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No Wealthy Parent Left Behind: An Analysis of Tax Subsidies for Higher Education

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NO WEALTHY PARENT LEFT BEHIND:

AN ANALYSIS OF TAX SUBSIDIES FOR HIGHER EDUCATION

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INTRODUCTION

As most students attending colleges and universities (and their parents) understand, the cost of higher education is quite high. In

* Professor of Law, *American University Washington College of Law.* The author wishes to thank Sarah Mengers and Philip Hinkle for their research assistance on this Article. In addition, the author wishes to thank his late colleague, Professor Janet Spragens, for her recurring lessons that the tax law affects low-income Americans in important and often under-studied ways. Finally, the author wishes to thank Barbara Sarshik for her editorial advice, her encouragement and so much else.

the past year, tuition and fees at four-year colleges increased by approximately six percent with an inflation rate in the range of three percent.[1] Over the last three decades, the cost of attendance at colleges and universities increased at rates well in excess of the economy-wide rate of inflation.[2] During this period, the real income levels for most of the population have not increased significantly.[3] Moreover, in recent years, colleges and universities have allocated more of their financial aid budgets towards "merit" scholarships with a smaller percentage of grants awarded on the basis of financial need.[4] As a result, these costs make it difficult, if not impossible, for lower-income students to attend four-year institutions, even when they are academically qualified to do so.[5]

Economists argue that higher education produces positive externalities because it produces benefits to society at large, including the creation of a more productive workforce.[6] Commentators assert that higher education provides low-income children with the greatest opportunity for economic advancement.[7] For these reasons, the federal government has long provided financial assistance to help students pay for the cost of attendance at

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1. Robert Tomsho, *As Tuition Soars, Federal Aid to College Students Falls*, WALL ST. J., Oct. 25, 2006, at B-1.

2. *See* COLLEGE BD., TRENDS IN COLLEGE PRICING 7 (2006), *available at* http://www.collegeboard.com/trends [hereinafter TRENDS IN COLLEGE PRICING] (finding a three percent increase in the average inflation-adjusted tuition and fees for private four-year colleges and a four percent increase in tuition and fees for public four-year colleges).

3. *See* JACQUELINE E. KING, AM. COUNCIL ON EDUC., 2003 STATUS REPORT ON THE PELL GRANT PROGRAM 7 (2003) (noting that the average income for low-income families decreased by six percent during the past three decades while the average income for middle-income families increased by only eight percent).

4. *See* ELAINE M. MAAG & KATIE FITZPATRICK, URBAN INST., FEDERAL FINANCIAL AID FOR HIGHER EDUCATION: PROGRAMS AND PROSPECTS 7, 39 (2004) (recognizing that the amount of "institutional grants" offered to students in the highest income quartile have increased by ten percent from the 1990s to 2000 while grants to students in the lowest income quartile have only increased about two percent).

5. *See* Tomsho, *supra* note 1 (asserting that low-income students are opting to attend two-year colleges as a way of making higher education more affordable).

6. *See* INST. FOR HIGHER EDUC. POLICY, REAPING THE BENEFITS: DEFINING THE PUBLIC AND PRIVATE VALUE OF GOING TO COLLEGE 14 (1998), *available at* http://www.ihep.org/Pubs/PDF/Reap.pdf (listing other public economic benefits as increased tax revenue, increased consumption, increased workforce flexibility, and decreased reliance on government financial support).

7. *See id.* at 8 (noting that Bill Clinton stated that in 1996, the average worker with a college degree made seventy-three percent more in annual earnings than a worker without a college degree); *see also* Lindsey Vada, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, 17-18 (2001) (contending that one way to fight poverty is to promote higher education to the lower class).

institutions of higher education.[8] At the outset, this assistance focused on students whose family circumstances were quite modest. In 1972, Congress enacted the Pell Grant program[9] to help lower-income families pay for university education. Subsequently, Congress enacted the federal student loan program.[10] Today, this program provides both subsidized loans[11] and unsubsidized loans.[12] Each year, the annual volume of new student loans exceeds $50 billion.[13]

Over the past fifteen years, Congress turned to tax expenditure programs to help taxpayers pay for the cost of higher education.[14] Prior to these enactments, the federal income tax only minimally addressed the tax benefits that could arise from paying the cost of higher education. The principal tax issues that arose from paying higher educational expenses were whether educational expenses could be deducted as an ordinary and necessary business expense[15] and whether interest paid with respect to student loans was deductible.[16]

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8. *See* Chessconsulting.org, History of Financial Aid, http://www.chessconsulting.org/financialaid/history.htm (last visited Mar. 29, 2007) (noting the 1958 National Defense Education Act ("NDEA"), later renamed as the Federal Perkins Loan Program, as one of the first measures that provided a student loan program offering long-term, low-interest loans to students in the fields of mathematics, science and foreign languages).

9. Pell Grants were originally called Basic Educational Opportunity Grants. Education Amendments of 1972, Pub. L. No. 92-318, § 410, 86 Stat. 235, 247-48. The original grant program was renamed the Federal Pell Grant Program in 1980. Higher Education Amendments of 1980, Pub. L. No. 96-374, § 402, 94 Stat. 1367, 1401.

10. *See* Higher Education Amendments of 1992, Pub. L. No. 102-325, § 411, 106 Stat. 448, 510 (creating the Federal Stafford Loan Program and PLUS Loans).

11. The federal government pays the interest costs during the period in which the student is in college or graduate school.

12. *See* Higher Education Amendments of 1992, Pub. L. No. 102-325, §§ 427-28, 106 Stat. 448, 549.

13. AM. COUNCIL FOR POLICY ANALYSIS, FEDERAL STUDENT LOAN DEBT: 1993 TO 2004 1 (2005).

14. BARRY D. BURGDORF & KENT KOSTKA, ELIMINATING COMPLEXITY IN FEDERAL FINANCIAL AID PROGRAMS FOR HIGHER EDUCATION STUDENTS: TOWARDS A MORE STRATEGIC APPROACH 2 (2006), *available at* http://www.ed.gov/about/bdscomm/list/hiedfuture/reports/burgdorf-kostka.pdf.

15. 26 U.S.C. § 162 (2000); *see* Treas. Reg. § 1.162-5 (2005) (allowing a deduction for education expenses if the education maintains or improves skills either required by the individual in his trade or business or required by an individual's employer).

16. Although I.R.C. § 163(a) authorizes a deduction for interest paid on indebtedness during the taxable year, I.R.C. § 163(h) disallows any deduction for personal interest. Except to the extent that I.R.C. § 221 allows a deduction, interest paid on student loans is treated as non-deductible personal interest. The Tax Reform Act of 1986, Pub. L. No. 99-514, § 511, 100 Stat. 2085, 2244-48, eliminated the deduction for personal interest. The Taxpayer Relief Act of 1997 then restored partial deductibility of student loan interest. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 202, 111 Stat. 788, 806-09. I.R.C. § 127 also provides a tax exclusion for a limited amount of tuition that an employer pays for an employee's educational assistance. 26 U.S.C. § 127 (2000).

Congress has added numerous statutory provisions designed to help taxpayers pay for the cost of higher education.[17] In 1997, Congress enacted the Hope and Lifetime Learning Credits, which provide a tax credit of up to $2,000 per year for taxpayers who pay for attendance at a school of higher education.[18] These tax credits are available for taxpayers whose "modified adjusted gross income" does not exceed specified statutory limits.[19] Specifically, an unmarried taxpayer is eligible for one of these tax credits only if the taxpayer's modified adjusted gross income is less than $55,000, and married taxpayers are eligible for a tax credit only if their modified adjusted gross income is less than $110,000.[20]

Congress enacted § 222 in 2001 to provide a degree of assistance for higher income families.[21] Under this provision, taxpayers may claim an above-the-line deduction[22] for a limited portion of their higher education expenses.[23] Unmarried taxpayers with incomes of up to $65,000 (and married taxpayers with incomes of up to $130,000) may deduct up to $4,000 of "qualified tuition and related expenses."[24] For taxpayers whose incomes exceed these limits but do

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17. This Article discusses only the education tax credits authorized in I.R.C. § 25A, the deduction for educational expenses in I.R.C. § 222 and the tax benefits arising in connection with qualified tuition plans established pursuant to I.R.C. § 529. Overall, the Internal Revenue Code contains numerous other provisions that may affect the tax treatment of students attending higher education. INTERNAL REVENUE SERV., PUBLICATION 970: TAX BENEFITS FOR EDUCATION (2006) [hereinafter I.R.S. PUB. 970]. The provisions discussed herein are those that provide the most widely available benefits for taxpayer-paid higher education expenses.

18. 26 U.S.C. § 25A (2000); *see infra* notes 38-40 and accompanying text (discussing in general terms the mechanical operation of this provision). *See generally* Glenn E. Coven, *Bad Drafting—A Case Study of the Design and Implementation of the Income Tax Subsidies for Education*, 54 TAX LAW. 1 (2000) (providing a more comprehensive discussion of technical issues that arise in connection with these credits). The maximum amount of the Hope Scholarship Credit is adjusted, for years after 2001, to reflect inflation. 26 U.S.C. § 25A(h)(1)(A)-(B) (2000). The maximum level of the Lifetime Learning credit is not subject to inflation adjustments. *Id.*

19. 26 U.S.C. § 25A(d)(1)-(2) (2000 & West Supp. 2006).

20. *Id.* These dollar limits are indexed for inflation. 26 U.S.C. § 25A(h)(2) (2000). Revenue Procedure 2005-70 contains the inflation adjusted dollar limits applicable in 2006. Rev. Proc. 2005-70, 2005-47 I.R.B. 979.

21. 26 U.S.C. § 222 (Supp. IV 2004).

22. *See* 26 U.S.C. § 62(a)(18) (Supp. IV 2004) (allowing a § 222 deduction from gross income in order to reach adjusted gross income rather than as a deduction from adjusted gross income in computing an individual's taxable income).

23. *See* 26 U.S.C. § 222 (Supp. IV 2004), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933 (postponing the termination date of this provision to December 31, 2007).

24. 26 U.S.C. § 222(a), (b)(2)(B)(i) (Supp. IV 2004).

not exceed $80,000 for unmarried taxpayers (or $160,000 for married taxpayers), the deduction is limited to $2,000.[25]

In addition, Congress enacted § 529, which allows taxpayers to exclude from income investment returns that are used to pay certain higher educational expenses.[26] This provision provides a significant tax benefit for taxpayers who are able to save for the higher education of their children or grandchildren. Unlike the tuition tax credits and the § 222 deduction, there are no explicit dollar limits imposed on the magnitude of the tax benefits that taxpayers may realize from this provision.[27] And unlike those provisions, § 529 does not contain income limits that prevent high income taxpayers from contributing to § 529 plans.[28]

During this period of growth of tax-based federal grants for higher education, Congress constrained funding for the traditional expenditure programs. Specifically, the Pell Grants awarded to

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25. *Id.* § 222(a), (b)(2)(B)(ii). Section 25A and § 222 utilize slightly different income measures to determine eligibility for the benefits under these provisions. *Compare* 26 U.S.C. § 25A(d)(3) (2000) (defining "modified adjusted gross income" as the adjusted gross income for a taxable year increased by any amount excluded by §§ 911, 913, or 933), *with* 26 U.S.C. § 222(b)(2)(C)(i)-(ii) (Supp. IV 2004) (defining "adjusted gross income" "(i) without regard to this section and sections 199, 911, 931 and 933 and (ii) after application of sections 86, 135, 137, 219, 221, and 469").

26. 26 U.S.C. § 529(c) (2000). Congress enacted I.R.C. § 529 in 1996. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1806, 110 Stat. 1755, 1895-99. As enacted in 1996, § 529 created two significant tax benefits if taxpayers use plan assets to pay higher education expenses. First, it deferred the taxation of the investment income until amounts were distributed from the plan. Second, it taxed the plan beneficiary (i.e., the lower tax-bracket student) rather than the account owner (typically the student's higher tax-bracket parent or grandparent). In 2001, Congress significantly enhanced the tax benefits arising in connection with 529 plans. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 402, 115 Stat. 38, 60-63. The 2001 Act provisions were scheduled to sunset for taxable years beginning after December 31, 2010. *Id.* § 901(a)(1), 115 Stat. 38, 150. Congress eliminated these sunset provisions in the Pension Protection Act of 2006, Pub. L. No. 109-280, § 1304(a), 120 Stat. 780, 1109. Congress also enacted I.R.C. § 530, which created the so-called Coverdell Education Savings Account. This provision differs from § 529 in several significant respects. First, contributions to a Coverdell Education Savings Account are limited to $2,000 per year. 26 U.S.C. § 530(b)(1)(A)(iii) (Supp. IV 2004). Second, taxpayers with incomes in excess of prescribed statutory limits may not make contributions to a Coverdell Education Savings Account. *Id.* § 530(c)(1). Third, distributions from a Coverdell Education Savings Account are excluded from income if used for either higher education expenses or certain elementary or secondary education expenses. 26 U.S.C. § 530(b)(2) (2000). Apart from the tax preferred treatment of expenditures for the elementary or secondary education expenses, § 530 provides no tax advantages as compared to the tax savings available in § 529 plans. For this reason, this Article will not discuss the Coverdell Education Savings Account provisions.

27. 26 U.S.C. § 529(b)(6) (2000) (prohibiting contributions in excess of those necessary to cover the higher education expenses of the beneficiary, but placing no actual dollar limit on the amount the taxpayer may contribute to an account).

28. *See* 26 U.S.C. § 529(b) (2000 & Supp. IV 2004) (listing requirements that must be met to establish a qualified tuition program).

undergraduate students failed to keep pace with the cost of higher education.[29] In the late 1970s, the maximum Pell Grant covered 99% of the cost of attendance, including tuition, fees, room and board, at public two-year colleges, 77% of the cost of attendance at public four-year colleges, and 36% of the cost of attendance at private colleges and universities.[30] In 2003, the maximum Pell Grant covered 68% of the costs at two-year institutions, 41% at four-year public institutions, and 16% at four-year private institutions.[31] This decline continued in recent years, with the maximum Pell Grant covering only 33% of the cost of tuition, fees, room and board at four-year colleges in 2005-06.[32]

The decline in the purchasing power of the Pell Grant resulted from two different factors. First, the cost of attendance at colleges and universities grew faster than the general inflation rate.[33] Incomes for many families have not kept pace with these escalating costs. Second, the maximum Pell Grant failed to grow in line with the general rate of inflation, most significantly in the period from 1978 to 1996.[34] Although significant increases in the maximum Pell Grant were enacted in the late 1990s, the maximum Pell Grant increased from $4,000 in academic year 2002-03 to only $4,050 today.[35]

Moreover, in recent years many universities have shifted their financial aid resources toward merit-based scholarships and away

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29. BURGDORF & KOSTKA, *supra* note 14, at 2 (citing AMANDA SHARKEY, CENTER FOR AM. PROGRESS, PAYING FOR POSTSECONDARY EDUCATION: AN ISSUE BRIEF ON COLLEGE COSTS AND FINANCIAL AID 9 (2005)).

30. KING, *supra* note 3, at 4.

31. *Id.*

32. *See* TRENDS IN COLLEGE PRICING, *supra* note 2, at 5 (finding the average total cost of attendance at a four-year public college in 2005-06 to be $12,115 and the average total cost of attendance at a four-year private college to be $28,743); SHARKEY, *supra* note 29, at 11 (recognizing that the current amount of Pell Grant funds available to undergraduate students is between $400 and $4,050).

33. TRENDS IN COLLEGE PRICING, *supra* note 2, at 4.

34. From 1978 to 1996, the inflation-adjusted value of the maximum Pell Grant declined from $4,201 to $2,796. KING, *supra* note 3, at 28.

35. COLLEGE BD., TRENDS IN STUDENT AID 2004: PELL GRANT STATUS REPORT 1 (2004), *available at* http://www.collegeboard.com/prod_downloads/press/cost04/pell2004.pdf. Both Congress and the President have recognized that the level of the maximum Pell Grant is too low. In January, the House of Representatives passed legislation that would increase the maximum Pell Grant to $4,310 for the 2007-08 academic year. H.R.J. Res. 20, 110th Cong. (2007). In its budget proposals for fiscal year 2008, the Bush administration has proposed to increase the maximum Pell Grant to $4,600, with additional $200 increases in the next four years. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 2008 51 (2007). The administration proposed to eliminate the Supplemental Educational Opportunity Grant program and the Perkins Loan program. *Id.*

from students with greater financial need.[36] Combined with the decline in purchasing power of the Pell Grants and the expansion of subsidies provided under the Internal Revenue Code, the distribution of resources available to low- and moderate-income students has changed substantially. This Article will examine whether the tax provisions constitute a sensible component of the federal financial aid expenditure programs.[37]

Part I of this Article discusses the principal tax provisions that provide subsidies for higher education and analyzes the allocation of benefits that arise from these provisions. Part II evaluates these provisions from a tax policy perspective. Part III contains conclusions and policy recommendations.

I. ANALYSIS OF TAX PROVISIONS

A. *Higher Education Tax Credits*

1. *General considerations*

Section 25A includes two higher education tax credits, the Hope Scholarship Credit and the Lifetime Learning Credit.[38] A tax credit directly reduces the amount of tax that a taxpayer owes. To the extent that the taxpayer has tax liability prior to applying the tax credit under this provision, the benefit that a taxpayer enjoys does not depend upon the taxpayer's tax bracket.[39] In contrast, a deduction offsets the amount of income that is subject to tax. Consequently, the tax benefit that a tax deduction generates depends on the taxpayer's tax bracket because the deduction offsets income that would have been taxed at that rate of tax.[40]

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36. *See, e.g.*, Lynn O'Shaughnessy, *Not Just for the Needy*, BUS. WK., Mar. 19, 2007, at 98 (criticizing that instead of providing full scholarships to the most financially needy students, universities have started offering smaller scholarships to more students from wealthy families as a way to increase university rankings and bring in students who can pay a large portion of their own tuition).

37. It is possible that delivering financial aid using both expenditure programs and tax benefits may represent a sensible overall program. David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 958 (2004). As Victor Thuronyi observed, it is sensible to ask whether "a tax provision . . . can be replaced with a non-tax-based federal program that fulfills the current tax provision's purposes at least as effectively as does the current provision itself." Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 DUKE L.J. 1155, 1186 (1988).

38. 26 U.S.C. § 25A (2000).

39. These credits are non-refundable. Treas. Reg. § 1.25A-1(a) (2002). Consequently, a taxpayer otherwise eligible for a tax credit under I.R.C. § 25A receives no benefit to the extent that the credit exceeds the taxpayer's tax liability.

40. *See* INTERNAL REVENUE SERV., PUBLICATION 17: YOUR FEDERAL INCOME TAX FOR INDIVIDUALS 249 (2006) [hereinafter I.R.S. PUB. 17] (including tax tables for varied

These tax credits are available to taxpayers whose incomes do not exceed limits prescribed in the statute. Specifically, an unmarried taxpayer is eligible for one of these tax credits only if the taxpayer's modified adjusted gross income is less than $55,000, and married taxpayers are eligible for a tax credit only if their modified adjusted gross income is less than $110,000.[41] For unmarried taxpayers with incomes between $45,000 and $55,000, the dollar amount of these tax credits is phased-out.[42] Consequently, unmarried taxpayers with "modified adjusted gross income" of $47,000 would have their higher educational tax credit reduced by twenty percent.[43] Similarly, the tax credits are phased-out for married taxpayers with incomes between $90,000 and $110,000.[44]

The higher education credits are allowed with respect to "qualified tuition and related expenses" that are paid during any year to an "eligible educational institution."[45] Section 25A(f) defines "qualified tuition and related expenses" as the tuition and fees required for courses of instruction.[46] Although a college includes a student's living expenses, such as room and board, in computing the school's cost of attendance, these expenses are not "qualified tuition and related expenses."[47] For purposes of these credits, the tuition and fees that the educational institution charges are reduced by all tax-free

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taxable income levels and filing status, and showing that as a taxpayer's taxable income increases, so does the taxpayer's tax bracket); *see also* Michael Mumper, *The Future of College Access: The Declining Role of Public Higher Education in Promoting Equal Opportunity*, 585 ANNALS 97, 106 (2003) (explaining that the these credits do not involve direct payment to students, but rather reduce the taxpayer's taxable income, and thus the amount of tax actually owed, with the assumption that the extra money saved in taxes will be spent on education).

41. 26 U.S.C. § 25A(d) (2000 & West Supp. 2006). The dollar limits in the text reflect the effect of indexation of the dollar limits to reflect inflation. 26 U.S.C. § 25A(h)(2) (2000). Revenue Procedure 2005-47 contains the inflation adjusted dollar limits applicable in 2006. Rev. Proc. 2005-70, 2005-47 I.R.B. 979.

42. 26 U.S.C. § 25A(d) (2000 & West Supp. 2006). For the mathematical formula that applies to calculate the phase-out of the credit, see I.R.S. PUB. 970, *supra* note 17, at 14-15.

43. 26 U.S.C. § 25A(d)(2) (2000 & West Supp. 2006). § 25A(d)(3) defines modified adjusted gross income as the taxpayer's adjusted gross income increased by the deductions allowed pursuant to §§ 911, 931 and 933.

44. 26 U.S.C. § 25A(d)(2)(A)(ii) (West Supp. 2006).

45. § 25A defines an "eligible educational institution" as an institution described by the Higher Education Act, and generally includes all accredited institutions. In addition, the program must be eligible to participate in a financial program under Title IX of the Act. 26 U.S.C. § 25A(f)(2) (2000).

46. *Id.* § 25A(f)(1).

47. The term "qualified tuition and related expenses" does not include nonacademic fees or education programs involving sports, games, or hobbies, unless this course is part of the individual's degree program. *Id.* § 25A(f)(1)(B)-(C); *see* I.R.S. PUB. 970, *supra* note 17, at 12 (2006) (explaining that nonacademic fees include amounts paid for insurance, medical expenses, room and board, transportation or similar personal, living or family expenses).

educational assistance (including qualified scholarships and educational assistance paid under veterans' programs).[48]

Taxpayers face several choices in connection with these tax credits.[49] First, the taxpayer's family must determine which family member will receive the largest tax benefit as a result of claiming the credit. A taxpayer may claim the credit for the tuition and fees paid with respect to the taxpayer, the taxpayer's spouse, or the taxpayer's dependent.[50] Expenses paid by a dependent student are treated as being paid by the taxpayer claiming the credit.[51] Either the parent or dependent child, but not both, may claim the credit for a taxable year.[52]

Second, taxpayers must decide whether to claim the Hope Scholarship credit or the Lifetime Learning credit with respect to a student for a given year. As discussed below, the two credits are computed differently.[53] A taxpayer may not claim both a Hope Scholarship credit and a Lifetime Learning credit with respect to the same student in the same tax year.[54] Consequently, the taxpayer must decide which tax credit yields the larger tax benefit.

Third, taxpayers must decide whether to claim an education tax credit or a § 222 deduction for higher education expenses. A taxpayer is prohibited from claiming both a credit and the deduction for a particular student in the same year.[55] Again, the taxpayer must decide which tax provision yields the largest tax benefit. Empirical evidence suggests that taxpayers frequently fail to make the optimal choice.[56]

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48. 26 U.S.C. § 25A(g)(2) (2000). The interplay between the exclusions for such tax-free items as scholarships and the education tax credits may produce unexpected and complex interactions. *See* Coven, *supra* note 18, at 38 (realizing that in some cases, benefits from tax credits may be greater than the benefit of excluding tax-free aid from income, and thus a student may not maximize her potential government assistance by having to choose one over the other).

49. Albert J. Davis uses tax benefits for higher education as the basis for a case study in "choice complexity" that results from the proliferation of tax provisions. Albert J. Davis, *Choice Complexity in Tax Benefits for Higher Education*, 55 NAT'L TAX J. 509, 509 (2002). He observes that "too many choices are overly burdensome. In some circumstances, families don't just make inferior choices, they may choose an education benefit that makes them worse off than if they had chosen no benefit." *Id.*

50. 26 U.S.C. § 25A(f)(1)(A) (2000).

51. *Id.* § 25A(g)(3).

52. I.R.S. Notice 97-60, 1997-2 C.B. 310, Q&A (7), (10).

53. *See* discussion *infra* Parts I.A.2-3.

54. Treas. Reg. § 1.25A-1(b)(1) (2002).

55. 26 U.S.C. § 25A(g)(5) (2000).

56. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, LIMITED RESEARCH EXISTS ON EFFECTIVENESS OF TOOLS TO ASSIST STUDENTS AND FAMILIES THROUGH TITLE IV AND TAX PREFERENCES 4 (2005), *available at* www.gao.gov/cgi-bin/getrpt?GAO-05-684 [hereinafter U.S. GOV'T ACCOUNTABILITY OFFICE, EFFECTIVENESS OF TOOLS] (noting that twenty-one percent of those taxpayers who claimed the tuition deduction would

In making these determinations, taxpayers must take into account the fact that the higher education tax credits are not refundable.[57]

2. *Hope Scholarship Credit*

The Hope Scholarship credit is structured to produce the largest tax benefit for taxpayers who pay relatively modest amounts of tuition for two years following graduation from high school—in other words, for students attending community college.[58] For these students, the Hope Scholarship credit may equal all, or a very large percentage, of the tuition charges.[59] This credit is available only for the first two years of a student's undergraduate education.[60] The credit is available only for students who are at least half-time students during one academic period during the taxable year.[61]

For 2006, the magnitude of the Hope Scholarship credit equals the sum of: (1) 100% of the first $1,100 of tuition and related expenses paid during the year, and (2) 50% of the next $1,100 paid during the year.[62] Consequently, the maximum Hope Scholarship credit available with respect to any student for 2006 was $1,650.[63] A taxpayer may claim the Hope Scholarship credit for each eligible student in the taxpayer's family.[64]

3. *Lifetime Learning Credit*

Unlike the Hope Scholarship tax credit, the Lifetime Learning credit provides the greatest benefit with respect to students who attend more expensive colleges and universities, and it is available for all years of undergraduate and graduate education. Specifically, the

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have reduced their tax liability if they had claimed the Lifetime Learning credit instead).

57. *See* 26 U.S.C. § 26(a)(1)(A) (2000) (limiting the amount of tax credits allowable to the taxpayer's tax liability for the taxable year). The refundable tax credits are those authorized in §§ 31-36. *Id.* §§ 31-36; *see also id.* § 6401(b) (classifying refundable credits that exceed tax liability as an overpayment that will be refunded to the taxpayer).

58. *See* Davis, *supra* note 49, at 516 (calculating that for the 2004 taxable year, the Hope credit was most beneficial to middle-income taxpayers who incur education costs up to $7,250); Coven, *supra* note 18, at 26 (stating that because the deduction available under the Hope credit is small, it is most beneficial to students attending two-year community colleges).

59. *See* TRENDS IN COLLEGE PRICINGS, *supra* note 2, at 5 (noting that the average charge for tuition and fees at a two-year public institution in 2005-06 was $2,182); *see also* Coven, *supra* note 18, at 26 (recognizing that the Hope credit is a "high percentage credit" applicable to a rather small amount of tuition and fees).

60. 26 U.S.C. § 25A(b)(2) (2000).

61. *Id.* § 25A(b)(2)(B).

62. *Id.* § 25A(b)(1). The dollar limits specified in this provision are indexed to reflect inflation beginning in 2002. *Id.* § 25A(h)(1).

63. Rev. Proc. 2005-70, 2005-47 I.R.B. 979, 982.

64. I.R.S. Notice 97-60, 1997-2 C.B. 310.

Lifetime Learning credit equals 20% of the first $10,000 paid for "qualified tuition and related expenses."[65] Assuming that a student would be eligible for both credits, in 2006 the Lifetime Learning credit produces a larger credit than the Hope Scholarship credit if the "qualified tuition and related expenses" paid with respect to the student exceed $8,250.[66] Unlike the Hope Scholarship credit, the Lifetime Learning credit is not limited to the student's first two years of post-secondary education.[67]

The Lifetime Learning credit is available for costs attributable to instruction taken for the purposes of acquiring or improving job skills.[68] Consequently, the instruction does not have to be part of a degree program.[69] Further, unlike the Hope Scholarship credit, the Lifetime Learning credit does not require that the student carry a course load of at least one-half the full-time course load.[70] Therefore, the Lifetime Learning credit is available to a student who enrolls for a single course at an eligible institution that enhances the student's job skills.[71]

Finally, unlike the Hope Scholarship credit, which is calculated on a per-student basis, the Lifetime Learning credit is calculated on a per-family basis.[72] That is, the maximum credit that a taxpayer may claim in any given year is $2,000, regardless of how many students are in the taxpayer's family.[73]

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65. 26 U.S.C. § 25A(c)(1) (2000). The $10,000 limitation on the "qualified tuition and related expenses" taken into account for purposes of calculating the Lifetime Learning credit is not indexed for inflation. *See generally id.* § 25A(h) (indexing the amount of Hope Scholarship credits, but not providing for inflation adjustments on the Lifetime Learning credit).

66. For a taxpayer who paid "qualified tuition and related expenses" of $8,250, the Lifetime Learning credit would equal $1,650, which equals the maximum Hope Scholarship credit for 2006. I.R.S. PUB. 970, *supra* note 17, at 18.

67. *See* 26 U.S.C. § 25A(c)(1) (2000) (omitting the two-year limitations as imposed by 26 U.S.C. § 25A(b)(2)).

68. *Id.* § 25A(c)(2)(B).

69. *See* Treas. Reg. § 1.25A-4(c)(1) (2002) (providing that a course not part of a postsecondary degree program is characterized as a qualified tuition and related expense if it is taken to improve job skills).

70. *See* 26 U.S.C. § 25A(c) (2000) (omitting the half-time exclusion imposed by the Hope Scholarship Credit under 26 U.S.C. § 25A(b)(2)(B)).

71. I.R.S. Notice 97-60, 1997-2 C.B. 310, Sec. 2, Q&A (4).

72. *See* 26 U.S.C. § 25A(c)(1) (2000) (omitting the language "any eligible student" as referenced under the Hope Scholarship Credit section, 26 U.S.C. § 25A(b)(1), and tying the credit to 20% of $10,000); I.R.S. PUB. 970, *supra* note 17, at 18.

73. 26 U.S.C. § 25A(c)(1) (2000).

B. The "Above the Line" Deduction for Qualified Tuition and Related Expenses

Section 222 establishes a tax deduction for higher education expenses that serves as an alternative tax benefit to the education tax credits. As discussed above, this provision provides that taxpayers may claim a deduction for a limited portion of their higher education expenses.[74] Unlike most other deductions allowed with respect to expenditures that are personal in nature, this deduction is treated as an "above-the-line" deduction.[75] Most taxpayers do not itemize their deductions.[76] Because § 222 creates an "above-the-line" deduction, taxpayers who do not itemize their deductions may claim the deduction for higher education expenses.

Similar to the education tax credits, § 222 contains both eligibility requirements based on income and limitations on the magnitude of the tax benefits. Unmarried taxpayers with incomes of up to $65,000 (and married taxpayers with incomes of up to $130,000) may deduct up to $4,000 of "qualified tuition and related expenses."[77] For taxpayers whose incomes exceed these limits but do not exceed $80,000 for unmarried taxpayers (or $160,000 for married taxpayers), the deduction is limited to $2,000.[78] As enacted, § 222 applied only for taxable years 2002 to 2005.[79] In 2006, Congress extended the benefits of § 222 to taxable years 2006 and 2007.[80]

As with the education tax credits, room and board are not treated as "qualified tuition and related expenses."[81] Similarly, the tuition and fees that the educational institution charges are reduced by all

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74. 26 U.S.C. § 222 (Supp. IV 2004), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933 (extending the sunset date for this provision through December 31, 2007).

75. *See id.* § 62(a)(18) (directing that adjusted gross income shall be calculated after § 222 deductions).

76. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-02-509, TAX DEDUCTIONS: FURTHER ESTIMATES OF TAXPAYERS WHO MAY HAVE OVERPAID FEDERAL TAXES BY NOT ITEMIZING 1 (2002) (reporting that in recent years only thirty percent of Americans have itemized deductions on their tax returns).

77. 26 U.S.C. § 222(a), (b)(2)(B)(i) (Supp. IV 2004), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933.

78. *Id.* § 222(b)(2)(B)(ii) (Supp. 2004), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933. Section 25A and § 222 utilize slightly different income measures to determine eligibility for the benefits under these provisions. *See supra* note 25 (comparing § 25A(d)(3)'s definition of "modified adjusted gross income" with § 222(b)(2)(C)'s definition of "adjusted gross income").

79. 26 U.S.C. § 222(b)(2)(A), (B) (Supp. IV 2004), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933.

80. Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933.

81. I.R.S. PUB. 970, *supra* note 17, at 12 (2006).

tax-free educational assistance (including qualified scholarships and educational assistance paid under veterans' programs).[82] A taxpayer may not claim this deduction if the taxpayer claims an educational tax credit with respect to the same student.[83]

Unlike a tax credit, which directly offsets the amount of tax that a taxpayer owes, a deduction offsets the amount of income that is subject to tax. Consequently, the economic benefit that a taxpayer enjoys from the § 222 deduction depends upon the taxpayer's tax bracket because the deduction offsets income that would have been taxed at that rate.[84] Thus, a taxpayer who deducts $4,000 as higher education expenses and who has a marginal tax rate of 25% will realize tax savings of $1,000.[85]

C. *Section 529 Qualified Tuition Programs*

Section 529 provides significant tax benefits for taxpayers who make investments in a "qualified tuition program." As discussed below, the investment income that these investments generate is exempt from taxation to the extent that these amounts are used to pay higher education expenses.[86] The popular media and the financial press refer to plans satisfying the requirements of this section as "529 plans."[87]

Section 529 plans have their origin as prepaid tuition arrangements created under state law.[88] Under these prepaid tuition plans, parents (or grandparents) were able to prepay the tuition at a

82. *See* 26 U.S.C. § 222(c)(2)(B) (Supp. IV 2004), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933 (noting that qualified tuition and related expenses are to be reduced in accordance with 26 U.S.C. § 135(d)).

83. *Id.* § 222(c)(2)(A), *amended by* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922, 2933 (2006).

84. *See* INTERNAL REVENUE SERV., TAX TUTORIAL-TAX CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES, TAX DEDUCTION V. TAX CREDIT, http://www.irs.gov/app/understandingTaxes/jsp/hows/tt/module08/tax_mod8_2.jsp (illustrating the effect of a deduction on a taxpayer's income tax liability).

85. Under the tax rate schedule in effect in 2006, an unmarried individual with taxable income between $30,650 and $74,200 faces a statutory marginal tax rate of twenty-five percent. I.R.S. PUB. 17, *supra* note 40, at 262. To the extent that the taxpayer is subject to income-based reductions in other tax benefits (or other non-tax governmental benefits) that are based upon adjusted gross income, the tax savings resulting from the "above-the-line" deduction for higher education expenses may exceed the statutory marginal tax rate.

86. *See* discussion *infra* Part I.C.

87. John W. Schoen, *College Saving 101: Sorting Through the Choices: From Taxable Accounts to 529 Plans, Investment Options can Stymie Parents*, MSNBC, July 31, 2005, http://www.msnbc.msn.com/id/8716152.

88. Wayne M. Gazur, *Abandoning Principles: Qualified Tuition Programs and Wealth Transfer Taxation Doctrine*, 2 PITT. TAX REV. 1, 2 (2004).

particular college or university when their child was young.[89] In form, these arrangements looked like an advance purchase of a service, i.e., college tuition.[90] Because the purchaser was able to lock in the then-current tuition rates, the prepayment produced an economic return to the extent that higher tuition rates were charged when the student actually attended the college or university.[91]

Prior to the enactment of § 529, the Internal Revenue Service challenged the asserted tax benefits arising from an arrangement that the State of Michigan had created.[92] Specifically, it asserted that the legal entity formed to receive the prepayments was a taxable corporation, with the result that its income, including its investment income, was subject to federal income tax.[93] Ultimately, the United States Court of Appeals for the Sixth Circuit rejected this challenge, and held that the income of this legal entity was exempt from federal income taxation.[94]

Congress enacted § 529 in 1996 in part to codify the Sixth Circuit's holding with respect to the Michigan prepaid tuition plan. The Senate Finance Committee Report stated that "[t]he Committee believes that it is appropriate to clarify the tax treatment of State-sponsored prepaid tuition and educational savings programs in order to encourage persons to save to meet post-secondary educational expenses."[95]

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89. *See, e.g.*, Eric A. Lustig, *Taxation of Prepaid Tuition Plans and the 1997 Tax Provisions—Middle Class Panacea or Placebo? Continuing Problems and Variations on a Theme*, 31 AKRON L. REV. 229, 240-43 (1997) (detailing that in 1997, various models for state prepaid tuition existed, many based upon plans originating in Michigan, Ohio and Massachusetts).

90. *See id.* at 240 (following the Michigan plan, beneficiaries could purchase predetermined tuition benefits at an early age, thereby locking-in a tuition price based upon a contract).

91. *Id.*

92. Michigan v. United States, 40 F.3d 817 (6th Cir. 1994).

93. *Id.* at 821. State law required Michigan to request a favorable ruling from the Internal Revenue Service as to whether the advance payment tuition structure would be considered income of the legal entity. *Id.* The Internal Revenue Service responded to the State of Michigan, stating that while no income would be realized by the purchaser when purchasing the prepaid tuition, the trust would be subject to taxation on its investment income. *Id.*

94. *Id.* at 818.

95. S. REP. NO. 104-281, at 106 (1996). The Honorable Connie Morella, commenting on prepaid tuition plans before Congress, stated:

> Recently, I introduced a resolution regarding tuition prepayment plans by States to allow families to save for their children's college education at a fixed rate. I am very pleased that this conference report includes an amendment which would prohibit the Internal Revenue Service from taxing State-sponsored prepaid college tuition plans until the funds are distributed. These State-sponsored plans have allowed more than 500,000 American families to save years in advance for their children's college tuition. The provision regarding prepaid tuition plans will make it possible for more

As enacted, however, this provision went further: it created three significant tax benefits if plan assets were used to pay higher education expenses. First, it exempted qualifying State tuition programs from taxation.[96] Consequently, the investment income generated during the years in which funds were held and invested by the State tuition program was not taxed.[97] Second, the provision deferred the taxation of the investment income to the plan beneficiary (or the account owner) until amounts were distributed from the plan.[98] Third, it taxed the plan beneficiary (typically, the lower tax-bracket student) rather than the account owner (typically, the student's higher tax-bracket parent or grandparent).[99] In addition, it provided these benefits to two forms of educational savings: the prepaid tuition programs and the education savings account structure.[100]

Congress enhanced the tax benefits given to § 529 plan investments in 2001.[101] Most significantly, the 2001 amendments to § 529 exempted from taxation any distribution from a § 529 plan used to pay "qualified higher education expenses."[102] The 2001 amendments were scheduled to sunset for taxable years beginning after December 31, 2010.[103] However, Congress eliminated these sunset provisions in the Pension Protection Act of 2006.[104] Unlike the other educational tax incentives, § 529 contains no explicit limitations on the dollar amounts that may be invested.[105] Nor does it limit eligibility for participation to taxpayers whose incomes are less than statutory dollar limits.[106] And, contrary to the scope of the other higher education tax incentives, § 529's favorable tax treatment is not limited to tuition and fees; the favorable tax treatment extends to room and board as well.[107]

> States to adopt similar programs, affording more families the opportunity to save for their children's education.

142 CONG. REC. 15, 21361 (1996).

96. 26 U.S.C. § 529(a) (2000).

97. The exemption of the qualified state tuition program from taxation codified the holding in *Michigan v. United States*, 40 F.3d 817 (6th Cir. 1994).

98. 26 U.S.C. § 529(c)(3)(A) (2000).

99. *Id.*; *see* Linda Levine, *Saving for College Through Qualified Tuition (Section 529) Programs*, CONG. RESEARCH SERV., May 17, 2005, at 10.

100. Gazur, *supra* note 88, at 6.

101. Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, 107th Cong. § 402 (2001).

102. 26 U.S.C. § 529(c)(3)(B)(i) (Supp. IV 2004).

103. Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, 107th Cong. § 901 (2001).

104. Pub. L. No. 109-280, § 1304(a), 120 Stat. 780, 1109 (2006).

105. *Id.*

106. 26 U.S.C. § 529 (Supp. IV 2004).

107. *Id.* § 529(e)(3)(B)(i).

Indeed, § 529 contains two provisions that encourage taxpayers to make extremely large contributions to these plans. First, § 529 characterizes any contribution to a qualified tuition program as a completed gift, which is not a future interest in property.[108] As a result, a contribution to a § 529 plan is eligible for the annual gift tax exclusion,[109] which in 2006 and 2007 equals $12,000. Second, § 529 provides that a taxpayer may elect to treat a contribution to a 529 plan in excess of the annual gift tax exclusion as if it were made ratably over a five year period.[110] Consequently, a parent (or grandparent) could today contribute up to $60,000 in a lump sum to a § 529 plan for each beneficiary, without the imposition of any federal gift tax.[111] If two parents (or grandparents) take advantage of this provision, the maximum gift tax-free lump sum contribution to the plan would equal $120,000. As a result, § 529 anticipates the potential accumulation of several hundred thousand dollars per beneficiary.[112]

II. TAX POLICY ANALYSIS OF THE TAX PROVISIONS

The tax provisions discussed above are properly viewed as a federal expenditure program implemented through the tax system.[113] They are designed as programs to help American families pay the ever-increasing costs of higher education. There is little argument that these provisions represent structural provisions of an income tax.[114]

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108. 26 U.S.C. § 529(c)(2)(A)(i) (2000). Because the contribution is made to the plan to pay future higher educational expenses rather than a payment to a college or university for current tuition, the contribution will not qualify as a "qualified transfer" for purposes of 26 U.S.C. § 2503(e). *Id.* § 529(c)(2)(A)(ii). Consequently, the contribution is treated as a taxable gift to the beneficiary except to the extent that the annual gift tax exclusion applies. *See generally* Gazur, *supra* note 88, at 15 (discussing the transfer tax treatment of contributions to a § 529 plan).

109. 26 U.S.C. § 2503(b) (2000).

110. *Id.* § 529(c)(2)(B).

111. *Id.*

112. *See* Gazur, *supra* note 88, at 25 (identifying state plans that permit the accumulation of up to $315,270 per beneficiary).

113. For the classic analysis of governmental expenditures implemented through the tax system, see Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

114. *See generally* Treas. Reg. § 1.162-5(b)(1) (1967) (characterizing educational expenses as "personal expenditures or constitute an inseparable aggregate of personal and capital expenditures" and declaring that these expenditures are, presumptively, not deductible as ordinary and necessary business expenditures). Some have argued that the appropriate tax base should be consumption rather than income. Under a consumption tax, income invested during a year would not be taxed currently, but instead, taxation would occur when consumption took place. The tax treatment of investment income under § 529 is consistent with consumption tax treatment.

Consequently, it is appropriate to evaluate these provisions in the same manner as one would evaluate a traditional expenditure program that provides grants to students who attend higher education institutions. When evaluated on this basis, these tax provisions have serious shortcomings.

At the outset, it is important to note that these tax provisions constitute an increasingly large portion of the federal financial aid effort. In fiscal year 2007, the federal Pell Grants totaled nearly $13 billion, with an average grant of less than $2,500.[115] According to the list of tax expenditures reported in connection with the 2008 budget, the tax provisions discussed above result in revenue losses of $7.8 billion in fiscal year 2007.[116] Specifically:

- The Hope Scholarship credit reduced tax collections in fiscal year 2007 by $3.33 billion. During fiscal years 2008 to 2012, it is estimated this credit will reduce income tax collections by almost $20 billion.
- The Lifetime Learning credit reduced tax collection by $2.19 billion in 2007, and will reduce income tax collections by an estimated $12.7 billion during fiscal years 2008 to 2012.
- The tax preferences arising in connection with § 529 plans reduced tax collection by $830 million in fiscal year 2007. The revenue losses arising in connection with these plans will increase at an extremely rapid rate in subsequent years, and will reduce income tax collections by an estimated $7.5 billion during fiscal years 2008 to 2012, with the annual revenue loss doubling over this five-year period.[117]
- The "above-the-line" deduction for higher education expenses reduced tax collections in fiscal year 2007 by $1.45 billion.[118]

115. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2008 330-31 (2007).

116. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2008 288 (2007) [hereinafter 2008 BUDGET PERSPECTIVE].

117. Prior to the elimination of the sunset provisions applicable to § 529 plans in the Pension Protection Act of 2006, the estimated revenue losses arising in connection with these plans for the fiscal years 2007-2011 were estimated to total $4.16 billion. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2007 288 (2006).

118. 2008 BUDGET PERSPECTIVE, *supra* note 116, at 288. The tax expenditures revenue estimates were based upon the law in effect on December 31, 2006. *Id.* at 285. Because the deduction authorized in § 222 is scheduled to sunset after 2007,

It is appropriate to ask whether these expenditures represent a sensible supplement to the federal government's direct spending programs.

A. *Analysis of the Education Tax Credits and the "Above-the-Line" Deduction for Qualified Tuition and Related Expenses*

In several respects, the education tax credits contained in § 25A and the "above-the-line" deduction for qualified tuition and related expenses contained in § 222 are seriously flawed tools for delivering financial aid for higher education.

The first set of concerns relates to the general administration of federal financial aid programs. Apart from the tax provisions, the process for obtaining financial aid is well understood by potential college students and their parents. When applying for financial aid for college, students submit the dreaded Free Application for Federal Student Aid ("FAFSA") form.[119] Colleges and universities use the information reported in this form to determine eligibility for a broad range of federal financial aid programs, including Pell Grants, federal subsidized loans, unsubsidized loans, PLUS loans and federal work-study funds.[120] In addition, colleges and universities use this information to determine whether to award grants and loans from their own financial aid resources.[121] Further, the creation of federal grants in the Internal Revenue Code requires that students and parents learn about the tax provisions that create a separate source of financial aid. These students and parents must also figure out how to comply with the specific requirements of these tax provisions.

Delivering financial aid through the tax system also creates a serious cash flow problem. Students generally must pay their tuition bills at the start of an academic semester. A Pell Grant that a student receives is reflected in the student's tuition bill.[122] Thus, the student does not need to obtain financing for the portion of the tuition bill that the Pell Grant satisfies. In contrast, taxpayers will receive the economic benefits from the education tax credits (and the deduction

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the tax expenditure tables do not contain a five-year estimate of revenue losses attributable to this provision.

119. U.S. Dep't of Educ., 2007-2008 FAFSA on the Web Worksheet, at 1, http://www.fafsa.ed.gov/fafsaws78c.pdf (last visited Apr. 20, 2007).

120. King, *supra* note 3, at 5-6.

121. *Id.* at 6.

122. *See* U.S. Dep't of Educ., Student Guide 2005-2006, Types of Federal Student Aid, http://studentaid.ed.gov/students/publications/student_guide/2005-2006/english/types.htm (last visited Apr. 20, 2007) (providing that the schools can apply the funds to existing student accounts or can send a check directly to the student).

for higher education expenses) only after they file their tax returns.[123] The tax benefits that a taxpayer claims are based upon tuition paid in the prior taxable year. Consequently, the taxpayer may have a cash flow problem in connection with the payment of the portion of her tuition bill that ultimately will be satisfied by the tax credit (or the tax benefit attributable to the deduction under § 222).

In addition, the statutory language establishing eligibility for, and the magnitude of, the credits is complicated and confusing. As one scholar has noted, "the drafting of the dollar ceiling on the Hope Scholarship credit is an extraordinary exercise in gobbledygook."[124] The complex statutory requirements require that taxpayers identify, and comply with, a set of rules separate from the traditional financial aid applications.

Admittedly, the Pell Grant program and the other federal programs also contain complex and technical requirements. Colleges and universities, however, implement these programs.[125] Consequently, a comparatively small number of entities must master the technical requirements of these programs. Compliance with the tax credits, in comparison, is decentralized to a much larger number of individual taxpayers, each of whom receives a relatively modest benefit. As discussed above, choosing the optimal tax provision requires analysis of difficult and confusing choices.[126]

Delivering a federal subsidy through the tax system also raises compliance concerns that do not exist in programs such as the Pell Grant program. Colleges and universities administer the Pell Grant program, and they make certain that the Pell Grant awarded does not exceed prescribed statutory limits.[127] They also identify which students are eligible for the Pell Grants; students cannot self-certify

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123. Although it is possible that sophisticated taxpayers could adjust their income tax withholding to take into account the anticipated tax benefits that will result from claiming the education tax credit and the deduction for higher education expenses, it is unlikely that most taxpayers will do so.

124. Coven, *supra* note 18, at 35.

125. *See* 20 U.S.C. § 1070a(i) (2000) (defining the character of the agreements made between institutions of higher education and the Secretary regarding the disbursement of Pell Grants to eligible students).

126. *See supra* note 56 and accompanying text (illustrating how students have access to federal grants and loans while their families are eligible for education-related tax breaks, but noting that the effectiveness of these programs is unclear due to the programs' complexities). Many taxpayers will seek expert advice to assist them in this process. In many instances this will result in a financial burden for these taxpayers.

127. *See* 20 U.S.C.A. § 1070a(b) (2000) (outlining the purpose and amount of Pell Grants to be given to eligible students).

their eligibility for grants under that program.[128] In comparison, taxpayers determine their own eligibility for the education tax credits and the deduction for qualified tuition and related expenses. Many taxpayers may be unaware of their eligibility for these provisions, with the result that they will not claim available credits or deductions. The Government Accounting Office ("GAO") estimated that twenty-seven percent of taxpayers eligible for either the education tax credit or the education tax deduction failed to take advantage of these provisions.[129]

In addition, taxpayers may claim tax benefits in excess of those allowed under the statute. Frequently, the Internal Revenue Service cannot determine the amount of qualified tuition and related expenses paid during a given year.[130] Moreover, eligibility to claim a child as a dependent affects eligibility for the credits, and this determination turns on factual questions. Given the relatively small tax benefits that any individual taxpayer may claim, it is unlikely that the Internal Revenue Service will audit taxpayers to determine the correctness of the claimed tax benefits.

The second and more serious set of concerns relates to the distributional effects of the education tax credits. Empirical data suggests that middle-income and upper-middle-income taxpayers enjoy most of the benefits from the education tax credits.[131] The problems arise primarily from the fact that the education tax credits are not refundable.[132] Consequently, the structure of the education

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128. *See id.* § 1070a(f) (delegating the responsibility of calculating students' eligibility for the Pell Grant to the institutions of higher education acting as contractors).

129. U.S. GOV'T ACCOUNTABILITY OFFICE, EFFECTIVENESS OF TOOLS, *supra* note 56, at 3-4.

130. *See* Instructions for Forms 1098-E and 1098-T (2007), http://www.irs.gov/instructions/i1098et/ar02.html (last visited Mar. 30, 2007) (requiring colleges and universities to file information returns that identify certain students who enroll at the institution). Although these institutions may report payments received, or amounts billed, for qualified tuition and related expenses, they are not required to do so. *Id.* In addition, they are not obligated to report amounts that a student pays for attendance that is not part of a degree or certificate program, even though these expenditures may give rise to eligibility for the Lifetime Learning credit. *Id.*; *see* Frequently Asked Tax Questions and Answers: Lifetime Learning Credit, http://www.irs.gov/faqs/faq-kw104.html (last visited Mar. 30, 2007) (explaining that students may be qualify for a Lifetime Learning Credit if they are enrolled in one or more courses at an eligible educational institution).

131. Pamela J. Jackson, *An Overview of Tax Benefits for Higher Education Expenses*, CONG. RESEARCH SERV., Jan. 17, 2006, at 21, *available at* http://opencrs.cdt.org/rpts/RL32554_20060117.pdf (last visited Mar. 29, 2007).

132. *See* Lily Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 49, 54 (2006) ("Refundable tax credits are the only straightforward way to provide a uniform subsidy for behavior generating positive externalities through the individual income

tax credits denies any benefit to the students with the greatest financial need. As Batchelder, Goldberg and Orszag have observed, each year more than one-third of households have no federal income tax liability and almost one-half of all children live in households with no tax liability.[133]

For example, all unmarried individuals who are not a dependent of any other taxpayer with income of up to $8,450 have no federal income tax liability.[134] These taxpayers enjoy no benefit from the education tax credits. Similarly, a family of four that files a joint return in 2006 and that has income of less than $23,600 also receives no benefit from the education tax credit. For many other middle-income taxpayers, the non-refundable nature of the education tax credits limits the tax benefit available from the credit: their pre-credit tax liability is too small.[135] In contrast, taxpayers with greater amounts of income enjoy the full tax credit.

These provisions particularly disadvantage undergraduate students who are classified as independent of their parents. The Pell Grant program characterizes students as independent only if they are: (1) at least twenty-four years of age, (2) married, or (3) have dependents of their own.[136] This group of students includes single parents and those who are returning to school after some years in the work force. These independent students constitute more than fifty percent of the Pell Grant recipients.[137]

Most of the concerns discussed above in connection with the education tax credits apply with equal, if not greater, force to the deduction for higher education expenses. For example, students and their families must identify the existence of the federal tax deduction, and determine which tax benefit produces the largest tax benefit. As with the credits, taxpayers receive the tax savings arising from deducting higher education expenses long after they must pay the tuition bills. The distributional effects of the deduction for higher education expenses, however, raise one additional concern.

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tax . . . . The limits of non-refundable tax incentives can be seen in an array of current programs.").

133. *Id.* at 54.

134. *See* I.R.S. PUB. 17, *supra* note 40, at 25, 132 (clarifying that a taxpayer is eligible for a standard deduction of $5,150 and a personal exemption of $3,300).

135. *See* TRENDS IN COLLEGE PRICING, *supra* note 2, at 10 (reporting that, in 2004-05, the average tax saving from the education tax credits and deduction was only $644).

136. *See* KING, *supra* note 3, at 11 (explaining that a student cannot obtain independent status for purposes of the Pell Grant program as a result of the parents' failure to claim their child as a dependent for federal income tax purposes).

137. *Id.* at 13.

Typically, the decision to use tax deductions to deliver economic subsidies raises two distinct distributional issues. First, most of these deductions are allowed only if taxpayers itemize their deductions. These deductions provide no economic benefit to the two-thirds of taxpayers who claim the standard deduction rather than itemizing their deductions.[138] The deduction for higher education expenses, however, is an "above-the-line" deduction.[139] As a result, both itemizers and non-itemizers may claim this deduction. Consequently, § 222 is not subject to this first criticism.

Second, the tax savings that result from claiming the deduction for higher education expenses depend upon a taxpayer's marginal tax rate. For a taxpayer in the fifteen percent tax bracket, the maximum § 222 deduction ($4,000) results in a tax savings of $600.[140] For a taxpayer in the twenty-eight percent tax bracket, the corresponding tax savings is $1,120.[141] The "upside-down" pattern of benefits, with higher-income taxpayers receiving a larger economic benefit than lower-income taxpayers, is problematical. Unless the tuition subsidy for these higher-income taxpayers yields a larger societal benefit than a comparable subsidy for lower-income taxpayers, this distribution of tax benefits cannot be justified.[142]

In conclusion, the non-refundable nature of the education tax credits skews the tax benefits in a regressive manner: the working poor receive no benefit; the lower-middle class receive modest benefits; and the upper-middle class receive the largest benefit.[143] Similarly, the deduction for higher education expenses yields a regressive pattern of benefits. It yields no benefit unless the taxpayer would have had a positive tax liability prior to claiming this

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138. Batchelder, Goldberg & Orszag, *supra* note 132, at 53.

139. *See supra* notes 74-75 and accompanying text (citing statutes that make tax benefits accessible to those who may not qualify for a Hope Scholarship credit or a Lifetime Learning credit).

140. 26 U.S.C. § 222(b)(2)(B)(i) (Supp. IV 2004).

141. Section 1 of the Internal Revenue Code contains explicit marginal tax rates in excess of twenty-eight percent. In 2006, these rates apply to married taxpayers filing a joint return with taxable incomes in excess of $188,450 and to unmarried taxpayers with taxable incomes of $154,800. Rev. Proc. 2005-70, 2005-47 I.R.B. 979. Taxpayers subject to these higher marginal tax rates have incomes that disqualify them from claiming the deduction for higher education expenses. It is possible that, after taking into account the effect of the § 222 deduction on the income-based phase-out of other tax benefits, the overall marginal effect of the deduction will exceed the amounts stated in the text.

142. Batchelder, Goldberg & Orszag, *supra* note 132, at 47.

143. *See* discussion *supra* notes 131-135 and accompanying text (arguing that the structure of the credit system, which denies benefits to students with the greatest financial need, defeats the purpose of a distributional tax credit).

deduction.[144] And, for taxpayers with positive tax liabilities, the greatest benefits accrue to those subject to higher marginal tax rates.[145] These results violate the tax policy goal of achieving vertical equity and cannot be justified as achieving a rational social policy goal.[146]

B. Analysis of § 529

The tax credits and the deduction for higher education expenses provide tax benefits when taxpayers pay college tuition and fees. In comparison, § 529 provides tax benefits for taxpayers who set aside savings to pay for future higher education costs. This savings incentive creates many of the problems discussed above. In addition, the structural provisions of § 529 create distributional concerns that are much more serious.

Perhaps the most serious criticism of § 529 is that it provides a tax windfall without achieving any societal benefit. Section 529 does not identify those who save additional amounts to pay higher educational expenses; it simply rewards those who deposit funds into accounts that satisfy the requirements of § 529. Many have analyzed tax provisions that exempt from taxation certain investment vehicles. For example, the GAO and Jane Gravelle of the Congressional Research Service have analyzed research relating to tax-preferred savings vehicles.[147] While acknowledging that different researchers reached different conclusions, the GAO observed that "recent research examining the universal IRA experience estimated that at most 9 cents of each dollar contributed represented new saving."[148] Gravelle also questioned whether tax-preferred savings vehicles

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144. *See* discussion *supra* notes 131-135 and accompanying text (demonstrating how those who do not earn enough to possess a positive tax liability cannot benefit from the very educational tax benefits which could push them to a higher income level)

145. *See* discussion *supra* notes 140-142 and accompanying text (illustrating how individuals with higher marginal tax rates would accordingly possess a higher household income while also benefiting from larger educational tax benefits intended for less wealthy people who cannot afford education at all).

146. *See* Cynthia E. Garabedian, *Tax Breaks for Higher Education: Tax Policy or Tax Pandering?*, 18 VA. TAX REV. 217, 234 (1998) ("[L]ow-income families may not enjoy many of the benefits, while higher-income families may be able to take advantage of loopholes even where they are strictly above the income limitations.").

147. U.S. GOV'T ACCOUNTABILITY OFFICE, GOVERNMENT PERFORMANCE AND ACCOUNTABILITY: TAX EXPENDITURES REPRESENT A SUBSTANTIAL FEDERAL COMMITMENT AND NEED TO BE REEXAMINED 51-52 (2005), *available at* http://unclefed.com/GAOReports/gao05-690.pdf [hereinafter GOVERNMENT PERFORMANCE AND ACCOUNTABILITY]; Jane G. Gravelle, *Proposed Savings Accounts: Economic and Budgetary Effects*, CONG. RESEARCH SERV. REP., June 30, 2006, *available at* http://www.annuity-insurers.org/pdfs/CRS-Report-on-LSAs-RSAs.pdf.

148. GOVERNMENT PERFORMANCE AND ACCOUNTABILITY, *supra* note 147, at 50-51.

generate a substantial amount of savings that would not have taken place in the absence of the preferential tax treatment.[149] Section 529 promotes no societal goal to the extent that taxpayers simply shift existing savings into § 529 plans.[150] It merely creates a tax windfall.

Another concern is that § 529 benefits high-income and wealthy taxpayers to a disproportionate extent. This disproportionate distribution of benefits results from several distinct factors. First, higher income individuals are more likely to participate in a § 529 plan because they have more disposable income (or existing savings) available for investing in the plans. They also tend to be more financially sophisticated investors; they can either master the complexities of § 529 plans, or obtain guidance from a financial advisor to navigate the § 529 terrain.[151]

Second, wealthier taxpayers have the capacity to make larger contributions to a § 529 plan when a child is very young. The longer the period that money is invested in a § 529 plan, the greater the tax savings.[152] Third, high-income taxpayers enjoy a larger tax benefit for each dollar of investment income generated in the § 529 plan.[153] For example, a 35% tax-bracket taxpayer would owe 35 cents of tax on each dollar of interest income earned in a taxable account. This taxpayer avoids this tax when the interest income is earned in a § 529 plan. A 15% tax-bracket taxpayer would enjoy a tax savings less than half as great.[154]

To illustrate the relative tax savings of different investors in § 529 plans, consider the examples illustrated in the two tables contained in the Appendix. Table 1 examines a situation in which two parents (or grandparents) each contribute $60,000 to a § 529 plan in 2007 when a child (or grandchild) is born.[155] If this one-time investment of $120,000 earns a 6% return, the balance in the plan will grow to

149. *See* Gravelle, *supra* note 147, at 10-12 (weighing all sides of the debate around the distributional effects of individual retirement accounts on savings).
150. Penelope Wang, *The Trouble with 529 Plans: More and More, States are Messing Up a Good Thing with Fees, Commissions, and Bum Funds*, CNNMONEY.COM, Oct. 7, 2003, http://money.cnn.com/2003/10/07/pf/college/529_0310/.
151. *See id.* ("Most folks simply lack the time and expertise to sort through those choices.").
152. *See* discussion *infra* Part II.B (comparing Appendix Tables 1 and 2).
153. *See* Jackson, *supra* note 131, at 19-20 (explaining the reasons behind these advantages and projecting that they may stimulate greater participation of higher income taxpayers than lower-income taxpayers in such savings programs).
154. To the extent that the § 529 plan investments generate returns taxed at lower tax rates (such as capital gains or qualified dividends), the differential tax savings of taxpayers in different tax brackets are reduced or eliminated.
155. The $60,000 contribution is the amount that a taxpayer may transfer to a § 529 plan for one beneficiary without creating a taxable gift for purposes of the gift tax. 26 U.S.C. § 529(c)(2)(B).

$363,072 in 2025, when the child is ready to enter college. Assuming that the contributors were 35% tax-bracket taxpayers during all relevant years, the same investment in a taxable savings vehicle would have grown to only $248,243. In other words, the tax savings resulting from investing in the § 529 plan generated an additional $114,829 for these high-income taxpayers. In comparison, the tax savings attributable to the § 529 plan would generate only an additional $54,304 for the 15% tax-bracket contributors.[156] Thus, the benefit to the high-income taxpayer in this example is more than double the benefit to the lower income taxpayer, even if one ignores the greater ability of high-income taxpayers to make contributions to a § 529 plan.

Table 2 in the Appendix examines a similar situation with one significant difference: instead of the one-time investment of $120,000, the parents (or grandparents) make 19 annual contributions (or a total of $190,000) to the § 529 plan beginning in 2007 when the child (or grandchild) is born. Again, the plan investments earn a 6% return. When the child is ready to enter college in 2025, the balance in the plan will total grow to $357,856. If the contributors would have been taxed at a 35% rate during the intervening years, the same investment in a taxable savings vehicle would have grown to only $284,710. Here, the tax savings resulting from investing in the § 529 plan generated an additional $73,146 for these high-income taxpayers. In comparison, the tax savings attributable to the § 529 plan generated only $34,680 for the 15% tax-bracket contributors. Again, the benefit to the high-income taxpayer is more than double the benefit to the lower-income taxpayer.

These two examples demonstrate the significance of the timing of contributions to a § 529 plan. In both examples, the investments accumulated to approximately $360,000 in 2025 despite the fact that the contributors in Table 2 contributed an additional $70,000 to the plan. The ability of the contributors in Table 1 to front-load the contributions produced significantly greater benefits. For the 35% tax-bracket taxpayers who were able to make the one-time contribution of $120,000, the tax savings resulting from investing in the § 529 plan generated an additional $114,829. In comparison, the tax savings attributable to the § 529 plan generated only $73,146 for the 35% tax-bracket contributors who contributed $10,000 to the plan each year. Thus, the greatest benefit goes to the wealthiest

156. This example makes an unrealistic assumption that two taxpayers in the fifteen percent tax bracket could afford to make a one-time investment of $120,000.

taxpayers who can afford to shift large sums into a § 529 plan when a child is born.

Significantly, these examples are comparing the "haves" and the "haves-even-more." It is extraordinarily unlikely that many lower- and middle-income families can afford to contribute $10,000 per year to a § 529 plan.

In conclusion, the benefits that arise in connection with § 529 plans are available only to those who can afford to save. The greatest benefits accrue to those who can afford to front-load their contributions and to those in the highest tax brackets.[157] All of these factors skew the rewards arising in connection with § 529 plans to favor the high-income and wealthy taxpayers. And as the examples demonstrate, the magnitude of the benefits arising from a § 529 plan may greatly exceed the maximum benefits that might arise in connection with the education tax credits and the deduction for higher education expenses analyzed above.[158]

Apart from these distributional concerns, the current rules governing § 529 plans create opportunities for unintended estate and gift tax avoidance. Wayne Gazur has pointed out that the transfer tax provisions contained in § 529 conflict with generally applicable estate and gift tax principles.[159] The Wall Street Journal reports that estate planners now take advantage of these inconsistencies to use § 529 as the centerpiece of a highly flexible estate planning tool.[160] When using these plans, wealthy individuals (such as grandparents) may transfer large sums, and accumulate investment income, for the benefit of their grandchildren while retaining two significant powers.[161] First, they will retain the power to decide which of the beneficiaries will receive the plan assets to pay for higher education, or for any other purpose.[162] Second, they may retain effective power to revest the plan to themselves, albeit with income tax consequences, without causing the plan assets to be included in their estate for estate tax purposes.[163] Use of § 529 to achieve these estate planning

157. *See* discussion *supra* Part II.B (describing the results of the scenarios based on Appendix Tables 1 and 2).

158. *Supra* Part II.A.

159. Gazur, *supra* note 88, at 4.

160. *See* Ron Lieber, *Green Thumb: A New Trick For Avoiding Estate Taxes*, WALL ST. J., Feb. 24, 2007, at B1 (revealing that 529 accounts allow the account owners to "move huge piles of money out of their estates without paying taxes" while still retaining control over the money).

161. *Id.*

162. *Id.*

163. *Id.*; Gazur, *supra* note 88, at 44-45.

goals is an unintended consequence of overly broad statutory language.

In addition to the tax policy concerns discussed above, critics have identified flaws in the administration of § 529 plans. Many programs impose sizeable fees, which make the savings plans far less effective as investment vehicles.[164] In some cases, critics claim that the economic burden of these fees completely offsets the tax benefits.[165] Critics also complain that the fee structures vary extensively from state to state, resulting in significant inequities among investors.[166] To the extent that § 529 plans charge excessive fees, the plans serve to enrich the states and the financial institutions that administer the plans, rather than the American families seeking to save to pay college tuition and related expenses.

CONCLUSIONS AND POLICY RECOMMENDATIONS

The Internal Revenue Code contains several provisions designed to help American families pay for the cost of higher education. The Hope Scholarship tax credit, the Lifetime Learning credit and the deduction for higher education expenses constitute federal expenditure programs that are implemented in the Internal Revenue Code. Unfortunately, these provisions are seriously flawed. First, students and parents must learn about these tax provisions and their requirements. Second, the tax provisions create a cash flow problem: taxpayers must pay tuition many months before the tax benefits are received. Third, and most significantly, the distributional effects of the education tax credits and the deduction for higher education expenses raise serious fairness issues: empirical data suggest that middle-income and upper-middle-income taxpayers enjoy most of the

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164. *See* Austan Goolsbee, *The "529" Rip-Off: Those New College Savings Plans Aren't So Great*, SLATE, Aug. 23, 2002, http://www.slate.com/id/2070062 (accusing Arizona's InvestEd plan of being "one of the most egregious examples," but explaining that Arizona is only one of twenty-seven states with excessively high fees).

165. Gazur, *supra* note 88, at 5 n.16; *see* Wang, *supra* note 150 ("The average 529 plan generates $1 million in state fees for every billion dollars invested . . . . Add them all up, and the fees on some 529s can easily wipe out the benefit of the savings plan's tax deferral."); *see also* John F. Wasik, *College Funding is Subject to Unfair Rules, Expensive Fees*, SEATTLE TIMES, Nov. 28, 2004, at F7 (arguing that "sophisticated financial planning" will be required for individuals to obtain funding for college until the "playing field" of college-funding options is made more easily accessible).

166. Goolsbee, *supra* note 164. *But see* Anne Marie Chaker, *529 Plans Lose Their Luster*, WALL ST. J. COLL. J., Mar. 6, 2006, http://www.collegejournal.com/aidadmissions/financialissues/20060306-chaker.html (providing examples of changes being made in some states, such as Missouri and Wisconsin, to "burnish the appeal of 529s and simplify the process," including "broadening the investment options available and negotiating lower fees").

benefits from the education tax credits. Low-income families receive little, if any, benefit.

Section 529 provides tax benefits for taxpayers who set aside savings to pay for future higher education costs. For many plan participants, § 529 provides a tax windfall because it rewards taxpayers who simply shift existing or expected savings into a tax-preferred form of savings. This provision also benefits high-income and wealthy taxpayers to a disproportionate extent. Moreover, the magnitude of these tax benefits may greatly exceed the tax savings from the education tax credits or the deduction for higher education expenses. These shortcomings represent unacceptable flaws in a tax-based federal expenditure program.

These tax provisions do not represent the only federal higher education financial aid programs. They are just a part, albeit a very large part, of the overall federal effort. The tax-based programs have grown most rapidly in the last few years. Over the same period, the maximum Pell Grant award has lost purchasing power in terms of overall college costs. It is unwise education policy to lessen support to those families with the greatest financial need while providing much greater levels of support to those with greater financial resources.

In light of these conclusions, Congress should enact legislative changes. One possible alternative would be to repeal these tax provisions and replace them with an enhanced expenditure program that will provide assistance to American families who must pay college costs for their children. These legislative changes would consolidate the separate sources of federal financial aid grants in one program. Fortunately, such a program already exists: the Pell Grant program. Proceeding in this manner would create a single procedure for parents and students seeking federal aid. From the students' and parents' perspective, this procedure would simply involve filing the FAFSA form, the one step that they already perform.

Revenue losses totaling $7.8 billion are attributable to the educational tax credits, the deduction for higher education plans and § 529 plans in fiscal year 2007.[167] If this amount were allocated to an expansion of the Pell Grant program, aggregate grants could increase from the current level of $13 billion to almost $21 billion without any net effect on the federal budget. The expanded Pell Grant program could provide benefits to students from a broader range of families,

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167. *See supra* notes 116-118 and accompanying text (discussing the tax revenues lost from reduced tax collections stemming from the Hope Scholarship credit, Lifetime Learning credit, and tax preferences in connection with § 529 plans).

so that many of the middle-income families who benefit from the existing tax provisions would receive a Pell Grant. This change would also reverse the practice of the past fifteen years of shifting resources from the Pell Grant program, and other federal expenditure programs, toward tax-based programs that are less efficient and equitable.

Unfortunately, there are legislative obstacles to enacting these changes. Different Congressional committees have authority over tax legislation and non-tax federal expenditure programs.[168] It is difficult to enact legislation when different committees must operate in a coordinated fashion. This is particularly true when the tax-writing committees would need to abandon tax provisions that appeal to the individual members of the Committee.

If these programs will remain in the Internal Revenue Code, several legislative changes to these tax provisions would enhance their distributional fairness.

First, Congress should make the Hope Scholarship credit and the Lifetime Learning credit refundable.

Second, the separate deduction for higher education expenses should terminate at the end of 2007, its currently scheduled sunset date. If Congress were to decide that higher-income taxpayers should receive financial assistance, Congress could modify the provisions of the Lifetime Learning credits. For example, taxpayers with incomes in excess of the current income limits could be allowed a credit less than the current maximum credit of $2,000.

Third, Congress should enact limits on the benefits available from participating in § 529 plans. One possibility would involve two steps. First, income from a § 529 plan would be included in income for federal income tax purposes. Second, a refundable tax credit would be allowed to lessen the burden of taxation.[169] For example, the credit could equal 20% of the investment income attributable to the

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168. *See* Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165, 1168, 1188 (1993) (explaining that the House Ways and Means Committee and the Senate Finance Committee are "charged principally with matters of tax and finance," whereas the appropriations and budget committees "impose overall spending limits in general areas").

169. *See* Len Burman, Jason Furman, Greg Leiserson & Roberton Williams, *An Evaluation of the President's Health Insurance Proposal*, TAX NOTES, Mar. 12, 2007, at 1013 (discussing and analyzing a proposal put forth by President Bush with a similar approach to modifying the existing tax treatment of health insurance). Under this proposal, an employee would include in income her employer's contribution to the cost of the employee's health insurance cost. *Id.* A separate standard deduction for health insurance premiums would offset the tax burden resulting from this income inclusion. *Id.*

§ 529 plan. As with the Hope Scholarship and Lifetime Learning credits, the proposed credit would be limited to a specified dollar amount. This suggested tax credit would apply equally to taxpayers, irrespective of their income level. In addition, the limits incorporated in the credit would assure that the existing disparities in the benefits arising from § 529 plans would be mitigated.

APPENDIX

Table 1

Assumptions: One-time Contribution of $120,000; 6% interest rate

Year	**Amounted Contributed**	**Account Balance 529 Plan**	**Account Balance Taxable Investment 35% Tax Bracket**	**Account Balance Taxable Investment 15% Tax Bracket**
2007	120,000	127,200	124,680	126,120
2008	0	134,832	129,543	132,552
2009	0	142,922	134,595	139,312
2010	0	151,497	139,844	146,417
2011	0	160,587	145,298	153,884
2012	0	170,222	150,964	161,733
2013	0	180,436	156,852	169,981
2014	0	191,262	162,969	178,650
2015	0	202,737	169,325	187,761
2016	0	214,902	175,929	197,337
2017	0	227,796	182,790	207,401
2018	0	241,464	189,919	217,979
2019	0	255,951	197,326	229,095
2020	0	271,308	205,021	240,779
2021	0	287,587	213,017	253,059
2022	0	304,842	221,325	265,965
2023	0	323,133	229,956	279,529
2024	0	342,521	238,925	293,785
2025	0	363,072	248,243	308,768
Additional Accumulation in Section 529 Plan			114,829	54,304

Table 2

Assumptions: $10,000 Annual Contributions; 6% interest rate

Year	**Amount Contributed**	**Account Balance 529 Plan**	**Account Balance Taxable Investment 35% Tax Bracket**	**Account Balance Taxable Investment 15% tax Bracket**
2007	10,000	10,600	10,390	10,510
2008	10,000	21,836	21,185	21,556
2009	10,000	33,746	32,401	33,165
2010	10,000	46,371	44,055	45,367
2011	10,000	59,753	56,163	58,191
2012	10,000	73,938	68,744	71,668
2013	10,000	88,975	81,815	85,833
2014	10,000	104,913	95,395	100,721
2015	10,000	121,808	109,506	116,368
2016	10,000	139,716	124,167	132,812
2017	10,000	158,699	139,399	150,096
2018	10,000	178,821	155,226	168,261
2019	10,000	200,151	171,669	187,352
2020	10,000	222,760	188,754	207,417
2021	10,000	246,725	206,506	228,505
2022	10,000	272,129	224,950	250,669
2023	10,000	299,057	244,113	273,963
2024	10,000	327,600	264,023	298,445
2025	10,000	357,856	284,710	324,176
Additional Accumulation in Section 529 Plan			73,146	33,680