

Access Assured: Restoring Progressivity in the Tax and Spending Programs for Higher Education

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I. INTRODUCTION

Paying for a child's college education is the single largest financial investment a parent will make in his or her child's future. For many middle-income parents, this inter vivos investment in the human capital of their child replaces intergenerational transfers at death in the form of bequests and inheritances.¹ Trends in college costs, college enrollment, and the labor market suggest that college is more important and more expensive than ever before. Over the past decade, college tuition increases outpaced both inflation and growth in median family income.² Despite this, college enrollment rates continue to grow.³ One reason for the failure of tuition increases to slow enrollment is the increased financial returns associated with investments in higher education.⁴ However, these enrollment increases

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¹ See John H. Langbein, *The Twentieth-Century Revolution in Family Wealth Transmission*, 86 MICH. L. REV. 722, 732–36 (1988) (arguing that for most families intergenerational wealth transmission occurs during a parent's lifetime via the provision of human capital rather than at death via the provision of physical capital).

² COLLEGE BOARD, TRENDS IN STUDENT AID 23 (2006), available at http://www.collegeboard.com/prod_downloads/press/cost06/trends_aid_06.pdf [hereinafter TRENDS IN STUDENT AID 2006]. While tuition and fees at public four-year institutions grew by an inflation-adjusted 52% (in constant 2005 dollars) over the past decade, median family income grew by only 3% over the same time period. *Id.*

³ SANDY BAUM & KATHLEEN PAYEA, COLLEGE BOARD, EDUCATION PAYS UPDATE 3 (2005), available at http://www.collegeboard.com/prod_downloads/press/cost05/education_pays_05.pdf. In 1970, only 21% of the population enrolled in some form of college. *Id.* In 2004, over 50% of the population participated in some form of postsecondary education. *Id.*

⁴ COLLEGE BOARD, EDUCATION PAYS 9 (2004), available at http://www.collegeboard.com/prod_downloads/press/cost04/EducationPays2004.pdf [hereinafter EDUCATION PAYS 2004]. Over the course of a forty-year career, a four-year college graduate can expect to earn 73% more in wages than the average high school gradu-

and the associated earnings premiums have not been shared proportionately among income groups.⁵ Students from lower-income families still lag behind their more affluent peers in postsecondary educational attainment.⁶ For many low-income families, the availability of some form of financial assistance can be the determining factor in the college enrollment decision.⁷

Presently, the federal government subsidizes the higher education expenses of individual college students through two distribution channels: the tax system and the transfer system. Under each subsystem, there are a multitude of programs available to assist students in meeting their postsecondary educational expenses.⁸ The proliferation of these many forms of federal student aid raises issues of intra- and inter-program effectiveness. In their current form, the tax benefits for higher education do not get the right amount to the right people at the right time. The federal college spending programs, on the other hand, get the right amount to the right people but do so in the wrong manner. The intersection of these two financial aid distribution channels amplifies their individual deficiencies. The resulting complex web of overlapping, contradictory, and partially or completely uncoordinated tax and spending programs impedes the government's ability to achieve its public policy goal in providing federal student aid, namely, to expand access to college for low income students for whom cost remains a barrier. This Article argues that significant equity, efficiency, and simplicity gains can be realized by consolidating substantially similar college tax programs and by increasing their coordination with traditional, transfer-based forms of student financial assistance.

ate. *Id.* at 11. Even a community college graduate realizes average lifetime earnings that are approximately 25% higher than those of a high school graduate. *Id.*

⁵ BAUM & PAYEA, *supra* note 3, at 8. In 2003, 80% of students from families in the highest family income quintile, 65% of students from families in the second highest quintile, and 61% of students from families from the middle-income quintile enrolled in college. *Id.* Only 49% of students from families in the two lowest quintiles combined enrolled in college. *Id.*

⁶ *Id.* The enrollment gap between the highest income quintile and the lowest income quintile in 2003 was 27%. *Id.*

⁷ Unless otherwise indicated, "low-income" as used in this Article refers to families in the two lowest income quintiles during 2005, or families with incomes below \$36,000. U.S. CENSUS BUREAU, CURRENT POPULATION SURVEY, 2006 ANNUAL SOCIAL AND ECONOMIC SUPPLEMENT Table HINC-05, http://pubdb3.census.gov/macro/032006/hhinc/new05_000.htm.

⁸ See *infra* Parts III.A & IV.A.

The federal higher education spending programs are authorized under Title IV of the Higher Education Act of 1965 (HEA).⁹ The HEA provides financial assistance directly to college students in the form of grants, loans and work-study awards.¹⁰ These need-based financial aid programs are distributed on a progressive basis, with the largest subsidies allocated to those students with the least ability to pay.¹¹ Targeting subsidies in this manner is not only equitable, but it is also efficient, since lower-income students are the most price sensitive and underrepresented socioeconomic cohort in higher education.¹² By expanding college enrollment across the income spectrum, the government facilitates realization of the positive externalities associated with an educated citizenry by society as a whole.¹³

Title IV is not without its problems. Eligibility for Title IV aid is determined under a statutorily prescribed formula that assesses the income and assets of a family in order to determine their ability to pay and their concomitant need for federal student aid.¹⁴ However, complexity in this needs analysis system and in the financial aid application process itself threatens the effectiveness of these programs and may present additional enrollment obstacles for low-income students.¹⁵

As originally enacted, the HEA promised to “give new meaning to the phrase ‘equality of opportunity.’”¹⁶ That promise has been eroded over the past decade as Congress shifted its focus away from need-based Title IV aid toward a panoply of new non-need-based higher education tax incentives. These college tax programs can be regressive in the distribution of their benefits, providing the largest subsidies to higher-income families and little or no subsidy to lower-income families.¹⁷ Such a pattern of distribution is not only inequitable, but also inefficient as a means of distributing educational opportunities in the American polity. It also works at cross-purposes with

⁹ Higher Education Act of 1965, Pub. L. No. 89-329, § 401, 79 Stat. 1219, 1232 (1965).

¹⁰ *Id.*

¹¹ *See infra* Part III.B.

¹² *See infra* Part II.C.

¹³ *See infra* Part II.B.

¹⁴ *See infra* Part III.B.

¹⁵ *Id.*

¹⁶ *Higher Education Act of 1965: Hearings on H.R. 3220 Before the Spec. Subcomm. on Educ. of the H. Comm. on Educ. and Labor*, 89th Cong. 26 (1965) [hereinafter *Hearings on 3220*] (statement of Hon. Anthony J. Celebrezze, Sec’y of Health, Educ. & Welfare).

¹⁷ *See infra* Part IV.B.1.

the progressive distribution of benefits observed under Title IV. The preferred treatment that these college tax subsidies receive under Title IV's needs analysis system exacerbates their inherent distributional inequity.¹⁸ In certain circumstances, claiming an education-related tax allowance will effectively increase eligibility for Title IV need-based student aid where such need could not otherwise be demonstrated.¹⁹

Legal scholars have considered the proper treatment of higher education expenses under a normatively correct income tax system.²⁰ Others have evaluated the tax benefits for higher education under tax and education policy norms.²¹ Economists have long been interested in the impact of traditional forms of financial aid on college enrollment²² and the incentive effects of the federal needs analysis system under Title IV.²³ This Article views the federal financial aid system as an integrated whole, critically analyzing its individual parts and their interaction with each other, and illustrates that the net effect of the various aid programs is less than the sum of its parts.²⁴

¹⁸ See *infra* Part V.

¹⁹ *Id.*

²⁰ See, e.g., Loretta Collins Argrett, *Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive*, 41 SYRACUSE L. REV. 621 (1990); Charlotte Crane, *Scholarships and the Federal Income Tax Base*, 28 HARV. J. ON LEGIS. 63 (1991); David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793 (1992); Joseph M. Dodge, *Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized*, 54 OHIO ST. L.J. 927 (1993).

²¹ See, e.g., Ruth Lynch Buchwalter, *Should 1 + 1 = 2? Does the Structure of Federal Income Tax Expenditures for Higher Education Disadvantage Women and Low-Income Individuals?*, 22 WOMEN'S RTS. L. REP. 77 (2000); Cynthia E. Garabedian, *Tax Breaks for Higher Education: Tax Policy or Tax Pandering?*, 18 VA. TAX REV. 217 (1998); 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 (1997); Natasha Mulleneaux, *The Failure to Provide Adequate Higher Education Tax Incentives for Lower-Income Individuals*, 14 AKRON TAX J. 27 (1999); Amy J. Oliver, *Improving the Tax Code to Provide Meaningful and Effective Tax Incentives for Higher Education*, 12 U. FLA. J.L. & PUB. POL'Y 91 (2000).

²² See, e.g., Donald E. Heller, *Student Price Response in Higher Education: An Update to Leslie and Brinkman*, 68 J. OF HIGHER EDUC. 624–59 (1997); Larry L. Leslie & Paul T. Brinkman, *Student Price Response in Higher Education: The Student Demand Studies*, 58 J. OF HIGHER EDUC. 181 (1987); Michael S. McPherson & Morton O. Schapiro, *Does Student Aid Affect College Enrollment? New Evidence on a Persistent Controversy*, 81 AM. ECON. REV. 309 (1991).

²³ See, e.g., Andrew W. Dick & Aaron S. Edlin, *The Implicit Taxes from College Financial Aid*, 65 J. PUB. ECON. 295 (1997); James Monks, *An Empirical Examination of the Impact of College Financial Aid on Family Savings*, 57 NAT'L TAX J. 189 (2004).

²⁴ See ELAINE M. MAAG & KATIE FITZPATRICK, FEDERAL FINANCIAL AID FOR HIGHER EDUCATION: PROGRAMS AND PROSPECTS 4 (2004) (arguing that the analysis of the fed-

While the economic literature has begun to examine the relationship between Title IV and the tax benefits for higher education,²⁵ the legal literature has left this important subject largely untouched.²⁶

Following this introduction, Part II will describe the history of and justification for federal financial assistance for college students, including a summary of the economic studies supporting the use of financial subsidies to affect enrollments. Part III will describe the Title IV student financial aid programs, including a discussion of the complexity endemic to the aid application process and the federal needs analysis system. Part IV will describe the tax benefits for higher education and analyze them under the norms of equity, efficiency, and simplicity. Part V will describe how the education-related tax programs intersect with Title IV under the needs analysis system and address the implications of that intersection. Part VI will illustrate the equity, efficiency, and simplicity gains that can be realized by consolidating substantially similar tax programs and by coordinating them with Title IV under the federal needs analysis.

II. HISTORY OF AND JUSTIFICATION FOR FEDERAL INVOLVEMENT IN HIGHER EDUCATION

A. *History*²⁷

The federal government's direct involvement in financing college students' education is of relatively recent origin.²⁸ The GI Bill of 1944 offered returning World War II veterans an unprecedented op-

eral financial assistance programs for college students "needs to proceed in an environment that examines the net effects of all the programs, taken together.").

²⁵ See, e.g., Leonard E. Burman et. al., *The Distributional Consequences of Federal Assistance for Higher Education: The Intersection of Tax and Spending Programs* (The Urban-Brookings Tax Policy Center, Discussion Paper No. 26 2005), available at http://www.taxpolicycenter.org/UploadedPDF/311210_TPC_DiscussionPaper_26.pdf; Susan Dynarski, *Tax Policy and Education Policy: Collision or Coordination? A Case Study of the 529 and Coverdell Saving Incentives*, in 18 TAX POL'Y & THE ECON. 81, 105 (James M. Poterba ed., 2004); Susan Dynarski, *Who Benefits from the Education Savings Incentives? Income, Educational Expectations and the Value of the 529 and Coverdell*, 57 NAT'L TAX J. 359 (2004) [hereinafter Dynarski, *Who Benefits*]; Thomas J. Kane, *Beyond Tax Relief: Long-Term Challenges in Financing Higher Education*, 50 NAT'L TAX J. 335 (1997); Thomas J. Kane, *Savings Incentives for Higher Education*, 51 NAT'L TAX J. 609 (1998); MAAG & FITZPATRICK, *supra* note 24.

²⁶ But see Buchwalter, *supra* note 21, at 88–89.

²⁷ See LAWRENCE E. GLADIEUX & ARTHUR M. HAUPTMAN, *THE COLLEGE AID QUANDARY: ACCESS, QUALITY, AND THE FEDERAL ROLE* 14–37 (1995) (providing thorough treatment of history of federal student aid programs).

²⁸ *Id.* at 14.

portunity to attend college.²⁹ The first real widespread democratization in higher education came with the passage of the HEA of 1965.³⁰ Passed during the tenure of President Lyndon B. Johnson, the HEA promised to increase access to higher education for qualified students by reducing or eliminating financial barriers thereto.³¹ In proposing the HEA, President Johnson hoped to “give new meaning to the phrase ‘equality of opportunity.’”³² The goal of increasing access to higher education for economically disadvantaged students was the public policy goal supporting this new substantial federal financial commitment to higher education.

The need-based student financial aid programs under Title IV came in three forms: grants, loans, and work-study programs.³³ The grant program was designed “to assist in making available the benefits of higher education to qualified high school graduates of exceptional financial need, who for lack of financial means of their own or of their families would be unable to obtain such benefits without such aid.”³⁴ The HEA also authorized a federally guaranteed loan program that expanded credit opportunities and reduced the cost of borrowing for qualified college students.³⁵ The federal work-study program subsidized the part-time salaries of eligible college students.³⁶

Issues of middle-income affordability have always simmered below the surface of higher education debates. While Congress contemplated enacting the HEA, the most substantial federal financial commitment to need-based student aid, it also considered several tax relief proposals designed to relieve the financial burden of college on

²⁹ *Id.*

³⁰ *Id.* at 15.

³¹ *Id.* The HEA of 1965 can be viewed as part of President Johnson’s anti-poverty, anti-welfare, Great Society initiatives, which sought to deal with the poverty problem by offering poor persons the opportunity to better their station in life through work, training and/or education. See Dennis J. Ventry, Jr., *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit*, in MAKING WORK PAY: THE EARNED INCOME TAX CREDIT AND ITS IMPACT ON AMERICA’S FAMILIES, 15, 16–18 (Bruce D. Meyer & Douglas Holtz-Eakin eds., 2001).

³² *Hearings on 3220, supra* note 16.

³³ See generally Higher Education Act of 1965, Pub. L. No. 89-329, § 401, 79 Stat. 1219, 1232 (1965).

³⁴ *Id.* § 401. These grants were called Educational Opportunity Grants and were administered through the institutions rather than being distributed directly to or for the benefit of the student as grants under the successor Pell grant program are distributed today. *Id.*

³⁵ See generally *id.* §§ 421–440.

³⁶ *Id.* §§ 441–442.

middle-income families.³⁷ During the 1965 HEA congressional hearings, several congressmen expressed concern about whether the HEA programs would do enough for middle-income families, whom one Congressman proclaimed to be “the backbone of this country.”³⁸ In response, Commissioner of Education Keppel indicated that the first order of priority for the federal government was to expand postsecondary educational opportunities for students from lower-income families.³⁹ He concluded with the following statement: “I do not wish to suggest that all of us are not sympathetic with the problems of middle-income families The problem is what is the wisest public policy at this time.”⁴⁰

The concern for “middle income families who pay taxes, but by and large are excluded from participation in the student financial aid programs” surfaced again during subsequent HEA reauthorization hearings.⁴¹ In 1978, in order to placate those legislators calling for higher education tax benefits to relieve “middle-income squeeze,” Congress enacted the Middle Income Student Assistance Act (MISAA).⁴² MISAA expanded need-based grant eligibility into the middle-income range and removed financial need as an eligibility requirement for subsidized federally guaranteed student loans.⁴³ Although need was reintroduced as a criteria for receiving subsidized student loans in 1981,⁴⁴ concern for the plight of the politically influential middle class remained. During the rest of the 1980s, grant aid declined, loan volume grew, and the overall purchasing power of student aid began to erode.⁴⁵ Although legislators voiced concern about these trends, they came up with no alternatives as tuition growth at

³⁷ *Hearings on 3220, supra* note 16, at 49 (citing Dr. Allen Carter, *Tax Relief and the Burden of College Costs* (1964)). In the first eight weeks of the 88th session of Congress, more than ninety bills relating to higher education tax relief were sent to committee. *Id.*

³⁸ *Id.* at 419 (question posed by Congressman Reid during statement of Hon. Francis Keppel, Comm’r of Educ., and Peter Muirhead, Assoc. Comm’r for Higher Educ.).

³⁹ *Id.* at 48 (response made by Hon. Francis Keppel, Comm’r of Educ., during statement of Hon. Anthony J. Celebrezze, Sec’y of Health, Educ. & Welfare).

⁴⁰ *Id.*

⁴¹ *Higher Education Amendments of 1971: Hearings on H.R. 32, H.R. 5191, H.R. 5192, H.R. 5193, and H.R. 7248 Before the Subcomm. on Educ. of the H. Comm. on Educ. and Labor*, 92d Cong. 81 (1971) (opening remarks of Hon. Edith Green, chairman of the special subcommittee).

⁴² GLADIEUX & HAUPTMAN, *supra* note 27, at 17.

⁴³ ARTHUR M. HAUPTMAN & ROBERT H. KOFF, *NEW WAYS OF PAYING FOR COLLEGE* 36 (1991).

⁴⁴ *Id.* at 18.

⁴⁵ *Id.*

both public and private institutions continued to outpace inflation and the growth in median family incomes.⁴⁶

In the 1992 reauthorization of the HEA, Congress chose to address the needs of the middle class in two important ways. First, it expanded borrowing opportunities by creating a new federally guaranteed unsubsidized⁴⁷ student loan option and a parental loan option, both of which were available to all students (or their parents), regardless of financial need.⁴⁸ Second, it instituted a new federal formula for determining financial need under Title IV called the federal methodology (FM), which is still utilized today.⁴⁹ The cornerstone of the FM is the calculation of the expected family contribution (EFC). The EFC is the amount that the federal government expects a family to contribute towards a student's higher education expenses before any need-based federal financial aid becomes available. Under the 1992 reauthorization, home equity and retirement accounts were statutorily excluded as assets available to pay for college. As a result of these changes, eligibility of middle-income families for Title IV financial aid increased with no corresponding reduction in net worth or standard of living. Consequently, the pool of students eligible for federal financial aid expanded with no commensurate increase in federal funding. As a result, financial aid per student fell and the beneficiaries of need-based aid expanded into middle and upper income range.

Still not satisfied with the level of middle-class college subsidies and concerned with the overall tax burden on the middle class,⁵⁰ President William J. Clinton proposed and Congress enacted a package of new tax incentives for higher education in the Taxpayer Relief Act of 1997 (TRA).⁵¹ Prior to 1997, outside of the employment context,⁵² the tax benefits for higher education available to students

⁴⁶ *Id.*

⁴⁷ "Unsubsidized" in the sense that the federal government did not provide an in-school interest subsidy. GLADIEUX & HAUPTMAN, *supra* note 27, at 19.

⁴⁸ *Id.*

⁴⁹ *Id.*; see also SANDY BAUM, COLLEGE BOARD, A PRIMER ON ECONOMICS FOR FINANCIAL AID PROFESSIONALS 3 (2004), available at http://www.collegeboard.com/prod_downloads/highered/fa/Economics-Primer-2004.pdf (noting that this was actually the "second iteration of the congressional attempt to legislate a need analysis system, the Congressional Methodology (CM) having been in effect from 1988 through 1992.").

⁵⁰ See Statement by President William J. Clinton Upon Signing H.R. 2014, as reprinted in 1997 U.S.C.C.A.N. 1620-1 [hereinafter *Statement by President Clinton*].

⁵¹ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997).

⁵² Within the employment context, there is a deduction for employment-related educational costs. I.R.C. § 162 (2000). This section applies if the education main-

and/or their parents were somewhat limited and included only: (1) an exclusion for qualified scholarships;⁵³ (2) a parental dependency exemption for students aged nineteen to twenty-three;⁵⁴ (3) an exclusion for interest earned on certain qualified savings bonds used to pay qualified higher education costs;⁵⁵ (4) relief from discharge of indebtedness income on the forgiveness of certain student loans;⁵⁶ and (5) an exclusion for earnings on qualified state tuition programs.⁵⁷ The new education-related tax provisions introduced by the TRA included two tuition tax credits,⁵⁸ a deduction for interest paid on qualified educational loans,⁵⁹ a new tax-favored savings vehicle for higher education,⁶⁰ and a provision allowing penalty-free withdrawals from individual retirement accounts for payment of higher education expenses.⁶¹ Subsequently, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)⁶² introduced a new deduction for higher education expenses⁶³ and expanded the tax benefits provided by the student loan interest deduction and the higher education savings incentives. More recently, the Pension Protection Act of 2006⁶⁴ made certain of the temporary education-related savings incentives passed under EGTRRA permanent.⁶⁵

tained or improved a skill required in the taxpayer's current trade or business, if the education met the express requirement of taxpayer's employer or an applicable law, or was imposed as a condition of continued employment. See *Treas. Reg. § 1.162-5* (1967). In addition, there is an exclusion for employer-provided educational assistance. I.R.C. § 127 (2000). See generally STAFF OF J. COMM. ON TAXATION, 108TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX BENEFITS FOR HIGHER EDUCATION (2004), available at <http://www.house.gov/jct/x-52-04.pdf>.

⁵³ I.R.C. § 117 (2000).

⁵⁴ *Id.* § 152(c)(3)(A)(ii).

⁵⁵ *Id.* § 135.

⁵⁶ *Id.* § 108(f).

⁵⁷ *Id.* § 529.

⁵⁸ *Id.* § 25A.

⁵⁹ I.R.C. § 221.

⁶⁰ *Id.* § 530.

⁶¹ *Id.* § 72(t)(2)(E).

⁶² Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

⁶³ I.R.C. § 222 (2000 Supp. I).

⁶⁴ Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006).

⁶⁵ *Id.* § 1304.

According to President Clinton, the educational purpose⁶⁶ of the TRA higher education tax initiatives was to make “[two] years of college universally available and . . . make the third and fourth years of college more affordable . . . [and] to help families save for higher education.”⁶⁷ It is interesting to note the formal introduction of affordability as a policy goal supporting these new non-need-based federal higher education tax initiatives. Prior to 1997, access was the *sine qua non* of federal higher education policy, and the federal government pursued this policy goal through the need-based financial aid programs under Title IV of the HEA.

B. Justification: Private and Public Benefits of Higher Education

Why is the federal government involved at all in higher education financing? There are both private and public benefits associated with postsecondary educational attainment.⁶⁸ College graduates earn a high rate of return on their investment in the form of increased lifetime earnings.⁶⁹ Over the course of a forty-year career, a four-year college graduate can expect to earn 73% more in wages than the average high school graduate.⁷⁰ Even a community college graduate realizes average lifetime earnings that are approximately 25% higher than those of a high school graduate.⁷¹ The equality of opportunity rationale first espoused by President Johnson also supports government subsidies for higher education for low-income students to ensure access to these increased earnings opportunities for those most in need.⁷² Indeed, advanced educational attainment may be one means to reduce income inequality and poverty.⁷³

Not only does increased participation in higher education reward the individual student, but society as a whole reaps many re-

⁶⁶ The TRA higher education tax incentives were designed not only to further educational goals, but also to provide tax relief to the middle class. See *Statement by President Clinton*, *supra* note 50; THOMAS J. KANE, THE PRICE OF ADMISSION: RETHINKING HOW AMERICANS PAY FOR COLLEGE 45 (1999), available at <http://brookings.nap.edu/books/0815750137/html/index.html> (arguing that these provisions are tax relief not educational policy).

⁶⁷ *Statement by President Clinton*, *supra* note 50.

⁶⁸ EDUCATION PAYS 2004, *supra* note 4, at 7.

⁶⁹ *Id.* at 9.

⁷⁰ *Id.* at 11.

⁷¹ *Id.*

⁷² PAMELA J. JACKSON, CONG. RESEARCH SERVICE, HIGHER EDUCATION TAX CREDITS: TEST AN ECONOMIC ANALYSIS 4 (2006), available at http://www.opencrs.com/rpts/RL32507_20060117.pdf.

⁷³ *Id.*

wards from an educated citizenry.⁷⁴ These societal benefits in excess of private returns to higher education, or positive externalities, include lower levels of unemployment,⁷⁵ poverty,⁷⁶ and crime;⁷⁷ increased productivity;⁷⁸ technological advancement;⁷⁹ tax revenues;⁸⁰ civic participation;⁸¹ and reduced reliance on social safety nets.⁸² The individual student may not factor these societal benefits in deciding whether to attend college. As a result, absent a subsidy, underinvestment in higher education may occur.⁸³ Accordingly, the goal of government college subsidies is to stimulate private demand in order to attain more optimal levels of education.⁸⁴ According to a report by the Advisory Committee on Student Financial Assistance, an independent committee created by Congress to advise on student aid policy, “[r]ecent estimates suggest that if the 32-percentage point gap in the college-going rates of the highest and lowest income Americans were narrowed significantly, we would add nearly \$250 billion to the gross domestic product and \$80 billion in taxes.”⁸⁵

C. Prices, Aid, and Enrollment

The federal government uses financial subsidies as its policy instrument of choice to induce increased college attendance. This approach is supported by economic studies that illustrate the inverse relationship between cost and enrollment, although the magnitude of this relationship varies. A well-known 1987 article by Larry Leslie and Paul Brinkman reviewed and standardized the results of the existing economic studies analyzing the effect of price increases on college

⁷⁴ EDUCATION PAYS 2004, *supra* note 4, at 9.

⁷⁵ *Id.* at 16 fig. 7 (noting that “[f]or all racial/ethnic groups, the unemployment rate falls as education level increases.”).

⁷⁶ *Id.* at 17. The poverty rate for college graduates is approximately one-third of the poverty rate for high school graduates. *Id.*

⁷⁷ *Id.* at 20. Incarceration rates decrease as education level increases. *Id.*

⁷⁸ JACKSON, *supra* note 72, at 2.

⁷⁹ MAAG & FITZPATRICK, *supra* note 24, at 8.

⁸⁰ EDUCATION PAYS 2004, *supra* note 4, at 10. The average college graduate working full-time pays over 100% more in federal income taxes than the average high school graduate. *Id.*

⁸¹ *Id.* at 23. In every age group, higher education levels correlate with higher voting rates. *Id.*

⁸² MAAG & FITZPATRICK, *supra* note 24, at 8.

⁸³ *Id.*

⁸⁴ JACKSON, *supra* note 72, at 2.

⁸⁵ ADVISORY COMM. ON STUDENT FIN. ASSISTANCE, 107TH CONG., ACCESS DENIED: RESTORING THE NATION’S COMMITMENT TO EQUAL EDUCATIONAL OPPORTUNITY 2 (2001), available at http://www.ed.gov/about/bdscomm/list/acsfa/access_denied.pdf [hereinafter ACCESS DENIED].

entry. The authors found that the mean response to a \$100 increase in tuition was a .7% drop in college enrollment.⁸⁶ Thomas Kane converted the Leslie and Brinkman finding into a more standardized format, translating their result as a 5% decrease in college enrollment for every \$1,000 increase in annual tuition costs.⁸⁷ More recently, Susan Dynarski estimated that an increase of \$1,000 in grant aid, which equates to a \$1,000 decrease in net price, increased the probability of attending college by about 3.6%.⁸⁸

A contrary and controversial 1983 time series study by W.L. Hansen found that the availability of grant aid failed to increase access for low-income students.⁸⁹ In a later study in the early 1990s, Michael McPherson and Morton Schapiro attempted to reconcile the discrepancies in the student demand literature.⁹⁰ Using an econometric analysis of time-series data, the authors demonstrated that “increases in net cost over time lead to decreases in enrollment rates for lower-income students.”⁹¹ An important companion finding was that increases in net cost had no effect on the enrollment patterns of wealthier students.⁹² A later study by Kane buttressed the McPherson and Schapiro findings.⁹³ Kane estimated that a \$1,000 difference in public two-year tuition resulted in a 4.5% decrease in enrollment, while the same price reduction in public four-year tuition resulted in only .8% decline in enrollment.⁹⁴ Since low-income students are disproportionately represented in two-year public colleges, this finding supported the conclusion that lower-income students are more sensitive to price in making the college enrollment decision than their wealthier peers.⁹⁵

⁸⁶ Leslie & Brinkman, *supra* note 22, at 188–89 (calculated in 1982–83 dollars).

⁸⁷ KANE, *supra* note 66, at 114.

⁸⁸ See generally Susan Dynarski, *Does Aid Matter? Measuring the Effect of Student Aid on College Attendance and Completion*, 93 AM. ECON. REV. 279 (2003). Dynarski’s conclusion is based on an analysis of the effect that the elimination of the Social Security student benefit program in 1982 had on college attendance. *Id.*

⁸⁹ W.L. Hansen, *Impact of Student Financial Aid on Access*, in THE CRISIS IN HIGHER EDUCATION 84–96 (Joseph Froomkin ed., 1983).

⁹⁰ MICHAEL S. MCPHERSON & MORTON OWEN SCHAPIRO, *THE STUDENT AID GAME: MEETING NEED AND REWARDING TALENT IN AMERICAN HIGHER EDUCATION* (1998).

⁹¹ *Id.* at 39 (finding that a \$150 net cost increase (in 1993–1994 dollars) resulted in a 1.6% decrease in enrollment levels for students from families with incomes below \$20,000).

⁹² *Id.*

⁹³ KANE, *supra* note 66, at 105.

⁹⁴ *Id.*

⁹⁵ *Id.* at 106 (“low-income” included the bottom 40% of the family incomes in the study).

Over the past decade, college tuition increases outpaced both inflation and the growth in median family income. Tuition and fees at public and private four-year colleges rose an average of 4.2% and 2.8% per year, respectively, in inflation-adjusted dollars.⁹⁶ Even after accounting for grant aid, average net prices at public and private four-year colleges rose an average of 2.7% and 2.4% per year, respectively, in inflation-adjusted dollars.⁹⁷ While tuition and fees at public four-year institutions grew in total by an inflation-adjusted 52% over the past decade, median family income grew by only 3% during the same time period.⁹⁸

Given the studies on the effect of price on enrollment, the increase in net tuition paid by college students over the past decade should have caused enrollments to decline. Surprisingly, college enrollment rates actually increased during this period.⁹⁹ In 1990, only 39% of the population entered college.¹⁰⁰ By 2000, over 50% of the population pursued some form of postsecondary education.¹⁰¹ One reason for the failure of tuition increases to slow enrollment is the increased financial returns associated with higher education.¹⁰² These enrollment increases and the associated earnings premiums, however, have not been shared equally among income groups. Low-income students still lag behind their more affluent peers in postsecondary educational attainment. In 2003, 80% of students from families in the highest family income quintile, 65% of students from families in the second highest income quintile, and 61% of students from families from the middle-income quintile enrolled in college.¹⁰³ In contrast, only 49% of students from families in the two lowest income quintiles combined enrolled in college.¹⁰⁴

⁹⁶ COLLEGE BOARD, TRENDS IN COLLEGE PRICING 10 (2006), available at http://www.collegeboard.com/prod_downloads/press/cost06/trends_college_pricing_06.pdf [hereinafter TRENDS IN COLLEGE PRICING 2006]. At public two-year colleges, the equivalent average increase in tuition and fees was 1.8% per year. *Id.*

⁹⁷ *Id.* at 15–16. Net price is defined as the published price less the average grant aid from all sources and the amount of any education tax benefits (education-related credit or deduction only) per full-time student. *Id.* Interestingly, over the past decade, average net tuition and fees at public two-year colleges have declined by about \$600 in constant 2006 dollars. *Id.* at 17.

⁹⁸ TRENDS IN STUDENT AID 2006, *supra* note 2, at 23 (author's own calculation in constant 2005 dollars).

⁹⁹ BAUM & PAYEA, *supra* note 3, at 3 fig. 2b.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² See *supra* notes 70–72 and accompanying text.

¹⁰³ BAUM & PAYEA, *supra* note 3, at 8 (figures represent 2003 high school graduates who enrolled in college immediately after high school).

¹⁰⁴ *Id.*

In combination, the student demand studies and the actual data on enrollment suggest that to effectively increase college enrollment, financial subsidies should be targeted to the most price-sensitive and underrepresented socioeconomic group in higher education, namely, lower-income students. Title IV of the HEA attempts, albeit imperfectly, to target student financial aid in exactly this manner.

III. TITLE IV OF THE HEA

A. Description of Programs

The three-pronged approach under Title IV of the HEA to federal student aid (grants, loans and work-study) remains largely intact today, although the composition has changed over time. During the 2004–2005 academic year, the federal government distributed approximately \$83 billion in Title IV financial aid to college students.¹⁰⁵ The two largest programs under Title IV are the federal Pell grant program and the federally guaranteed student loan programs.

The Pell grant¹⁰⁶ program accounted for approximately \$13 billion of the total Title IV financial aid distributed during the 2004–2005 academic year.¹⁰⁷ The Pell grant program is the largest federal need-based grant program and the only pure subsidy under Title IV.¹⁰⁸ It is also the most progressive federal student aid program, with 84% of the funds distributed to dependent undergraduate students with family incomes below \$40,000.¹⁰⁹ Individual grants for the 2004–2005 academic year ranged from \$400–\$4,050.¹¹⁰ Although the maximum Pell grant award increased between academic years 2001–2002 to 2005–2006, its purchasing power fell. During this period, the

¹⁰⁵ TRENDS IN STUDENT AID 2006, *supra* note 2, at 6 tbl. 1. This includes Title IV aid to both undergraduate and graduate students. *Id.*

¹⁰⁶ The Pell Grant was so named in honor of former Senator Claiborne Pell of Rhode Island. TERRY W. HARTLE ET AL., AM. COUNCIL ON EDUC., WHAT EVERY STUDENT SHOULD KNOW ABOUT FEDERAL AID 7 (2005), <http://www.acenet.edu/bookstore/pdf/2005paying4college.pdf>.

¹⁰⁷ TRENDS IN STUDENT AID 2006, *supra* note 2, at 6 tbl. 1 (in current 2005–2006 dollars).

¹⁰⁸ This is in contrast to loans, which must be repaid, and work-study dollars, which the student must work to earn.

¹⁰⁹ LUTZ BERKNER ET AL., NAT'L CTR. FOR EDUC. STAT., 2003–04 NAT'L POSTSECONDARY STUDENT AID STUDY (NPSAS:04) STUDENT FINANCIAL AID ESTIMATES FOR 2003-04 (NCES 2005-158) 6 (2005), <http://nces.ed.gov/pubs2005/2005163.pdf> (hereinafter STUDENT FINANCIAL AID ESTIMATES).

¹¹⁰ TRENDS IN STUDENT AID 2006, *supra* note 2, at 17 tbl. 8b.

average cost of attendance at a public four-year institution covered by a Pell grant declined from 42% to 33%.¹¹¹

Federally guaranteed student loans accounted for approximately \$63 billion of the total Title IV aid distributed during the 2004–2005 academic year.¹¹² This total includes loans distributed on the basis of demonstrated financial need, including Perkins¹¹³ and subsidized Stafford¹¹⁴ loans, and loans available to all students regardless of need, including unsubsidized Stafford and Parent Loans for Undergraduate Students (“PLUS loans”).¹¹⁵ Generally, federal student loans enjoy a lower-than-market interest rate because of the federal guarantee.¹¹⁶ In addition, the government pays interest on need-based loans while the student remains in college. Dynarski estimated that the subsidy value of a subsidized Stafford loan was 30% of the face amount of the loan while the subsidy value of an unsubsidized Stafford loan was only 15% of the loan amount.¹¹⁷

B. Federal Methodology

Student eligibility for the Pell grant and subsidized loan programs under Title IV is determined on the basis of financial need.¹¹⁸ The statutorily prescribed formula under Title IV for determining

¹¹¹ *Id.* at 17.

¹¹² *Id.* at 6 tbl. 1.

¹¹³ Perkins loans are distributed through the financial aid offices of participating colleges and universities. HARTLE ET AL., *supra* note 106, at 8.

¹¹⁴ Stafford loans are low-interest loans distributed directly to college students. *Id.* at 9.

¹¹⁵ PLUS loans are distributed to the parents of dependent undergraduate students. Parental borrowers must have sufficiently good credit to qualify for a PLUS loan. See Federal Student Aid, Plus Loans, <http://studentaid.ed.gov/PORTALS/WebApp/students/english/parentloans.jsp?tab=funding> (last visited Sept. 26, 2007).

¹¹⁶ The interest rate on Perkins loans is 5%. 20 U.S.C.A. § 1087dd(c)(1)(D) (West 2006). For Stafford loans made after July 1, 1994 and prior to July 1, 2006, the interest rate was a variable rate adjusted every July 1, with an interest rate cap of 8.25%. *Id.* §§ 1077a(f)–(k), 1087e(b)(1)–(7). For Stafford loans made on or after July 1, 2006, the rate converts to a fixed 6.8%. *Id.* §§ 1077a(1)(1), 1087e(b)(7)(A). For PLUS loans made after July 1, 1998 and before July 1, 2006, the interest rate was a variable rate adjusted every July 1 with a 9% cap on interest. *Id.* §§ 1077a(k)(3), 1087e(b)(4). The interest rate on PLUS Loans disbursed on or after July 1, 2006 made under the William D. Ford Federal Direct Loan (Direct Loan) Program is fixed at 7.9%. *Id.* § 1087e(b)(7)(B). The interest rate on PLUS loans disbursed on or after July 1, 2006 made under the Federal Family Education Loan (FFEL) program is fixed at 8.5%. *Id.* § 1077a(1)(2).

¹¹⁷ Susan Dynarski, *Loans, Liquidity and Schooling Decisions* 4–5 (Joint Ctr. for Poverty Research, Northwestern Univ./Univ. of Chicago Working Paper Series, JCPR Working Paper No. 346, 2003), available at http://ksghome.harvard.edu/~S_Dynarski/Dynarski_loans.pdf.

¹¹⁸ MCPHERSON & SCHAPIRO, *supra* note 90, at 11–12.

need is called the federal methodology (FM).¹¹⁹ This federal needs analysis system can be reduced to a deceptively simple formula under which need equals the cost of attendance (COA) less the expected family contribution (EFC).¹²⁰ COA includes an allowance for tuition, fees, books, supplies, room, board, transportation, etc.¹²¹ EFC is the amount that the federal government expects a family to contribute toward college costs before any federal financial assistance becomes available.¹²² It attempts to measure a family's ability to pay postsecondary education expenses out of the family's own resources.

A few general observations about the FM should be made before exploring the details. First, no student can qualify for financial aid in excess of the total cost to attend a given institution. Second, a student whose EFC exceeds the COA at a given institution will have no financial need and consequently will not qualify for any need-based aid. Third, at any given COA, a family with a higher EFC will qualify for less financial aid than a family with a lower EFC. Finally, at any given EFC, a student applying to a more expensive school will demonstrate more need and consequently qualify for more financial aid than a student applying to a less expensive school. Overall, the goal of the FM is to distribute federal financial aid progressively based on need.

There are three basic statutorily prescribed formulas used to calculate the EFC, depending on whether the student is a dependent student, an independent student with no dependents other than a spouse, or an independent student with non-spouse dependents.¹²³ A dependent student's EFC is the sum of a parental contribution from income and assets and a student contribution from income and as-

¹¹⁹ BAUM, *supra* note 49, at 3. This can be compared to the institutional methodology, which individual schools use to distribute non-federal financial aid to their students. *Id.*

¹²⁰ 20 U.S.C. § 1087kk (2000).

¹²¹ *Id.* § 1087ll. The institutions provide this variable in the formula.

¹²² *Id.* § 1087mm.

¹²³ *Id.* §§ 1087oo–1087qq. A student is independent for purposes of the federal methodology if he or she: (1) is twenty-four years of age or older by December 31 of the award year; (2) is an orphan or ward of the court or was a ward of the court until age eighteen; (3) is a veteran of the U.S. armed forces; (4) is a graduate or professional student; (5) is married; (6) has legal dependents other than a spouse; or (7) is designated as independent by a financial aid administrator. *Id.* § 1087vv(d). *See also* 2006–2007 FEDERAL STUDENT AID HANDBOOK, APPLICATION AND VERIFICATION GUIDE 22 [hereinafter FSA HANDBOOK], available at <http://ifap.ed.gov/sfahandbooks/attachments/0607AVG.pdf>. As of 2006, those serving on active duty in the armed forces are also treated as independent students. Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8019, 120 Stat. 4, 176 (2006).

sets.¹²⁴ The first step in calculating the parents' contribution is to determine the parents' income available to be put towards the child's education, or their "available income."¹²⁵ "Available income" is equal to the parents' "total income" less certain allowances including, inter alia, an allowance for federal taxes and an income protection allowance.¹²⁶ "Total income" is defined as the parents' adjusted gross income (AGI)¹²⁷ plus some items of untaxed income and benefits, minus some items of excludable income.¹²⁸ In the 2006–2007 academic year, the income protection allowance for a family of four with one student in college protects up to \$22,200 in after-tax income from assessment under the FM.¹²⁹

A parental contribution from assets is then added to "available income."¹³⁰ For many middle-income families, however, the parental asset contribution is increasingly irrelevant because home equity and retirement accounts are excluded from consideration as assets available to be put towards a student's higher education expenses.¹³¹ Includable assets now are limited to cash accounts, the net worth of investments held outside of retirement plans, and the adjusted value of farm and business assets.¹³² The value of includable parental assets is offset by an asset protection allowance that varies by the age of the

¹²⁴ 20 U.S.C. § 108700(a)–(b) (2000).

¹²⁵ *Id.* § 108700(b). This Article is focused mainly on dependent undergraduate students. The plight of independent and graduate students is beyond the scope of this paper.

¹²⁶ *Id.* § 108700(c).

¹²⁷ AGI is gross income (income from all sources per I.R.C. § 61 (2000)) less certain deductions allowed to all taxpayers regardless of whether they itemize or not. *See* I.R.C. § 62 (2000).

¹²⁸ 20 U.S.C. § 1087vv(a)(1) (2000). Untaxed income and benefits include, inter alia, (1) child support; (2) certain welfare benefits; (3) workman's compensation; (4) certain veterans' benefits; (5) tax-exempt interest; (6) earned income tax credit; (7) untaxed portion of pensions; and (8) payments to individual retirement accounts and Keogh accounts excluded from income for Federal income tax purposes. *Id.* § 1087vv (b)(2000); *see id.* § 1087vv(e) (defining excludable income).

¹²⁹ FSA HANDBOOK, *supra* note 123, at 56 tbl. A3 (providing updated inflation-adjusted amounts).

¹³⁰ 20 U.S.C. § 108700(b)(1)(B) (2000).

¹³¹ KANE, *supra* note 66, at 23–24 (this includes pension, 401(k), and IRA account balances).

¹³² 20 U.S.C. § 108700(d)(2) (2000). The net worth of farm and business assets is adjusted to protect a portion of these assets from assessment under the EFC formula. *See* FSA HANDBOOK, *supra* note 123, at 56 tbl. A4 (providing updated inflation-adjustment amounts). Under changes made by HERA 2005, the net worth of a family-owned and controlled small business is now excluded from consideration under the EFC formula. Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8019, 120 Stat. 4, 176 (2006).

older parent and the number of parents in the household.¹³³ In 2006, a two-parent household where the older parent is age forty-five, could protect up to \$44,300 in includable assets before any such assets would be assessed by the FM.¹³⁴ The value of includable assets over the asset protection allowance is multiplied by 12%, with the resulting sum representing the parents required contribution from their assets.¹³⁵

The sum of the parents' "available income" is added to their contribution from assets to arrive at an intermediate sum called "adjusted available income."¹³⁶ The parental "adjusted available income" is subjected to a progressive marginal rate schedule that ranges from 22% to 47% to arrive at the total parental contribution to the student's EFC.¹³⁷ Stated another way, the financial aid system expects a dependent student's parents annually to contribute a maximum of 47% of their total income and 5.64% of their includable assets over the respective allowances towards their child's postsecondary expenses.¹³⁸ The parental contribution is further adjusted if there are multiple children in college at the same time.¹³⁹ Under these circumstances, the total parental contribution is divided by the number of students in college.¹⁴⁰

The income and assets of the student are assessed by the FM in a similar manner. However, the EFC formula expects the student to contribute more of his or her own resources towards college than is expected of the student's parents. The student's available income is assessed at a flat rate of 50%.¹⁴¹ Furthermore, the student's assets are

¹³³ 20 U.S.C. § 1087oo(d)(1)(B), (d)(3) (2000). The allowances for ages forty through sixty-five are set to approximate the present cost of an annuity which, when combined with Social Security benefits, would provide at age sixty-five a moderate income for a retired couple or single person. FSA HANDBOOK, *supra* note 123, at 39; *see id.* at 57 tbl. A5 (for updated asset protection allowance table).

¹³⁴ *Id.* at 57 tbl. A5.

¹³⁵ 20 U.S.C. § 1087oo(d)(1)(C), (d)(4) (2000).

¹³⁶ *Id.* § 1087oo(b)(1).

¹³⁷ FSA HANDBOOK, *supra* note 123, at 57 tbl. 6. The maximum rate of 47% is reached when the parents' adjusted available income is \$26,101 or more. *Id.*

¹³⁸ The 5.64% is arrived at by multiplying 12% (the percentage of includable assets included in adjusted available income) by the maximum marginal rate on adjusted available income of 47%.

¹³⁹ 20 U.S.C. § 1087oo(b)(3) (2000).

¹⁴⁰ *Id.*

¹⁴¹ *Id.* § 1087oo(g)(5). Available income of the student is total income less certain allowances, including, *inter alia*, an allowance for federal income taxes and an income protection allowance. *Id.* § 1087oo(g)(1)(A)-(B), (g)(2). Prior to HERA 2005, the income protection allowance was \$2,200 (indexed for inflation). *Id.* § 1087oo(g)(2)(D). HERA 2005 increased the student's income protection allowance

assessed at an annual flat rate of 35%.¹⁴² Under changes made by the Higher Education Reconciliation Act of 2005 (HERA 2005), beginning with the 2007–2008 academic year, the annual assessment rate for student-owned assets will be reduced to 20%.¹⁴³ The total EFC is the sum of the parental income and asset contribution and the student income and asset contribution.¹⁴⁴

For certain lower-income families, there is a simplified EFC formula available that considers only the income and not the assets of the family as resources available to be put towards paying college costs. In 2006, a dependent student qualified for the simplified formula if two requirements were met: (1) neither the student nor the parents were required to file an IRS Form 1040, except in order to claim an education tax credit and (2) the parents' combined AGI was less than \$50,000.¹⁴⁵ For the very poorest families where the parents' AGI is \$20,000 or less, an automatic zero EFC is assigned to the dependent student.¹⁴⁶

The EFC is calculated by the U.S. Department of Education (DOE) on the basis of financial and other information submitted by the student on his or her Free Application for Federal Student Aid (FAFSA).¹⁴⁷ To be eligible for any federal student aid (except parental PLUS loans), the student must have completed a FAFSA in the

to \$3,000 in 2006. Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8017(a)(1)(A), 120 Stat. 4, 173–74 (2006).

¹⁴² 20 U.S.C. § 108700(h) (2000). There is no asset protection allowance available for the student. FSA HANDBOOK, *supra* note 123, at 40.

¹⁴³ Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8017(a)(1)(B), 120 Stat. 4, 173–74 (2006).

¹⁴⁴ 20 U.S.C. § 108700(a) (2000).

¹⁴⁵ FSA HANDBOOK, *supra* note 123, at 35. If the parents were not required to file a tax return, income earned from work is substituted for AGI in determining whether the student qualifies for the simplified formula. *Id.* Under HERA 2005, a student may qualify for the simplified-needs EFC if, in addition to meeting the relevant income criteria, the student (or spouse), or the dependent student's parent(s), received benefits from a means-tested Federal benefit program. Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8018(a)(1)(A), 120 Stat. 4, 174 (2006). According to the Department of Education, the receipt of a Federal means-tested benefit does not make a student automatically eligible for the simplified needs test; it is simply an alternative to the tax return filing standard. Letter GEN-06-10 from James Manning, Assistant Secretary for Postsecondary Education, and Theresa S. Shaw, COO Fed. Student Aid, to Colleagues (June 20, 2006), *available at* <http://www.ifap.ed.gov/dpcletters/GEN0610.html>. The income criteria must also be met. *Id.*

¹⁴⁶ Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8018(a)(2)(B), 120 Stat. 4, 174 (2006).

¹⁴⁷ See Susan M. Dynarski & Judith E. Scott-Clayton, *The Cost of Complexity in Federal Student Aid: Lessons from Optimal Tax Theory and Behavioral Economics*, 59 NAT'L TAX J. 319, 321–23 (2006) (describing the federal student aid application process in textual and graphic formats).

year preceding the intended award year.¹⁴⁸ A FAFSA or renewal FAFSA must be filed anew each year in order to qualify for federal aid for the next academic year. After receiving a completed FAFSA, the DOE will process the information and send the student a Student Aid Report (SAR), which contains the student's calculated EFC.¹⁴⁹ The DOE will also send the information contained in the SAR to those colleges the student listed on his or her financial aid application form.¹⁵⁰ The colleges and universities will then use the EFC to construct a financial aid package consisting of federal, state and institutional aid.¹⁵¹ A prospective freshman cannot apply for federal financial aid until January of his or her last year in high school because many of the FAFSA questions require financial information from the immediately preceding calendar year.¹⁵² This same potential college student does not receive a financial aid package until March or April of the senior year of high school.¹⁵³ Although some select colleges and universities are committed to satisfying 100% of a student's need via financial aid, most schools leave a financial aid gap (difference between calculated financial need and the COA at a particular institution).¹⁵⁴

Susan Dynarski and Judith Scott-Clayton criticized the complexity in this financial aid application process.¹⁵⁵ Completing the FAFSA is an extraordinarily complex and time consuming undertaking.¹⁵⁶ The FAFSA is longer in length and asks more questions than an IRS Form 1040.¹⁵⁷ The goal of the FAFSA is to elicit sufficient information to create a precise financial snapshot of the family's ability to pay for college and concomitant need for aid. As argued by Dynarski and Scott-Clayton, however, there is a trade-off between precision and

¹⁴⁸ FSA HANDBOOK, *supra* note 123, at 3. The FAFSA is the only form that a student must complete for Title IV federal aid. However, the individual institutions may require additional information for purposes of determining qualification for institutional aid. *Id.*

¹⁴⁹ Dynarski & Scott-Clayton, *supra* note 147, at 322 fig. 1; *see also* FSA HANDBOOK, *supra* note 123, at 6.

¹⁵⁰ The report sent to the schools listed on the FAFSA is called the Institutional Student Information Record. *Id.*

¹⁵¹ *See* HARTLE ET AL., *supra* note 106, at 11.

¹⁵² Dynarski & Scott-Clayton, *supra* note 147, at 323.

¹⁵³ *Id.* (arguing that this may be too late to affect the college-going decisions of students who are most sensitive to net price, or lower-income students).

¹⁵⁴ HARTLE ET AL., *supra* note 106, at 6 (calling this the level of "unmet need").

¹⁵⁵ Dynarski & Scott-Clayton, *supra* note 147, at 319.

¹⁵⁶ *Id.* at 323 tbl. 1 (comparing 2006–2007 FAFSA with IRS Forms 1040, 1040A, and 1040 EZ).

¹⁵⁷ *Id.* (although the official estimates of time to prepare are less for the FAFSA than any of the tax forms).

complexity.¹⁵⁸ Using optimal tax theory and behavioral economics, the authors argue that provisions designed to more precisely target aid to the neediest students create complexity and result in regressive compliance costs.¹⁵⁹ These compliance costs are disproportionately borne by exactly those lower-income families they are intended to help.¹⁶⁰ The study also demonstrated that although the costs of complexity were large, the benefits were small because much of the information elicited on the FAFSA failed to improve the targeting of aid.¹⁶¹ By using only parents' AGI, marital status, family size, and the number of children in college plus a few more variables, the authors were able to capture 90% of the variation in Pell grant awards.¹⁶²

IV. TAX EXPENDITURES FOR HIGHER EDUCATION

The goal of Title IV remains increasing access to higher education by removing financial barriers thereto. The FM attempts to determine precisely the amount of unmet need faced by a student in attending the college of his or her choice. Need-based Title IV funds are then distributed progressively, with the poorest students receiving the largest amount of financial aid. The Title IV need-based aid system is quite effective from a distributional standpoint, with 84% of the Pell grant funds awarded to families with incomes below \$40,000.¹⁶³ This distribution of college aid is the one most likely to affect access.¹⁶⁴

The tax benefits for higher education, on the other hand, are non-need-based higher education subsidies in the form of tax expenditures rather than transfer payments.¹⁶⁵ "Tax expenditure," as used in this Article, refers only to those tax allowances that are specifically enacted by Congress as subsidies to encourage taxpayers to engage in a socially desirable activity. In other words, the tax system is simply the mechanism through which the federal dollars are distributed with

¹⁵⁸ *Id.* at 321.

¹⁵⁹ *Id.* at 320.

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Id.* Dynarski and Scott-Clayton also argued that the time lag between filing the FAFSA and actually receiving information about the amount and type of aid awarded also potentially blunts the enrollment impact of Title IV aid. *Id.* at 320–21. The authors argue that providing financial aid information to the student in the spring of the student's final year in high school is too late for the subsidy to affect behavior. *Id.*

¹⁶³ BERKNER ET AL., *supra* note 109.

¹⁶⁴ *See supra* Part II.C.

¹⁶⁵ *See supra* notes 58–63 and accompanying text (for listing of tax benefits for higher education).

regard to the particular activity. With regard to these types of tax expenditures, Congress alternatively could have enacted a direct spending program or expanded an existing spending program to induce participation in the desired activity. Viewed in this light, the tax expenditures for higher education are college spending programs implemented through the tax system. However, there are equity, efficiency and complexity implications to placing these spending programs in the tax system rather than distributing an equivalent amount of federal higher education dollars through existing Title IV spending programs.

In 2005, the Joint Committee on Taxation (JCT) estimated that the tax expenditures for higher education that assist students in paying for college would cost the federal government \$8.6 billion, with the total foregone revenue broken down by program as follows: (1) Hope Scholarship Credit/Lifetime Learning Credit: \$5.2 billion; (2) deduction for qualified tuition and related expenses: \$2.8 billion; (3) exclusion of earnings on Coverdell education savings accounts: \$.1 billion; and (4) exclusion of earnings on qualified tuition programs: \$.5 billion.¹⁶⁶ These tax benefits for higher education are becoming an increasingly important piece of the federal student aid puzzle. The education tax credits and the deduction for qualified tuition and related expenses alone accounted for 6% of the total federal student aid distributed in 2005–2006.¹⁶⁷ The following section will briefly describe these various tax programs.

¹⁶⁶ STAFF OF JOINT COMM. ON TAX, 109TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2005–2009, at 35 (Comm. Print 2005), available at <http://www.house.gov/jct/s-1-05.pdf>. The Joint Committee on Taxation is required by the Congressional Budget and Impoundment Control Act of 1974 to calculate the subsidy value of various tax expenditures, defined as the amount of foregone governmental tax revenue, as a tool for the government to use “in determining the relative merits of achieving specified public goals through tax benefits or direct outlays.” *Id.* at 2. This Article is only concerned with those tax benefits for higher education that are available to dependent undergraduate students to assist in paying their college expenses at the time of enrollment and that intersect with the needs analysis system under Title IV. Accordingly, the deduction for student loan interest was purposely omitted. See I.R.C. § 221 (2000). The interest subsidy associated with this tax deduction is generally not realized until the student matriculates and begins repaying college loans.

¹⁶⁷ TRENDS IN STUDENT AID 2006, *supra* note 2, at 5.

A. Description of Programs

1. Hope Scholarship Credit

The Hope Scholarship Credit (Hope credit) is a nonrefundable income tax credit for qualified tuition and related expenses paid during the taxable year.¹⁶⁸ Qualified tuition and related expenses include tuition and fees only, not room and board or other college costs.¹⁶⁹ Qualified expenses must be reduced by the amount of any qualified scholarship, including a Pell grant award.¹⁷⁰ The Hope credit is available on a per student basis and only during the first two years of the student's postsecondary education.¹⁷¹ The credit can cover the qualified expenses of the taxpayer, the taxpayer's spouse or any dependent claimed by the taxpayer.¹⁷² The maximum credit amount is \$1,500 and is calculated as the sum of 100% of the first \$1,000 in qualified expenses of the student and 50% of the next \$1,000 in qualified expenses.¹⁷³ The Hope credit is phased out ratably for taxpayers with an inflation-adjusted¹⁷⁴ modified AGI¹⁷⁵ between \$40,000 and \$50,000 (\$80,000 and \$100,000 in the case of a joint return).¹⁷⁶

2. Lifetime Learning Credit

The Lifetime Learning Credit (LLC) is a per-taxpayer, nonrefundable credit against income tax for the qualified tuition and related expenses paid by the taxpayer.¹⁷⁷ The maximum credit amount is \$2,000, calculated as an amount equal to 20% of up to \$10,000 in qualified tuition and related expenses.¹⁷⁸ Unlike the Hope credit, the

¹⁶⁸ "Nonrefundable" means that the taxpayer can only claim the credit to the extent of his or her positive income tax liability. See *infra* notes 232–36 and accompanying text (for a discussion of the equity implications of this form of tax credit).

¹⁶⁹ I.R.C. § 25A(f)(1)(A) (2000).

¹⁷⁰ *Id.* § 25A(g)(2)(A).

¹⁷¹ *Id.* § 25A(b)(1), (b)(2)(C). The student must be enrolled on at least a half-time basis and must not have been convicted of a felony drug offense relating to the possession or distribution of a controlled substance. *Id.* § 25A(b)(2)(B), (b)(2)(D).

¹⁷² *Id.* § 25A(f)(1)(a)(i)–(iii).

¹⁷³ *Id.* § 25A(b)(1). This maximum credit is adjusted for inflation for all taxable years beginning after 2001. *Id.* § 25A(h)(1).

¹⁷⁴ *Id.* § 25A(h)(2).

¹⁷⁵ I.R.C. § 25A(d)(3).

¹⁷⁶ *Id.* § 25A(d); see also BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 37.2.3 (2005).

¹⁷⁷ I.R.C. § 25A(c) (2000).

¹⁷⁸ *Id.* § 25A(c)(1).

LLC can be claimed during any year of postsecondary schooling.¹⁷⁹ The AGI limits for the LLC are the same as those for the Hope credit.¹⁸⁰ In addition, the LLC uses the same definition of qualified expenses as the Hope credit.¹⁸¹ However, the qualified expenses of any student for whom the Hope credit is claimed cannot be taken into account for purposes of the LLC, even if those expenses exceed the maximum Hope credit amount.¹⁸² In effect, a taxpayer must choose on a per-student basis between claiming the LLC or Hope credit.

3. Deduction for Tuition and Related Expenses

EGTRRA enacted an alternative to either of the educational credits in the form of a deduction for the qualified tuition and related expenses paid by the taxpayer during the year.¹⁸³ The deduction is allowable in computing AGI, making it available to all taxpayers whether they itemize deductions or not.¹⁸⁴ This deduction was enacted as a temporary measure; as such it was scheduled to expire in 2005. However, Congress extended the deduction through 2007.¹⁸⁵ The maximum deduction amount is \$4,000 if the taxpayer's AGI¹⁸⁶ does not exceed \$65,000 (\$130,000 in the case of a joint return); or \$2,000, if the taxpayer's AGI does not exceed \$80,000 (\$160,000 in the case of a joint return); or zero in all other cases.¹⁸⁷

4. Qualified Tuition Programs

Qualified tuition programs are authorized by section 529 of the Internal Revenue Code and are colloquially referred to as "529 plans." A 529 plan is a college savings program established by a state or an eligible educational institution. There are two types of 529 plans: (1) prepaid tuition (prepaid 529 plans) and (2) college savings (college savings 529 plans). States are authorized to offer both types

¹⁷⁹ The LLC is also available if the student is enrolled on less than a half-time basis. *See id.* § 25A(c).

¹⁸⁰ *Id.* § 25A(d).

¹⁸¹ *Id.* § 25A(c)(2)(B).

¹⁸² *Id.* § 25A(c)(2)(A).

¹⁸³ I.R.C. § 222(a), (c)(2)(A) (2000 Supp. I). Qualified tuition and related expenses are defined the same as for the education credits, including the reduction in the amount of qualified expenses to account for the receipt of any Pell grant award. *Id.* § 222(d)(1).

¹⁸⁴ *See* I.R.C. § 62(a)(18) (2000 Supp. I).

¹⁸⁵ Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922 (2006).

¹⁸⁶ AGI as defined in I.R.C. § 222(b)(2)(C) (2000 Supp. I).

¹⁸⁷ *Id.* § 222(b)(2)(B).

of 529 plans. However, eligible institutions may only offer prepaid 529 plans. Currently, nineteen states (or institutions) offer prepaid 529 plans, whereas all fifty states offer college savings 529 plans.¹⁸⁸

A prepaid 529 plan allows a person to prepay the tuition of a designated beneficiary by purchasing tuition credits or certificates in advance of such beneficiary's enrollment in college. These certificates or credits are redeemed at the time the beneficiary attends college to purchase an amount of higher education credits equivalent to the amount he or she would have purchased in the original investment year.¹⁸⁹ The purpose of the prepayment is to lock in tuition at current rates, thereby hedging against future tuition inflation. The sponsoring state or institution itself invests prepaid 529 plan contributions and uses the return to meet its current liabilities under the program.¹⁹⁰ A prepaid 529 plan operates similarly to a traditional defined benefit plan with the investment risk on the sponsoring state or institution that the return on contributions will be insufficient to cover tuition increases.¹⁹¹

A college savings 529 plan allows a person to make contributions to an account established for the purpose of meeting the qualified higher education expenses of a designated beneficiary. The account owner¹⁹² chooses to direct contributions into one of several different

¹⁸⁸ See College Savings Plans Network, 529 Plan Comparison By State, <http://www.collegesavings.org/planComparisonState.aspx> (last visited Dec. 18, 2006) (listing the types of prepaid 529 plans offered by each state).

¹⁸⁹ Katherine Baird, *The Political Economy of College Prepaid Tuition Plans*, 29 REV. OF HIGHER EDUC. 141, 142 (2006) (noting that “[i]n almost all states, accounts can also be redeemed for the equivalent in-state tuition value should the beneficiary choose to attend either a private or out-of-state institution.”).

¹⁹⁰ *Id.*

¹⁹¹ Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 494 (2004) (indicating that “prepaid tuition programs are a defined-benefit-style device, pooling resources (the prepaid tuition payments from families concerned about increasing education costs), shifting the risk associated with such costs to the program, and guaranteeing an output in the form of in-state tuition (whatever that might be when a child is ready for higher education).”). Many states’ prepaid 529 plans are operating at a loss because investment returns failed to keep pace with tuition increases. Baird, *supra* note 189, at 143. States responded by either closing the program to new participants, increasing the price of tuition credits available under the plan, or by reducing the face value of previously purchased tuition credits. *Id.* For those states that guaranteed their prepaid tuition plans, funding shortfalls are absorbed by the state legislature, and ultimately by the taxpayers of the state. *Id.*

¹⁹² See Prop. Treas. Reg. § 1.529-1(c), 63 Fed. Reg. 45019 (Aug. 24, 1998) (defining “account owner” as “the person who . . . is entitled to select or change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated”).

investment vehicles offered by the state,¹⁹³ which are usually managed by private investment firms or large financial institutions.¹⁹⁴ College savings 529 plans operate similarly to defined contribution plans with the investment risk on the designated beneficiary and his or her family that the return on contributions will be insufficient to cover tuition increases.¹⁹⁵

Both types of 529 plans are required to accept only cash contributions, maintain a separate accounting for each beneficiary, and restrict the investment direction of the contributor or designated beneficiary.¹⁹⁶ Generally, there is no age or other limit on who may be an eligible designated beneficiary. Although there are no per contributor or per student annual contribution limits on 529 plans, each state or sponsoring institution must impose an overall account limit equal to the amount reasonably necessary to provide for the qualified higher education expenses of the designated beneficiary.¹⁹⁷ In most states, control over a 529 plan, including the ability to make withdrawals or change designated beneficiaries, is vested in the account owner.¹⁹⁸ The account owner can be any person and need not be the plan originator, contributor, or designated beneficiary.

¹⁹³ See *id.* § 1.529-2(g). This is allowed despite the statutory prohibition against a “contributor to, or a designated beneficiary under, such [qualified tuition] program . . . directly or indirectly direct[ing] the investment of any contribution to the program (or any earnings thereon).” I.R.C. § 529(b)(4) (2000 Supp. I).

¹⁹⁴ Michael A. Olivas, *State College Savings and Prepaid Tuition Plans: A Reappraisal and Review*, 32 J.L. & EDUC. 475, 477 (2003). The author offers some illuminating insights into the decreased state presence in these plans largely run by private investment firms. See *id.* at 490–500. Cf. Mercer E. Bullard, *The Visible Hand in Government-Sponsored Financial Services: Why States Should Not Be Allowed to Offer 529 Plans*, 74 U. CIN. L. REV. 1265 (2006) (arguing against state sponsorship of 529 plans).

¹⁹⁵ Zelinsky, *supra* note 191, at 495.

¹⁹⁶ I.R.C. § 529(b)(2)–(4) (2000 Supp. I). A plan does not violate this requirement if the person who establishes the account is permitted to select among different investment strategies chosen by the program. Prop. Treas. Reg. § 1.529-2(g), 63 Fed. Reg. 45019 (Aug. 24, 1998).

¹⁹⁷ I.R.C. § 529(b)(6) (2000 Supp. I). The state cumulative contribution limits range from \$235,000 to \$344,000. See Compare 529 Plans by Maximum Contributions, http://www.savingforcollege.com/compare_529_plans/index.php?plan_question_idpercent5Bpercent5D=308&mode=Go&page=compare_plan_questions (last visited Sept. 26, 2007).

¹⁹⁸ See *supra* note 192.

Generally, the 529 plan itself is exempt from taxation.¹⁹⁹ Contributions to a 529 plan are not deductible; however, the amounts contributed grow income tax-free until distributed.²⁰⁰ For taxable years after 2001,²⁰¹ distributions from 529 plans applied towards the payment of the qualified higher educational expenses of the designated beneficiary are excluded from gross income.²⁰² Qualified higher education expenses include tuition, fees, books, supplies and equipment, and in the case of a student enrolled on at least a half-time basis, room and board.²⁰³ Non-qualified distributions (those used for some purpose other than the payment of the higher education expenses of the designated beneficiary) are taxable to the distributee as an annuity.²⁰⁴ In addition to the regular income tax imposed on nonqualified distributions, subject to certain exceptions, a 10% penalty tax is also imposed.²⁰⁵ Rollovers to another 529 plan²⁰⁶ or a change in designated beneficiary of an existing 529 plan are income-tax-free as long as the new designated beneficiary is a member of the family²⁰⁷ of the original designated beneficiary.²⁰⁸

¹⁹⁹ I.R.C. § 529(a) (2000). This was not always the case. Prior to the enactment of § 529 in 1996, there was continuing litigation regarding the exempt status of the Michigan Educational Trust, the first state-sponsored prepaid plan. *See, e.g.*, Michigan v. United States, 40 F.3d 817 (6th Cir. 1994), *rev'd*, 802 F. Supp. 120 (W.D. Mich. 1992); *see also* Jeffrey S. Lehman, *Social Irresponsibility, Actuarial Assumptions, and Wealth Redistribution: Lessons About Public Policy from a Prepaid Tuition Program*, 88 MICH. L. REV. 1035 (1990) (providing a detailed analysis of the original Michigan Education Trust); Eric A. Lustig, *supra* note 21, at 244–53 (describing history of taxation of 529 plans prior to enactment of I.R.C. § 529).

²⁰⁰ I.R.C. § 529(c)(1) (2000).

²⁰¹ Prior to the 2001 Act, distributions from 529 plans were generally taxable to the beneficiary or contributor. *See generally* STAFF OF JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS—BLUE BOOK 9–11 (Comm. Print 2001), *available at* <http://waysandmeans.house.gov/Documents.asp?section=8> (follow link to report). The Pension Protection Act of 2006 made permanent the EGTRRA changes to I.R.C. § 529, including the federal tax exclusion for qualified distributions from a 529 plan. Pension Protection Act of 2006, Pub. L. No. 109-280, § 1304, 120 Stat. 780, 1109 (2006).

²⁰² I.R.C. § 529(c)(3)(B) (2000 Supp. I).

²⁰³ *Id.* § 529(e)(3).

²⁰⁴ *Id.* § 529(c)(3) (cross-referencing annuity rules set forth in I.R.C. § 72).

²⁰⁵ *Id.* §§ 529(c)(6), 530(d)(4). The penalty tax is not imposed if a distribution is (1) made on or after the death of a beneficiary; (2) attributable to the beneficiary's being disabled; (3) made on account of a scholarship, allowance, or payment that is described in § 25A(g)(2); and (4) made on account of the beneficiary attending certain U.S. military academies. *Id.*

²⁰⁶ Rollovers can be to a plan for the same beneficiary or for a different beneficiary. *Id.* § 529(c)(3)(C)(i).

²⁰⁷ A member of the family includes a designated beneficiary's spouse, child or descendant of a child (or their spouse), sibling or step-sibling (or their spouse), parent or ancestor of parent (or their spouse), step parent, niece or nephew (or their

In addition to the income tax benefits just described, certain significant federal wealth transfer tax benefits attach to 529 plans. Contributions to 529 plans are considered completed gifts of present interests.²⁰⁹ Absent this provision, contributions to 529 plans would be tested under the normal gift tax rules to determine whether the gift was complete and whether it was of a present interest in property.²¹⁰ Automatically treating all contributions as completed gifts of present interests in property qualifies all contributions for the annual gift tax exclusion.²¹¹ In 2006, this would allow a single donor to make up to a \$12,000 contribution to a 529 plan gift tax-free.²¹² Additionally, a donor can elect to treat a single contribution as made ratably over a five-year period, thereby allowing the contributor to front-load up to five years worth of gift tax annual exclusions.²¹³ In 2006, such an election would allow a contributor to make a single transfer of \$60,000 to a 529 plan without any federal wealth transfer tax imposed.²¹⁴ Distributions from 529 plans are not considered taxable gifts.²¹⁵ Rollovers or changes in designated beneficiaries are also exempt from gift and generation-skipping transfer taxation, as long as the new designated beneficiary is assigned to the same generation (or

spouse), aunt or uncle (or their spouse), son-in-law (or his spouse), daughter-in-law (or her spouse), father-in-law (or his spouse), mother-in-law (or her spouse), brother-in-law (or his spouse) or sister-in-law (or her spouse), or a first cousin. *Id.* §§ 529(e)(2), 152(d)(2).

²⁰⁸ *Id.* § 529(c)(3)(C).

²⁰⁹ *Id.* § 529(c)(2)(A)(i).

²¹⁰ See Treas. Reg. § 25.2511-2 (as amended in 1999) (explaining when a gift is complete for purposes of the gift tax); Treas. Reg. § 25.2503-3(b) (as amended in 1983) (defining present interest in property). A 529 plan contributor, with the power, as account owner or otherwise, to withdraw a previously made contribution or to change plan beneficiaries, would not receive completed gift treatment on the original plan contribution. The existence of these powers would depend on the plan itself. The inability of the 529 plan beneficiary to immediately use, possess, or enjoy the contribution would defeat a finding of a present interest in property.

²¹¹ I.R.C. § 2503(b) (2000); see Rev. Proc. 2005-70, 2005-2 C.B. 974 (listing \$12,000 as the inflation-adjusted annual exclusion amount under § 2503(b) for taxable year 2006).

²¹² See Rev. Proc. 2005-70, 2005-2 C.B. 974. In 2006, married couples that elected gift-splitting could transfer up to \$24,000 gift tax-free. I.R.C. § 2513 (2000).

²¹³ I.R.C. § 529(c)(2)(B) (2000 Supp. I). In the event that the donor dies during the five-year period following such a contribution, the gross estate of the donor includes the portions of the contributions allocable to periods after the death of the donor. *Id.* § 529(c)(4)(C).

²¹⁴ In 2006, married couples who elected gift-splitting and who chose to treat a single contribution to a 529 plan as made ratably over a five-year period could transfer up to \$120,000 gift tax-free. See *supra* notes 212–13.

²¹⁵ I.R.C. § 529(c)(5)(A) (2000 Supp. I).

higher) as the old beneficiary.²¹⁶ Subject to certain exceptions, an interest in a 529 plan will not cause estate tax inclusion for any individual.²¹⁷

5. Coverdell Education Savings Account

A Coverdell education savings account (Coverdell account) is “a trust created or organized in the United States exclusively for the purpose of paying the qualified education expenses” of the designated beneficiary.²¹⁸ Until 2001, these tax-favored college savings plans were known as “Education IRAs.”²¹⁹ Although similar in purpose to a college savings 529 plan, Coverdell accounts are privately administered rather than state or institution sponsored. The income and transfer tax consequences for contributions to and distributions from Coverdell accounts are similar to those of college savings 529 plans.²²⁰ In addition, both types of college savings plans enjoy similar liberal rules regarding changes in beneficiary and plan rollovers.²²¹

Despite general similarity in tax treatment, Coverdell accounts differ from 529 plans in several important ways. First, Coverdell accounts include elementary and secondary educational expenses as qualified expenses.²²² Second, contributions to Coverdell accounts must be made before the designated beneficiary’s eighteenth birthday²²³ and any balance in the account must be distributed within thirty days of the beneficiary’s thirtieth birthday or, if the beneficiary dies before attaining age thirty, must be distributed within thirty days after the date of death.²²⁴ Third, annual account contributions are limited in the aggregate to \$2,000 per year.²²⁵ Fourth, unlike 529

²¹⁶ *Id.* § 529(c)(5)(B).

²¹⁷ *Id.* § 529(c)(4). This section indicates that the two exceptions to this rule are for amounts distributed on account of the death of a beneficiary, and in the case of a deceased donor who elected to treat a contribution as made ratably over a five-year period, only the portion of such contribution properly allocable to periods after the death of the donor. *Id.* Under normal estate tax rules, an account owner with the ability to change beneficiaries or to cause account balances to be distributed to the account owner would suffer estate tax inclusion of all or a portion of the college savings plans. *See* I.R.C. §§ 2036, 2038, 2041 (2000).

²¹⁸ I.R.C. § 530(b)(1) (2000 Supp. I).

²¹⁹ *See* Act of July 26, 2001, Pub. L. No. 107-22, § 1, 115 Stat. 196, 196–97 (officially changing the name from “Education IRA” to “Coverdell education savings account”).

²²⁰ *See* I.R.C. § 530(d) (2000 Supp. I).

²²¹ *Id.* § 530(d)(5)–(6).

²²² *Id.* § 530(b)(2).

²²³ *Id.* § 530(b)(1)(A)(ii).

²²⁴ *Id.* § 530(b)(1)(E).

²²⁵ *Id.* § 530(b)(1)(A)(iii). This means that no accelerated gift tax annual exclusion option is necessary, and accordingly none is provided.

plan contributors, Coverdell account contributors are subject to certain AGI limitations. The ability to make the maximum contribution amount to a Coverdell account begins to phase out for an individual with a modified AGI²²⁶ exceeding \$95,000 (\$190,000 in the case of a joint return) and is completely phased out for an individual with an AGI exceeding \$110,000 (\$220,000 in the case of a joint return).²²⁷

B. Equity, Efficiency, and Complexity

Delivering these higher education subsidies through the tax system rather than through traditional student aid spending channels has certain implications for the equity, efficiency, and complexity of the federal financial aid system as a whole.

1. Equity

The tax benefits for higher education in the form of a deduction or an exclusion from income, including the deduction for higher education expenses and the exclusion of earnings in tax-favored college savings plans, are regressive in the distribution of their benefits. The value of the subsidy provided by these types of tax expenditures increases as the taxpayer's marginal rate bracket increases.²²⁸ Furthermore, non-taxpayers are completely foreclosed from realizing any higher education subsidy from the education-related deduction and exclusions.²²⁹ In 2004, 35% of taxpayers had no positive income tax liability, and these same taxpayers housed almost half of all America's children.²³⁰

One way to temper the regressivity of these types of tax expenditures is to impose AGI limits on who may claim the benefit. As described above, AGI limits are imposed on the education-related de-

²²⁶ "Modified" AGI means the AGI of the contributor increased by any amount excluded from gross income under I.R.C. §§ 911, 931, or 933. *Id.* § 530(c)(2).

²²⁷ *Id.* § 530(c); see also BITTKER & LOKKEN, *supra* note 176, at ¶ 16.8.

²²⁸ STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 71-72 (1985) (describing the upside-down nature of many tax subsidies). The subsidy value of a deduction or exclusion from income is equal to the amount of deduction or exclusion multiplied by the taxpayer's marginal income tax rate.

²²⁹ *Id.* at 72.

²³⁰ Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 28 (2006) (citing William G. Gale, *Tax Bracket and Tax Liabilities for Families with Children*, 105 TAX NOTES 1145 (2004); Peter R. Orszag & Matthew G. Hall, *Nonfilers and Filers with Modest Tax Liabilities*, 100 TAX NOTES 723 (2003); Scott A. Hodge, *Number of Americans Outside the Income Tax System Continues to Grow*, FISCAL FACTS 27 (Tax Found., Washington, D.C.), June 9, 2005, available at <http://www.taxfoundation.org/publications/show/542.html>).

duction and credit claimants, and Coverdell account contributors.²³¹ Although this does not cure regressivity below the AGI limitation, it does prevent high-income taxpayers from claiming the college tax benefit. On the other hand, 529 plans impose no AGI limitations and therefore allow the highest income taxpayers, those least in need of federal financial assistance, to claim disproportionately large federal higher education subsidies.

Another way to mitigate the regressive distribution of tax expenditure benefits is to design the tax program as a credit against tax rather than as a deduction or exclusion.²³² This is the approach of the education-related tax credits. The amount of a Hope credit or a LLC reduces the claimant's income tax payable on a dollar-for-dollar basis regardless of the family's marginal rate bracket. However, since neither education-related credit is refundable, the maximum credit is limited by the amount of the taxpayer's positive income tax liability.²³³ In 2006, a married couple with two dependents who claimed only the standard deduction and personal exemptions would not incur positive income tax liability until their gross income reached \$23,500.²³⁴ To claim the maximum LLC of \$2,000, this same family would need to report at least \$41,850 in gross income.²³⁵ Both of these thresholds would be pushed higher if the same family claimed the earned income tax credit.²³⁶ Accordingly, the poorest families cannot benefit

²³¹ See *supra* notes 176, 180, 187, 227 and accompanying text. It is interesting to note that the more regressive tax benefits for higher education (education-related deductions and exclusions) enjoy higher AGI limitations than the less regressive tax benefits (education credits).

²³² SURREY & MCDANIEL, *supra* note 228, at 108.

²³³ See Bridget Terry Long, *The Impact of Federal Tax Credits for Higher Education Expenses*, in COLLEGE CHOICES: THE ECONOMICS OF WHERE TO GO, WHEN TO GO, AND HOW TO PAY FOR IT 101, 115 (Caroline M. Hoxby ed., 2004) (using 1999 income tax return data, Long's study found that "half of the higher education tax credit beneficiaries were not able to take the full credit for which they were otherwise eligible" because of insufficient positive income tax liability).

²³⁴ Author's calculation assuming that the family has no other deductions except the standard deduction (\$10,300 in 2006) and personal exemptions (\$3,300 each). See Internal Revenue Service 2006 Form 1040, <http://www.irs.gov/pub/irs-pdf/f1040.pdf?portlet=3>.

²³⁵ Author's calculation. The level of taxable income required to incur at least \$2,000 in taxes for 2006 is \$18,350. See Internal Revenue Service 2006 1040A Instructions, <http://www.irs.gov/pub/irs-pdf/i1040a.pdf>. To have \$18,350 in taxable income after personal exemptions and credits requires at least \$41,850 in gross income.

²³⁶ I.R.C. § 32 (2000). The earned income tax credit is a refundable tax credit available to low-income working families. In 2007, married taxpayers filing jointly with one qualifying child could claim a partial earned income tax credit if their AGI was below \$35,241. Rev. Proc. 2006-53, 2006-48 I.R.B. 996.

from the education-related tax credits at all and lower-income families may see their educational credit amount limited by their otherwise minimal positive income tax liability.

The empirical data supports the hypothesis that the tax benefits from the tuition deduction and the higher-education-related tax credits are largely enjoyed by middle- and upper-middle-income taxpayers. In 2004, 35% of the tax savings from claiming an education credit went to families with AGIs between \$25,000 and \$49,999; 31% went to families with AGIs between \$50,000 and \$74,999; and 23% went to families with AGIs between \$75,000 and \$99,999.²³⁷ Only 11% of the tax savings from the education-related credits went to families with AGI below \$25,000.²³⁸ The data on the higher education deduction claimants is skewed even further up the income scale.²³⁹ Thirty-six percent of the tax benefit from the tuition tax deduction was claimed by families with AGIs between \$50,000 and \$99,999, and 41% was claimed by families with AGIs between \$100,000 and \$160,000.²⁴⁰

Although no tax return data is available with regard to the tax savings associated with the education-related savings accounts, the regressive distribution of tax benefits combined with the relatively higher AGI limit for Coverdell account contributors and the lack of an AGI limitation for 529 plan contributors suggests that the subsidies associated with contributions to college savings plans are enjoyed by those families on the highest end of the income scale.²⁴¹ Using a 2001 Survey of Consumer Finances, Dynarski estimated that the median income of households holding a tax-favored college savings account was \$91,000, which was \$41,000 higher than the median income for all households with children under the age of sixteen.²⁴²

An additional distributional problem, unique to tax-favored college savings plans, is introduced by the fact that families cannot realize any tax benefit until they actually make a plan contribution from their own funds. Lower-income families may lack available after-tax disposable income to contribute to a 529 plan or Coverdell account. Even for a lower-income family with available funds, a 529 plan or

²³⁷ TRENDS IN STUDENT AID 2006, *supra* note 2, at 25 fig. 16.

²³⁸ *Id.*

²³⁹ This is a result of the higher AGI limit imposed on taxpayers claiming the tuition deduction. *See supra* note 187 and accompanying text.

²⁴⁰ TRENDS IN STUDENT AID 2006, *supra* note 2, at 25 fig. 17.

²⁴¹ Since there is no deduction for contributions to tax-favored college savings plans, there is nothing for a plan contributor to report on his or her tax return. In addition, the exclusion from income associated with college savings plans is also not reported on a tax return.

²⁴² Dynarski, *Who Benefits*, *supra* note 25, at 364 tbl. 1.

Coverdell account may not be a wise investment. The small tax benefit realized may be far outweighed by the risks involved in committing funds to a tax-favored college savings plan or account.²⁴³ Recall that non-qualifying plan or account distributions incur a regular income tax and a 10% penalty tax. For lower-income families, the risk that non-qualifying distributions will be made is higher than for other families because there is a greater risk that the designated beneficiary will not attend college or that the college savings funds will be needed for other current consumption purposes.²⁴⁴ For the highest-income taxpayers, the large tax savings that can be realized by saving in a 529 plan or Coverdell account may outweigh the very small risks of nonattendance or needing the funds for non-qualifying purposes.

The additional federal wealth transfer tax advantages afforded 529 plans and Coverdell accounts also skew the benefits of these plans in favor of high-income taxpayers. Lower- and middle-income taxpayers are simply not subject to these taxes and derive no benefit from any transfer tax expenditure.²⁴⁵ Even when a non-qualified distribution is made, there is no recapture of any federal wealth transfer tax benefits previously provided to the contributor. Compare this to the income tax treatment of non-qualifying distributions. In the case of a non-qualifying distribution from a tax-favored college savings account, an income tax and a penalty tax attach. Presumably, since the income tax exemption is justified as a way of encouraging families to save for college, when that assumption turns out to be false, the exemption no longer applies. However, the treatment of the initial transfer as a completed gift of a present interest when it would not otherwise have been is not recast upon a non-qualifying distribution. In addition, the contributor can continue to exert control over the beneficial enjoyment of the property as account owner, with no fear of estate tax inclusion, even if the funds are not used to pay college expenses.²⁴⁶ Depending on the contributor, these transfer tax bene-

²⁴³ As described above, the subsidy value of an exclusion from gross income is directly tied to the taxpayer's marginal rate bracket. The amount of tax saved by excluding an item of income is equal to the amount of the exclusion multiplied by the taxpayer's marginal income tax rate.

²⁴⁴ See *supra* note 5 (detailing the enrollment gaps between the lowest income quintiles and the highest).

²⁴⁵ Currently, the gift tax is not imposed until taxable gifts exceed one million dollars and the estate tax is not imposed until the taxable estate exceeds two million dollars. I.R.C. §§ 2010(c), 2505(a)(1) (2000 Supp. I). Married couples can effectively double these taxable limits.

²⁴⁶ See *supra* notes 210, 217 (discussing the normal transfer tax rules that would be applicable to a contributor to or account owner of a tax-favored college savings plan).

fits may overcome the income and penalty taxes imposed and make investing in a tax-favored college savings plan a winning proposition no matter how the designated beneficiary ultimately uses the funds.

The higher education tax expenditures mainly benefit middle- and upper-income taxpayers with little or no subsidy provided to low-income taxpayers. This distribution pattern works at cross purposes with progressive goals of Title IV and introduces an unsavory amount of regressivity into the overall distribution of federal higher education dollars. However, one could argue that the college tax subsidies temper the impact of the high marginal implicit tax rates that families face under the EFC formula in the Title IV needs analysis. The process of calculating the EFC by assessing the income and assets of a family at statutorily prescribed rates has been criticized as a system of implicit taxation that reduces incentives to work and to save.²⁴⁷ For those families subject to the FM, every additional dollar of income or increase in includable²⁴⁸ asset value results in a proportionate decrease in eligibility for Title IV need-based aid. Under this line of analysis, the annual maximum implicit tax rate under the FM on parental income is 47% and on parental assets is 5.64%.²⁴⁹ However, the assessment process under the FM is an annual one, resulting in a cumulative parental asset implicit taxation rate over a four-year period of 21%.²⁵⁰ Similarly, the implicit annual tax rates on student income and assets are 50% and 35%, respectively.²⁵¹ Cumulatively, the FM implicitly taxes student assets at a rate of 82% over a four-year college career.²⁵²

There are multiple responses to this argument. First, these implicit tax rates may be overstated because they assume that financial aid is an entitlement that covers 100% of a student's need as calculated under the FM.²⁵³ In fact, except at certain elite institutions, financial aid covers less than 100% of need.²⁵⁴ Second, although economic theory suggests a potential disincentive to work and to save as

²⁴⁷ See, e.g., Dick & Edlin, *supra* note 23, at 295–322; Martin Feldstein, *College Scholarship Rules and Private Savings*, 85 AM. ECON. REV. 552, 552–66 (1995).

²⁴⁸ See *supra* note 132 and accompanying text.

²⁴⁹ See *supra* note 138 and accompanying text.

²⁵⁰ Dynarski, *Who Benefits*, *supra* note 25, at 378 (using formula $[=1-(1-.0564)^4]$).

²⁵¹ See *supra* notes 141–43 and accompanying text. Note that this does not take into account the reduction in asset rate applied to student assets under HERA.

²⁵² Dynarski, *Who Benefits*, *supra* note 25, at 378.

²⁵³ Dick & Edlin, *supra* note 23, at 296–97, 319 (finding that financial aid implicit tax rates are smaller than those suggested in earlier studies because the earlier studies assumed that aid equals need under the FM while their study used empirical data on actual aid awards to calculate financial aid awards).

²⁵⁴ *Id.* at 297.

a result of implicit taxation under Title IV, empirical evidence is needed to prove that the FM actually affects work and savings.²⁵⁵ Even critics admit that the extent to which parents understand these incentives and act accordingly remains unclear.²⁵⁶ Therefore, the need for mitigation through tax subsidies is overstated.

Third, the marginal implicit tax rates under the FM apply only to those families who are potentially eligible for financial aid. Two types of families on opposite ends of the income spectrum are entirely exempt from implicit taxation under the aid system.²⁵⁷ The lowest income families will qualify for the maximum amount of Title IV need-based aid regardless of marginal changes in income or wealth. The very highest income families will never qualify for Title IV need-based aid regardless of marginal changes in income or wealth.²⁵⁸ Hence, any college tax subsidy that benefits these two categories of families cannot be justified on the basis of its ameliorating effect on implicit marginal tax rates under the FM. While the poorest families realize no tax benefit from the higher education tax expenditures, the wealthiest families enjoy the largest subsidies associated with the tax-favored college savings plans.²⁵⁹

The final response to the argument that college tax benefits are necessary to mitigate the effects of high implicit tax rates under the FM relates to the fact that middle-income families have been receiving relief from implicit tax rates on assets under the FM since 1992, when home equity and retirement accounts were excluded from implicit taxation. This lowered the overall effective implicit marginal tax rate on assets under the EFC formula. Accordingly, it is questionable whether additional relief through a tax subsidy is necessary.

²⁵⁵ See Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 546–52 (1994) (offering a similar critique of the claim by critics of the earned income tax credit that the credit creates disincentives to work over its phase-out range).

²⁵⁶ Dick & Edlin, *supra* note 23, at 319. A lack of understanding of the EFC formula results from its complexity and the fact that the financial aid applicant does not actually calculate the EFC; the Department of Education does. See *supra* notes 147–54 and accompanying text. However, familiarity with the EFC formula and its disincentive effects may be increasing with the advent of websites that contain EFC calculators and that detail financial aid maximization strategies. See, e.g., FinAid!, <http://www.finaid.org/>; Financial Aid—Petersons, <http://www.petersons.com/financial/file.asp?id=780&path=ug.pfs.financial> (last visited Dec. 14, 2006).

²⁵⁷ Dynarski, *Who Benefits*, *supra* note 25, at 376.

²⁵⁸ For both sets of families, the implicit tax rate on an additional dollar of income or asset value is zero. *Id.* at 376–77.

²⁵⁹ This is a result of the relatively high AGI limitations that apply to Coverdell account contributors and the lack of an AGI limitation applicable to 529 plan contributors. See *supra* note 227 and accompanying text.

The asset exclusions also created inequities in the distribution of Title IV need-based benefits. Consider two families with equal amounts of income and wealth. On a pure ability-to-pay basis, each family should qualify for the same amount of need-based federal financial aid. However, the composition of their asset holdings may change the predicted outcome. The family that holds most of their wealth in the form of home equity and retirement accounts will qualify for more need-based aid than the family with a different asset mix. This violates notions of horizontal equity. Consider also the case of two families of unequal wealth who both qualify for the same amount of federal need-based financial aid because the wealthier family holds a portion of their wealth in the form of home equity and retirement plans. In this case, vertical equity is violated. The preference in the aid system for home ownership and retirement accounts is in addition to the already generous treatment of these assets by the federal income taxation system.²⁶⁰

2. Efficiency

One can measure efficiency in a number of different ways. This Part is concerned only with one type of efficiency, namely, the ability of the tax expenditures for higher education to achieve their stated public policy goals of increased college access, affordability, and savings.²⁶¹

a. Access

The tax benefits for higher education can only increase access to college if the financial subsidy induces students who would not otherwise attend college to enroll. Otherwise, the government is subsidizing an activity that would have occurred anyway absent the subsidy. The economic studies cited in Part II.C suggest that lower-income potential college students are the most sensitive to price in making the enrollment decision. In addition, lower-income students are the most underrepresented population, by family income level, of college attendees.²⁶² Accordingly, to expand access to higher education, and to make it more equally available across income classes, federal subsi-

²⁶⁰ See, e.g., I.R.C. §§ 121, 163 (2000) (for income tax benefits available to homeowners); *id.* §§ 401, 403, 408, 408A (for income tax benefits available to retirement savers).

²⁶¹ Statement by President Clinton, *supra* note 50.

²⁶² A 32% gap remains between the college participation rates of families earning below \$25,000 per year and families earnings above \$75,000 per year. See ACCESS DENIED, *supra* note 85.

dies should be aimed at lower-income students. As previously described, the tax benefits for higher education provide little or no benefit to lower-income students. This suggests that they will have little effect on college enrollment levels. Available empirical data on the education-related credits support this conclusion. Bridget Terry Long studied the impact of the educational credits on college access three years after enactment and found no enrollment response after the introduction of the credits.²⁶³

The study's lack of an enrollment response from the college tax credits can be partially explained by a lack of knowledge about the existence of the tax credits at the time of the study.²⁶⁴ Even those taxpayers who are aware of the education tax credits do not always claim the credit for which they are eligible.²⁶⁵ Furthermore, the distributional impact of the college tax credits favors middle-income taxpayers, who would have attended college with or without the subsidy.²⁶⁶ In addition, the timing of the delivery of the tax credits may further explain why these provisions failed to induce increased college enrollment.²⁶⁷ Simply put, the tuition subsidy may come too late to affect access. In most cases, a family that pays its tuition bill in August will not realize the federal subsidy until it files a tax return in the year following the year of payment. In other words, the tax credit amount reimburses the claimant for tuition payments already made. Title IV aid, on the other hand, offsets current tuition bills. For families lacking the liquidity to pay their tuition charges as they fall due, the existence of a future tax credit may have no effect on their current enrollment decision. Even for those families who can afford to make the tuition payment, the subsidy is delivered after the enrollment decision was already made.

²⁶³ Long, *supra* note 233, at 137.

²⁶⁴ *Id.* at 122 (finding that only one-third of the parents asked in a 1999 National Household Education Survey (NHES) had heard of one of the education tax credits, and only 21.5% and 18.7% had heard of the Hope scholarship credit and LLC, respectively).

²⁶⁵ A recent study suggests that 74% of eligible students used the Hope credit and 63% used the LLC. Burman et al., *supra* note 25, at 15. The authors note that "participation tends to rise with income, raising the concern that those most in need are least likely to participate, even when eligible." *Id.* The authors speculate that low-income families' lower take-up rate is attributable to a lack of knowledge of the existence of the credits combined with the minimal or nonexistent benefit available when positive income tax liability is limited or lacking. *Id.* at 15–16.

²⁶⁶ See *supra* notes 232–40 and accompanying text (describing distributional effects of education-related tax credits); see also Burman et al., *supra* note 25, at 14.

²⁶⁷ Long, *supra* note 233, at 103–04; see also JACKSON, *supra* note 72, at 16 (noting that it is possible to mitigate the timing problem if taxpayers adjust their income tax withholding so that their take-home pay is greater over the entire tax year).

In reality, the timing of the tuition subsidy provided by the college tax credits may only be a problem during the first year of post-secondary education. When the bill for the second year arrives, the increased wealth realized as a result of the tax credits or deduction could be put towards the higher education expenses of that year. However, a family could also spend their increased wealth on a vacation or another consumption-type expense. Accordingly, as noted by Kane, the higher education credits and deduction will primarily produce an income effect on families with college students, rather than a price effect, “as if the federal government were sending families a tax refund unrelated to how much more they spend on college.”²⁶⁸

The potential effect (or non-effect) on college access of the tuition tax deduction would be similar to that of the education credits because it serves as an alternative to either of the tax credits. As for 529 plans and Coverdell accounts, if a family lacks the financial wherewithal to save in the first place, there is no potential enrollment response to be realized by the existence of these tax-favored savings plans.

b. Affordability

It is unclear whether the tax benefits for higher education make college more affordable, especially if, as noted by Kane above, they primarily produce an income rather than a price effect. To make college more affordable, the tax subsidies must reduce net price. If colleges and universities raise their tuitions in response to the existence of additional federal funds, then students realize no net price decrease.²⁶⁹ Under this scenario, the tax benefits serve as an indirect subsidy to colleges and universities. When the education-related tax credits were introduced, many states reacted by explicitly considering ways to capture the new federal higher education dollars.²⁷⁰ Long studied the possible effects of the introduction of the education credits on college pricing and found “some evidence to support that public two-year colleges responded to incentives created by the tax credits by raising tuition price beyond what can be explained by fluctuations in state support, and the responses were stronger for schools with a

²⁶⁸ KANE, *supra* note 66, at 45.

²⁶⁹ Note also that if schools reduce their own need-based aid in response to the existence of the college tax subsidies, a similar result would follow.

²⁷⁰ Long, *supra* note 233, at 144–145 (describing how California, Arkansas, Minnesota, North Carolina, Washington, and New York all considered raising in-state tuition at public colleges to capture the additional federal aid).

greater proportion of credit-eligible students.”²⁷¹ This institutional response has a particularly harsh effect on low-income students who are disproportionately represented at public two-year colleges, and who face increased tuition as a result of the existence of the college tax credits without the ability to claim their benefits because of minimal positive income tax liability.²⁷²

The higher education tax expenditures will also not affect affordability if the existence of the additional subsidy induces students to attend more expensive colleges. The structure of the education-related tax credits encourages students to attend more expensive colleges, especially the LLC credit, where the maximum amount cannot be obtained until the student incurs \$10,000 in tuition expenses.²⁷³ The existence of a large balance in a tax-favored college savings plan may also induce a student to attend a more expensive college in order to minimize the possibility of paying the taxes associated with non-qualifying distributions of excess unused plan funds upon matriculation.²⁷⁴ Affordability will also not be enhanced to the extent that a portion of the tax savings associated with a college savings plan is lost to financial intermediaries in the form of commissions and fees.²⁷⁵ This is especially true with regard to state sponsored 529 plans, which are usually managed by private investment firms or large financial institutions.²⁷⁶

²⁷¹ *Id.* at 161.

²⁷² TRENDS IN STUDENT AID 2006, *supra* note 2, at 22 (chart entitled “Income Distribution of Families within Public Two-Year and Four-Year Institutions, 2003–4004” shows that while 31% of families in the lowest income quartile attended a public two-year institution only 18% of families in the top income quartile attended public two-year institutions).

²⁷³ See *supra* note 178 and accompanying text.

²⁷⁴ The liberal beneficiary change and rollover rules for the tax-favored college savings plans could mitigate this possibility, which, in turn, would mitigate the incentive effect to maximize the use of the funds for any one beneficiary’s higher education expenses. See *supra* notes 206–08, 221 and accompanying text.

²⁷⁵ See SURREY & MCDANIEL, *supra* note 228, at 84. On the issue of 529 plan fees, see LINDA L. LEVINE, CONG. RESEARCH SERVICE, SAVING FOR COLLEGE THROUGH QUALIFIED TUITION (SECTION 529) PROGRAMS 5–8 (2004) (chronicling the history of Congress’s investigation into the fees charged by various plans and the regulatory oversight of such plans, including a discussion of whether 529 plans are subject to the federal securities laws regarding financial information disclosure). Reportedly, expenses and fees in 529 plans are higher than in other types of savings vehicles. *Id.* at 5.

²⁷⁶ Olivas, *supra* note 194, at 490–500 (offering illuminating insights into the decreased state presence in these plans largely run by private investment firms). In 2003, approximately two-thirds of college savings 529 plans were sold through financial intermediaries. LEVINE, *supra* note 275, at 6.

The amount of tax assistance available to a family with a student in college depends not only on the level of higher education expenses incurred by the family, but also on the family's overall tax situation for the year.²⁷⁷ This may impede the ability of the higher education tax benefits to make college more affordable in any given year. For example, if Congress lowers income tax rates, or the family's income suddenly drops them into a lower tax bracket, the tax benefits available to the family may be limited for that year. For example, between 2001 and 2002, participation in the education tax credit programs decreased.²⁷⁸ This may be attributable to the overall income tax rate reduction enacted under EGTRRA.²⁷⁹

c. Savings

According to the JCT, in enacting the tax-favored college savings plans, Congress wanted "to encourage families and students to save for future education expenses."²⁸⁰ It is unclear whether 529 plans and Coverdell accounts have induced new college savings or have simply allowed wealthy individuals to shift existing non-tax advantaged college savings into these new vehicles. In 2001, Dynarski profiled Coverdell and 529 investors as those with "incomes, education and wealth that are higher than those of both retirement savers and the general population."²⁸¹ These characteristics suggested that the families who are taking advantage of the college savings incentives are those who probably would have saved for higher education anyway absent the subsidy.²⁸² What the study did not show was whether the dollars invested in the college savings plans were new savings dollars,

²⁷⁷ See SURREY & MCDANIEL, *supra* note 228, at 103-04.

²⁷⁸ JACKSON, *supra* note 72, at 8. "Participation" as used in the text includes a decrease in the number and amount of credits claimed. *Id.* at 8 tbl. 1.

²⁷⁹ *Id.*

²⁸⁰ STAFF OF JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997—BLUE BOOK 27 (1997), available at <http://waysandmeans.house.gov/Documents.asp?section=8> (follow link to report) [hereinafter TAX LEGISLATION ENACTED IN 1997].

²⁸¹ Dynarski, *Who Benefits*, *supra* note 25, at 365. Dynarski admitted to the deficiencies in using a 2001 Survey of Consumer Finances, as the data set predated the expansion of tax benefits of college savings plans under the 2001 Act. *Id.* at 363. In concluding, Dynarski stated "college savers may become more similar to the typical household with children, and to other savers, as the programs widen in popularity." *Id.* at 365. Since 2001, the amount of funds in state-sponsored 529 plans has ballooned from \$2.5 million to \$8.5 million. TRENDS IN STUDENT AID 2006, *supra* note 2, at 24 fig. 15. Accordingly, the education saver profile might look quite different today.

²⁸² Dynarski, *Who Benefits*, *supra* note 25, at 365; see also Burman et al., *supra* note 25, at 16 (making a similar observation).

or existing savings dollars merely shifted into the new tax- advantaged accounts.²⁸³ In the latter case, no increase in overall savings would result.

3. Complexity

The addition of these tax expenditures for higher education adds complexity to an already complex federal student aid system.²⁸⁴ Complexity potentially limits the effectiveness of the tax benefits as vehicles through which higher education subsidies may be delivered to their intended beneficiaries.

Initially, lack of knowledge of the existence of the various education-related tax benefits slowed expected participation rates. For example, the actual revenue loss to the federal government from 1998–2002 associated with the education-related tax credits was 30% less than the JCT originally estimated.²⁸⁵ Even if taxpayers knew about some of the education related tax provisions, they may not have known about all of them. Although there are five tax expenditures for higher education described above, many more exist, including, inter alia, the exclusion for scholarship income,²⁸⁶ the parental exemption for students aged eighteen to twenty-three,²⁸⁷ penalty-free withdrawals from IRAs,²⁸⁸ student loan interest deduction,²⁸⁹ and the exclusion of interest on qualifying educational bonds.²⁹⁰

Even if a family knows about the various tax benefits for higher education, determining eligibility is a difficult task. Each college tax benefit may differ in AGI limitations and phase-out ranges, definition of qualifying expenses, and annual contribution limits. In addition, some of the tax benefits apply on a per student basis and some tax benefits may apply on a per taxpayer basis.²⁹¹

Once eligibility for the various programs is determined, the issue of choice complexity arises.²⁹² Choosing among the programs for

²⁸³ See Dynarski, *Who Benefits*, *supra* note 25, at 365 n.10.

²⁸⁴ See discussion *supra* Part III.B about complexity in the financial aid needs analysis system.

²⁸⁵ JACKSON, *supra* note 72, at 8.

²⁸⁶ I.R.C. § 117 (2000).

²⁸⁷ *Id.* § 152(c) (3) (A) (ii).

²⁸⁸ *Id.* § 72(t) (2) (E), (t) (7).

²⁸⁹ *Id.* § 221.

²⁹⁰ *Id.* § 135.

²⁹¹ For example, the Hope credit is a per student credit while the LLC is a per taxpayer credit. Compare I.R.C. § 25A(b) (1) (Hope), with I.R.C. § 25A (c) (1) (LLC).

²⁹² The term “choice complexity” is derived from an article by Albert J. Davis, a Ways and Means Committee member in 2002, devoted to describing in detail the is-

which a family is eligible in order to maximize the total benefit received is challenging. One impediment to choosing the optimum mix of college tax expenditures derives from the fact that the subsidy values of the individual tax exceptions are calculated differently. For example, the college tax credits reduce tax payable on a dollar-for-dollar basis, whereas the subsidy value of the education-related deductions and exclusions is calculated by multiplying the amount of the deduction/exclusion by the taxpayer's marginal tax rate. This difference may not be readily apparent to the average taxpayer. Compounding this problem is the fact that all or a part of the subsidy associated with the education-related tax credits may be recaptured under the alternative minimum tax system.²⁹³

Choice complexity is amplified by the fact that Congress enacted coordinating provisions designed to prevent a taxpayer from obtaining multiple tax exceptions for any given dollar of higher education expense. For example, eligible expenses for purposes of the higher education deduction must be reduced by the amount of those expenses covered by the earnings portion of any tax-free distribution from a 529 plan or Coverdell savings account.²⁹⁴ A similar provision prevents a taxpayer from using the same dollar of higher education expense to support an education credit and a tax-free distribution from a college savings plan.²⁹⁵ Still another provision prevents a family from claiming a higher education deduction in any year that an education credit is claimed.²⁹⁶

The coordinating provisions between the tax-favored college savings plans are equally complex. Prior to 2001, a 6% excise tax was imposed on contributions to a Coverdell account if the contributions were made by anyone to a 529 plan for the benefit of the same beneficiary in the same year, and vice versa.²⁹⁷ EGTRRA repealed that excise tax, and now contributions can be made to both types of plans for the benefit of the same beneficiary in the same year.²⁹⁸ However,

sue of complexity at the taxpayer level with regard to choosing among the various tax programs for higher education. See Albert J. Davis, *Choice Complexity in Tax Benefits for Higher Education*, 55 NAT'L TAX J. 509 (2002).

²⁹³ *Id.* at 512; see also Long, *supra* note 233, at 110.

²⁹⁴ I.R.C. § 222(c)(2)(B) (2000 Supp. I).

²⁹⁵ *Id.* §§ 529(c)(3)(B)(v), 530(d)(2)(C)(i).

²⁹⁶ *Id.* § 222(c)(2)(A).

²⁹⁷ STAFF OF JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS—BLUE BOOK 37 (2003), available at <http://waysandmeans.house.gov/Documents.asp?section=8> (follow link to report).

²⁹⁸ Note that this provision effectively writes the annual contribution limit on Coverdell accounts out of the Internal Revenue Code if a family is willing to set up both a 529 plan and a Coverdell account for the same beneficiary.

if distributions from a 529 plan and a Coverdell account on behalf of the same beneficiary are made in a single year, and those distributions exceed the beneficiary's qualified higher education expenses for that year (after a reduction for the expenses covered by the education credits), the excess expenses must be allocated among the distributions to determine the amount excludable under each provision.²⁹⁹ This opaque matrix of coordinating provisions, combined with differences in eligibility criteria and in the calculation of subsidy value, makes it difficult for taxpayers to choose the most beneficial mix of tax benefits.

An additional type of choice complexity unique to 529 plans is directly related to the overwhelming number of programs available to families. Every state and the District of Columbia now offer a college savings 529 plan, and fourteen states and a consortium of institutions offer prepaid 529 plans.³⁰⁰ There are significant substantive differences among the various plans. For example, 529 plans can differ in , the availability of a state income tax deduction, residency requirements, fees, minimum and maximum contribution amounts, refund policies, and the availability of a state guarantee on the rate of return in prepaid plans.³⁰¹ It is a Herculean task to determine at the time the account is created (which may be eighteen years before the funds will actually be used), which plan offers the best combination of benefits for a particular family.

Choice complexity is also affected by the temporary nature and uncertain future of several of the tax provisions enacted under EGTRRA. All of the higher education tax benefits enacted under EGTRRA are subject to the sunset provision of that Act,³⁰² and will automatically expire on their own terms on December 31, 2010 unless an intervening Congress extends them.³⁰³ Additionally, as originally enacted, the deduction for qualified higher education expenses was a temporary provision applicable to tax years 2002–2007

²⁹⁹ I.R.C. §§ 529(c)(3)(B)(vi), 530(d)(2)(C)(ii) (2000 Supp. I).

³⁰⁰ For a complete listing of individual states' plans, see Savingforcollege.com, 529 Plans, http://www.savingforcollege.com/529_plan_details/ (last visited Mar. 3, 2007).

³⁰¹ See generally LEVINE, *supra* note 275, 18–46 (chart detailing state level variances in 529 plans).

³⁰² Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(a), 115 Stat. 38, 150 (2001) (providing that “[a]ll provisions of, and amendments made by, this Act shall not apply (1) to taxable, plan, or limitation years beginning after December 31, 2010”).

³⁰³ Note that the Pension Protection Act of 2006 made the tax benefits of 529 plans enacted under EGTRRA permanent. Pub. L. No. 109-280, § 1304, 120 Stat. 780, 1109 (2006).

only.³⁰⁴ Although this provision was recently extended through 2007, its future remains uncertain.³⁰⁵

The final level of complexity is at the system-wide level. Delivering these educational subsidies through the tax system, rather than through traditional aid channels, shifts the responsibility for their administration and enforcement from the DOE to the IRS.³⁰⁶ The IRS lacks the expertise in the higher education area that the DOE possesses. As a result, the IRS relies heavily on third party reporting by various institutions, including colleges and universities, state agencies, and financial intermediaries to ensure that eligibility requirements are met and that the anti-double dipping rules are not violated. Much of the information requested of these third parties by the IRS is already in the possession of the DOE, resulting in duplication of efforts and burdens.³⁰⁷

V. TREATMENT OF TAX BENEFITS UNDER THE FEDERAL METHODOLOGY

In the previous section, the tax benefits for higher education were analyzed in isolation under the norms of equity, efficiency and complexity. These college tax expenditures for higher education do not operate in a vacuum. They interact with Title IV through the FM. This interaction adds to the complexity of Title IV and detracts from its overall progressiveness.

As previously described, eligibility for need-based financial aid under Title IV is based on a family's demonstrated financial need. Under the FM, need is determined by subtracting from the cost of attendance the student's EFC.³⁰⁸ The EFC is the amount that the federal government expects the family to contribute from its own income and assets before any federal financial assistance will be available. In effect, the FM assesses the income and assets of the family in order to determine their level of unmet need.

Recall that the EFC assessment rates for income are applied to a base called "available income," which is defined as "total income" less certain allowances, including one for federal income taxes payable.³⁰⁹ Recall also that the starting point for calculating "total income" is

³⁰⁴ See I.R.C. § 222(e) (2000 Supp. I).

³⁰⁵ Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 101, 120 Stat. 2922 (2006).

³⁰⁶ See SURREY & MCDANIEL, *supra* note 228, at 106.

³⁰⁷ JACKSON, *supra* note 72, at 21.

³⁰⁸ See *supra* Part III.B.

³⁰⁹ See *supra* notes 125–38 and accompanying text.

AGI. By defining “available income” with reference to AGI and federal taxes payable, the FM inherently incorporates into its base for assessment the effects of any tax preference items that affect AGI and/or federal income taxes payable. The tax benefits for higher education are included in those tax preference items.

It is important to understand the income tax effect of the various tax incentives for higher education before attempting to comprehend how those income tax effects are incorporated into the federal financial aid formula. The deduction for qualified tuition and related expenses reduces a taxpayer’s AGI by the amount deducted.³¹⁰ Reducing AGI by the amount of the education-related deduction in turn reduces the amount of federal income taxes payable. The actual amount of the reduction in taxes payable is equal to the amount of the reduction in AGI multiplied by the taxpayer’s marginal income tax rate.³¹¹ To summarize, claiming an education-related tax deduction causes a simultaneous decrease in AGI and a smaller decrease in income taxes payable. The exclusion of earnings on tax-favored college savings plans has a similar simultaneous effect on a taxpayer’s AGI and federal income tax payable.³¹²

Since the EFC uses “available income” as its assessment tax base, and since “available income” is defined by reference to AGI and the amount of federal taxes payable, the dual income tax effects of claiming an education-related tax deduction or exclusion (decrease in AGI, decrease in federal taxes payable) will be captured by the FM. A reduction in AGI, for income tax purposes, resulting from claiming a higher education-related deduction or exclusion will result in a concomitant reduction in “available income” under the EFC formula. Simultaneously, the reduction in income taxes payable resulting from claiming an education-related deduction or exclusion will cause a smaller increase in “available income,” since income taxes payable is an offset to “available income” under the FM. The net effect is an overall decrease in “available income” under the EFC calculation. This will result in a proportionate decrease in the family’s EFC, which

³¹⁰ I.R.C. § 62(a)(18) (2000 Supp. I). Under these sections, the deduction for qualified tuition and related expenses is “above the line,” or allowable against gross income in arriving at AGI. *Id.*

³¹¹ This calculation becomes more complicated if, as a result of the change in AGI, the taxpayer’s marginal rate bracket changes. For simplicity’s sake, I assume that the reduction in AGI does not change the taxpayer’s marginal rate bracket.

³¹² The effect on AGI of an exclusion from income is equivalent to inclusion of the same amount in gross income coupled with a deduction allowable in arriving at AGI.

will increase its eligibility for need-based Title IV student aid.³¹³ It is worth reflecting on this result—the receipt of a non-need-based federal higher education subsidy in the form of a tax deduction or exclusion will *increase* a family's eligibility for need-based federal higher educational subsidies under Title IV. For example, all else being equal, a parent of a dependent student who is otherwise in the 28% marginal income tax bracket that claims the maximum deduction for tuition and related expenses in 2006 of \$4,000 will see the student's EFC decrease by as much as \$1,354 resulting in an equal increase in the student's eligibility for need-based aid under Title IV in 2007.³¹⁴

While an education-related tax deduction or exclusion simultaneously affects AGI and income tax payable, an education-related tax credit affects only income taxes payable by reducing such amount on a dollar-for-dollar basis by the amount of the credit claimed. Since federal income taxes payable operate as a direct offset to "total income" in arriving at "available income" under the EFC, any decrease in income taxes payable caused by claiming an education-related tax credit should cause an equal increase in "available income." The resulting proportionate increase in the family's EFC should reduce its eligibility for need-based aid under Title IV. However, the expected result is foreclosed by a provision in the HEA that specifically prevents the amount of an education-related tax credit from being taken into account as an asset or income of either the parent or student in calculating the EFC.³¹⁵ As a result, claiming an education credit will

³¹³ The amount of the actual decrease in the EFC will depend on the assessment rate applied to total income under the FM, which in turn depends on whether the students' or parents' EFC is being calculated. A \$1.00 decrease in total income of the student will result in a \$.50 decrease in EFC. *See supra* note 141 and accompanying text. A \$1.00 decrease in the total income of the parent will result in a \$.22 to \$.47 decrease in EFC, depending on the marginal assessment rate applied to the parent's total income under the FM. *See supra* note 137 and accompanying text.

³¹⁴ Total income is decreased by \$4,000. Federal tax payable is decreased by \$1,120 (28% of \$4,000). Accordingly, the net change on available income is \$2,880 (\$4,000 minus \$1,120). Assuming the parent's available income is subject to the highest marginal rate under the FM of 47%, the net decrease in EFC would be \$1,354 (47% of \$2,880). There is a possibility that the amount of any education-related income tax deduction or exclusion could be treated as an item of untaxed income that is added to total income in arriving at available income. However, neither Congress nor the DOE currently requires this treatment, possibly because of the complexity involved in actually accounting for the combined income tax effects of these tax expenditures under the FM. Also, given the preferred treatment of the education-related tax credits under the FM, a good argument can be made that Congress intended these tax benefits for higher education to be in addition to Title IV aid. Therefore, excluding them from consideration as an item of untaxed income under the FM seems proper.

³¹⁵ 20 U.S.C. § 1087v(a)(2) (2000).

not reduce a family's eligibility for need-based aid compared to what it would have been had the credit not been claimed.³¹⁶

The effect of claiming an education-related tax credit on eligibility for need-based Title IV aid should be compared to the effect of claiming an earned income tax credit (EITC). The EITC is refundable tax credit that operates as a wage supplement to low-income working families. The largest beneficiaries of EITC dollars are families with children earning under \$35,000.³¹⁷ Since 84% of Pell grant recipients are from families earning \$40,000 or less, there is substantial overlap in the population receiving the EITC and the Pell grant. The EFC formula, which determines eligibility for a Pell grant, requires the amount of any EITC to be added back to AGI as an item of untaxed income subject to assessment under the FM.³¹⁸ Thus, a low-income family will see its eligibility for Title IV need-based aid decrease as a result of claiming an EITC, while a middle-income family will realize no adverse impact on eligibility for Title IV need-based aid as a result of claiming an education-related credit. This is a particularly harsh result given the fact many lower-income families, who do not have enough positive tax liability to claim an aid system advantaged education-related credit, will be able to claim an aid system disadvantaged EITC because of its refund feature.

To summarize, claiming an income tax deduction or exclusion for higher education increases eligibility for need-based aid under Title IV, while claiming an education-related income tax credit is neutral with regard to eligibility for need-based aid. With regard to the effect of the education-related credits, this was clearly the intended result. A 1998 letter sent by the DOE explicitly expressed the administration's view that the amount of any education-related credit claimed should not displace any Title IV need-based aid.³¹⁹

³¹⁶ The EFC formula technically gets to this result by reducing AGI by the amount of the credit claimed, effectively treating the amount of the credit as an item of taxable income that is excluded from available income when calculating the EFC. FSA HANDBOOK, *supra* note 123, at 17–18 (requiring the amount of any education credit to be listed on Worksheet C Excluded Income).

³¹⁷ ALAN BERUBE, THE NEW SAFETY NET: HOW THE TAX CODE HELPED LOW-INCOME FAMILIES DURING THE EARLY 2000S, at 2 (2006), http://www.brookings.edu/metro/pubs/eitc/20060209_newsafety.pdf.

³¹⁸ 20 U.S.C. § 1087vv(b)(8) (2000).

³¹⁹ Letter ANN-98-16 from Richard W. Riley (December 1998), *available at* http://ifap.ed.gov/dpccletters/doc0497_bodyoftext.htm. Specifically, the letter stated that

[i]n developing these tax credits, we wanted to ensure that they would provide additional help for families to pay for college and not simply substitute for existing sources of financial assistance. At the Federal level, we

However, the aid eligibility effect of claiming a deduction for higher education expenses is probably a result of legislative oversight rather than explicit legislative intent. Considering that Congress enacted the deduction for higher education expenses as an alternative to either of the education-related credits for those families whose AGI exceeded the income thresholds, the difference in aid eligibility effects between the two types of tax subsidies seems irreconcilable. Furthermore, if you account for the difference in distributional impact, the result seems somewhat perverse. The majority of the benefits of the deduction for higher education expenses accrue to families with cash incomes between \$100,000 and \$200,000, whereas the majority of the benefits of the Hope credit and LLC accrue to families with cash incomes between \$50,000 and \$100,000.³²⁰ With regard to eligibility for Title IV aid, it would be difficult to ascribe to Congress an explicit legislative intent to advantage higher-income families claiming the tuition and fees deduction over relatively lower-income families claiming the education-related credits. However, the lack of coordination between the various programs under the two systems of federal college financial aid results in exactly this outcome.

As indicated above, Congress intended the tax deduction and credits for higher education to be in addition to any amounts of financial aid available under Title IV. While it is true that the amount of any education-related credit or deduction claimed under the tax system will not reduce eligibility for a Pell grant under Title IV (it may even increase it), the converse is not also true. The amount of a Pell grant received under Title IV will reduce on a dollar-for-dollar basis the amount of expenses eligible to be claimed as a tuition credit or deduction.³²¹ In one sense, it makes sense to disallow a double federal subsidy for a single dollar of higher education expense. However, this rationale would apply only if the higher education ex-

did not want to force any student to lose a Pell Grant, for example, as a result of benefiting from a tax credit. Consequently, . . . Congress enacted . . . a change to the eligibility formulas to ensure that receipt of a . . . tax credit would not reduce any student's eligibility for Federal student financial assistance.

Id.

³²⁰ Burman et al., *supra* note 25, at tbls. 3–5; *see id.* at tbl. 3 (for a definition of cash income).

³²¹ *See* I.R.C. § 25A(g)(2)(A) (2000) (requiring a reduction in the amount of qualified tuition and related expenses by the amount of any qualified scholarship excludable from gross income under I.R.C. § 117, which would include a Pell grant); *see also id.* § 222(d)(1) (2000 Supp. I) (incorporating by reference the definition of qualified tuition and related expenses from the educational credits, including the offset for the amount of any Pell grant received).

penses covered by a Pell grant are identical to those covered by the education-related credits. In fact, they differ. Pell grants cover a wide range of expenses included in the cost of attendance, including, *inter alia*, books, supplies, transportation, and room and board.³²² On the other hand, the education-related credits and deduction are allowed only with respect to tuition and fees.³²³ To see the potential problem this creates consider this example. Assume that the cost of attending a university is \$2,000, with \$1,000 representing tuition and \$1,000 representing room and board. A student who qualifies for a \$500 Pell grant will only have \$500 in expenses eligible for an education-related tax credit after accounting for the amount of the Pell grant. In effect, the income tax rules assume that a Pell grant is applied first to reduce tuition, before offsetting any other higher education expenses. If the education-related credits and deduction were truly a supplement to Title IV aid, the amount of a Pell grant should be applied first to expenses not otherwise covered by the education-related credits or deduction. In the example, the student would get a \$500 Pell grant and would have \$1,000 in qualifying tuition expenses eligible for the Hope credit or LLC. Congress could also choose to deal with this problem by adopting the same definition of qualifying expenses under both the tax system and Title IV.

The education-related tax deduction and credits are not the only college tax expenditures that interact with Title IV under the FM. Since the EFC formula assesses not only the income but also the assets of a family with a student in college, the income-tax-advantaged educational savings vehicles also potentially interact with the FM. There has been inconsistency over time, and across savings vehicles, as to how to treat the asset balances in these plans under the federal needs analysis.

Prior to 2006, Congress statutorily prescribed the federal methodology's treatment of only prepaid 529 plans. For all of the other education-related savings vehicles, it left the difficult policy questions about their proper treatment under the expected family contribution formula to the DOE. The original HEA rule with regard to prepaid 529 plans required the amount of any distribution from such a plan to be treated as offsetting the cost of attendance under the FM on a dollar-for-dollar basis,³²⁴ thereby reducing the qualified beneficiary's

³²² See 20 U.S.C. § 1087ll (2000) (giving a complete listing of the expenses allowed in calculating the COA).

³²³ See I.R.C §§ 25A (g) (2) (A), 222(d) (1) (2000 Supp. I).

³²⁴ 20 U.S.C. § 1087vv(j) (2000); *see also* Letter GEN-04-02 from Sally Stroup, Assistant Sec'y for Postsecondary Educ. to Colleagues (Jan. 22, 2004) (describing treat-

eligibility for need-based Title IV aid by the dollar amount of the prepaid 529 plan distribution.³²⁵ The prepaid 529 plan balance itself was not further assessed as an asset by the FM.³²⁶

With regard to Coverdell accounts, the DOE originally took the position that these accounts should be treated as an asset of the beneficiary-student in calculating the student's EFC under the FM.³²⁷ This treatment by the FM resulted in the balance in a Coverdell account reducing a student's eligibility for need-based Title IV aid at rate of 35% per year.³²⁸ In addition, since there was no asset protection allowance applied to a student's contribution from assets under the EFC formula, the entire balance of a Coverdell account was subject to assessment.³²⁹

Prior to 2006, the DOE treated 529 savings plans (as opposed to 529 prepaid plans) as assets of the account owner, which were entered into the calculation of a student's EFC only if the student or parent were the owner.³³⁰ The FM treated a student-owned 529 savings plan identically to a Coverdell account. On the other hand, a parent-owned 529 savings plan was assessed by the EFC formula at the more favorable parental asset rates.³³¹ Accordingly, the balance in a parent-owned 529 savings plan was subject to a maximum assessment rate of only 5.64% per year.³³² In addition to a lower marginal assessment rate, the effective assessment rate applied to a parent-owned 529 savings plan was even lower because of the availability of an asset protection allowance.³³³ In addition, a 529 savings plan for the benefit of a student could avoid assessment by the FM if a grandparent or other relative owned the account.

ment of 529 prepaid plans under FM), *available at* <http://www.ifap.ed.gov/dpclatters/GEN0402.html>.

³²⁵ Recall that under the FM, need is equal to COA less the EFC. Accordingly, reducing the COA by the amount of the prepaid 529 plan distribution resulted in an exactly equivalent reduction in need. *See generally* LINDA LEVINE & CHARMAINE MERCER, CONG. RESEARCH SERVICE, TAX FAVORED HIGHER EDUCATION SAVINGS BENEFITS AND THEIR RELATIONSHIP TO TRADITIONAL FEDERAL AID, 2006, at 21–28 (2006).

³²⁶ FSA HANDBOOK, *supra* note 123, at 20.

³²⁷ *See* 2001–2002 FEDERAL STUDENT AID HANDBOOK, APPLICATION AND VERIFICATION GUIDE 22 (2001), *available at* <http://www.ifap.ed.gov/sfahandbooks/attachments/0102AVGCh2appquestions.pdf> [hereinafter FSA HANDBOOK 2001–2002] (providing that Education IRAs should be treated as an asset of the student).

³²⁸ *See supra* note 142 and accompanying text.

³²⁹ *See* note 142.

³³⁰ *See, e.g.*, FSA HANDBOOK 2001–2002, *supra* note 327, at 23; Letter from Stroup, *supra* note 324.

³³¹ *See supra* note 138 and accompanying text.

³³² *See id.*

³³³ *See supra* notes 133–34 and accompanying text.

In early 2004, the DOE changed course regarding the treatment of Coverdell accounts by the FM. In a “Dear Colleague” letter to all financial aid officers, the DOE provided a “clarification on the treatment of . . . educational savings plans in the determination of . . . eligibility for Federal student aid.”³³⁴ The letter indicated that Coverdell accounts would be treated the same as 529 savings plans under the FM.³³⁵ As a result, the asset balances in Coverdell accounts education savings plans were treated as an asset of the account owner in calculating the student’s EFC. This allowed parent-owned Coverdell accounts to enjoy the lower assessment rate and the asset protection allowance normally applied to parental assets under the EFC. The difference in treatment between prepaid 529 plans, on the one hand, and college savings 529 plans and Coverdell accounts, on the other hand, remained.

Under HERA 2005, Congress fixed this anomaly by repealing the provisions of Title IV that treated distributions from prepaid 529 plans as offsetting the COA on a dollar-for-dollar basis.³³⁶ Congress also provided that no matter who owned the account, the asset value in a tax-favored college savings plan would not be considered as an asset of a dependent student under the FM.³³⁷ These two changes removed the historical competitive disadvantages of prepaid 529 plans as compared to 529 savings plans and Coverdell accounts. According to the DOE, the net result of these changes with regard to dependent students is that the only way the value of an income-tax advantaged college savings plan would be included in the calculation of a student’s EFC is if the parent were the account owner.³³⁸

While Congress aligned the treatment of all types of tax-favored college savings plans under Title IV, questions still remain as to whether the current treatment is the proper one. The most glaring problem with the statutorily-prescribed treatment of college savings plans under the FM is the ability to completely escape assessment by simply naming a grandparent, other relative, or close advisor as the account owner. Escaping assessment means that the college savings

³³⁴ Letter from Stroup, *supra* note 324.

³³⁵ *Id.*

³³⁶ 20 U.S.C.A. § 1087vv(f)(5) (West 2006) (creating a new category of assets named qualified education benefits and including in that category both types of 529 plans and Coverdell accounts).

³³⁷ *Id.* § 1087vv(f)(3).

³³⁸ Letter GEN-06-05 from Susan Beaudoin, Office of Postsecondary Educ., and Theresa S. Shaw, Chief Operating Officer Fed. Student Aid (April 2006) *available at* <http://www.ifap.ed.gov/dpclatters/GEN0605.html> (discussing changes made by HERA 2005 to certain provisions of Title IV of the HEA).

plan balance, no matter how large, will not be counted as a resource available to be put towards the student's higher education expenses under the FM. This leads to inequities in the overall distribution of Title IV funds. Consider two students, each with equal amounts of family income and wealth, both of whom are applying for Title IV need-based aid in order to attend the same four-year public undergraduate institution. However, one student is the beneficiary of a grandparent-owned 529 plan with a balance of \$11,000.³³⁹ Under the current rules, both students will qualify for the same amount of Title IV need-based aid, despite the fact that the 529 plan beneficiary's actual need is less than the other student's need.³⁴⁰

Perhaps this should not be considered too much of an equity problem because any Title IV need-based aid claimed will displace the 529 funds and leave a balance remaining in the account upon matriculation, necessitating a non-qualifying distribution incurring an income and penalty tax.³⁴¹ The response to this argument is three-fold. First, in the event that excess funds remain in the 529 plan upon matriculation, the liberal rollover and change in beneficiary rules for 529 plans would allow the grandparent to rollover the account balance to another grandchild's account or simply name another grandchild as beneficiary to avoid the consequences of a non-qualifying distribution.³⁴² Additionally, even if a rollover or benefi-

³³⁹ The average account balance in a college savings 529 plan in 2006 was \$10,569. TRENDS IN STUDENT AID 2006, *supra* note 2, at 24 fig. 15.

³⁴⁰ One criticism of this example is that it is unlikely to occur because a student with a 529 plan balance this large would probably come from a wealthy family and would not qualify for need-based Title IV aid. While this may be true with regard to Pell grant recipients, it is not true with regard to subsidized federal student loan recipients. In 2003–2004, 24.5% of dependent students from families with incomes between \$80,000 and \$99,999, and 11.2% of dependent students from families with incomes over \$100,000, received subsidized federal student loans. BERKNER ET AL., *supra* note 109, at 14 tbl. 5.

³⁴¹ This would occur under the facts as given under several reasonable assumptions. If we assume the student attended a public four-year institution as an in-state resident where the average cost of attendance was \$16,357 per year in 2005–2006, the student would need a total of \$65,428 to cover his total cost of attendance over a four-year period. TRENDS IN COLLEGE PRICING 2006, *supra* note 96, at 6 fig. 2. In addition, if we assume the dependent undergraduate student received the 2003–2004 average amount of federal loans, grants, and work-study awards, then Title IV aid would amount to \$9,500 per year, or \$38,000 over a four-year period. STUDENT FINANCIAL AID ESTIMATES, *supra* note 109, at 5. The sum of Title IV aid plus the 529 plan balance would be \$49,000. Under these average assumptions, there would be \$16,428 remaining in the 529 plan at the end of the four years, assuming the grandparent requires the student to exhaust his or her Title IV aid before 529 plan distributions would be made.

³⁴² See *supra* notes 206–08 and accompanying text.

ary change is not possible, a penalty tax may not apply because of the exception for a distribution on account of a scholarship or other allowance.³⁴³ Lastly, even if an income and penalty tax is imposed on the 529 plan beneficiary, it does not help the other student whose share of Title IV need-based aid was less because of having to share the limited pool of federal Title IV funds with the 529 plan beneficiary.

It is also not clear that an income and penalty tax overcomes the exclusion of the asset from assessment under Title IV in the first instance. These tax-favored savings plans represent funds specifically set aside to pay for the designated beneficiary's postsecondary education expenses. It seems odd that the FM does not count these assets as resources available to be put towards this very purpose. While the exemption of home equity and retirement assets from assessment under Title IV may be justified by a balancing of conflicting federal policies with regard to encouraging education, home ownership, and retirement savings, no such conflicting policy exists with regard to college savings plans. Indeed, the income tax exemption granted to these plans is premised on the funds being actually put towards the payment of higher education expenses. Title IV should further this income tax policy by capturing the balances in college savings plans under the EFC formula as assets available to pay for college.

VI. CONSOLIDATION AND COORDINATION

This Part illustrates that significant equity, efficiency, and simplicity gains in the overall distribution of federal higher education dollars can be realized by consolidating substantially similar college tax programs and by coordinating the benefits provided under both tax and transfer systems to achieve an overall progressive distribution in federal higher education dollars.

A. Consolidation

1. Grant-Like Tax Programs

The Hope scholarship credit, the LLC, and the higher education tax deduction all operate as tuition subsidies reimbursing families for tuition payments previously made. These substantially similar grant-like higher education tax programs should be consolidated into a

³⁴³ See I.R.C. §§ 529(d)(6), 530(d)(4)(B)(iii) (2000 Supp. I) (note the exception to penalty taxation only applies "to the extent the amount of the payment or distribution does not exceed the amount of the scholarship, allowance, or payment").

single refundable college tax credit with an advance payment feature.³⁴⁴ This type of tax subsidy would be distributionally superior to the existing education-related credits and deduction. Furthermore, a single refundable college tax credit with an advance payment mechanism is more likely than any of the existing tuition tax subsidies to further the dual public policy goals of increased access and affordability in higher education.³⁴⁵ Lastly, a consolidated college tax credit will reduce choice complexity at the taxpayer level.

Similar to its nonrefundable brethren, a refundable tax credit reduces income tax payable on a dollar-for-dollar basis regardless of the taxpayer's marginal income tax rate bracket.³⁴⁶ This avoids the regressive distribution of benefits associated with the tuition tax deduction.³⁴⁷ However, a refundable tax credit goes further, delivering its subsidy to an eligible family regardless of the existence or level of income tax payable.³⁴⁸ After reducing income tax to zero, a family with excess credit eligibility would receive a cash payment from the government in the amount of such excess.³⁴⁹ Disconnecting the level of the subsidy from the amount of income tax owed mitigates the distributional defects associated with the Hope credit and the LLC.³⁵⁰

Recall that to be most effective, higher education subsidies should be targeted at the most price-sensitive and underrepresented college student population, that is, lower-income students.³⁵¹ Title IV attempts to target its need-based financial aid programs in this manner.³⁵² To capture Title IV's preferred progressive distribution pattern, the maximum refundable education tax credit amount should

³⁴⁴ See Susan Dynarski & Judith Scott-Clayton, *Simplify and Focus the Education Tax Incentives*, 111 TAX NOTES 1290 (June 12, 2006) (arguing for a similar single, refundable tax credit delivered at the time of college enrollment).

³⁴⁵ Although this Article speaks of efficiency in terms of the ability of the college tax expenditures to achieve their stated public policy goals, a recent article made a strong economic efficiency argument for using a uniform refundable tax credit as the default form of tax incentive when the goal of the government in enacting the tax provision is to induce socially desirable behavior generating positive externalities. See Batchelder et al., *supra* note 230.

³⁴⁶ See *supra* notes 232–33 and accompanying text.

³⁴⁷ See *supra* notes 228–30 and accompanying text.

³⁴⁸ SURREY & MCDANIEL, *supra* note 228, at 109–10 (recognizing that refundable credits would allow nontaxpayers to participate in tax expenditure programs but arguing that if the credit amount itself is not taxable, then an additional tax expenditure arises, which “will have the same upside-down effect as a deduction or exclusion”).

³⁴⁹ *Id.*

³⁵⁰ See *supra* notes 233–40 and accompanying text.

³⁵¹ See *supra* Part II.C.

³⁵² See *supra* Part III.B.

decrease incrementally as family income increases, with benefits phasing out up to a predetermined AGI level.³⁵³ An AGI cap would prevent windfalls to higher-income taxpayers who would have attended college anyway with or without the subsidy.³⁵⁴

Furthermore, to address the timing disadvantage associated with the current tuition tax credits, the new refundable college tax credit should offer an advance payment option.³⁵⁵ Recall that the current education-related tax credits and deduction operate as reimbursements for tuition payments previously made.³⁵⁶ These subsidies simply come too late to meaningfully impact the college enrollment decisions of families lacking the financial wherewithal to pay tuition payments as they fall due. An advance payment feature would allow a family to claim the subsidy at the time the tuition bill is due and payable, rather than waiting until April 15th of the following year. This enhances the ability of the new college tax credit to induce enrollment in students from liquidity constrained families. Both the EITC³⁵⁷ and health coverage tax credit³⁵⁸ currently offer an advance payment mechanism.

³⁵³ See Batchelder et al., *supra* note 230, at 27–28 (arguing that uniform refundable tax credits are more economically efficient with regard to tax incentives intended to encourage behavior generating positive externalities but conceding that non-uniform tax credits may be justified if there are “differences in externalities and elasticities by income class”).

³⁵⁴ Although this would create steep marginal combined tax and transfer rates in the consolidated college tax credit phase-out range, such a result is observed in all income-tested transfer programs. See Alstott, *supra* note 255, at 550 (providing graphic illustration of the increase in marginal rates at different income levels that results in the phase-out range of the earned income tax credit in a hypothetical combined tax and transfer fiscal system).

³⁵⁵ See Dynarski & Scott-Clayton, *supra* note 344.

³⁵⁶ See *supra* notes 267–68 and accompanying text.

³⁵⁷ I.R.C. § 32 (2000). The earned income credit advance payment feature allows taxpayers to receive the credit amount over the course of the year in their regular paychecks through reduced withholding. *Id.* § 3507. However, the advance payment feature is rarely utilized. In 1998, only 1.1% of EITC recipients used the advance payment option. Joseph Hotz & John Karl Scholz, *The Earned Income Tax Credit, in MEANS-TESTED TRANSFER PROGRAMS IN THE UNITED STATES* 58 (Robert A. Moffitt ed., 2003), cited in David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 1022 (2004); see also George K. Yin et al., *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 AM. J. OF TAX POL’Y 225, 257–58 (1994) (discussing of the possible causes of the low take-up rate for the advance EITC).

³⁵⁸ I.R.C. § 35 (2000 Supp. II). The health coverage tax credit, enacted in 2002, is a refundable tax credit equal to 65% of the cost for coverage under a qualified health insurance plan for certain eligible individuals. *Id.* § 35(a). Under the advance payment option, the federal government pays 65% of the health insurance premium each month directly to the insurer. See generally Health Coverage Tax

To make college more affordable, a financial subsidy must meaningfully affect net price, including all relevant costs. Qualified expenses for purposes of the education-related tax credits and deduction include only tuition and fees.³⁵⁹ Title IV, on the other hand, allows its grants to subsidize the entire cost of attendance, including room, board, books, transportation expenses, etc.³⁶⁰ All of these costs factor into a student's cost-benefit analysis when making the enrollment decision. Accordingly, in order to enhance the ability of the consolidated refundable college tax credit to increase college attendance by decreasing cost, the new tax credit should adopt Title IV's expanded definition of COA.³⁶¹ Harmonization of the definition of qualified expenses should also avoid certain anomalies associated with the interaction between the two systems when differing eligible expense definitions apply.³⁶²

Simplicity gains can be realized by reducing choice complexity faced by taxpayers in determining which of the current tuition tax subsidies for which they are eligible provides the greatest benefit.³⁶³ Recall that the tuition tax deduction and the tuition tax credits have different AGI limitations.³⁶⁴ Additionally, the subsidy value of the tuition tax deduction is calculated differently from that of the tuition tax credits.³⁶⁵ Furthermore, the maximum Hope scholarship amount is determined under a different formula than the maximum LLC amount.³⁶⁶ A single refundable college tax credit with a uniform set of eligibility criteria and a single subsidy value and maximum amount would be less complex than the current matrix of tuition tax subsidy rules. Simple financial aid programs are the ones most likely to affect access.³⁶⁷

Credit (HCTC) Overview, *available at* <http://www.irs.gov/individuals/article/0,,id=109960,00.html> (last visited Sept. 25, 2007).

³⁵⁹ See *supra* note 169 and accompanying text (listing eligible expenses for purposes of Hope credit, LLC, and tuition deduction).

³⁶⁰ See *supra* note 121 and accompanying text (defining COA under FM which determines Pell grant eligibility).

³⁶¹ Using the same definition of qualified higher education expenses under the tax system and Title IV would enhance their compatibility and allow better coordination between the two systems.

³⁶² See *supra* notes 321–23 and accompanying text.

³⁶³ See *supra* Part IV.B.3.

³⁶⁴ Compare *supra* note 176 and accompanying text, with note 187 and accompanying text.

³⁶⁵ Compare *supra* note 228 and accompanying text, with notes 232–33 and accompanying text.

³⁶⁶ Compare *supra* note 173 and accompanying text, with note 178 and accompanying text.

³⁶⁷ Dynarski & Scott-Clayton, *supra* note 147, at 319–20.

2. Tax-Favored Savings Programs

Currently, college savers must choose between investing in a 529 plan or a Coverdell account. Both types of college savings options offer federal tax advantages designed to induce more college savings. However, the form of the tax exception, an exclusion from income for earnings on plan balances, provides the largest benefits to the wealthiest taxpayers, those most likely to save even in the absence of a subsidy.³⁶⁸ Little or no tax benefit is provided to lower-income families, those most in need of an inducement to engage in college savings.³⁶⁹ This result is not only distributionally problematic, but it also hampers the ability of these plans to achieve their public policy goal of increasing college savings. Furthermore, the sheer number of college savings plan options creates choice complexity at the taxpayer level, which itself may prove a barrier to entry for the novice potential college saver.³⁷⁰ To address these equity, efficiency, and simplicity concerns, the existing college savings options should be consolidated into a single college savings plan with a federal match for lower-income families.³⁷¹

Consolidation of the tax-favored college savings plans into a single college savings vehicle would simplify the savings process once the college savings decision was made, but it would not induce more college savings among those lower-income families, who are least likely to save. In order to stimulate new college savings, contributions to the new consolidated college savings vehicle by low-income families should be accompanied by a federal match, in the form of a refundable tax credit deposited directly into the college savings account. This would allow lower-income families to realize an educational subsidy from investing in tax-favored college savings plans without regard to their marginal income tax rate bracket. A similar credit already exists that provides up to a \$2,000 federal match for voluntary contributions to qualified retirement plans for certain qualified individuals.³⁷² The match rate under the existing retirement saver's credit is progressive, with the match percentage decreasing as family income increases.³⁷³ A college saver's credit with a similar design would not only reduce the regressivity associated with the benefit provided un-

³⁶⁸ See *supra* notes 228–29 and accompanying text; see also Part IV.B.2.c.

³⁶⁹ See *id.*

³⁷⁰ See *supra* Part IV.B.3.

³⁷¹ The consolidated college savings plan could continue to allow for both prepaid and college savings types of accounts.

³⁷² I.R.C. § 25B(a) (2000 Supp. I).

³⁷³ See *id.* § 25B(b).

der existing college savings plans but would also increase the likelihood that the consolidated program would capture new college savings dollars.³⁷⁴ To further mitigate regressivity, AGI limitations, similar to those set forth currently for Coverdell accounts, should be imposed on contributors.³⁷⁵

A single college savings vehicle with one set of eligibility criteria will reduce choice complexity at the taxpayer level. For the reasons cited above, the definition of eligible expenses under the new consolidated savings program should be identical to the definition of COA under Title IV.³⁷⁶ Coordinating provisions between the consolidated savings plan and the consolidated college tax credit will still be needed to prevent multiple tax exceptions for the same dollar of higher education expense. However, such provisions will be less extensive than those currently in place because there will only be two tax expenditures for higher education requiring coordination.

Finally, annual contribution limits should apply to bring the new consolidated college savings plan in line with other tax-advantaged retirement and health care individual savings accounts.³⁷⁷ By imposing annual contribution limits, the ability of the highest income taxpayers to use these accounts as conduits through which to make transfer-tax advantaged gifts for non-educational purposes is reduced.³⁷⁸ To further ensure that the funds in these accounts are used for their intended purposes, the current income and penalty tax structure should apply to the new consolidated college savings program.³⁷⁹

B. *Coordination Between Tax System and Title IV*

Part V described how the current treatment by the FM of the tax benefits for higher education produces inequitable results with regard to eligibility for need-based Title IV financial aid. Claiming an education-related deduction or exclusion effectively increases eligibility for need-based Title IV aid.³⁸⁰ Claiming an existing tuition tax credit does not affect Title IV need-based aid eligibility, even though

³⁷⁴ See *supra* Part IV.B.2.c.

³⁷⁵ See *supra* note 227 and accompanying text.

³⁷⁶ See *supra* notes 359–62 and accompanying text.

³⁷⁷ See I.R.C. § 408(a)(1) (2000) (annual contribution limits on traditional individual retirement accounts); *id.* § 408A(c)(2) (annual contribution limits on Roth individual retirement accounts); § 223(b) (2000 Supp. II) (annual contribution limits on health savings accounts).

³⁷⁸ See *supra* notes 245–46 and accompanying text.

³⁷⁹ See *supra* notes 201–05, 220 and accompanying text.

³⁸⁰ See *supra* note 313 and accompanying text.

under the FM it should.³⁸¹ The tortured history of the Title IV treatment of tax-favored college savings plans resulted in legislation that effectively allows families to self-exempt college savings plan balances from assessment under the FM.³⁸² These anomalies are largely due to a lack of coordination between the benefits provided under the two systems; however, in some cases, it is a direct result of congressional coordinating directives that aid families able to claim benefits under both systems. Accordingly, in order to preserve the progressivity gains in the distribution of federal dollars for higher education realized by consolidating substantially similar tax benefits, this section describes how the consolidated educational tax subsidies should be treated by the FM under Title IV.

The current education-related tax credits were intended to complement Title IV aid rather than displace it.³⁸³ This is an acceptable policy goal if all families who qualify for need-based Title IV aid can also claim the tuition tax credits. With regard to lower-income families, this is generally not the case.³⁸⁴ After consolidation, however, lower-income families could participate in both the refundable college tax credit program and Title IV need-based aid programs. Accordingly, it seems proper to continue to disregard the amount of the consolidated college tax credit for purposes of determining eligibility for need-based Title IV aid under the FM. This would increase the overall progressivity in the distribution of federal dollars for higher education, since more total student financial aid would be available to lower-income families.³⁸⁵

Furthermore, a single consolidated refundable tax credit uniformly ignored under Title IV will avoid the existing anomalies between the FM treatment of the higher education deduction versus the education-related credits.³⁸⁶ Under the current system, a taxpayer deciding between a tuition tax credit or deduction needs to account not only for differing subsidy values under the tax system but also for

³⁸¹ See *supra* notes 315–16 and accompanying text.

³⁸² See *supra* notes 324–38 and accompanying text.

³⁸³ See *supra* note 319 and accompanying text.

³⁸⁴ See *supra* notes 228–30 and accompanying text.

³⁸⁵ This results because lower-income families could claim the maximum refundable tax credit amount without negatively impacting their eligibility for Title IV need-based aid. Middle-income taxpayers would qualify for less Title IV aid because of their reduced level of financial need and may be limited in claiming the maximum refundable tax credit amount if they are in the phase-out range (and totally excluded from credit eligibility if their AGI exceeds the statutory limitation).

³⁸⁶ Compare *supra* notes 313–14 and accompanying text, with *supra* notes 315–16 and accompanying text.

differing treatment of each type of tax expenditure by the FM. Consolidation and coordination should make the post-income-tax, post-FM-assessment, subsidy value of the consolidated college tax credit more transparent.

Ignoring the new college tax credit under Title IV also harmonizes its FM treatment with that of a Pell grant. Currently, the amount of any Pell grant received by a student is statutorily excluded from consideration as income or an asset under the FM.³⁸⁷ Aligning the FM treatment of a Pell grant recipient with a consolidated college tax credit recipient recognizes the similarities between the two types of federal student aid programs. Both are grant-like tuition subsidies that are simply delivered through two different distribution channels.³⁸⁸

The FM should capture the balance in a new consolidated college savings plan as an asset available to be put towards the designated beneficiary's higher education expenses. To recap, under the changes made by HERA, the balance in any type of tax-favored college savings plan is treated as an includable asset under the FM only if the parent is the account owner.³⁸⁹ For those parent-owned plans captured by Title IV, plan balances are assessed at an annual rate of 5.64%, and then only if the plan balances exceed the existing asset

³⁸⁷ 20 U.S.C. § 1087vv(a) (2) (2000) (excluding any "portion of any student financial assistance received from any program" from the expected contribution formula as income or an asset). Absent this provision, a Pell grant, which is excluded from gross income under I.R.C. § 117, may be considered an item of untaxed income that is added to the student's AGI in arriving at student total income under the EFC formula. *See supra* note 128. The result of this would be to increase available income and proportionately decrease eligibility for need-based Title IV aid.

³⁸⁸ The similarity between Pell grants and tuition tax subsidies led Dynarski and Scott-Clayton to argue for consolidation of Pell grants and existing tuition tax subsidies into a simple, single grant program administered through the DOE, using information supplied by the IRS. SUSAN M. DYNARSKI & JUDITH SCOTT-CLAYTON, THE HAMILTON PROJECT, COLLEGE GRANTS ON A POSTCARD: A PROPOSAL FOR SIMPLE AND PREDICTABLE FEDERAL STUDENT AID (2007), http://www3.brookings.edu/views/papers/200702dynarski-scott-clayton_pb.pdf; *see also* David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004) (arguing that substantially similar tax and spending programs should be integrated when such integration would result in better achievement of the public policy at issue and that the choice between integration into the tax system or the spending system should be a matter of institutional design). *But see* Nancy Staudt, *Redundant Tax and Spending Programs*, 100 NW. U. L. REV. 1197 (2006) (arguing that even if integration of similar tax and spending programs were politically possible, it may result in sole control over the integrated program being vested in a single Congressional committee, resulting in a normatively unappealing shift from a system of parallel decision-making to one of hierarchical decision-making).

³⁸⁹ *See supra* notes 336–38 and accompanying text.

protection allowance.³⁹⁰ An account owned by a student, non-parent relative, or close advisor is effectively exempted from assessment under the EFC formula. In effect, the tax system provides an exemption for non-parent owned college savings plans to encourage college savings but Title IV does not consider those savings as available for the payment of college expenses.

The current treatment by the FM of college savings balances is too generous and easily manipulated. However, if the FM required the entire plan balance to offset eligibility for need-based Title IV aid, families may refrain from investing in these plans and the goal of increasing college savings would be hampered. Accordingly, to ensure that Title IV captures plan balances, but not in an unduly harsh way that deters families from engaging in saving for college, the FM should treat the consolidated college savings plan as an asset of the designated beneficiary. This was the original approach of the DOE with regard to the needs analysis treatment of Coverdell accounts.³⁹¹ Under current law, this would result in plan balances being subject to assessment under the EFC formula at an annual rate of 20%.³⁹² Since there is no asset protection allowance provided for student assets, the first dollars in the plan would be subject to assessment.

Treating the new consolidated college savings plans as student assets under the FM would accomplish three important goals. First, it would align the goals of the tax system and Title IV with regard to these plans. The federal government offers an income tax exemption to these plans to encourage savings for future college expenses. Title IV should further this goal by capturing the value in these accounts as available to be put towards their intended purpose. Second, it reduces the inequity associated with the current advantaged position these assets hold under Title IV as compared to other non-tax advantaged forms of savings.³⁹³ Lastly, by more accurately reflecting a family's reduced level of need as a result of the existence of a college savings plan, it increases the overall progressivity in the distribution of Title IV aid.

³⁹⁰ See *supra* notes 249–50 and accompanying text. This would result in a cumulative assessment rate of 21% over a four-year period. *Id.*

³⁹¹ See *supra* notes 327–29 and accompanying text.

³⁹² See *supra* note 143 and accompanying text. This would result in a cumulative assessment rate on the college savings plan balance of 59% over a four-year period. See *supra* note 250 (author's own calculation using described formula).

³⁹³ See *supra* notes 339–40 and accompanying text.

VII. CONCLUSION

Attending college is more important and more expensive than ever. For many potential college students, financial constraints remain a barrier to access. Traditionally, the federal government assisted college students through the progressive spending programs under Title IV. Over the past decade, however, the federal government increasingly turned to tax expenditures as a way to mitigate the effects of rising college costs. The addition of the tax benefits for higher education introduced an unsavory amount of regressivity into the overall distribution of federal dollars for higher education. Distributionally, the college tax benefits favor middle- and upper-income families and provide little or no benefit to lower-income families. Middle-income families can potentially claim educational benefits under both Title IV and the tax system, while lower-income families are effectively limited to Title IV subsidies only. Furthermore, the favorable treatment that these college tax subsidies receive under the FM advantages those middle-income families who claim benefits under both systems. This interaction between the two systems magnifies the distributional inequities associated with the tax benefits for higher education standing alone. Consolidating substantially similar college tax programs and coordinating them with Title IV under the FM can make significant equity and simplicity gains. Furthermore, the federal government is more likely to achieve its public policy goals in providing financial aid, namely, expanding college access, affordability, and savings.