

Congress Should Allow the Tuition and Fees Deduction to Expire

Mark Kantrowitz

Publisher of FinAid.org and FastWeb.com

November 22, 2009

EXECUTIVE SUMMARY

The Tax Extenders Act of 2009 proposes to extend the Tuition and Fees Deduction through 2010 along with several other tax relief provisions that are set to expire at the end of 2009. The Tuition and Fees Deduction is an above-the-line exclusion from income for qualified tuition and related expenses. The one-year extension of the Tuition and Fees Deduction is estimated to cost \$1.529 billion.¹

RECOMMENDATIONS

The Tuition and Fees Deduction overlaps with the Hope Scholarship Tax Credit and the Lifetime Learning Tax Credit. It is also regressive, providing a greater financial benefit to high-income taxpayers than to low-income families.

- Congress should consider allowing the tuition and fees deduction to expire at the end of 2009.
- Instead, Congress should consider making permanent the temporary improvements to the Hope Scholarship Tax Credit that were enacted by the American Recovery and Reinvestment Act of 2009.²

This will target the funding more effectively at low and moderate-income families. The financial benefit from the Tuition and Fees Deduction is disproportionately directed at high-income taxpayers.

OVERLAP WITH OTHER EDUCATION TAX BENEFITS

The Tuition and Fees Deduction, also known as the Torricelli Deduction, allows taxpayers to exclude up to \$4,000 in qualified tuition expenses as an above-the-line exclusion from income. This deduction may be taken even if the taxpayer does not itemize and it reduces adjusted gross income. The deduction is phased out for taxpayers with adjusted gross incomes of \$65,000 to \$80,000 (single filers) and \$130,000 to \$160,000 (married filing jointly). Within the income phaseout bands the amount of the exclusion is

¹ This cost estimate does not appear to consider the likelihood that eligible taxpayers will switch to the Lifetime Learning Tax Credit if the Tuition and Fees Deduction is not extended. Assuming that eligible taxpayers will switch to the Lifetime Learning Tax Credit, allowing the Tuition and Fees Deduction to expire will save at most \$500 million (less than one third of the cost estimate).

² The author of this student aid policy analysis paper has previously argued in favor of repealing all three education tax benefits and redirecting the savings into the Pell Grant program. The Pell Grant program is the most effective need-based federal student aid program and provides funding up front when students need it to pay college bills. However, if the education tax benefits are to be retained, there is an opportunity to simplify them and improve their effectiveness by allowing the Tuition and Fees Deduction to expire.

reduced to \$2,000 in qualified tuition expenses. Depending on the taxpayer's federal income-tax bracket, the Tuition and Fees Deduction yields up to a \$1,000 reduction in tax liability.

As the following table illustrates, the Tuition and Fees Deduction overlaps with the Hope Scholarship Tax Credit and Lifetime Learning Tax Credit. The Hope Scholarship Tax Credit is focused on undergraduate students, since it is limited to the first few years of postsecondary education. Both the Tuition and Fees Deduction and the Lifetime Learning Tax Credit are available to graduate and continuing education students in addition to undergraduate students. The Lifetime Learning Tax Credit is inferior to the Hope Scholarship Tax Credit and is used mainly by taxpayers who do not qualify for the Hope Scholarship Tax Credit. Before Congress expanded the Hope Scholarship Tax Credit as part of the American Recovery and Reinvestment Act of 2009, the Tuition and Fees Deduction was the preferred education tax benefit for high-income families because it had higher income phaseouts. With the recent expansion of the Hope Scholarship Tax Credit, the Tuition and Fees Deduction will mainly be used by graduate and continuing education students who earn too much money to qualify for the Lifetime Learning Tax Credit.

Some low-income families prefer the Tuition and Fees Deduction because it reduces the taxpayer's adjusted gross income (AGI). If AGI drops below certain thresholds, it can trigger eligibility for certain federal means-tested benefit programs, such as increased federal student aid and the Earned Income Tax Credit. Forgoing the greater financial benefit of the Hope Scholarship Tax Credit might be worthwhile for some taxpayers because of this side effect of the Tuition and Fees Deduction. For example, students with family income less than \$50,000 who are eligible to file an IRS Form 1040A³ or 1040EZ (or who are not required to file a federal income tax return) or who receive certain federal means-tested benefits⁴ will qualify for the simplified needs test, which disregards assets when determining eligibility for the Pell Grant and other federal need-based education grant programs. If claiming the Tuition and Fees Deduction makes the student eligible for a small Pell Grant, this can make the student eligible for the \$4,000 National SMART Grant, compensating for the inferior education tax benefit.

Tax Benefit	Amount of Benefit	Value of Benefit	Phaseouts
Tuition & Fees Deduction	\$4,000 exclusion from income per taxpayer. Reduced to \$2,000 within the income phaseouts.	Maximum \$1,000 reduction in tax liability (up to 25% discount on \$4,000). Secondary benefits from reduction in AGI.	\$130,000/\$160,000 (joint) \$65,000/\$80,000 (single) Not indexed for inflation
Hope Scholarship Tax Credit (pre-ARRA)	\$1,800 tax credit. 100% of the first \$1,200 and 50% of the second \$1,200 in qualified tuition and related expenses per student per taxpayer. 2 year limit per student.	\$1,800 reduction in tax liability per student (75% discount on \$2,400)	\$100,000/\$120,000 (joint) \$50,000/\$60,000 (single) Indexed for inflation
Hope Scholarship Tax Credit (2009 and 2010)	\$2,500 tax credit. 100% of the first \$2,000 and 25% of the second \$2,000 in qualified tuition and related expenses per student per taxpayer. 4 year limit per student.	\$2,500 reduction in tax liability per student (62.5% discount on \$4,000)	\$160,000/\$180,000 (joint) \$80,000/\$90,000 (single) Not indexed for inflation
Lifetime Learning Tax Credit	\$2,000 tax credit. 20% of first \$10,000 of qualified tuition and related expenses per taxpayer.	\$2,000 reduction in tax liability (20% discount on \$10,000)	\$100,000/\$120,000 (joint) \$50,000/\$60,000 (single) Indexed for inflation

³ Taxpayers can claim the Tuition and Fees Deduction on either IRS Form 1040 or IRS Form 1040A.

⁴ These benefit programs include SSI, Food Stamps, Free and Reduced Price School Lunch, TANF and WIC.

OVERLAP AND COMPLEXITY LEADS TO CONFUSION

The overlap of the Tuition and Fees Deduction with the Hope Scholarship and Lifetime Learning tax credits can be a source of confusion for families. The US Government Accountability Office (GAO) reported in May 2008⁵ that the “postsecondary tax preferences are difficult for families to understand and use correctly,” finding that the complexity of the tax provisions may cause hundreds of thousands of taxpayers to “fail to claim tax preferences to which they are entitled” or to “not claim the tax preference that would be most advantageous to them.” The GAO recommended “reducing the number of choices students and their families have to make” in order to reduce the potential for confusion and mistakes.

Anecdotal evidence suggests that some families may claim the Tuition and Fees Deduction instead of the Hope Scholarship Tax Credit because it appears earlier in the federal income tax return even though the tax credit yields a greater financial benefit.

WEAKLY TARGETED BASED ON NEED

The following tables, which are based on IRS Statistics of Income (SOI) data for 2007,⁶ demonstrate that the Tuition and Fees Deduction is claimed by and benefits high-income families to a much greater extent than the Hope Scholarship and Lifetime Learning tax credits. More than 4.5 million taxpayers claimed a total of \$10.6 billion in Tuition and Fees Deductions (yielding as much as \$1.9 billion in reduced tax liabilities) and more than 7.4 million taxpayers claimed a total of \$6.9 billion in education tax credits. A third of taxpayers claiming the Tuition and Fees Deduction had an AGI over \$100,000, compared with only 3% of taxpayers claiming the education tax credits. The disparity is even greater when one considers the financial benefit, with nearly half of the financial benefit from the Tuition and Fees Deduction accruing to taxpayers with an AGI over \$100,000, compared with only 2% for taxpayers claiming the education tax credits. If the Tuition and Fees Deduction is allowed to expire and eligible taxpayers switch to the Lifetime Learning Tax Credit, an estimated 6% of taxpayers claiming the education tax credits would have an AGI over \$100,000, less than half the current prevalence of high-income taxpayers.

The first table shows the AGI distribution of the number of taxpayers claiming the education tax benefits.

Tax Benefit	\$50,000 to		
	< \$50,000	\$100,000	≥ \$100,000
Tuition & Fees Deduction	42%	25%	33%
Education Tax Credits	60%	37%	3%
Combined	53%	33%	14%

The second table shows the AGI distribution of the financial benefit from the education tax benefits.

Tax Benefit	\$50,000 to		
	< \$50,000	\$100,000	≥ \$100,000
Tuition & Fees Deduction	30%	23%	47%
Education Tax Credits	52%	46%	2%
Combined	47%	41%	12%

⁵ HIGHER EDUCATION: Multiple Higher Education Tax Incentives Create Opportunities for Taxpayers to Make Costly Mistakes, GAO-08-717t, May 1, 2008. www.gao.gov/cgi-bin/getrpt?GAO-08-717t

⁶ www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html

Note that this data predates the expansion of the Hope Scholarship Tax Credit by the American Recovery and Reinvestment Act of 2009. That expansion may lead to greater utilization of the Hope Scholarship Tax Credit by wealthy families since the Hope Scholarship Tax Credit's income phaseouts are now greater than the income phaseouts for the Tuition and Fees Deduction and the tax credit is also more generous. The Tuition and Fees Deduction will be used mainly by high-income taxpayers who do not qualify for the Hope Scholarship Tax Credit, such as graduate and continuing education students. The Tuition and Fees Deduction will be preferred over the Lifetime Learning Tax Credit for taxpayers in the 25% tax bracket because of the higher income phaseouts, greater financial benefit (e.g., 25% vs. 20%) and more favorable treatment under the Alternative Minimum Tax (AMT).

Although the 2003-04 National Postsecondary Student Aid Study (NPSAS) includes variables to evaluate utilization of the three education tax benefits, similar variables are not currently available in the data analysis system for the 2007-08 NPSAS.