

**Tax Issues**

**Tax Issue 1: Taxation of Student Aid (Modify IRS Code)**

**Recommendation:** Eliminate the taxation of student assistance funds.

**Rationale:** While certain scholarship and student aid funds are not taxable, other scholarship, fellowship, and FWS assistance is taxable if such funds are used for items such as room and board, travel, research, clerical help, equipment, etc. NASFAA strongly endorses elimination of this tax so that students have all the aid they are entitled to without having to pay taxes on a portion of it.

Current HEA Law	NASFAA Proposed Statutory Language
<p>TITLE 26 - INTERNAL REVENUE CODE, Subtitle A - Income Taxes, CHAPTER 1 - NORMAL TAXES AND SURTAXES, Subchapter B - Computation of Taxable Income, PART III - ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME</p> <p>Sec. 117. Qualified scholarships</p> <p>(a) General rule. Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii).</p> <p>(b) Qualified scholarship. For purposes of this section –</p> <p>(1) In general. The term "qualified scholarship" means any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.</p> <p>(2) Qualified tuition and related expenses. For purposes of</p>	<p>TITLE 26 - INTERNAL REVENUE CODE, Subtitle A - Income Taxes, CHAPTER 1 - NORMAL TAXES AND SURTAXES, Subchapter B - Computation of Taxable Income, PART III - ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME</p> <p>Sec. 117. Qualified scholarships</p> <p>(c) General rule. Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii).</p> <p>(d) Qualified scholarship. For purposes of this section –</p> <p>(1) In general. The term "qualified scholarship" means any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.</p> <p>(2) Qualified tuition and related expenses. For purposes of</p>

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<p>paragraph (1), the term "qualified tuition and related expenses" means -</p> <p>(A) tuition and fees required for the enrollment or attendance of a student at an educational organization described in section 170(b)(1)(A)(ii), and</p> <p>(B) fees, books, supplies, and equipment required for courses of instruction at such an educational organization.</p>	<p>paragraph (1), the term "qualified tuition and related expenses" means -</p> <p>(A) tuition and fees required for the enrollment or attendance of a student at an educational organization described in section 170(b)(1)(A)(ii), <del>and</del></p> <p>(B) fees, books, supplies, and equipment required for courses of instruction at such an educational organization-, <b>and</b></p> <p><b>(C) any other applicable allowances included in the educational organization's cost of attendance as defined by section 472 of the Higher Education Act.</b></p>
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**Tax Issue 2: Eliminate Hope/Lifetime Learning Benefits (Modify IRS Code)**

**Recommendation:** Repeal the Hope/Lifetime tax credits and tuition deduction only if such tax expenditures are on a dollar-for-dollar basis transferred to pay for creation of a Pell Grant entitlement or are used as an offset for other appropriate Title IV budgetary offsets.

**Rationale:** NASFAA recommends repeal of the Hope/Lifetime tax credits and the recently enacted tuition deduction. We do so for several reasons. The use of tax credits during the period of postsecondary school attendance is less helpful as a part of a national student assistance policy; because of the significant impact on the federal budget and the trade-offs inherent in such practice, and the inefficiency and inequity of tuition tax credits as public policy.

NASFAA believes that the use of these three tax expenditures to support citizens in their postsecondary education is inappropriate. NASFAA agrees with several higher education finance experts who suggest that the use of the tax system can play an important role in helping pay the costs of a postsecondary education. We believe that use of the tax system is appropriate before entrance into a postsecondary school and after the individual leaves the institution, but use of the tax system during times of enrollment is inappropriate, inefficient, and not well targeted to those with the most need for assistance. For example, using tax breaks to encourage savings for college before an individual attends is an efficient method of encouraging a behavior few would object to. And, providing a tax credit or deduction for interest paid on student loans after leaving school is an efficient method of reducing a borrower's debt burden. But, the use of the tax system with the array of benefits as currently structured for periods of enrollment, experts state, is a misguided and not well-targeted policy.

Further, NASFAA recommends this position because tax credits are not available to students when the funds are needed, i.e., during the school year when the tuition bill must be paid. The students or their parents receive the tax credits after filing their federal tax returns when the academic year is nearly completed. Thus, the tax credits do not reach the students at the appropriate time.

Since it is a non-refundable tax credit, low-income families with little or no tax liability who in fact need the most assistance with college costs cannot receive this assistance to help them for any out of pocket college costs.

Tax credits to middle and upper-middle income students do not encourage college attendance – they simply reward behavior that would have taken place in the absence of the tax credits. On the other hand, Pell Grants awarded to the neediest of students enable them to attend college, which was previously out of their reach.

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Tax credits reach students after the funds are needed and are thus an inefficient means of providing educational funding. In its September 2002 report, "Student Aid and Tax Benefits," the GAO reported that in tax year 1999, 6.4 million tax filers obtained about \$4.8 billion in higher education tax credits through the tax code. The government also provided direct support to 3.7 million of the neediest students in the country through the Federal Pell Grant Program, expending \$7.2 billion. It is well known that the Pell Grant Program has been underfunded for many years, with the buying power of the federal grant losing ground since its inception. Congress has not appropriated the dollars necessary to fund the maximum authorized Pell levels simply because it has been too expensive to do so. However, NASFAA argues that if Congress is able to forego well over \$45 billion in tax revenues over ten years through Hope and Lifetime Learning tax credits and the tuition deduction to the less needy, it should be able to fully fund and expand the Pell Grant Program and also make up past shortfalls by canceling education tax credits and using the revenues for the neediest students in the country.

Consequently, NASFAA recommends shifting that large amount of funding from spending on tax credits and the tuition deduction to paying for improvements in the Title IV student aid programs such as making the Pell Grant Program a true entitlement with a maximum grant of \$8,000, or elimination of the origination fee, or increasing loan limits or a combination of these recommendations or other positive changes that better target scarce federal resources to those most in need of such assistance.

While some middle-income families certainly will lose the benefits of these tax credits, it is equally true that other HEA changes suggested by NASFAA will increase middle-income families' eligibility for Title IV program benefits. Our recommendation for increases in loan limits will provide benefits beyond those provided by the tax code. Another increase of benefits, which could accrue to the middle-income families, is the increase in the Pell Grant maximum award which would result in the receipt of a Pell Grant award which could fully or partially offset any loss of tax benefits for which the taxpayer qualifies under current tax code. Again, in an era of limited federal funding resources, NASFAA suggests targeting funding to the most needy of our citizens, rather than those who are better able to afford a postsecondary education.

We recognize such a proposal has certain dangers. Consequently, we are making this recommendation contingent on any such change must transfer on a dollar-for-dollar basis such tax expenditure amounts for Hope, Lifetime, and the deduction to the Title IV programs to set up a Pell Grant entitlement and/or to be used as an offset to pay for other NASFAA recommendations, for example, to eliminate the origination fee or increase loan limits. We would vigorously oppose any elimination of any education tax expenditure to fund some other tax benefit not related to education such as elimination of the double taxation of dividends. Again, to be perfectly clear our support of elimination of these three tax expenditures is contingent on such funds being used to support the Title IV HEA student assistance programs.

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Finally, we encourage the Bush Administration and the Department of Education to join with us in this recommendation for retargeting scarce federal resources on our most financially needy students.

<b>Current HEA Law</b>	<b>NASFAA Proposed Statutory Language</b>
TITLE 26 - INTERNAL REVENUE CODE, Subtitle A - Income Taxes, CHAPTER 1 - NORMAL TAXES AND SURTAXES, Subchapter A - Determination of Tax Liability, PART IV - CREDITS AGAINST TAX, Subpart A - Nonrefundable Personal Credits, Sec. 25A. <i>Hope</i> and Lifetime Learning credits	<p><b>Repeal TITLE 26 - INTERNAL REVENUE CODE, Subtitle A - Income Taxes, CHAPTER 1 - NORMAL TAXES AND SURTAXES, Subchapter A - Determination of Tax Liability, PART IV - CREDITS AGAINST TAX, Subpart A - Nonrefundable Personal Credits, Sec. 25A. <i>Hope</i> and Lifetime Learning credits</b></p> <p><b>Repeal section 222 of Part VII of subchapter B of chapter 1 (relating to additional itemized deductions for individuals)</b></p>

**Tax Issue 3: Tax Credit For Student Loan Interest Paid [Modify IRS Code]**

**Recommendation:** NASFAA recommends establishment of the tax credit up to \$2,000 for interest paid on student loans in addition to the current deduction. We also recommend a borrower option that such a tax credit could be sent directly to the holder of the loan to help reduce the borrower's loan debt.

**Rationale:** NASFAA recommends establishment of the tax credit up to \$2,000 for interest paid on student loans in addition to the current deduction. Such a tax credit would be refundable and is, obviously, more valuable than the current tax deduction. We also recommend a borrower option that such a tax credit could be sent directly to the holder of the loan to help reduce the borrower's loan debt. This would be a relatively painless way to automatically reduce not only the time of repayment, but also the total student debt burden.

Current HEA Law	NASFAA Proposed Statutory Language
Modify IRS Code Section 221 and various other sections.	<p><b>DEDUCTION FOR INTEREST ON EDUCATION LOANS CONVERTED TO CREDIT.</b></p> <p><b>(a) IN GENERAL-</b> Section 221 of the Internal Revenue Code of 1986 (relating to interest on education loans) is hereby moved to subpart A of part IV of subchapter B of chapter 1 of such Code, inserted after section 25B, and redesignated as section 25C.</p> <p><b>(b) Conversion to 50 Percent Credit-</b> Subsection (a) of section 25C of such Code, as redesignated by subsection (a), is amended to read as follows:</p> <p><b>(a) ALLOWANCE OF CREDIT-</b> In the case of an individual, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to 100 percent of the interest paid by the taxpayer during the taxable year on any qualified education loan. In the case of an individual without a tax imposed, in whole or in part, such individual shall be allowed a refundable credit in the amount equal to 100 percent of the interest paid by the taxpayer during the taxable year on any qualified education loan.</p>

**(c) LIMITATION BASED ON MODIFIED ADJUSTED GROSS INCOME-** Subsection (b) of section 25C of such Code, as redesignated by subsection (a), is amended to read as follows:

**(b) LIMITATION BASED ON MODIFIED ADJUSTED GROSS INCOME-**

**(1) IN GENERAL-** The amount which would (but for this subsection) be allowed as a credit under this section shall be reduced (but not below zero) by the amount which bears the same ratio to the amount which would be so allowed as--

**(A) the excess of--**

**(i) the taxpayer's modified adjusted gross income for such taxable year, over**

**(ii) \$75,000 (\$150,000 in the case of a joint return), bears to **(B) \$15,000 (\$30,000 in the case of a joint return).****

**(2) MODIFIED ADJUSTED GROSS INCOME-** For purposes of this subsection, the term 'modified adjusted gross income' means adjusted gross income determined without regard to sections 911, 931, and 933.

**(3) INFLATION ADJUSTMENTS-**

**(A) IN GENERAL-** In the case of a taxable year beginning after 2003, the \$75,000 and \$150,000 amounts in paragraph

**(1)(A)(ii) shall each be increased by an amount equal to--**

**(i) such dollar amount, multiplied by**

**(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 2002' for 'calendar year 1992' in subparagraph (B) thereof.**

**(B) ROUNDING-** If any amount as adjusted under subparagraph (A) is not a multiple of \$5,000, such amount shall be rounded to the next lowest multiple of \$5,000.

**(c) The taxpayer may designate that the tax credit benefit provided by this section may be sent directly to the holder or**

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	<b>holders of their education loan or loans to be applied to the principal balance of such education debt.</b>
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