

**Focus on Tax Policy**  
**Consolidation of Educational Tax Credits**  
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**Background and Current Issues**

College students and families can take advantage of several programs to subsidize the costs of higher education. Two of the most utilized support systems are federal financial aid and the tax system. The tax system has provided various forms of relief since the 1940s, but tax credits for educational expenses only began in the 1990s.

President Bill Clinton believed an educational tax credit was necessary for low-income and middle-class taxpayers to alleviate the burden of rising tuition costs. In his second term as president, Clinton signed and passed the Taxpayer Relief Act of 1997, which introduced the Hope Scholarship Credit and the Lifetime Learning Credit (LLC). Within a decade, the tax system introduced a few more credits and incentives, such as the tuition and fee deduction, that subsidized the costs of attaining higher education and advanced training.

Following the Great Recession of 2007, Congress and President Barack Obama wanted more students and families to qualify for an educational tax credit. Obama signed and passed the American Recovery and Reinvestment Act of 2009, which introduced an improved and broader version of the Hope Credit, known as the American Opportunity Tax Credit (AOTC). The AOTC allows for a maximum tax credit of \$2,500 per eligible student based on the amount of qualified educational expenses. Up to \$1,000 of the total credit may be refundable. The AOTC can be claimed for the first four years of a degree-awarding program and will expire by the end of 2017.

However, taxpayers can only utilize one of these incentives per taxable year. For example, if the AOTC is claimed for the taxable year then the LLC and the tuition deduction cannot be claimed for the same year. Choosing the tax credit that offers the most benefit can be a complex situation that creates stress and burden on taxpayers, especially those without the resources to hire a tax practitioner. Each one has similarities but also differences in key definitions and eligibility rules. Taxpayers who appeared eligible for the LLC and the tuition deduction failed to minimize their federal tax liability in two ways.<sup>48</sup> Some failed to claim any credit at all while others selected the suboptimal choice. For example, about 40% of the 588,000 taxpayers who claimed the tuition deduction would have increased their tax benefit by an average of \$284 had they utilized the LLC instead of claiming the deduction.

**Proposal**

Congress has heard many ideas and proposals to consolidate the educational tax credits into a more simple and certain tax credit. In the 113th Congress, Representatives Diane Black and Danny K. Davis introduced H.R. 3393, which contained several changes to the existing educational tax credits. There are four key changes:

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<sup>48</sup> United States Government Accountability Office, *Higher Education - Improved Tax Information Could Help Families Pay for College*, May 2012, 32-38.  
<http://www.gao.gov/assets/600/590970.pdf#page32>.

- Consolidating the AOTC, LLC, tuition deduction, and Hope Credit into a broader version of the AOTC.
- Coordinating in conjunction with Pell Grants by excluding amounts received via Pell Grants from the taxpayer's gross income increasing the refundable portion of the AOTC to \$1,500.
- Making the AOTC permanent.

## Analysis

The consolidation into one tax credit would simplify the educational tax credits, because there is only one tax credit available to utilize. Less time would be spent researching which tax credit to use. Consequently, the chances of selecting the suboptimal choice would be eliminated, and everyone would be entitled to the same amount of tax benefit.

The current system penalizes Pell Grant receivers because of the lack of cohesion between the educational tax credits and Pell Grants. This group of students finds financial assistance more beneficial than those in the middle-class. Therefore, the proposal allows them to receive the same amount of tax benefit as any other taxpayer.

The higher refundable credit allows for more money in the taxpayers' pockets, which indirectly benefits state and local governments because this could incentivize using the refund towards purchases and investments. The permanence provides certainty to families and students with tax planning for the future. Families can feel assured that they can send their children to college and know that they will receive the same benefits as those who are receiving it today.

Many people admired the proposal, but others still had issues with it. Congressman Sander Levin showed concern for the students who

would no longer receive assistance from the LLC and the tuition deduction.<sup>49</sup> Because the bill consolidates everything to be under the AOTC, it generally takes on its current provisions. Only undergraduate students would have access to the credit. So graduate students and lifetime learners, though technically still seeking more education would no longer be eligible for an educational tax credit.

The concern from Congressman Rush D. Holt was in regards to the lack of means to fund the expanded tax credit.<sup>50</sup> The lack of funding would increase the nation's deficit. He suggested that better alternatives to assisting with secondary education exist and the focus should be on fixing student loan debt and Pell Grant funding.

Jeffrey A. Porter, Chair of the American Institute of Certified Public Accountants, thought the proposal had the right intentions but does not satisfy the goal of simplifying the educational tax credits.<sup>51</sup> Increasing the refundable tax credit does not simplify the incentive and does not guarantee more utilization of it. He makes a few suggestions

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<sup>49</sup> House of Representatives, 113th Congress 2nd Session, *Student and Family Tax Simplification Act*, July 17, 2014, 38-39.

<https://www.congress.gov/113/crpt/hrpt526/CRPT-113hrpt526.pdf>

<sup>50</sup> House of Representatives, *Congressional Records - Extension of Remarks*, July 24, 2014, 7.

<http://www.gpo.gov/fdsys/pkg/CREC-2014-07-24/pdf/CREC-2014-07-24-extensions.pdf>

<sup>51</sup> American Institute of Certified Public Accountants, *The Education Incentives Included in the Tax Reform Act of 2014 and the Student and Family Tax Simplification Act (H.R. 3393)*, March 27, 2014,

<https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA%20Comment%20Letter-%20Education%20HR%203393%20AOTC%203-27-14.pdf>.

to help ensure simplification, such as making the entire tax credit refundable, offering the credit on a per-student basis (as opposed to a per-taxpayer basis), and lengthening the credit to 6 years of any type of post-secondary schooling.

Although this proposal died in Congress, it took positive steps toward fixing the educational tax credits.

### Principles of Good Tax Policy Worksheet

Principle	Application	Rating
<p><b>Equity and Fairness</b> – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual’s income level and where they live.</p>	<p>Similarly situated taxpayers can be viewed in multiple ways. Taxpayers who are similar in being students would be seen as treated differently. An undergraduate student in his/her first year would be treated differently than an undergraduate student in their fifth year because they would no longer be able to claim the AOTC past the fourth year. They are both still students yet because one has attended college longer they are not eligible to claim the credit. Other groups of students, such as graduate students or lifetime learners, are ineligible for the AOTC despite sharing a common interest as an undergraduate student, which is to attain higher education.</p> <p>On an income level, taxpayers would all be treated equally. The main difference would be that Pell Grant receivers would perceive the educational tax credits as being fair. Currently, if a Pell Grant receiver has the same income level of a non-receiver, than the latter might receive more tax benefit than the former. The lack of coordination with Pell Grants has penalized those who receive it; their benefit would decrease either through a reduction of their qualified expenses or recognition of additional income. The proposal would entitle receivers to the same benefits as those who do not need financial aid.</p>	+/-
<p><b>Certainty</b> – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?</p>	<p>There is no change when the benefits of the tax credits would be received. In most cases, if the taxpayer is receiving a refund they can assume it would arrive to them within a few weeks of filing their tax return. The only change regarding the amount being paid is if the taxpayer is entitled to the full \$1,500 refundable credit. The same calculation would be done where the credits are first applied to the tax liability and any remaining amount, up to \$1,500, would be refunded. Because the AOTC has been in use since 2009 those who have been claiming it and are still eligible would continue to do the same process moving forward.</p>	+

<p><b>Convenience of payment</b> – is the tax due at a time that is convenient for the payer?</p>	<p>There is no change regarding when to claim the tax credit and when the refundable credit would be received. It would be claimed on the annual tax return and the refund should be received shortly after filing and any adjustments have been made. This creates convenience to the taxpayer because they do not need to do anything differently.</p>	+
<p><b>Economy in collection</b> – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax.</p>	<p>There are no additional costs to taxpayers because the changes do not create such burdens. Taxpayers can mimic the way they carried out transactions in previous years because it is essentially the same tax credit as before. The changes from the proposal are a minor cost to the government. The content of Form 8863, Education Credits would need to be updated to remove the LLC, which is not a difficult task.</p> <p>The AOTC has been in existence for a few years now so the tax credit has already been implemented. In the year of change, the differences from the proposal are only adjustments to certain numbers and changes in specific rules.</p>	+
<p><b>Simplicity</b> - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?</p>	<p>A goal of the proposal is to simplify the existing educational tax credits and it does so in several ways. The consolidation of the educational tax credits leaves the public with one tax credit to choose from. Therefore, the proposal would remove overlapping tax credits with the same goal. It would also remove the complexity of defining the same word that have discrepancies in their meanings from one tax credit to another. The permanence of the AOTC would cease discussion and debate as to whether the credit should be extended. This could also reduce the frequency of how often the merits of the credit would change.</p> <p>Those who claimed nothing or incorrectly would not encounter the same confusion as they did before. Therefore, they could reasonably conclude that only one educational tax credit exists and if they are eligible they could utilize it. Additionally, the reporting requirement changes for qualified educational institutions would assist taxpayers in claiming the proper amount of tuition paid rather than tuition billed.</p> <p>Having all these changes limits the margin of error, thus enabling better decision making. The complexity of the current system can create a perception of unfairness. However, these changes toward simplicity ensures that taxpayers can have a better understanding of the single tax credit available and reduces any burdens.</p>	+

<p><b>Neutrality</b> - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p>H.R. 3393 rewards taxpayers, via a tax credit, for attaining higher education. The tax credit may influence taxpayers to enroll in post-secondary school. Unlike some sort of additional tax, these changes offer incentives that influence taxpayers into an activity that should develop themselves and the economy. It is unlike proposals that might influence a taxpayer to buy one product over another, which could create unfairness for one business over another. Therefore, it could be called a positive-form of neutrality because it should lead to positive outcomes. The alternative to attending college is a missed opportunity to additional education. Not having the additional education may force the taxpayer to potentially settle for a lower wage in comparison to the earnings potential they could have with a college degree.</p> <p>A goal of educational tax credits is to increase college attendance. It can be concluded that the government would prefer taxpayers to obtain more education or, in other words, they want a certain activity to be carried out. Even though there are some taxpayers who attend college regardless of tax-based aid, there are others who may see these changes as an incentive to attaining higher knowledge.</p>	+/-
<p><b>Economic growth and efficiency</b> – will the tax unduly impede or reduce the productive capacity of the economy?</p>	<p>This proposal tries to fix the complexities of the currently available educational tax credits in hopes that simplification will influence taxpayers into attaining higher education and making the process of claiming an educational tax credit easier. Despite the negative effects on the nation's deficit, there are reasons to believe this could help the nation's economy in the long run. If more taxpayers attend college then it would have a positive effect on the economy through higher paying jobs. Additionally, the higher refundable credit means more money in the taxpayer's pocket, which they might use to make additional purchases or investments.</p> <p>However, if the student drops out or fails to complete a college degree the hope is that the individual has gained some benefit from college to enhance themselves and the economy, or else it could be seen as wasted resources on behalf of the government.</p>	+/-

<p><b>Transparency and Visibility</b> – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</p>	<p>Form 8863, Education Credits, would no longer contain provisions of the LLC and just those of the AOTC. Currently, taxpayers fill out a questionnaire that either leads to the AOTC, LLC, or no tax credit at all. The questionnaire would be updated to determine eligibility of merely the AOTC or no tax credit at all. Therefore, if someone receives a 1098-T then they would fill the form out and see if they qualify or not. Therefore, the consolidation and emergence of one tax credit would be visible on this tax form.</p> <p>The consolidation should also make it easier to understand what is available and how that affects your taxes and your costs of college.</p>	+
<p><b>Minimum tax gap</b> – is the likelihood of intentional and unintentional non-compliance likely to be low?</p>	<p>The changes from H.R. 3393 should help increase compliance both intentionally and unintentionally. On an intentional basis, the taxpayer could select only one educational tax credit and there are not ways to manipulate it to falsely claim the credit. Even if a taxpayer tried to manipulate the system, the revised reporting requirements would ensure that they could only claim what they paid. The information reports would provide the IRS proof as to whether an individual is correctly or incorrectly claiming the AOTC.</p> <p>The chances of unintentional compliance would be low because of the same reasons. The taxpayer would not accidentally pick the tuition billed for the credit because they would know it is the tuition paid that provides the tax credit. The margin for error is larger with multiple educational tax credits because the taxpayer might misunderstand the rules or apply a definition from one tax credit to another in an incorrect manner. Thus, one tax credit would help ensure people understand what they are claiming and doing so properly.</p>	+
<p><b>Appropriate government revenues</b> – will the government be able to determine how much tax revenue will likely be collected and when?</p>	<p>The government would be able to project how much tax revenue they would lose. This estimate can be done by reviewing the previous year's tax returns that have a 1098-T, whether it was utilized for a tax credit or not. The calculation could be made by taking the number of taxpayers with the information report and applying it to their tax liability. In doing so, they can make a reasonable estimate on the amount of the tax expenditure. Therefore, they have the necessary tools to make a projection.</p>	+



## **Conclusion**

The proposal was admirable because it would simplify the overlapping tax credits and reduce complexity. It meets most of the principles of good tax policy with an exception for fairness, for graduate students and lifetime learners would no longer be eligible. This exclusion violates the goals of financial assistance for educational expenses. The proposal has no argument or support as to why these two groups of currently eligible students would be excluded; they are essentially seeking the same goal as undergraduate students, which is to attain more education.

Although not adequate to be passed, aspects of this proposal and the suggestions of those against it should be taken into account for this issue to be resolved in the future. The biggest winners of this proposal would be Pell Grant receivers would not be penalized from having to include amounts received from Pell Grant

in their taxable income, which would have allowed them to receive the same amount of benefit as any other taxpayer. Moving forward, the Pell Grant suggestions from this proposal should be used as a framework or mimicked so that the receivers feel enabled by educational tax credits, as opposed to being limited by them. As Porter suggested, increasing the refundable credit does not necessarily simplify the tax credit. Although it makes it look more appealing, it pours into the argument that Congressman Holt made about increasing the nation's deficit.

There are three routes that could occur for the future of educational tax credits: no action could be taken; the AOTC could be extended for a few more years; or the provisions of educational tax credits could be entirely shaken up, such as through a proposal like this.