and nearly a quarter of the benefits will go to those with annual incomes over $100,000.[xxiii]
- Preserving some relief to borrowers is important, given that recent college graduates have loan debt averaging $26,600.[xxiv] Under this proposal, the deduction would go to low- and modest-income students, helping them afford their student loan payments. At the same time, lowering the income limit and extending the phase-out range for this deduction would improve its targeting and free up resources that can be reinvested in expanding the AOTC for low-income students and in Pell Grants. This will have the effect of reducing student debt levels in the first place for borrowers who need it most.

Recommendation 7: Reform Qualified Tuition Programs to better target benefits and prevent abuse.

- Qualified Tuition Programs, also known as Section 529 plans, have grown rapidly over the last decade. Assets in these tax-subsidized college savings vehicles grew from $58.1 billion in 2003 to $205.7 billion in 2013.[xxv]
- These savings plans provide the large majority of their benefits to high-income individuals. According to the GAO, in 2009, the median income of households with either a Section 529 plan or Coverdell ESA was more than $120,000 per year.[xxvi]
- The consortium believes that the benefits of 529 plans should be better targeted and will explore various mechanisms for achieving this, such as setting meaningful contribution limits, establishing income limits, or changing the treatment of these assets in the Expected Family Contribution calculation under the Higher Education Act.

Recommendation 8: Limit the Exclusion for Employer Provided Educational Assistance to undergraduate education.

- In 2007, 46 percent of the recipients of Section 127 tax benefits for employer-provided educational assistance were graduate students. These employees benefited, on average, twice as much as recipients enrolled in undergraduate education, receiving an average of $3,701 in tax subsidies as compared to $1,849 for undergraduates. Recipients in graduate education were also much higher-paid than their undergraduate counterparts, with average annual earnings of $53,300 as compared to $33,707 for undergraduate employee recipients.[xxvii]

- As noted earlier, individuals in graduate programs can expect to have relatively high earnings on average after completing school compared to those who have no college degree. And because these workers already have an undergraduate degree, they are more able to afford school than workers without a college degree. Limiting this exclusion to undergraduate education would focus the benefits on those workers who most need further education and who have fewer resources to afford college.[xxviii]

Recommendation 9: Adopt a new institutional eligibility threshold for higher education tax benefits to colleges and universities.

- It is troublesome that the federal government is providing tax breaks (such as tax exempt status, charitable deduction eligibility, or access to tax-exempt bond financing) to institutions of higher education that fail to meet minimum college access and completion standards. Inadequate performance on the former suggests that an institution is not advancing a key mission of higher education, while inadequate performance against the latter suggests a poor federal investment. Metrics by which policymakers might measure institutional eligibility could include graduation rates, representation of low-income students, or other indicia to be developed. Our consortium will engage in extensive research and analysis to develop the details of this recommendation, including suggested demarcations of eligibility to support successful implementation.

Recommendation 10: Limit the tax exemption for interest earned on qualified 501(c)(3) bonds for private higher education institutions.

- Private colleges and universities can sell tax-exempt qualified 501(c)(3) bonds at a government-subsidized rate to raise capital for building construction or pay off previous debts. The primary beneficiaries of this government subsidy are private colleges and universities that issue the bonds (some of which have sizeable endowments) and bond purchasers at the highest marginal income tax rate—not students and families.
- The consortium believes these bonds should be limited and will explore various options for achieving this, such as: replacing the tax exemption for these bonds with a direct payment or tax credit to cover a portion of the bonds' interest; placing further restrictions on the use of funds from these bonds; or eliminating this financing mechanism for institutions that fail to meet minimum performance thresholds on student access and completion.

Recommendation 11: Improve transparency around institutional receipt of tax benefits.

- There is currently no information available about the amount of higher education tax benefits claimed by an institution's students or the amount an institution is receiving in its own tax benefits. This lack of transparency creates significant holes in understanding about the use and targeting of these benefits, as well as raises concerns about proper accountability to ensure benefits are received properly. We recommend that Treasury work with the Internal Revenue Service to produce public annual reports to Congress detailing the number and amount of higher education tax benefits broken down by institution.

SIMPLIFICATION

Goal: To create a system where students and families understand the benefits available to them and are able to easily claim benefits and make optimal choices. Proposals should eliminate redundancy and preserve or increase benefits that improve affordability, access, and completion for undergraduate students. Proposals should also seek to address any conflicting provisions and eliminate minor provisions that complicate the code.

Discussion

Research on other types of student aid finds that complexity reduces the impact of aid on college access and completion.[xxix] Simplifying the system to help students and parents more easily navigate tax-based aid could help them plan more effectively for postsecondary education. It would increase the odds that families choose the optimal tax-based aid benefit by reducing redundancies. Simplification also improves tax compliance and reduces tax filer errors. And in addition to simplifying tax-based aid, our recommendations below would result in better targeting.

Recommendations for Reform

Recommendation 12: Eliminate the Lifetime Learning Credit.

- The LLC has become increasingly redundant as benefits under the Hope Credit/AOTC have been expanded (from two years to four years, for example) and more students can claim the AOTC instead. Eliminating the LLC would simplify the tax code and reduce the risk that families claim a suboptimal benefit. In addition, nearly two-thirds (64 percent) of LLC benefits go to graduate students. As noted earlier, individuals with a graduate degree earn, on average, at least twice as much as those with only a high school diploma.
- While eliminating the LLC improves targeting and simplifies the tax code, it does negatively affect three other groups who are eligible for it but not eligible for the AOTC: students attending less than half-time; students who have already claimed higher education tax benefits for four calendar years; and students who are enrolled in job training courses at a Title IV-eligible institution but not seeking a certificate or degree. While we are concerned about the impact on less-than-half-time students, the fact that they are eligible for Pell Grants if they have low incomes may mitigate to some extent the effects of LLC ineligibility.
- We view as more serious the problem of how to meet the needs of students who must take longer than four calendar years to complete college, as more than half of undergraduates now attend part-time at some point during college.[xxx] Current law has two separate provisions about the length of time for which the AOTC is available, one which limits the AOTC to four calendar years and one which says the credit is allowed for the first four years of postsecondary education. These two rules come into conflict for students who cannot always attend full-time, often because they face financial pressures to work a substantial amount while in school.[xxxi] Adopting a lifetime cap on AOTC benefits equivalent to four years' worth of the credit (i.e. a $10,000 cap if the annual credit maximum is $2,500) is one way to solve this problem (see Recommendation 16).

Recommendation 13: Eliminate the Tuition and Fees Deduction.

- The Tuition and Fees Deduction is one of the most regressive tax-based aid benefits currently available. According to estimates from the Tax Policy Center, in 2013, more

College expenses are currently rising much faster than general inflation . . . adjusting the AOTC for inflation would provide some protection to students against higher education cost increases, while carving out time between now and 2018 to ramp up outreach efforts promoting the credit to the target population.

than half of this benefit will go to families earning over $100,000 per year.
- There is also significant overlap between those eligible to receive the LLC and the Tuition and Fees Deduction, adding unnecessary complexity to the system.

Recommendation 14: Eliminate Coverdell Education Savings Accounts (ESAs).

- Coverdell ESAs essentially provide a redundant benefit to 529 plans; more and more, they are becoming a subsidy for private elementary and secondary schools rather than a way to pay for college.
- Coverdell ESAs are very regressive. As mentioned above, the GAO reports that, in 2009, the median income of households with either a Section 529 plan or Coverdell ESA was more than $120,000 per year.[xxxii]

Recommendation 15: Adjust the AOTC for inflation beginning in 2018.

- College expenses are currently rising much faster than general inflation, reducing the net value of all forms of aid students receive. Eventually adjusting the AOTC for inflation would provide some protection to students against higher education cost increases, while carving out time between now and 2018 to ramp up outreach efforts promoting the credit to the target population.
- Doing so also provides predictability and stability for both the Internal Revenue Service and the taxpayers, as adjusting provisions in the tax code for inflation is typically the rule, not the exception.

Recommendation 16: Replace the four-year limit on the AOTC with an equivalent lifetime dollar cap.

- The criterion that a student can only claim the AOTC for four calendar years while also being eligible for the credit for four full years of postsecondary education creates confusion for academic institutions and students. As highlighted in a recent GAO report, the latter limit is not implemented uniformly and, as a result, some students receive the credit for more or less than the equivalent of four full academic years, adjusted for enrollment status.[xxxiii]
- The four-calendar-year standard punishes students who fluctuate between full- and part-time attendance. These "mixed enrollment" students now represent the majority of undergraduates.[xxxiv]
- A lifetime dollar cap would treat all students fairly, create uniformity across the system, and still preserve an incentive for students to complete. It could be set at a dollar amount that is equal to the current four-year limit, i.e. $10,000 (four years of a $2,500 maximum credit), and an annual maximum credit limit of $2,500 could be maintained to protect students against using up the lifetime limit too rapidly.

Recommendation 17: Eliminate the taxation of Pell Grants.

- Pell Grant recipients are typically the students most in need of additional financial assistance. The current policy of taxing Pell Grants spent on necessary educational expenses such as room and board does not make sense given high levels of unmet financial need and is unnecessarily punitive.

- Current taxation of Pell Grants also adds unnecessary complexity to the system, forcing students to track every Pell dollar.

Recommendation 18: Remove the lifetime ban on the AOTC for individuals convicted of a drug felony.

- Since laws with respect to possession or distribution of controlled substances differ dramatically from state to state, this provision unnecessarily complicates the tax code, reducing compliance and participation in tax aid. New research finds that a similar policy in the Higher Education Act (a two-year ban on federal Title IV financial aid to those convicted of a drug felony) did not deter young people from committing drug felonies but did delay their entry into college and reduced the odds they would ever attend college or complete a degree. This impact was largest for young people who lived in urban areas and whose mothers never attended college.[xxxv]

TIMELY DELIVERY OF AID

Goal: To deliver tax benefits in a way that increases take-up and maximizes their impact on affordability, access, and completion. Proposals to reform tax-based aid should consider alternative delivery options that ensure payments arrive when college costs are incurred, including advancing payments of tax-based aid to families or third-party payment mechanisms.

Discussion

Finding new ways to deliver the AOTC could increase its impact on affordability, access, and completion. Advance and third-party payment mechanisms have the potential to improve communication between the Treasury Department, families, and colleges about enrollment and expenses and to make claiming the credit simpler for families, all of which could improve tax compliance and increase take-up rates.

Advance or third-party payment of tax credits is not a new concept. Advance payment of the EITC existed for nearly 30 years before reporting and participation issues among employers and recipients led to its repeal in 2010.[xxxvi] The Health Coverage Tax Credit included as part of the Trade Adjustment Assistance program currently provides a credit for health insurance that is delivered monthly from the Treasury Department to the health plans. And most significantly, beginning in 2014 the Affordable Care Act will provide health insurance premium support through a tax credit that is paid monthly directly to insurance companies for millions of Americans. These types of mechanisms have not yet been attempted, however, in the tax-based student aid context.

Recommendations for Reform

Recommendation 19: Create a mechanism for timely delivery of the AOTC as college expenses are incurred.

- Options for timely delivery could include advance payment of tax aid to families or third-party payment mechanisms. These advance payments would be made closer to the start of each semester (or other academic period) based on the best available information about income and qualified expenses.
- Timely delivery could be combined with other steps to increase awareness among families of the AOTC and to make the credit easier to claim. These could

include adding AOTC information to the federal Financial Aid Shopping Sheet and the Student Aid Report; exploring the feasibility of an IRS portal for families with an AOTC estimator, similar to the existing EITC Assistant; and developing IRS online AOTC accounts for claiming the credits as either incremental payments through an advance AOTC option or as a year-end payment at tax time.

- In the coming months, our consortium will conduct research and analysis on various options to deliver the AOTC when college expenses are incurred and not just at tax time. We will examine previous and current efforts that deliver tax benefits through advance payment to glean lessons for the AOTC. We will develop options for new AOTC timely delivery mechanisms and evaluate these options based on a common set of criteria, such as the extent to which each option would increase take-up of the credit; strengthen the incentive for students to enroll, persist, and complete; impact college tuition and fee growth; and affect student receipt of other types of aid. In addition, we will assess the feasibility of implementation of each option and the risk of overpayments to families.

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INCREASING TAKE-UP AND AWARENESS OF THE AOTC

Goal: To increase take-up and awareness of the AOTC, especially among low- and modest-income students and parents. Proposals should address both process changes as well as informational impediments to claiming the AOTC. Proposals should also engage all actors: institutions, the Departments of Education and Treasury, community organizations, and volunteer and commercial tax preparation entities.

Discussion

As discussed above, there is substantial room to improve take-up and awareness of tax-based aid in general, as well as the refundable portion of the AOTC specifically. Increasing participation in the refundable portion of the AOTC is of great interest to this consortium, since it is targeted to low- to modest-income families.

There are various policy levers available to policymakers and administrators to increase take-up and awareness of tax-based aid. For example, the IRS could increase data sharing with the Department of Education, work with commercial and volunteer preparers to use products that automatically detect for eligibility, or highlight the availability of the credit in any communications about costs and financial aid. The agency could also launch an outreach campaign similar to its EITC work.

Recommendations for Reform

Recommendation 20: The Departments of Education and Treasury should collaborate to identify which types of eligible individuals are not claiming the AOTC and work together to reach out more aggressively to these populations.

New statutory authority could be given to the Departments so they could link tax and financial aid data (with appropriate privacy safeguards) in order to coordinate tax-based aid with other federal student aid policies and better analyze the impact of tax aid.

- Education and Treasury could explore ways to streamline and accelerate claiming of the AOTC, such as some of the strategies suggested under Recommendation 19.
- Information on the AOTC could be added to the federal Financial Aid Shopping Sheet and FAFSA.
- The federal TRIO and GEAR UP programs, which target low-income, first-generation students, could help promote AOTC and provide resources to ensure students and families know how to claim the credit.
- Our consortium will conduct further research and analysis to develop more detailed reform recommendations in this area. Unfortunately, there are significant data limitations that inhibit our ability to understand the extent of the problem. There are, however, lessons that can be drawn from other arenas, such as EITC outreach efforts.

Conclusion

Tax-based student aid, now the largest form of federal student aid excluding loans, is long overdue for reform. With college increasingly unaffordable for many Americans, the nearly $34 billion federal investment in tax-based aid must be restructured to address the problems of poor targeting, complexity, delayed payment of needed benefits, and lack of awareness or confusion among families about the help that is available.

Our Consortium's recommendations would direct tax-based aid toward low- and modest-income students, rather than to higher-income individuals who are already highly likely to attend college. We would also make it easier for families to understand and claim tax-based student aid. Our simplification reforms would have the added advantage of increasing tax compliance and reducing errors. We would also hold institutions that receive federal tax breaks accountable for meeting minimum thresholds for advancing college access and completion goals. And we propose to reinvest all of the savings from reform of tax-based aid in students, including through funding for the Pell Grant program.

Our reform package is feasible, fiscally responsible, and aligns the enormous investment in tax-based student aid with national goals of improving college affordability, access, and completion. As Congress considers an overhaul of the tax system, we hope our recommendations will inform its actions.

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[i] Estimates are from the President's FY14 Budget and the Department of Education's FY14 Budget Summary and Background Information.

[ii] It is important to note that no study to date has included the American Opportunity Tax Credit in its analysis. For a complete summary of the literature on the effectiveness of tax-based aid see, Reimherr, P., Strawn, J., Harmon, T., and Choitz, V. (2013). R*eforming Student Aid: How to Simplify Tax Aid and Use Performance Metrics to Improve College Choices and Completion*, pp. 21-22.

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[xviii] National Center for Education Statistics. (January 2011). *Trends in Student Financing of Undergraduate Education: Selected Years, 1995–96 to 2007–08.* NCES 2011-218.
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[xx] US Department of Labor, Bureau of Labor Statistics (2013). *Earnings and unemployment rates by educational attainment in 2012.* http://www.bls.gov/emp/ep_chart_001.htm.
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[xxii] CLASP calculations from Tax Policy Center data. Tax Policy Center (2013). *Distributions of Education Incentives under the Current Law Baseline in 2013: All Students*
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Higher Education Tax Reform

A Shared Agenda for Increasing College Affordability, Access, and Success

The Reimagining Aid Design and Delivery (RADD)
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policy solutions that work for low-income people

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