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The Higher Education and Skills Obtainment Act: A Proposal to Reform Higher Education Tax Credits

By
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Introduction

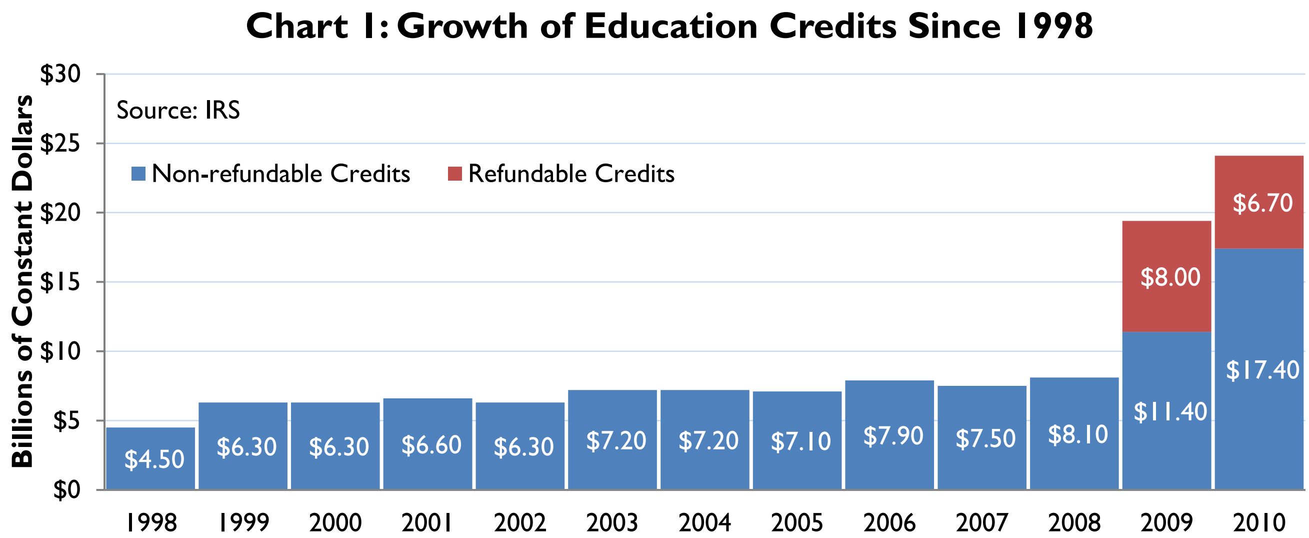
Senator Marco Rubio (R-FL) and Congressman Aaron Schock (R-IL) have recently introduced the Higher Education and Skills Obtainment Act, which would reform the current tax subsidies for higher education by eliminating the current assortment of education tax credits and deductions and consolidating them into one higher education credit called the Higher Education and Skills Obtainment Credit. This proposal reduces some complexity that exists in the current tax benefits for higher education, targets the credits for a narrower population of taxpayers, and saves taxpayers money.

However, there are still problems with using the tax code to subsidize higher education. Tax credits for higher education are likely contributing to rising tuition costs while not making students any more likely to enroll in college. Although this reform is a step in the right direction towards a simpler tax code, there is still room for a conversation about whether the tax code is the right tool for making college more affordable.

Higher Education Tax Benefits

Lawmakers have increasingly used tax credits as a way to help students cover the cost of college. From 1998, the first year these credits were available, to 2010, the use and cost of these credits has greatly increased. Chart 1 shows the cost of higher education tax credits has grown from $4.5 billion in 1998 to more than $24 billion in 2010. With more than 24 million taxpayers claiming the credit, the average taxpayer claimed roughly $1,000 in education tax credits.[1]

[1] Scott Hodge, *Are Tax Credits the Proper Tool for Making Higher Education More Affordable?*, Testimony before the U.S. Senate Committee on Finance, July 25, 2012, http://taxfoundation.org/article/are-tax-credits-proper-tool-making-higher-education-more-affordable.



Currently, there are three tax benefits for education that create an amalgamation of tax preferences for higher educational expenses. Each of these preferences has different benefit sizes, income limits, income definitions, and qualifying expenses. Table 1 shows the three available tax benefits for education expenses, their requirements, and their limitations.

The American Opportunity Credit, which was a temporary expansion of the Hope Credit, is a refundable tax credit of up to $2,500.[2] With the highest income limit of all education tax benefits, married taxpayers with incomes as high as $180,000 can claim this credit. On the other end, since this credit is refundable, taxpayers can receive the credit even without a tax liability. This credit has a four-year lifetime limit.

The second tax benefit, the Lifetime Learning Credit, is not as generous as the American Opportunity Credit. This provision gives taxpayers a non-refundable credit up to $2,000 on qualifying expenses and has an income limit of $124,000 for married taxpayers. However, unlike the American Opportunity Credit, it has no lifetime limit. Taxpayers can receive this tax credit as long as they have qualifying educational expenses anytime in their life.

The final benefit for educational expenses is the Deduction for Education Expenses. Unlike the previous two benefits, this is an above-the-line deduction. This means instead of reducing an individual taxpayer's tax bill, it reduces their taxable income. The deduction allows up to a $4,000 deduction and has an income limit of $160,000 for married taxpayers. Like the Lifetime Learning Credit, there is no lifetime limit on the number of years a taxpayer can claim this deduction.

[2] The American Recovery and Reinvestment Act of 2009 temporarily expanded and renamed the Hope Scholarship Credit to the American Opportunity Credit. It was set to expire in 2012 but subsequently extended five more years in the American Taxpayer Relief Act of 2012. In 2017, the credit will no longer be refundable and will revert back to a maximum benefit of $1,800 per eligible student.

Although there are three tax provisions for educational expenses, taxpayers can only claim one of the three available tax benefits. This means a taxpayer must calculate their income, school expenses, and potential tax savings for each of the benefits above to determine which one would be greater.

Table 1: Credits and Deduction Available for Higher Education Expenses
Tax Year 2012

Tax Benefit	Type	Maximum Credit/ Deduction	Refundable?	Income Limit	Qualified Expenses	Lifetime Limit
American Opportunity Tax Credit	Refundable Credit	Up to $2,500 credit per eligible student	Yes- 40% refundable	$180,000 if married; $90,000 if single or head of household	Tuition, required enrollment fees, and course materials required for a course of study whether or not they are paid to the institution	Yes - 4 Years
Lifetime Learning Credit	Credit	Up to $2,000 credit per return	No	$124,000 if married; $62,000 if single or head of household	Tuition and required enrollment fees including amounts required for course-related supplies only if paid to the institution	No
Deduction for Education Expenses	Deduction	Up to $4,000 deduction	N/A	$160,000 if married; $80,000 if single or head of household	Tuition and fees required for enrollment or attendance at an eligible postsecondary educational institution but not including living expenses	No

Source: IRS, Tax Benefits for Education, 2012

Changes to Current Law

Senator Rubio and Representative Schock's proposal would eliminate the current tax preferences for higher education expenses, replacing these provisions with a single new tax credit for higher education expenses called the Higher Education and Skills Obtainment Credit.[3] (See Table 2, below.)

This credit would be a $2,500 non-refundable tax credit (100 percent credit for the first $2,000 of qualifying expenses and 25 percent for the next $2,000). Qualified expenses would be defined as tuition and enrollment fees, course-related books, and required supplies and equipment. It also expands the definition of eligible education expenses to those enrolled in eligible job skills training programs identified by the Workforce Investment Act (WIA).

Use of the credit will be limited to people with incomes below 500 percent of the federal poverty level ($97,650 for a family of three) and will begin to phase out at 400 percent of FPL ($78,120). It will be

[3] This law will also repeal the Hope Scholarship Tax Credit, which is currently replaced by the American Opportunity Credit. In the absence of this repeal, the American Opportunity Credit will expire and be replaced by the Hope Tax Credit in 2017.

limited only to students that attend school at least half-time, and the credit will have a lifetime limit of four years. Nonresident aliens will not be eligible to claim this credit.

The bill also has provisions that seek to prevent fraud by requiring the IRS to review and verify the use of the credit to ensure that only eligible students get the credit.

According to the offices of Schock and Rubio, eliminating the current credits and deduction and replacing it with this single credit, plus all the fraud limitations, will save the government around $10-15 billion over ten years, most of these savings coming from the repeal of the American Opportunity Tax Credit's refundability.

Table 2: Proposed "Higher Education and Skills Obtainment Credit"

Tax Benefit	Type	Maximum Credit/ Deduction	Refundable?	Income Limit	Qualified Expenses	Lifetime Limit
Higher Education and Skills Obtainment Credit	Non-Refundable Credit	Up to $2,500 credit per eligible student	No	500 percent of the Federal Poverty Level	Tuition, required enrollment fees, course materials required for a course of study whether or not they are paid to the institution, and any fee associated with enrollment in a "Job Skills Training" program as defined by the Workforce Investment Act.	Yes - 4 Years

Source: Offices of Congressman Aaron Schock and Senator Marco Rubio

Simplifies the Tax Code

With any tax provision, the economic cost of the program will exceed its budgetary cost. This means that mere compliance with the tax code will cost society more than any direct cost it has to taxpayers. As the complexity of provisions increases, so does the cost to society.

This proposal will consolidate the three current benefits into one, aligning all definitions of income, expenses, and eligibility requirements. This will simplify this part of the tax code, saving taxpayers time and money when they file their taxes.

Attempts to Limit Fraud and Abuse

On top of compliance costs, higher education tax credits have a second economic cost: they are susceptible to fraud.[4] This is due to the high complexity, generosity, and lax IRS oversight of many of these programs. For instance, the Earned Income Tax Credit (EITC)—one of the most complex and generous aspects of the

[4] Scott Hodge, *Are Tax Credits the Proper Tool for Making Higher Education More Affordable?*, Testimony before the U.S. Senate Committee on Finance, July 25, 2012, http://taxfoundation.org/article/are-tax-credits-proper-tool-making-higher-education-more-affordable.

tax code—has an error rate as high as 25 percent, costing an estimated $11 billion to $13 billion in improper payments.[5]

Although not as bad, higher education tax credits also suffer from additional costs due to improper payments. According to the Treasury Inspector General for Tax Administration (TIGTA), "some taxpayers claimed the Hope Credit for more years than allowed," costing over $232 million.[6] Additionally, since the IRS doesn't require documentation that proves whether a student is eligible or even attends an accredited educational institution, there have been significant improper payments made through the American Opportunity Credit.[7]

Even further, educational institutions are spending millions of dollars supplying taxpayers with Tuition Statements even though "the IRS does not use the form in the compliance programs, or accept the Form as documentation to support claims for education credits," according to TIGTA.[8]

This proposal will attempt to reduce the amount of improper payments by requiring the IRS to enforce three new rules. First, it requires the IRS to review the Department of Education database file to confirm that a student meets the requirement of attending at least half-time. Second, it will require the IRS to review previous years' tax returns to ensure taxpayers don't improperly claim credits for more than four years. Third, it will also require that the social security number of the student appear on the tax return.

Sets Limits on Higher Education Tax Credits

With the recent expansion of the available tax preferences for higher education, especially through the American Opportunity Tax Credit, more and more taxpayers are claiming higher education tax credits. In fact, the most recent expansion in the law allows married taxpayers with income as high as $180,000, more than three times the median household income of $50,813, to claim the refundable American Opportunity Tax Credit. Taxpayers, through the Lifetime Learning Credit, can also receive a subsidy for as many years of education as they want, which extends the availability of the credit to those seeking education past a bachelor's degree.

The Rubio-Schock proposal will tie the income limit to the federal poverty level (FPL). The credit's value will begin to phase out at 400 percent, reaching zero at 500 percent of the FPL. For a family of three, this

[5] *Improper Payments in the Administration of Refundable Tax Credits*, Testimony of J. Russell George, Treasury Inspector General for Tax Administration, before the Committee on Ways and Means, Subcommittee on Oversight, U.S. House of Representatives, May 25, 2011, at 3.
[6] Treasury Inspector General for Tax Administration, *Improvements and Needed in the Administration of Education Credits and Reporting Requirements for Educational Institutions*, Sept. 30, 2009, Reference Number: 2009-30-141, at 2 [hereinafter TIGTA Report].
[7] Russell Testimony, *supra* note 5, at 7.
[8] TIGTA Report, *supra* note 6, at 2.

equals $97,650. This will limit the number of families with higher-than-average incomes who take advantage of the higher education tax credits.

At the bottom end, this proposal will remove the refundability of the credit. This will limit the credit to only those with tax liabilities, since you cannot credit against a tax liability of zero. Repealing the refundability portion, which has been responsible for the majority of the increased cost of this program, will save taxpayers around $8 billion over ten years alone.[9] Additionally, refundable tax credits are economically identical to cash transfers such as the Pell Grant program. It doesn't make sense to have a redundant transfer program when funding for Pell Grants could be used instead.

Their proposal also caps the number of years this credit can be used to four. Under current law, there is no limitation on the number of years one can claim the credit. As long as a taxpayer has higher education expenses, they can get a tax benefit, especially through the Lifetime Learning Credit. This proposal will limit the use of tax credits for the most part to those seeking a bachelor's degree by imposing a four year lifetime limit. However, there is no restriction on which degree a student seeks. For instance, if this credit is not used for a bachelor's degree, it may be used to offset the cost of a master's degree or a J.D. This attempts to prevent those seeking more than one degree from receiving a subsidy.

Expanded to Workforce Training Programs

This proposal also expands the use of the credit to qualified jobs skills training services. This will allow individuals who participate in job skills training at Workforce Investment Act (WIA) designated providers to claim this credit. Since WIA workforce training programs are aimed at those with lower incomes and without access to college, this proposal could be seen as a way to encourage lower-income individuals to receive education through the use of the tax credit. This would provide a new incentive to sign up for a work training program.

Are Tax Credits the Proper Tool for Making College More Affordable?

There is no doubt that this proposal reduces the complexity in the tax system, saves taxpayers money by limiting these credits, and attempts to make them less susceptible to fraud. However, the fact remains that tax credits for higher education may not be the best way to encourage college attendance.

Do These Tax Credits Encourage College Attendance?

It isn't actually clear whether tax credits for higher education expenses encourage college attendance. What little research that has been done on this subject is mixed. One of the first papers that analyzed the behavioral effects of the Hope and Lifetimes Learning Credits found that the credits did not increase the

[9] According to estimates by the offices of Senator Rubio and Congressman Schock.

likelihood of college attendance. In fact, those who were already likely to go to college were benefitting from the credit.[10]

Tax Credits May Actually Be Driving up Costs

It is likely that tax credits for higher education are driving up college costs rather than making them more affordable. Chart 3 shows that since 2000, the average college tuition for two- and four-year colleges and universities has increased by 35 percent, adjusted for inflation. This is an average increased cost of nearly $500 per year. The purpose of the higher education tax credits is to help families with this ever-increasing cost of college tuition. However, some empirical evidence suggests that tax benefits for educational expenses are doing the opposite.

One paper finds that "there is some evidence to support that public two-year colleges responded to incentives created by the tax credits by raising tuition price beyond what can be explained by fluctuations in state support, and the responses were stronger for schools with a greater proportion of credit-eligible students."[11]

Other research from the Center for College Affordability and Productivity found that "recent increases in financial aid have not improved affordability" and argue that this is due to the fact that colleges are able to "capture the aid" by increasing their tuition.[12] In other words, schools know that students receive this tax subsidy, raise their prices, and capture most of the subsidy.

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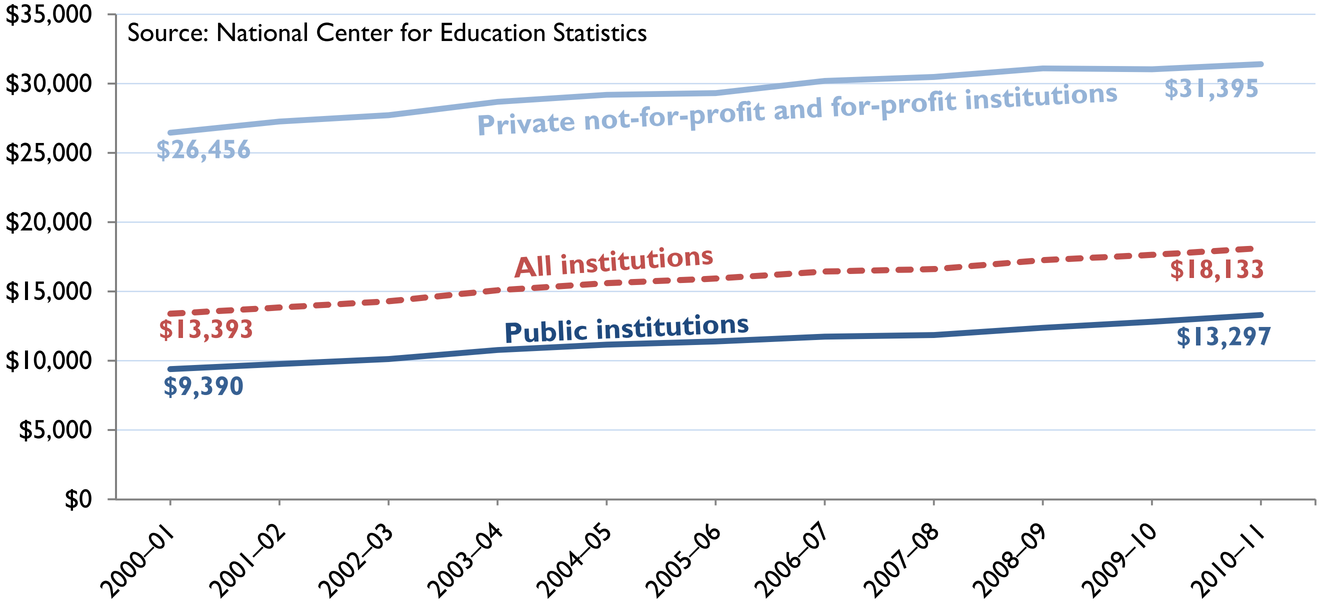
[10] Bridget Terry Long, *The Impact of Federal Tax Credits for Higher Education Expenses* (National Bureau of Economic Research, Working Paper No. 9553, Dec. 2006), http://www.nber.org/papers/w9553. For a list of other studies on this issue, *see* Neal McCluskey, *Yes, Aid Fuels Tuition Inflation*, CATO@LIBERTY, July 9, 2013, http://www.cato.org/blog/yes-aid-fuels-tuition-inflation.

[11] *Id.*

[12] Robert E. Martin & Andrew Gillen, *How College Pricing Undermines Financial Aid*, CENTER FOR COLLEGE AFFORDABILITY AND PRODUCTIVITY POLICY PAPER (Mar. 2011), at 13, http://centerforcollegeaffordability.org/uploads/How_College_Pricing_Undermines.pdf.

Chart 2. Average Tuition for Public, Private 4 and 2-Year Institutions, School Years 2000-01 through 2010-11 (Constant 2009-10 Dollars)



Conclusion

The Higher Education and Skills Obtainment Credit proposal certainly has provisions that improve the tax code. It simplifies the current tax benefits for higher education by reducing the number of provisions from three to one. It attempts to pare back the recent growth in tax education credits by changing income eligibility levels and abolishing refundability. It also moves to reduce fraud by giving the IRS the tools to enforce the rules of the credit.

However, there are lingering concerns with education tax credits. As the evidence suggests, credits do little to encourage college attendance and may be driving up the cost of college education. Perhaps these issues will encourage a wider discussion on whether tax credits for higher education are appropriate tax policy.

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