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George Salimbas

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EDUCATIONAL OPPORTUNITIES FOR TAXPAYERS

George Salimbas, JD, LL.M

I. INTRODUCTION

This article examines each of the educational opportunities contained within the Internal Revenue Code of 1997 (herein "Tax Code"), and considers three main issues. First, what opportunities does the Tax Code provide? Second, which taxpayers qualify for these opportunities? Lastly, how many taxpayers claimed these opportunities last year and why? The result of this examination demonstrates that the Tax Code provides substantial tax incentives for taxpayers in the ten percent tax bracket to acquire a post-secondary education.¹

To set the stage for discussion of these topics it is necessary to define an educational opportunity. An educational opportunity, for purposes of this article, is a tax credit, deduction, exemption or savings plan. Essentially, it is a congressionally created educational financing or savings incentive to help taxpayers obtain a post-secondary education. Currently, there are twelve different educational opportunities aimed at providing assistance to lower-income taxpayers.²

Since the opportunities are provided in the way of a credit, a deduction, an exemption or as a savings plan, it is necessary to use a consistent method for purposes of comparison. The method employed by this article is a tax liability reduction percentage, which is the amount that claiming a particular opportunity for educational expenditures reduces the taxpayer's overall tax liability.

Part II is a definitional section for the phrases and terms that are repeatedly used throughout this article. Unless otherwise stated, each phrase and term is defined as listed in this part.

Part III contains a detailed examination of the law for each opportunity. Examples are employed to determine the tax utility of each op-

1 See *infra* Part IV.

2 See *infra* notes 6-16 and accompanying text.

portunity, and also provide suggestions for improvement. These results are listed in Appendices One through Five and Ten.

Part IV first determines which taxpayers qualify for the various opportunities by looking solely to the income limitations set forth in each opportunity. Next, it employs a control test example to determine which of the opportunities reduces the tax liability of a ten percent tax bracket taxpayer by the greatest percentage. It also considers two surveys to see how many taxpayers claimed these opportunities last year and why. These results are listed in Appendices Six through Nine.

As intended by Congress, the Tax Code provides substantial tax incentives for taxpayers in the ten percent tax bracket to acquire a post-secondary education.³ For these taxpayers, the most beneficial opportunity is the Hope Scholarship Credit, since it potentially may reduce tax liability to zero.⁴ For all other taxpayers, the most beneficial opportunity is a Qualified Tuition Program, since it provides the greatest flexibility for investing at minimal taxable gain.⁵

II. TERMINOLOGY

A. Statutorily Defined Terminology

The “Double Benefit Limitation” prohibits the taxpayer from claiming two or more educational opportunities for the same educational expense. The Tax Code accomplishes this by reducing total qualified educational expenditures by each opportunity claimed by the taxpayer. This limitation applies to the following twelve opportunities: (1) Hope Scholarship and Lifetime Learning Credits,⁶ (2) early withdrawals from Individual Retirement Plans,⁷ (3) scholarships and fellowship grants,⁸ (4) Employer-Provided Educational Assistance Programs,⁹ (5) Educational Savings Bond Programs,¹⁰ (6) ordinary and necessary business deductions,¹¹ (7) Tuition and Related Expense Deductions,¹² (8) Qualified Tui-

³ 145 CONG. REC. S8415 (1997) (statement of Sen. George Miller).

⁴ See *infra* Part III Section 25A.

⁵ See *infra* Part III Section 529.

⁶ See generally I.R.C. § 25A (West 2002) (defining Hope Scholarship and Lifetime Learning Credits).

⁷ See generally *id.* § 408 (defining Individual Retirement Accounts).

⁸ See generally *id.* § 117 (defining Qualified Scholarships).

⁹ See generally *id.* § 127 (defining Employer-Provided Educational Assistance Programs).

¹⁰ See generally *id.* § 135 (defining Educational Savings Bond Programs).

¹¹ See generally I.R.C. § 162 (West 2002) (defining ordinary and necessary business deductions).

¹² See generally *id.* § 222 (defining Tuition and Related Expense Deductions).

tion Programs,¹³ (9) Coverdell Educational Savings Accounts,¹⁴ (10) Educational Assistance Programs,¹⁵ (11) Veterans' Assistance Programs, and (12) any other nontaxable payments received by the taxpayer.¹⁶ The Charitable Contribution Deduction,¹⁷ the tax-free discharge of student loan indebtedness,¹⁸ and the Student Loan Interest Deduction¹⁹ do not reduce the total qualified educational expenses available to the taxpayer, and therefore the double benefit limitation does not apply to them.

An "Eligible Educational Institution" is any college, university, vocational school, or other post-secondary educational institution eligible to participate in any of the student aid programs administered by the Department of Education.²⁰ This includes all accredited private, public, religious and secular educational institutions.²¹

An "Eligible Student" or "Student" is carrying at least half the normal full-time workload for the course of study that the student is pursuing at an eligible educational institution.²² Further, the eligible student cannot have been convicted of a felony drug charge,²³ and must be a United States citizen or resident alien.²⁴ An eligible student may include the taxpayer, his spouse, or his dependents.²⁵

"Payments" may include cash, and even loan proceeds to pay for qualified educational expenses, as long as the loan was obtained from a qualified lender.²⁶ Moreover, if someone other than the taxpayer makes a payment directly to an eligible educational institution for an eligible student's qualified educational expenses, then the student is treated as having received the payment directly from such person.²⁷ This allows for the

¹³ See generally *id.* § 529 (defining Qualified Tuition Programs).

¹⁴ See generally *id.* § 530 (defining Coverdell Educational Savings Accounts).

¹⁵ 20 U.S.C. § 1089(a) (2000). Secretary in this section is the Secretary of Education. *Id.* § 3404. See also *id.* § 1077 (2000).

¹⁶ Nontaxable payments are gifts, bequests, devises, inheritances or qualified loans as defined by I.R.C. § 102 (West 2002).

¹⁷ See generally I.R.C. § 170 (West 2002) (defining Charitable Contribution Deductions).

¹⁸ See generally *id.* § 108 (defining discharge of student loan indebtedness).

¹⁹ See generally *id.* § 221 (defining Student Loan Interest Deductions).

²⁰ 20 U.S.C. § 1088 (2000). An Eligible Educational Institution is described in section 481 of the Higher Education Act of 1965, and is eligible to participate in a program under Title IV of the Act. *Id.*

²¹ See *id.* § 1088(b).

²² *Id.* § 1091(b)(3). An Eligible Student satisfies the requirements of section 484(a)(1) of the Higher Education Act of 1965. 20 U.S.C. 1091(a)(1) (2000).

²³ *Id.* § 1091(r)(1).

²⁴ *Id.* § 1091(a)(5).

²⁵ See 20 U.S.C. § 1091.

²⁶ IRS, PUBLICATION 970: TAX BENEFITS FOR EDUCATION (2002) (explaining tax benefits that may be available to individuals saving for or paying for higher education).

²⁷ *Id.*

taxpayer to claim the educational opportunity for the Student that he claims as an exemption on his income tax return.²⁸

“Qualified Educational Expense(s), Expenditure(s) or Cost(s)” include tuition, academic fees, student-activity fees, books, academic supplies and other academic equipment required for the enrollment or attendance at an eligible educational institution.²⁹ Expenditures for athletic activities, hobbies, non-credited courses, insurance fees, medical expenses, and personal expenses are excluded from this definition.³⁰

A “Qualified Lender” refers to student loans made between the eligible student and any of the following entities: (1) the federal, state, or local government (or instrumentality thereof); (2) a tax-exempt public benefit corporation; or (3) an eligible educational institution.³¹ Loans made between the student and related persons and employers of the student are not qualified lenders.³²

If the taxpayer receives tax-free educational assistance for, or a refund of, an educational expense already claimed by at least one educational opportunity, then the taxpayer must “Recapture” that amount on the following year’s tax return.³³ This rule applies to all of the educational opportunities discussed in this article, except for the discharge of indebtedness income, charitable contribution deduction, and the student loan interest deduction.³⁴

“Tax Code” refers to the Internal Revenue Code of 1997, as amended.

B. Article Terminology

“Educational Cost” refers to the average tuition costs and fees for a: (1) public two-year (\$1,359), (2) public four-year (\$3,506), (3) private two-year (\$8,961), or (4) private four-year (\$15,531) post-secondary educational institution, as listed by the National Center for Educational Statistics.³⁵

“Educational Opportunities” or “Opportunity” refers to either all twelve of the educational opportunities discussed in this article, or to just one in particular depending on the context of its use.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ World Almanac 2002, p. 236, World Almanac Education Group, Inc., 512 Seventh Ave., New York, NY, ISBN-0-88687-872-1.

An “Ineligible Student” fails to satisfy the requirements of section 484(a)(1) of the Higher Education Act of 1965.³⁶ In other words, the student is carrying less than half the normal full-time workload for the course of study that the student is pursuing at an Eligible Educational Institution.

A “Joint Taxpayer(s),” refers to a married-couple filing a joint tax return. This taxpayer has one dependent that they claim an exemption for on their yearly tax returns.

A “Qualified Taxpayer(s)” refers to any taxpayer filing status, except for “Married Filing Separately” and “Head of Household.” Also, the taxpayer is a United States citizen or a resident alien for tax purposes.

A “Single Taxpayer(s)” refers to a single taxpayer filing an individual tax return. This taxpayer has no dependents.

The “Tax Base” refers to the tax liability of the taxpayer without the aid of an educational opportunity.

The “Taxpayer(s)” refers to a joint taxpayer as defined above, and may also mean eligible student depending on the context of its use.

C. Illustrative Taxpayer Models

This article will use four income tax brackets,³⁷ with five different sets of income limitations,³⁸ applicable to the twelve educational opportunities contained within the Tax Code. In order to test the tax utility of each opportunity, in relation to educational costs, four different taxpayer models³⁹ have been developed for this article. Each taxpayer model is married, with a dependent enrolled in an eligible educational institution, and files a joint tax return. The first taxpayer model (herein “TP1”) has an adjusted gross income of \$28,850. This taxpayer model represents all taxpayers in the 10 percent tax bracket, and remains as a constant throughout the article. The second taxpayer model (herein “TP2”) has an adjusted gross income of \$59,346. This taxpayer model represents the typical American taxpayer, and remains as a constant as well. The third taxpayer model (herein “TP3”) has an adjusted gross income that varies with the lower limit of the income limitation of each opportunity. Fi-

³⁶ See *supra* notes 22, 23 and 24.

³⁷ Actually, the current Tax Code employs six different tax brackets (with corresponding adjusted gross income ranges): 10% (\$0-\$28,850), 15% (\$28,851-\$63,550), 27% (\$63,551-\$129,700), 30% (\$129,701-\$188,800), 35% (\$188,801-\$323,900), and 38.6% (\$323,901+). See I.R.C. § 1 (West 2002).

³⁸ Income limitations are only used for sections: 25A, 135, 221, 222, and 530.

³⁹ The gross income of each of the four taxpayer models was determined by excluding the standard deduction (\$7,850) and exemption (\$3,000 for each exemption) available to each taxpayer. The total amount excluded was \$16,850.

nally, the fourth taxpayer model (herein "TP4") has an adjusted gross income that varies with the upper limit of the income limitation of each opportunity. These four taxpayer models will assist in the determination of how much the taxpayer is reducing his tax liability by claiming any one of the twelve opportunities.

III. THE CODE, THE ANALYSIS, AND THE SUGGESTIONS

Section 25A: The Hope Scholarship and the Lifetime Learning Credits

*A. The Law*⁴⁰

Introduction. The Taxpayer Relief Act of 1997 provides two different educational tax credits for qualified taxpayers: the Hope Scholarship Credit and the Lifetime Learning Credit.⁴¹ Typically, the Hope Scholarship Credit is for students enrolled in their first two years of their post-secondary education, whereas the Lifetime Learning Credit is targeted at taxpayers enrolled in continuing education programs.⁴² Although a student may qualify for both credits in the same year, the taxpayer may only claim one of the two credits for the student.⁴³ If the taxpayer pays the qualified educational expenses⁴⁴ for more than one student in the same year, however, the taxpayer may choose to claim the Hope Scholarship Credit for one student and the Lifetime Learning Credit for the other.

The Hope Scholarship Credit. A taxpayer who pays the qualified educational expenses of an eligible student,⁴⁵ enrolled at an eligible educational institution,⁴⁶ may elect to claim the Hope Scholarship Credit for those expenses. The amount of the credit equals the sum of: "100 percent of so much of the qualified tuition and related expenses paid by the taxpayer during the taxable year (for education furnished to the eligible student during any academic period beginning in such taxable year) as does not exceed \$1,000, plus 50 percent of such expenses so paid as exceeds \$1,000 but does not exceed the applicable limit."⁴⁷ The maximum

⁴⁰ See generally IRS, *supra* note 26, at 5-17 (2002) (defining Hope and Lifetime Learning Credits).

⁴¹ I.R.C. § 25A(a)(1), (2) (West 2002).

⁴² See IRS, *supra* note 26, at 5 Table 1-1.

⁴³ IRS, *supra* note 26, at 5.

⁴⁴ I.R.C. § 25A(f)(1) (West 2002).

⁴⁵ *Id.* § 25A(b)(3).

⁴⁶ *Id.* § 25A(b)(3).

⁴⁷ *Id.* § 25A(b)(1)(A)-(B).

Hope Scholarship Credit available to the taxpayer is \$1,500 per student each year.⁴⁸ The amount of the credit is gradually reduced by two percent for each \$200 that the adjusted gross income of the taxpayer exceeds \$82,000.⁴⁹ The amount of the credit is zero if adjusted gross income exceeds \$102,000.⁵⁰ IRS Publication 970⁵¹ provides the following example:

William and Karen are married and file a joint tax return. Their adjusted gross income is \$88,000. Their daughter is in her first year of college, and paid \$4,300 of qualified expenses. Their tentative Hope Credit is \$1,500 (100% of the first \$1,000 of qualified expenses, plus 50% of the next \$1,000 of qualified expenses). To figure their allowable credit, they multiply the tentative credit (\$1,500) by the following fraction:⁵² the numerator is the upper limit of the income limitation (\$102,000) minus their adjusted gross income (\$88,000). The denominator is \$20,000, which is the range of incomes for the phase-out period (\$82,000 - \$102,000). The result is the amount of their Hope Credit (\$1,050).

The Lifetime Learning Credit. The Lifetime Learning Credit is an elective per taxpayer credit.⁵³ Unlike the Hope Scholarship Credit, this credit applies to the aggregate educational expenses of the taxpayer, the taxpayer's spouse, and his dependents each year.⁵⁴ Further, it is available to an eligible student⁵⁵ taking one or more courses at any level in their post-secondary education⁵⁶ for the duration of their education.⁵⁷ The amount of the credit equals twenty percent of the qualified tuition and related expenses paid by the taxpayer that does not exceed \$5,000⁵⁸

48 The maximum Hope Scholarship Credit amount for Single Taxpayers is also \$1,500. IRS, *supra* note 26, at 5. Additionally, the Hope Credit may not be claimed against a Taxpayer's alternative minimum tax liability. I.R.C. § 25A(c)(2) (West 2002).

49 For Single Taxpayers, the amount of the credit is reduced by one percent for each \$100 that the Taxpayer's adjusted gross income exceeds \$41,000. IRS, *supra* note 26, at 5.

50 For Single Taxpayers, the credit is zero if adjusted gross income is greater than \$51,000. *Id.*

51 *Id.* at 9-10.

52 The Hope Scholarship Credit is calculated using the following fraction: [$\$1,500 \times (\text{maximum AGI limit} - \text{TP's AGI} / \$20,000) = \text{credit available}$]. *See id.* at 10.

53 *See* I.R.C. § 25A(e) (West 2002).

54 *Id.* § 25A(c)(1).

55 Person convicted of a felony drug charge may be an Eligible Student under the Lifetime Learning Credit rules. *Compare id.* § 25A(b)(2)(D) with *id.* § 25A(c).

56 The Lifetime Learning Credit includes graduate and professional schools. *See id.* at § 25A(c)(1); *see also* IRS, *supra* note 26, at 13.

57 *See* I.R.C. § 25A(c)(1); *see also* IRS, *supra* note 26, at 13.

58 After January 1, 2003 this amount is \$10,000.

per year.⁵⁹ The maximum Lifetime Learning Credit available to the taxpayer is \$1,000 each year.⁶⁰ As with the Hope Scholarship Credit, the amount of the credit is gradually reduced by two percent for each \$200 that the adjusted gross income of the taxpayer exceeds \$82,000.⁶¹ The amount of the credit is zero if adjusted gross income exceeds \$102,000.⁶² IRS Publication 970 provides the following example:⁶³

Bruce and Barbara are married and file a joint tax return. Their adjusted gross income is \$88,000. Barbara attends a local college for a nursing degree. She already holds a B.A. in history. Barbara has already paid \$4,000 for her fall semester. Their tentative Lifetime Credit is \$800 (20% of the first \$5,000 of qualified educational expenses). To figure their allowable credit, they multiply the tentative credit (\$800) by the following fraction:⁶⁴ the numerator is the upper limit of the income limitation (\$102,000) minus their adjusted gross income (\$88,000). The denominator is \$20,000, which is the range of incomes for the phase-out period (\$82,000 - \$102,000). The result is the amount of their Lifetime Learning Credit (\$560).

Limitations Applicable to this Provision. First, unused credits or excess qualified expenses are not carried forward.⁶⁵ For example, if the taxpayer has \$2,500 of expenses, and elects to claim the Hope Scholarship Credit, then the taxpayer may only claim the first \$1,500 under the Hope Scholarship Credit, and forego the remainder of the expenses. Second, the taxpayer is prohibited from claiming the same qualified expense for each credit. For example, if the expenses are \$1,000, then the taxpayer may not claim both the Hope and Lifetime Credits for the same \$1,000 expenditure. Finally, the double benefit limitation applies to this provision.⁶⁶

B. The Analysis

Introduction to the Test Models. For the analysis of this provision,

⁵⁹ See I.R.C. § 25A(c)(1).

⁶⁰ I.R.C. § 25A(c)(1) (West 2001). The maximum Lifetime Learning Credit for Single Taxpayers is also \$1,000. See IRS, *supra* note 26, at 12.

⁶¹ The credit is gradually reduced by one percent for each \$100 in excess of \$41,000 for Single Taxpayers. IRS, *supra* note 26, at 12.

⁶² For Single Taxpayers, the credit is zero if adjusted gross income exceeds \$51,000. *Id.*

⁶³ *Id.* at 15.

⁶⁴ The amount of the Lifetime Learning Credit is calculated using the following fraction: [(20% X qualified educational expenses) X (maximum AGI range – TP's AGI / \$20,000 (\$10,000 for Single Taxpayers))] = credit available]. *Id.*

⁶⁵ I.R.C. § 25A(g)(3).

⁶⁶ *Id.* § 25A(g).

TP3 has an adjusted gross income equal to the lower limit of the income limitation (\$82,000), whereas TP4's adjusted gross income is set at the upper limit (\$102,000). The adjusted gross incomes for TP1 and TP2 are \$28,850 and \$59,346, respectively. All data discussed below is contained in Appendix One ("25A Analysis").

Regardless of educational costs, the taxpayer in the ten percent tax bracket benefits the greatest from both the Hope and Lifetime Credits. TP1 reduces his tax liability between 98 and 100 percent by claiming the Hope Credit, and between 23 and 83 percent under the Lifetime Credit. Conversely, TP4 is unable to reduce his tax liability under either credit. TP3 reduces his tax liability between 10 and 13 percent under the Hope Credit, and between 2 and 9 percent under the Lifetime Credit. TP2 reduces his tax liability between 20 and 26 percent under the Hope credit, and between 5 and 17 percent under the Lifetime Credit. Under either credit, TP1 benefits the greatest out of all the taxpayer models, since his tax liability is reduced by the furthest percentage.

C. Suggestions for Improvement

The Hope Scholarship Credit will always reduce the tax liability of the taxpayer by a larger amount than will the Lifetime Learning Credit based upon the amount of credit available to the taxpayer.⁶⁷ A wise taxpayer will always choose the Hope Credit if he qualifies for both credits and understands the difference between the two credits. The best solution to improve this opportunity is to reduce taxpayer confusion by statutorily limiting the first two years of a post-secondary education to the Hope Credit, and all other future qualified expenses to the Lifetime Credit. With less choice available, the statutory scheme will always point the taxpayer in the correct and most beneficial direction.

Section 72: Early Withdrawal from an Individual Retirement Plan

A. The Law⁶⁸

Introduction. An Individual Retirement Plan accrues tax-free interest on the corpus of the investment, until its withdrawn by the taxpayer.⁶⁹ Generally, distributions are taxed at the marginal rate of the tax-

⁶⁷ See *infra* Appendix One.

⁶⁸ For an additional discussion of the law of retirement plans see generally IRS, *supra* note 26, at 44-45 (explaining early withdrawals from IRAs).

⁶⁹ This rule applies to Traditional, Roth, or SIMPLE IRAs. See I.R.C. § 72; see also IRS, *supra* note 26, at 44.

payer, unless it is made before the taxpayer is 59½ years old.⁷⁰ A ten percent penalty⁷¹ is assessed for withdrawals made before the taxpayer obtains the age of 59½, which are not used for qualified educational expenses⁷² of an eligible student⁷³ at an eligible educational institution.⁷⁴ For example:

Julian, age 35, withdraws \$10,000, which represents accrued interest and contributions, from his Traditional IRA to pay for his qualified educational expenses. If Julian uses the full \$10,000 to pay for his expenses, the full \$10,000 is taxed at his marginal tax rate. However, if his expenses are only \$8,000, then \$2,000 of the distribution is assessed the ten percent penalty (\$200). Thus, Julian pays tax on \$10,000 at his marginal rate, plus an additional \$200 in tax.

Limitations Applicable to this Provision. The double benefit limitation applies to this provision.⁷⁵

B. The Analysis

Essentially, this is a “last ditch” provision for taxpayers in dire need of funds to pay for educational costs, since it allows the taxpayer to use readily available funds for those costs. This opportunity does not reduce the tax liability of the taxpayer as an incentive to earn a post-secondary education, since accrued interest is taxed at his marginal income tax rate.

C. Suggestions for Improvement

The best solution is to allow for the tax-free rollover of excess distribution amounts into another IRA, U.S. savings bond, Coverdell Educational Savings Account, or Qualified Tuition Program. This would eliminate the harshness of the ten percent tax on excess distributions, and is consistent with other educational opportunities. Tax-free rollovers for excess distribution amounts are currently available for other opportunities, such as U.S. savings bonds and Qualified Tuition Programs.

⁷⁰ The taxable amount is only the interest component, and the remainder is a tax-free return of capital. See IRS, *supra* note 26, at 44.

⁷¹ I.R.C. § 72(t)(1).

⁷² Educational expenses also include room and board and special needs services for the student. *Id.*

⁷³ The taxpayer may claim this deduction for the qualified expenses of himself, his spouse, his dependents and grandchildren. *Id.*

⁷⁴ *Id.*

⁷⁵ See *id.* § 72(t)(2)(E).

Section 108: Discharge of Indebtedness Income

A. The Law

Introduction. Generally, if the taxpayer is forgiven of a student loan obligation, he recognizes discharge of indebtedness income.⁷⁶ However, tax-free treatment of the discharge may be available if: (1) the taxpayer works for the government,⁷⁷ a tax-exempt organization,⁷⁸ or an eligible educational institution;⁷⁹ (2) for a defined period of time;⁸⁰ and (3) pursuant to a written plan for the discharge of the student loan.⁸¹ If all three requirements are satisfied, then the taxpayer excludes the amount of the discharge from his gross income. For example:

Sibu has a student loan of \$10,000, and has been offered a job to work for the State of New York in exchange for the discharge of his entire student loan debt (\$10,000). According to their written plan, Sibu must work for the State for six months, before his loans are discharged. Sibu completed his obligation under the plan, and has received a discharge of his entire student loan debt (\$10,000). Sibu may exclude the entire discharged amount from his gross income.

Additional Benefits of this Section. Even if the taxpayer has received a tax-free discharge of indebtedness income, other educational opportunities may be available to the taxpayer, since the double benefit limitation does not apply to this provision. Specifically, if the taxpayer had been making student loan payments during the tax year and receives a tax-free discharge of that loan, then the taxpayer may still be able to deduct those interest loan payments under section 221. For example:

Same facts as the example above, except that Sibu has made \$180 of interest payments on the loan before it was discharged. Sibu may claim the \$180 payments under the student loan interest deduction of section 221, if he qualifies. Therefore, Sibu's potential educational opportunity is a \$10,000 exclusion and a possible \$180 deduction.

⁷⁶ I.R.C. § 108(f) (West 2002).

⁷⁷ The government includes, federal, state, local, and instrumentalities thereof. *Id.* § 108(f)(2)(A).

⁷⁸ A tax-exempt public benefit corporation that qualifies is one that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law. *Id.* § 108(f)(2)(C).

⁷⁹ *Id.* § 108(f)(2)(C)(i). An Eligible Educational Institution is recognized as a 501(c)(3) tax-exempt organization. *See id.*; *see also* § 501(c)(3).

⁸⁰ The taxpayer and his prospective employer determine the defined period of time. *Id.* § 108(f)(1).

⁸¹ *See id.*

B. *The Analysis*

This exclusion is not an incentive to obtain a post-secondary education since the taxpayer has already completed his education. Instead, it retroactively reduces the cost of an education by having the employer pay his student loan obligations.

C. *Suggestions for Improvement*

None. This windfall taxpayer provision allows for the exclusion of income that should be included in the broad definition of gross income contained within the Tax Code.

Section 117: Scholarships and Fellowship Grants

A. *The Law*

Introduction. Qualified scholarships⁸² and fellowship grants⁸³ are excluded from the gross income of an eligible student⁸⁴ if he is enrolled at an eligible educational institution.⁸⁵ Only amounts given for tuition costs, academic fees, research, supplies, meals, lodging, equipment, or salary⁸⁶ are qualified educational expenses.⁸⁷ However, any unused amount not returned to the grantor is included in gross income.⁸⁸ For example:

Joan is a full time student at Webutuck College and received a \$10,000 scholarship for her tuition and academic fees. Joan's tuition and aca-

⁸² A scholarship is statutorily defined as "an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies." Treas. Reg. § 1.117-3(a) (as amended in 1985).

A fellowship grant is statutorily defined as "an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research." *Id.* § 1.117-3(c).

⁸⁴ *Id.* § 1.117-3(e).

⁸⁵ *Id.* § 1.117-3(b).

⁸⁶ As long as every individual receiving a scholarship or fellowship grant must provide these employment services, then the amounts received as salary are excluded from gross income. *Id.* § 1.117-2(a)(1).

⁸⁷ Treas. Reg. § 1.117-1(b) (as amended in 1985). There is also another exception to this general rule, not specifically listed in the Tax Code itself, but it specifically pertains to section 117. Section 305 of the Safe and Affordable Schools Act of 1997 and the Affordable College Act of 1997, provides an exclusion of all amounts received by an individual for services performed under a federal work-study program operated under section 441 of the Higher Education Act of 1965. This provision specifically address provision 117(c), which states that amounts received as compensation while working for an Eligible Educational Institution under a scholarship is included in gross income.

⁸⁸ Treas. Reg. § 1.117-1(a) (1960).

demic fees total \$6,000, which she pays with the scholarship funds. The remainder of the scholarship (\$4,000) she spends on personal expenses. Joan excludes the \$6,000 from her gross income because she spent the money on qualified expenses (tuition and academic fees). The remainder of the funds (\$4,000), however, is included in her gross income because she spent the money on non-qualified personal expenses.

For ineligible students,⁸⁹ any amount received from a scholarship or fellowship grant is included in gross income, unless the grantor is a: (1) tax-exempt organization,⁹⁰ (2) federal or state government,⁹¹ or (3) a foreign organization.⁹² The amount of the exclusion, however, is limited to the first \$300 per month for a maximum period of thirty-six months.⁹³ After the thirty-sixth month has expired, or excess monthly amounts are received, the income exclusion does not apply.⁹⁴ For example:

Joan takes only one course at Webutuck College at a cost of \$900. Additionally, she has received a lump-sum scholarship in the amount of \$900, to cover her educational expenses. If presented in a lump sum, Joan must include \$600 of the scholarship in her gross income because she is only allowed to exclude \$300 of the scholarship each month. However, if she received three monthly payments of \$300 each, she may exclude the entire \$900 scholarship (\$300 per month).

Additional Benefits of this Provision. Employees of an eligible educational institution also benefit from this section. Although technically not a scholarship or fellowship grant, tuition reductions given to an employee are excluded from their gross income.⁹⁵ This exclusion also applies to the employee's: (1) spouse, (2) dependent, (3) widow, or (4) to former employees.⁹⁶

Limitations Applicable to this Provision. The double benefit limitation applies to this provision.⁹⁷

⁸⁹ An Ineligible Student is enrolled less than part-time at an Eligible Educational Institution. *See id.* § 1.25A-3(d).

⁹⁰ Treas. Reg. § 1.117-2(b)(2)(i) (as amended in 1946). A tax-exempt organization must be defined by I.R.C. § 501(c)(3) to qualify here. *Id.*

⁹¹ *Id.* § 1.117-2(b)(2)(ii). This includes federal and state instrumentalities. *Id.*

⁹² *Id.* § 1.117-2(b)(2)(iii). To qualify, the organization must be a foreign organization as specified in the Mutual Educational and Cultural Exchange Act of 1961, 22 U.S.C. § 2453 (2000). *Id.*

⁹³ *See id.* § 1.117-2(b).

⁹⁴ *Id.* § 1.117-1(b).

⁹⁵ I.R.C. § 117(d) (West 2002).

⁹⁶ *Id.*

⁹⁷ *Id.* § 117(c).

B. *The Analysis*

Although this educational opportunity does not provide an incentive for the taxpayer to obtain a post-secondary education by reducing his tax liability, it does provide an incentive for the taxpayer to apply for and accept scholarship amounts to assist him in the financing of his education without recognizing income. Further, this provision allows ineligible students to exclude up to \$300 per month of scholarship amounts from gross income.

C. *Suggestions for Improvement*

As explained in the example provided above, if an ineligible student and grantor are unaware of the nuances of this opportunity, lump sum payments will increase the student's taxable income by the amount received from the grantor in excess of three hundred dollars. The only suggestion for improvement is to replace the \$300 monthly limitation for ineligible students with a yearly limitation that will account for lump sum distributions and reduce the risk of mistake by either the grantor or taxpayer.

Section 127: Employer-Provided Educational Assistance Program

A. *The Law*⁹⁸

Introduction. Up to \$5,250 received from an Employer-Provided Educational Assistance Program⁹⁹ may be excluded from the gross income of an employee each year¹⁰⁰ for qualified educational expenses.¹⁰¹ Moreover, an employer is provided a deduction for all educational expenditures made for the benefit of an employee, as an incentive to establish such a program. An Employer-Provided Educational Assistance Program is established by the employer,¹⁰² for the benefit of its employ-

98 For an additional discussion of Employer Provided Educational Assistance Programs *see generally* IRS, *supra* note 26, at 50 (defining Employer-Related Educational Assistance Programs).

99 An Employer-Provided Educational Assistance Program is statutorily defined as "a plan established and maintained by an employer under which the employer provides financial assistance to the employees." Treas. Reg. § 1.127-2(a) (2003).

100 An employee is statutorily defined as any individual employed during the calendar year. *Id.*

101 However, amounts paid for tools or supplies that are retained by the employee after completion of study, as well as meals, transportation, lodging, and athletic activities are not qualified expenses here. *Id.* § 1.127-2(c)(3).

102 The program must be provided pursuant to a written plan between the employer and employees. *Id.* § 1.127-2(b).

ees, to enhance their level of education, even if the course of study is not job related.¹⁰³ All educational institutions qualify under this provision, and there is no minimum course load required of the employee.¹⁰⁴ For example:

Jeff works for Matrix as a payroll specialist. Matrix has a policy to provide all of its employees \$25,250 worth of educational assistance. Jeff decides to enroll in an accounting program to earn his C.P.A. degree at a cost of \$25,250 a year. Jeff may exclude the first \$5,250 of payments he receives from Matrix, but the remainder is included in his gross income (\$20,000).

Limitations Applicable to this Provision. An ineligible Employer-Provided Assistance Program is one that: (1) favors highly compensated employees, (2) favors the principal stockholders or owners, or (3) allows employees to choose between enrolling in the program or taking its cash equivalent.¹⁰⁵ Further, only employees may claim this exclusion, since its benefits are not extended to the employee's spouse or dependents.¹⁰⁶ Also, the double benefit limitation applies to this provision.¹⁰⁷

B. *The Analysis*

Although this educational opportunity does not provide an incentive for the taxpayer to obtain a post-secondary education by reducing his tax liability, it does provide an incentive for the taxpayer to participate in an employer provided educational program without recognizing income. However, amounts in excess of the \$5,250 limit are included in the taxpayer's gross income, which are taxed at his marginal income tax rate.

C. *Suggestions for Improvement*

For reasons of consistency, this exclusion should be extended to the taxpayer's spouse and his dependents, since other educational opportunities allow the taxpayer to claim a credit, deduction or exemption for payments made by a third-party to benefit an eligible student. For example, payments made by third-parties for the educational expenses of the student are treated as if the student made these payments directly for tax purposes.¹⁰⁸

¹⁰³ *Id.* § 1.127-2(c)(4).

¹⁰⁴ IRS, *supra* note 26, at 50.

¹⁰⁵ See Treas. Reg. § 1.127-2(e) (1983).

¹⁰⁶ *Id.* § 1.127-2(d).

¹⁰⁷ See Treas. Reg. § 1.127-2 (2003).

¹⁰⁸ IRS, *supra* note 26, at 50 (2002).

Section 135: Education Savings Bond Program

A. The Law¹⁰⁹

Introduction. Generally, interest earned on a U.S. savings bond is included in the gross income of the taxpayer in the year in which the bond is redeemed, unless the earned interest is used to pay for the qualified educational expenses of the taxpayer,¹¹⁰ or rolled-over into a Qualified Tuition Program, or a Coverdell Educational Savings Account.¹¹¹ Unlike most other educational opportunities, qualified educational expenses only include tuition and academic fees required for enrollment at an eligible educational institution.¹¹² A U.S. savings bond qualifies under this provision if it is either a Series EE bond issued after 1989 or a Series I bond.¹¹³ The amount of the interest exclusion is gradually reduced by two percent for each \$300¹¹⁴ that the adjusted gross income of the joint taxpayer exceeds \$86,400,¹¹⁵ which leads to zero if adjusted gross income is greater than \$116,400.¹¹⁶ For example:

Mark and Sue are married and file a joint tax return. Their adjusted gross income is \$86,400. They redeem a qualified savings bond to pay for \$7,500 of their daughter's qualified educational expenses. They receive proceeds of \$9,000, representing \$6,000 of principal and \$3,000 of interest. They are not claiming any other educational provision, and their daughter does not have any other tax-free educational benefits. They figure their tentative exclusion is \$3,000 (the total amount of interest earned). To figure their allowable exclusion, they multiply their tentative exclusion (\$3,000) by the following fraction:¹¹⁷ the numerator is the amount of paid qualified expenses (\$7,500), and the denominator is

109 For an additional discussion of the Education Savings Bond Program see generally IRS, *supra* note 26, at 46-49 (defining Education Savings Bond Program).

110 I.R.C. § 135(a) (West 2002). This also includes the Qualified Educational Expenses of the Taxpayer's spouse and his dependent. *Id.* § 135(c)(2).

111 I.R.C. § 135(c).

112 *Id.* § 135(c)(2)(A).

113 *Id.* § 135(c)(1). The bond may be issued in the name of both the Taxpayer and the Taxpayer's spouse. See I.R.C. § 135(c). Additionally, the owner of the bond must be at least twenty-four years old before the issue date of the bond. *Id.* § 135(c)(1)(B).

114 *Id.* § 135(b)(2)(A). For Single Taxpayers, the amount is reduced by one percent for every \$150. *Id.*

115 IRS, *supra* note 26, at 46. The amount is \$57,600 for Single Taxpayers. I.R.C. § 135(b)(2)(A) (West 2002); see also IRS, *supra* note 26, at 46.

116 I.R.C. §§ 135(b)(2)(A) (West 2002). The amount is \$72,600 for Single Taxpayers. *Id.* See also IRS, *supra* note 26, at 46.

117 The calculation is as follows: [interest earned X (educational expenses paid/total proceeds received)].

the proceeds received from cashing the bond (\$9,000). The result is the amount of tax-free interest earned on the bond (\$2,499). The difference between the total amount of interest earned and the amount of tax-free interest is taxable interest to them (\$501).

Limitations Applicable to this Provision. The double benefit limitation applies to this provision.

B. The Analysis

Introduction to the Test Examples. For the analysis of this provision, the adjusted gross income of each taxpayer model is as follows: TP1 is \$28,850, representing the 10 percent tax bracket; TP2 is \$59,346, representing the average taxpayer; TP3 is \$86,400, representing the lower limit of the income limitation; and TP4 is \$116,400, representing the upper limit of the income limitation. In order to assist in the calculation of the tax reduction percentage, each taxpayer redeemed a qualified savings bond to pay for \$7,500 of qualified educational expenses. They each received redemption proceeds of \$9,000, representing \$6,000 of principal and \$3,000 of interest. All data referred to in this section is listed in Appendix Two (“135 Analysis”).

Taxpayer model one (TP1) benefits the greatest from this exclusion by reducing his tax liability by 23 percent, whereas the allowable exclusion for TP4 is zero. TP2 reduces his tax liability by 6 percent, and the tax liability of TP reduces by 4 percent. Although this opportunity does not provide the greatest reduction of tax liability, it does reduce tax liability by up to 23 percent if the taxpayer can afford to purchase the bond. It also provides the taxpayer with an incentive to invest in U.S. savings bonds to help defray future educational costs with the exclusion of taxable accrued interest.

C. Suggestions for Improvement

None. This windfall taxpayer provision provides for an exclusion of accrued interest that should be included in gross income under the broad definition of income contained within the Tax Code.

Section 162: Ordinary and Necessary Business Deduction

A. The Law

Introduction. The taxpayer may deduct¹¹⁸ educational expenses¹¹⁹ as an “ordinary and necessary” business deduction,¹²⁰ if it: (1) maintains or improves the skills required of an employee for continued employment; or (2) satisfies the express requirements of an employer; or (3) satisfies the legal requirements imposed as a condition of continued employment.”¹²¹ Unlike most other educational opportunities, enrollment at any educational institution qualifies for this deduction.¹²² Further, there is no minimum course load required of the taxpayer,¹²³ and there are no applicable income limitations.¹²⁴

Limitations Applicable to this Provision. First, educational expenditures made by the taxpayer to “satisfy the minimum educational requirements for employment” are not deductible.¹²⁵ The regulations elaborate with an example:

Edward, who has earned his law degree and has enrolled in a bar review course, has been hired by a law firm while studying for the bar exam. The law and bar review courses constitute education required to meet the minimum educational requirements for the practice of law, and thus, are not deductible by Edward.¹²⁶

Second, “expenditures made by any individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business” are not deductible.¹²⁷ The regulations elaborate with an example:

Robert, a doctor, takes accounting courses to earn his C.P.A. degree. Robert’s accounting course expenses are not deductible because the courses do not maintain or improve skills required of him as a doctor,

¹¹⁸ This is a below-the-line deduction.

¹¹⁹ This deduction only applies to Taxpayers that itemize their tax returns. *See generally* I.R.C. § 162-5 (West 2002) (defining itemized deductions for individuals and corporations).

¹²⁰ This provision also allows an employer to take a deduction for Educational Expenses that the employer has paid for an employee. However, the employee is prohibited from deducting the same Educational Expenses claimed by his employer. *See id.*

¹²¹ *Id.*; Treas. Reg. § 1.162-5(a)(1)–(2) (as amended in 1967).

¹²² *See* Treas. Reg. § 1.162-5(a)-(b) (as amended in 1967).

¹²³ *See id.*

¹²⁴ *See id.*

¹²⁵ *Id.* § 1.162-5(b)(2).

¹²⁶ *Id.* § 1.162-5(b)(2)(iii) Example 3.

¹²⁷ Treas. Reg. § 1.162-5(b)(3)(i) (as amended in 1967).

and constitute a new trade or business.¹²⁸

Third, this deduction is only available to taxpayers that itemize their tax returns.¹²⁹ Finally, the double benefit limitation applies to this provision.¹³⁰

B. The Analysis

Introduction to the Test Examples. For the analysis of this provision, the adjusted gross income of each taxpayer model is as follows: TP1 is \$28,850, representing the 10 percent tax bracket; TP2 is \$59,346, representing the average taxpayer; TP3 is \$188,800, representing the upper limit of the 30 percent tax bracket; and TP4 is \$323,901, representing the highest tax bracket. Since the taxpayer has the election to choose between the standard deduction or to itemize his deductions, it is assumed for this problem that the itemized deduction will result in a lower tax liability for each taxpayer model. The amount of this deduction is equal to each of the various educational costs. For example, each taxpayer model has an itemized deduction equal to \$1,359, then \$3,506, and so forth. All data referred to in this section is listed in Appendix Three (“162 Analysis”).

This deduction provides a substantial incentive for obtaining a post-secondary education by significantly reducing the taxpayer’s tax liability. For example, TP1 benefits the greatest from this deduction with a reduction in his tax liability between 11 and 100 percent depending on the educational expenditure. TP2 reduces his tax liability between 4 and 40 percent, while TP3 and TP4 reduce their tax liability between 1 and 11 percent and between 1 and 6 percent, respectively.

Although this deduction provides a substantial incentive for taxpayers, it primarily benefits wealthier taxpayers.¹³¹ For example, if all four taxpayer models itemize their income tax returns and enroll at a private four-year educational institution at a cost of \$15,531 per year, then TP1 would eliminate his tax liability completely; TP2 reduces his tax liability by 40 percent; TP3 by 11 percent; and TP4 by 6 percent. Realistically, it is difficult to imagine that TP1 would spend over 53 percent of his gross income on educational expenses, and likewise TP2 spending over 26 percent for educational expenses. It is more plausible that TP3 would claim this deduction since he is only spending 8 percent of his gross in-

128 *Id.* § 1.162-5(b)(3)(ii) Example 3.

129 *See id.* § 1.162-5 (defining itemized deductions for individuals and corporations).

130 *See id.*

131 *See infra* Appendix Three.

come on educational expenses, and for TP4 to claim it since he is only spending 4.5 percent of his gross income on an education. Therefore, this opportunity tends to favor wealthier taxpayers since a lower percentage of their gross income is directed toward educational expenses.

Another drawback of this provision is that the type of education envisioned under this provision is continuing education courses.¹³² Therefore, taxpayers planning to pursue a degree program may not use this provision as an opportunity. Taxpayers pursuing a graduate degree in a field of study that they are currently employed in benefit the greatest, however, since these expenses will qualify under this provision. Finally, low-income taxpayers do not itemize their tax returns as a general rule, and therefore forego any reduction in tax liability that this opportunity might have offered them.

C. *Suggestions for Improvement*

None. This windfall taxpayer opportunity provides for an immediate deduction for educational costs that are normally not deductible under current tax policy. Also, see Section 222: Qualified Tuition and Related Expense Deduction for further analysis of this provision.

Section 170: Charitable Contribution Deduction

A. *The Law*

Introduction. Section 170 provides a charitable deduction for the taxpayer¹³³ who hosts and maintains a foreign exchange student.¹³⁴ The deduction is available if the student: (1) is in primary or secondary school, (2) resides with the taxpayer and (3) is not a relative of the taxpayer.¹³⁵ Further, there must be a written agreement between the taxpayer and the school¹³⁶ to maintain the student.¹³⁷ The amount of the de-

¹³² See generally Treas. Reg. § 1.162-5 (defining itemized deductions for individuals and corporations) (as amended in 1967).

¹³³ This deduction is only available to Taxpayers who itemize their tax returns. See generally I.R.C. § 170 (West 2002) (defining itemized deductions for individuals and corporations).

¹³⁴ *Id.* § 170(g).

¹³⁵ *Id.* § 170(g)(1). This provision defines "relative of a taxpayer" with reference to section 152(a)(1)-(8) of the Tax Code. *Id.* § 170(g)(3).

¹³⁶ *Id.* § 170(g)(1)(A). A school is also defined to include a 501(c)(3) tax-exempt organization.

¹³⁷ The organizations that this provision is referring to are: corporations, trust, or community chest, fund or foundation; a post or organization of war veterans, or auxiliary unit or society of, or trust or foundation; a domestic fraternal society, order, or association, operating under the lodge

duction is limited to \$600 for each student that the taxpayer maintains each year.¹³⁸ Excess expenditures are not carried forward and are foregone to the taxpayer.¹³⁹ Maintenance of a student is statutorily defined as any amount paid by the taxpayer for the benefit of the student, such as food, books, tuition, clothing, medical care and entertainment.¹⁴⁰ Expenditures for insurance, taxes, repairs or services provided by the taxpayer to the student are excluded.¹⁴¹ For example:

Foreign Exchange, a tax-exempt organization, is engaged in a program under which European children are placed in the homes of United States residents in order for the children to enroll in American public schools. Dennis, an itemized taxpayer, has agreed with Foreign Exchange to host and maintain a foreign exchange student, Katherine. She enrolls at the local high school for an academic year (9 months total). Dennis spent \$480 on food and \$220 on entertainment for her. Therefore, the total amount spend on Katherine is \$700. However, only \$600 of the \$700 is deductible by Dennis, and the remainder (\$100) is not carried forward, and is foregone to Dennis.¹⁴²

Limitations Applicable to this Provision. This deduction is only available to taxpayers that itemize their tax returns. The double benefit limitation does not apply to this provision.

B. *The Analysis*

Although this provision is not an opportunity for the taxpayer per se, it does provide a Congressional sanctioned deduction for the philanthropic taxpayer.

C. *Suggestions for Improvement*

None. Since this provision primarily benefits a small class of taxpayers and students, it does not warrant the privilege of a charitable deduction under current tax policy. Generally for charitable contribution to be deductible, the contribution must benefit numerous recipients in a wide range of endeavors. This deduction does not satisfy these general criteria for a contribution because its favors only those taxpayers who can host and maintain a foreign student, and perhaps should be repealed.

system. I.R.C. § 170(c)(2)-(4); *see also id.* § 170(g)(1)(A).

138 *See id.* § 170(g)(2)(A).

139 *See id.*

140 Treas. Reg. § 1.170A-2(a)(2) (1972).

141 *Id.*

142 *Id.* § 1.170A-2(e) Example 1.

Section 221: Student Loan Interest Deduction

A. The Law¹⁴³

Introduction. All taxpayers may deduct¹⁴⁴ from gross income¹⁴⁵ up to \$2,500 of interest¹⁴⁶ paid on qualified student loans¹⁴⁷ each year. The deduction is gradually reduced by two percent for each \$300 that the taxpayer's adjusted gross income exceeds \$100,000,¹⁴⁸ which leads to a deduction of zero if adjusted gross income exceeds \$130,000.¹⁴⁹ For example:

Steve and Beth are married and file a joint tax return. Their adjusted gross income is \$125,000, and they have paid \$800 of interest on their qualified student loans. They figure their tentative deduction is \$800 (the full amount of interest paid on the loans). To figure their allowable deduction, they multiply the tentative deduction (\$800) by the following fraction:¹⁵⁰ the numerator is their adjusted gross income (\$125,000) minus the lower limit of the income limitation (\$100,000). The denominator is \$30,000, which is the range of incomes for the phase-out range (\$100,000 - \$130,000). They then subtract their tentative deduction by this result (\$666.67), to calculate their allowable deduction (\$133.33).

A qualified student loan is any indebtedness incurred by the student¹⁵¹ to pay for the qualified educational expenses for himself, his spouse, or his dependent.¹⁵² It does not include loans, however, that are made between the student and related persons of the student.¹⁵³ Qualified educational expenses also include room and board and transportation

143 See generally IRS, *supra* note 26, at 18-23 (2002) (defining Student Loan Interest Deductions).

144 This is an above-the-line deduction.

145 I.R.C. § 221(a) (West 2002).

146 I.R.C. § 221(b)(1) (West 2002). Student loan interest also includes loan fees.

147 The student loan must have been made from a Qualified Lender. *Id.* § 221(d)(1).

148 The amount is \$50,000 for Single Taxpayers, reduced by one percent for each \$150 increment. *Id.* § 221(b)(2)(A), (B)(i)-(ii).

149 The amount for Single Taxpayers is \$65,000. *Id.* § 221(b).

150 The fraction is calculated as follows: [(the higher of the total interest paid, or \$2,500) minus X [(AGI - \$100,000 (\$50,000 for single tax return)) / \$30,000 (\$15,000 for a Single Taxpayer)]. *Id.*

151 I.R.C. § 221(d)(1) (West 2002).

152 *Id.*

153 *Id.* Related persons are broadly defined to include, spouses, siblings, half-siblings, ancestors, lineal descendants, and closely held corporations, partnerships, trusts, and tax-exempt organizations. *Id.*

costs required for attendance at an eligible educational institution.¹⁵⁴

B. The Analysis

Introduction to the Test Examples. For the analysis of this provision, the adjusted gross incomes of each taxpayer model are as follows: TP1 is \$28,850, representing the 10 percent tax bracket; TP2 is \$59,346, representing the average taxpayer; TP3 is \$100,000, representing the lower limit of the income limitation; and TP4 is \$130,000, representing the upper limit of the income limitation. It is also assumed that each taxpayer paid \$3,000 of interest on qualified student loans. All data referred to in this section is listed in Appendix Four (“221 Analysis”).

This deduction provides an incentive for the taxpayer to finance his education with student loans, since the interest payments on those loans are deductible. For example, TP1 benefits the greatest under this opportunity by reducing his tax liability by 25 percent, whereas TP4 receives no benefit from this deduction. TP2 reduces his tax liability by 8 percent, and by 5 percent for TP3. Although the amount of the tax reduction is not as great as is found in other opportunities, it is significant for taxpayers that must borrow funds for educational expenditures.

C. Suggestions for Improvement

None. This windfall taxpayer provision provides a deduction for expenses that are personal in character and are ordinarily non-deductible under the Tax Code.

Section 222: Qualified Tuition and Related Expense Deduction

A. The Law

Introduction. All taxpayers¹⁵⁵ may deduct up to \$3,000 of qualified educational expenses¹⁵⁶ paid during the year for themselves, their spouse, or their dependents¹⁵⁷ at an eligible educational institution.¹⁵⁸ The deduction is only available to taxpayers with an adjusted gross in-

¹⁵⁴ *Id.* § 221(d)(2).

¹⁵⁵ Taxpayers are also considered Eligible Students. See I.R.C. § 222(a) (West 2002).

¹⁵⁶ See *id.* at § 222(b).

¹⁵⁷ I.R.C. § 222(a) (West 2002).

¹⁵⁸ I.R.C. § 222(d) (West 2002). Also, this deduction will apply to primary and secondary educational institutions in the 2003 tax year. Joint Committee on Taxation, Description of H.R. 5193, the “Back to School Tax Relief Act of 2002,” (JCX-79-02), July 23, 2002.

come of \$130,000 or less,¹⁵⁹ since there is no applicable phase-out fraction. For example, taxpayers, with an adjusted gross income of \$130,000, are entitled to a \$3,000 deduction, whereas taxpayers with an adjusted gross income of \$130,001 are ineligible.

Additional Benefits of this Provision. For taxpayers that have educational expenses that qualify under this section and the ordinary and necessary business deduction, they may claim both deductions for these expenses. Since this deduction is an above-the-line deduction and the other deduction is a below-the-line deduction, a taxpayer may be able to lower his adjusted gross income, which may in turn, qualify him for other opportunities to further lower his tax liability.

Limitations Applicable to this Provision. The double benefit limitation applies to this provision.¹⁶⁰ Also, if the taxpayer claims either the Hope Scholarship or Lifetime Learning Credit, he is prohibited from claiming this deduction for any excess educational expenses that may be available to him. Further, the deduction is only available until December 31, 2004.¹⁶¹

B. The Analysis

Introduction to the Test Examples. For the analysis of this provision, the adjusted gross incomes of each taxpayer model are as follows: TP1 is \$28,850, representing the 10 percent tax bracket; TP2 is \$59,346, representing the average taxpayer; TP3 is \$130,000, representing the upper-income limitation; and TP4 is \$140,000, representing a disqualified taxpayer. Each taxpayer paid the varying education costs used throughout this article, and claimed the appropriate deduction on their income tax returns. All data referred to in this section is listed in Appendix Five (“222 Analysis”).

Although this deduction plateaus when educational costs exceed \$3,000, it does provide an incentive for taxpayers to obtain an education since tax liability is reduced significantly. For example, TP1 benefits the greatest under this opportunity with a tax liability reduction between 11 and 29 percent, although it plateaus at 29 percent for educational expenses above \$3,000. Conversely, TP4 receives no benefit from this opportunity. TP2 reduces his tax liability between 4 and 8 percent, and between 2 and 4 percent for TP3, with the same plateau effect for

¹⁵⁹ The income limitation for Single Taxpayers is \$65,000. I.R.C. § 222(b)(2)(A) (West 2002).

¹⁶⁰ *Id.* § 222(c).

¹⁶¹ *Id.* § 222(e).

educational expenses above \$3,000, 8 and 4, percent respectively.

C. Suggestions for Improvement

This opportunity was created by Congress to allow wealthier, non-itemizing taxpayers a chance to deduct qualified educational expenses that did not qualify under any other opportunity because their income is too high. However, this opportunity does not apply to many wealthier taxpayers, since the upper-income limitation of this provision and other opportunities is relatively similar. For example, if the taxpayer had qualifying educational expenses that qualified under the Hope Scholarship Credit, with its upper-income limitation of \$102,000 (i.e., mid- 27 percent tax bracket); and this provision, with its income limitation of \$130,000. This difference is relatively small since the benefits of section 222 only extend this opportunity to taxpayers in the bottom 30 percent tax bracket. Income limitations found in other opportunities have their upper-income limitation set to the upper-end of the income tax bracket. Therefore, for reasons of consistency, the income limitation of this provision should be increased to around \$180,000, which is near the upper-end of the 30 percent tax bracket.

Alternatively, this deduction should be limited to taxpayers with adjusted gross incomes above \$130,000, since Congress enacted this opportunity to benefit wealthier taxpayers, who are disqualified from other opportunities. This would eliminate any confusion amongst taxpayers as to which opportunity to claim for their educational expenses, since their choice of opportunities is limited.

Since this opportunity overlaps with the ordinary and necessary business deduction and may allow some taxpayers to lower the adjusted gross income to qualify for additional opportunities, this deduction should be made a below-the-line deduction to prevent wealthier taxpayers from abusing this deduction. Perhaps the better solution is to eliminate this opportunity altogether, since the income limitation is set rather low and generally will not substantially allow a greater number of wealthier taxpayers to claim this opportunity.

Section 529: Qualified Tuition Program

*A. The Law*¹⁶²

Introduction. There are two different types of Qualified Tuition

¹⁶² See generally IRS, *supra* note 26, 40-43 (2002) (defining Qualified Tuition Programs).

Programs that qualify under this provision.¹⁶³ The first type of program is where an individual¹⁶⁴ purchases tuition credits on behalf of a designated beneficiary¹⁶⁵ that entitles the beneficiary to waive the payment of future qualified educational expenses¹⁶⁶ at an eligible educational institution.¹⁶⁷ For the second type of program, an individual makes contributions to an account that is established for the purpose of meeting the future qualified education expenses of the beneficiary at an eligible educational institution.¹⁶⁸ A state¹⁶⁹ established and maintained program may be of either type, but a program established and maintained by a private educational institution must be of the first type.¹⁷⁰

Generally, the designated beneficiary is the student intended to receive the benefits of the Qualified Tuition Program.¹⁷¹ The designated beneficiary, however, may be transferred¹⁷² to a family member¹⁷³ once the Qualified Tuition Program has been established.¹⁷⁴ Moreover, the designated beneficiary may rollover the entire balance (i.e., including accrued interest) of a Qualified Tuition Program into another one in his name, or to a family member, to avoid tax on the accrued interest.¹⁷⁵

Limitations Applicable to this Provision. Contributions¹⁷⁶ to a Qualified Tuition Program may only be made in cash, and the contribution limit varies by state law.¹⁷⁷ Unlike other opportunities, there are no income limitations applicable to this provision.¹⁷⁸ The designated beneficiary is not taxed on the accrued earnings credited of the account until

163 I.R.C. § 529(b)(1)(A) (West 2002).

164 An individual may represent more than one person under this provision. See I.R.C. § 529 (West 2002).

165 *Id.* § 529(b)(1)(A)(i).

166 Qualified Educational Expenses also include room and board and special needs services. *Id.* § 529(e)(3)(A).

167 *Id.* § 529(e)(5).

168 *Id.* § 529(b)(1)(A)(ii).

169 An instrumentality of the state may also establish and maintain a Qualified Tuition Program. *Id.*

170 I.R.C. § 529(b)(1)(A).

171 See *id.* § 529(c).

172 Transferred also includes rollovers into an IRA or Coverdell Educational Savings Account of the name beneficiary, to another family member. I.R.C. § 529(c)(3)(C) (West 2002).

173 Family member broadly includes dependents, grandchildren, stepchildren, siblings and siblings-in-law, parents, parents-in-law, stepparents, step-parents-in-law, nephews and nieces, uncles and aunts, first cousins, and the spouse of any individual listed above. *Id.* at § 529(e)(2).

174 *Id.* § 529(c)(3)(C)(i).

175 *Id.* § 529(c)(3)(C)(ii).

176 Contribution may only be made in cash. *Id.* § 529(b)(2).

177 See *id.* § 529(b)(1).

178 See I.R.C. § 529 (West 2002).

they are distributed.¹⁷⁹ Also, distributions for qualified educational expenses are excluded from the gross income,¹⁸⁰ unless there are excess amounts which are assessed a ten percent penalty.¹⁸¹ For example:

Sara's parents opened a Qualified Tuition Program Account for her that was maintained by the state. Her parents contributed \$18,000 to the account, and Sara has decided to withdraw \$3,600 to pay \$3,500 of qualified educational expenses. The \$3,600 distribution has earned \$1,200 of interest. Sara calculates her taxable portion of the distribution by the following fraction:¹⁸² the numerator is the qualified educational expense paid (\$3,500), and the denominator is the total amount distributed during the year (\$3,600), multiplied by the total distributed earnings (\$1,200).¹⁸³ Sara then subtracts the interest earned on the distribution (\$1,200) from her tax-free earnings (\$1,166), resulting in taxable income of \$34.

In the case of a program maintained by a private educational institution, distributions are included in the beneficiary's gross income that is calculated by the following fraction:¹⁸⁴ the numerator is the total amount of contributions received, and the denominator is the balance of the account before the distribution, multiplied by the distribution itself. Then this result is subtracted from the distribution received.¹⁸⁵ For example:

Adam is the beneficiary of Qualified Tuition Program Account maintained by a private institution. The balance of the account, before the distribution, is \$10,000, of which \$7,500 is attributable to contributions and \$2,500 is attributable to earnings. Adam receives a distribution of \$4,000 that is used to pay for qualified educational expenses. Adam calculates his taxable earnings using the following formula:¹⁸⁶ the numerator is the amount of contributions received (\$7,500), and the denominator is the balance of the account before any withdrawals have been made (\$10,000), multiplied by the amount of the distribution (\$4,000). Adam then subtracts the amount of the distribution (\$4,000) from his return of capital as calculated by the fraction above (\$3,000), resulting in taxable income of \$1,000.

179 See *id.* § 529(c)(1).

180 *Id.* at § 529(c)(3)(B).

181 *Id.*

182 The taxable portion is calculated as follows: [(total distribution earnings received) - ([total distributed earnings received X (qualified educational expenses paid/total distribution amount received)])].

183 The calculation is as follows: $[(\$3,500/\$3,600) \times \$1,200] = \$1,166$ of tax-free earnings).

184 This fraction only applies to distributions made before 2004. *Id.* § 529(c)(3)(B)(iii).

185 I.R.C. § 529(c)(3)(B).

186 The formula is calculated as follows: $(\$4,000 - [\$4,000 \times (\$7,500/\$10,000)]) = \$1,000$.

Limitations Applicable to this Provision. The double benefit limitation applies to this provision.¹⁸⁷

B. The Analysis

Although this opportunity does not reduce the tax liability of the taxpayer (i.e., beneficiary), it does provide an incentive for the taxpayer to prepare in advance for future educational expenditures by investing in a savings plan that taxes accrued interest at a minimal level. Essentially, section 529 will reduce the out-of-pocket costs of an education with the interest component of the investment at a minimal taxable gain. Unlike most other opportunities, there are no income limitations applicable to contributors, and the maximum contribution amount varies by state law. Further, any individual may contribute to a Qualified Tuition Program for the benefit of the beneficiary. The benefits of this provision vary according to the timing of the distribution, interest earned and educational costs, although they far exceed the other opportunities. For example, a beneficiary with excess distribution amounts may rollover those amounts into another Qualified Tuition Program for himself or another family member without the recognition of taxable income. It is theoretically possible for a single Qualified Tuition Program to have an infinite duration (albeit that the name of the beneficiary changes) that has the ability to pay all of the qualified educational expenses for generations of family members.

The only drawback of this provision is that it requires large amounts of initial capital to earn enough accrued interest to cover the full amount of a post-secondary education. Even with limited means, however, it is possible for the beneficiary to reduce his educational costs if he establishes an account many years before it is required for his educational expenses.

C. Suggestions for Improvement

For reasons of consistency, a yearly contribution limitation of \$2,000 should be enacted as is applicable to individual retirement plans and in Coverdell Educational Savings Accounts. Alternatively, the Qualified Tuition Program could be amended to include primary and secondary educational institutions without yearly contribution limits for the reasons cited in the next section. Also, see Section 530: Coverdell Educational Savings Account for further analysis of this opportunity.

¹⁸⁷ See generally I.R.C. § 529 (defining Qualified Tuition Programs).

Section 530: Coverdell Education Savings Account

*A. The Law*¹⁸⁸

Introduction. All taxpayers¹⁸⁹ may establish a Coverdell Educational Savings Account to finance the qualified educational expenses¹⁹⁰ of a designated beneficiary¹⁹¹ enrolled at an eligible educational institution, but not all taxpayers may be able to contribute to one.¹⁹² Taxpayers¹⁹³ may contribute up to \$2,000 each year to a Coverdell Educational Savings Account if their adjusted gross income is less than \$220,000.¹⁹⁴ Contributions are gradually reduced by two percent for each \$300 that the adjusted gross income of the taxpayer exceeds \$190,000,¹⁹⁵ which leads to a contribution of zero if adjusted gross income exceeds \$220,000.¹⁹⁶ For example:

Paul and Grace are married, file a joint tax return, and open a Coverdell Account for their daughter. Their adjusted gross income is \$200,000. To figure their yearly contribution limit, they multiply the yearly contribution limit (\$2,000) by the following fraction:¹⁹⁷ the numerator is their adjusted gross income (\$200,000), minus the lower limit of the income limitation (\$190,000). The denominator is \$30,000, which is the range of incomes for the phase-out period (\$220,000 - \$190,000). They then subtract the yearly contribution limit (\$2,000) from the result obtained by the fraction above (\$666.67) to calculate their maximum allowable contribution (\$1,333.33).

Limitations Applicable to this Provision. A contributor may not

¹⁸⁸ See generally IRS, *supra* note 26, 29-34 (2002) (defining Coverdell Education Accounts).

¹⁸⁹ All Taxpayers includes married taxpayers filing separately. See I.R.C. § 530(a)(1) (West 2002).

¹⁹⁰ Qualified Educational Expenses also include uniforms, room and board, transportation, and special needs services. *Id.* § 530(b)(2).

¹⁹¹ *Id.* § 530(b)(1).

¹⁹² An Eligible Educational Institution also includes primary and secondary schools. *Id.* § (b)(2)(A).

¹⁹³ This includes the designated beneficiary as well. I.R.C. § 530(b) (West 2002).

¹⁹⁴ For Single Taxpayers, the amount is \$110,000. Additionally, any organization, corporation, partnership, trust, or rollovers may contribute to a Coverdell Educational Savings Account, without the applicable income limitations. *Id.* § 530(b)(1)(A).

¹⁹⁵ For Single Taxpayers, the amount is reduced by one percent for each \$150 above \$95,000. *Id.* § 530(c).

¹⁹⁶ For Single Taxpayers, the amount is zero if their income exceeds \$110,000. See *id.*

¹⁹⁷ The calculation is as follows: [\$2,000 X [(AGI – lower limit) / range of incomes] - \$2,000].

claim a deduction for any contributed amounts.¹⁹⁸ Additionally, yearly contributions cannot exceed \$2,000,¹⁹⁹ without the beneficiary being assessed an additional six percent penalty tax.²⁰⁰ Further, distributions in excess of the qualified educational expenses are included in gross income without penalty.²⁰¹ For example:

Gordon receives an \$850 distribution from a Coverdell Educational Savings Account to which \$1,500 has been contributed, and had a pre-distribution balance of \$1,800. He uses the \$850 distribution to pay for \$700 of qualified educational expenses. He calculates the taxable portion of the distribution by the following formula:²⁰² the numerator is the total contributions in the account (\$1,500) and the denominator is the total balance in the account before the distribution (\$1,800), and then multiplies it by the amount withdrawn (\$850).²⁰³ This result (\$708) is subtracted from the total amount distributed (\$850).²⁰⁴ Then this result (\$142) is multiplied by another fraction, where the numerator is the qualified educational expense paid (\$700) and the denominator is the total amount distributed from the account (\$850).²⁰⁵ This result (\$117) is then subtracted from the previous fraction amount (\$142),²⁰⁶ resulting in \$25 that must be included in his gross income.

Lastly, the double benefit limitation applies to this exception.

B. The Analysis

Although this opportunity does not reduce the tax liability of the taxpayer (i.e., beneficiary), it does provide an incentive for the taxpayer to prepare in advance for future educational expenditures by investing in a savings plan that taxes accrued interest at a minimal level. Essentially, a Coverdell account is similar to a section 529 plan but taxable gain on the investment receives less favorable treatment. The greatest benefit of this opportunity is that distributions may be used for primary, secondary and post-secondary educational institutions.

198 See *id.* § at 530(d)(1) – (2).

199 *Id.* § 530(b)(1)(A).

200 See *id.*

201 *Id.* § 529.

202 The calculation is as follows: [(distribution amount X (total contributions / total balance before distribution)] minus total distributions made] X [(qualified educational expenses / total distribution amount) minus [distribution amount X (total contributions / total balance before distribution)] minus total distributions made]].

203 The calculation is $([\$1,500 / \$1,800] \times \$850 = \$708)$.

204 The calculation is $(\$850 - \$708 = \$142)$.

205 The calculation is $([\$142 \times (\$700 / \$850)] = \$117)$.

206 The calculation is $(\$142 - \$117 = \$25)$.

C. Suggestions for Improvement

There are many overlaps amongst a Coverdell Educational Savings Account, an Individual Retirement Plan and a Qualified Tuition Program. However, there is a distinct difference between a Coverdell and a Qualified Tuition Program, that is - a Coverdell is limited to lower-income taxpayers because of the income limitations applicable to contributors that are non-existent for Qualified Tuition Programs and Individual Retirement Plans. It is similar to an Individual Retirement Plan in that there is a \$2,000 yearly contribution limitation, which is not applicable to a Qualified Tuition Program. Another major difference between a Coverdell and the other two provisions is that distributions may also be used for primary and secondary educational expenses, which is inapplicable to the other two provisions.

An Individual Retirement Plan was originally enacted to provide the taxpayer with funds necessary for his retirement. It became an educational opportunity by default when Congress decided to allow its funds to be used for educational costs. It is therefore not an educational savings plan in the same sense as a Coverdell or a Qualified Tuition program, since its original purpose was for retirement and not education. Moreover, distribution amounts are taxed at the marginal rate of the taxpayer, and excess distributions are assessed an additional ten percent penalty tax, whereas a Qualified Tuition Program is only taxed at a percentage of excess distributions.

Qualified Tuition Programs and Coverdell Educational Savings Accounts were specifically created by Congress to provide taxpayers with the funds necessary for future educational expenses. Both allow for the tax-free accrual of interest, until the funds are withdrawn. However, the amount of taxable gain on that interest is calculated differently. A Qualified Tuition Program only taxes accrued interest on excess distribution amounts, whereas a Coverdell taxes a percentage of the entire distribution. Ultimately, a Qualified Tuition Program results in lower taxable gain on accrued interest than does a Coverdell Account. Additionally, a Qualified Tuition Program does not have income limitations applicable to its contributors, and there is no \$2,000 yearly contribution limit as is found in a Coverdell.²⁰⁷ Therefore, a Qualified Tuition Program is more beneficial to the taxpayer as an educational saving plan, than a Coverdell because it provides more flexibility for investing at more favorable tax rates.

²⁰⁷ The maximum yearly contribution amount for a Qualified Tuition Program is governed by state law. See I.R.C. § 529(b)(1) (West 2002).

Considering these points, the best means to improve this opportunity is to repeal it since the Qualified Tuition Program provides more flexibility for investing, less taxable gain on interest, and is conceptually similar. Further, the Qualified Tuition Program should be amended to include primary and secondary educational institutions, thus making the Coverdell Account completely obsolete.

IV. TAX REDUCTIONS AND SURVEYS

Part IV is divided into two sections: Tax Reductions and Surveys. The first section tries to establish which taxpayer qualifies for a majority of the educational opportunities by looking solely to the income limitations applicable to each opportunity with the aid of a control test example. From the result of this example, another control test example is employed to determine which one of the educational provisions results in the lowest tax liability for this taxpayer. The second section examines the results obtained from the local CPA survey and from the informal poll to see which provisions are actually being claimed by all taxpayers and why.

A. Tax Reductions

Introduction. In order to determine which of the twelve educational opportunities provides the greatest tax reduction and to which taxpayer, it is first necessary to define the phrase "Greatest Tax Reduction." For purposes of this article, the greatest tax reduction will result in the lowest tax liability for the taxpayer as an incentive to enroll in a post-secondary educational institution. In other words, the "greatest tax reduction" is the amount of subsidization the federal government is willing to provide the taxpayer to obtain a post-secondary education without directly funding his education.

First, in order to determine which taxpayer qualifies for the largest number of the opportunities, a control test example is employed that looks solely to the income limitations of each opportunity and compares those limits to the example taxpayer's gross income (herein "ETP"). For example, ETP1 has a gross income of \$28,850 which represents the ten percent income tax bracket.²⁰⁸

²⁰⁸ ETP2 represents the 15% bracket with a gross income of \$63,550; ETP3 represents the 27% bracket with a gross income of \$129,700; ETP4 represents the 30% bracket with a gross income of \$188,800; ETP5 represents the 35% bracket with a gross income of \$323,900; and ETP6 represents the 38.6% bracket with a gross income of \$323,901.

For the second control test example, the ETP1²⁰⁹ has paid qualifying educational expenses of \$1,359, and his gross income is \$28,850.²¹⁰ Further, for reasons of simplicity, the amount of the distribution/proceeds for sections 135, 529, and 530 is \$1,400. Of this amount, \$924 represents the corpus of the investment and \$476 represents the interest component of the distribution. Also for sections 529 and 530, the taxpayer has contributed \$15,000 into his savings account, and has a pre-distribution balance of \$18,000. This test example will apply to every opportunity, except for sections 108, 170 and 221. These provisions do not provide an educational opportunity in the same sense as the other provisions, since they are not incentives to obtain a post-secondary education. Instead, these provisions provide an exclusion for taxable income, a deduction for student loan interest, or a deduction for a charitable contribution as an educational incentive. These provisions may lower a taxpayer's tax liability, but not necessarily encourage them to acquire a post-secondary educational.

Finally, this part will conclude with which taxpayer, at what tax bracket and at which educational institution, will ultimately benefit from the opportunities provided by the Tax Code.

Control Test Example 1: As stated above, this control test example looks solely to the income limitations of each educational opportunity, to determine which taxpayer at what income tax bracket qualifies under a majority of the twelve opportunities. All data referred to in this section is listed in Appendix Six ("Qualifiers").

Taxpayers in the ten percent and fifteen percent tax brackets qualify for all twelve educational opportunities. Next with eleven, are the twenty-seven percent tax bracket taxpayers. Lastly, are the remaining three tax brackets that still qualify for seven out of the possible twelve provisions. These results demonstrate that Congress has engineered a system of educational opportunities that provides the greatest tax reduction to lower-income taxpayers. This result is consistent with Congress' intent behind the enactment of each educational opportunity to provide lower-income taxpayers with the greatest number of incentives to acquire a post-secondary education.

Control Test Example 2: The Hope Scholarship Credit²¹¹ provides

209 This taxpayer is used for the second control test example because the first control test example established that the 10 and 15 percent taxpayers qualify for all twelve opportunities.

210 The \$28,850 amount is the highest gross income before the taxpayer is pushed into a higher tax bracket.

211 For purposes of this test, the Lifetime Learning Credit actually equaled the Hope Scholarship Credit. However, as soon as educational expenses exceed \$1000, the Hope Scholarship Credit provides the greater benefit of the two credits.

ETP1 with the greatest tax reduction to enroll in a post-secondary institution because his tax liability reduces to zero. This result is logical because a tax credit is directly applied to the tax liability of the taxpayer. In this case, the example taxpayer has a base tax liability of \$1,200 minus an educational credit of \$1,359, which results in a tax liability of zero.²¹² Next, the tax deduction provisions of sections 162 and 222 each reduce his tax liability by \$136 to \$1,064.²¹³ Again, this result is logical since a deduction reduces the adjusted gross income of the taxpayer before the calculation of tax liability. The exclusion provisions of 117 and 127 did not lower the taxpayer's tax liability, which is consistent with an exclusion provision since taxable income is neither increased nor decreased under an exclusion provision. Surprisingly, the mechanics of sections 135²¹⁴ and 529²¹⁵ only increase tax liability by \$14 to \$1,214. Unlike section 530, sections 135 and 529 do not factor in pre-distribution account balances and contribution amounts, which ultimately results in a lower taxable gain for the taxpayer. Section 530²¹⁶ increases tax liability by \$35 to \$1,235, for the reason just cited. Finally, section 72²¹⁷ increases the tax liability by \$235 to \$1,435. Section 72 was not originally designed to provide for future educational costs, but rather for retirement; and therefore, accrued interest is taxed at the marginal rate of the taxpayer, plus an additional 10 percent penalty for excess contribution amounts.

In summary, the ranking of these provisions, from best to worst, is as follows: credits (i.e., 25A), deductions (i.e., 162 and 222), exemptions (i.e., 117 and 127), and savings plans (i.e., 135, 529, 530 and 72). From a tax perspective these results are logical in that a credit reduces overall tax liability, a deduction lowers taxable income, an exemption excludes taxable income, and a savings plan provides a method of future investment at a reduced tax rate for accrued interest. Any other result would be inconsistent with current tax policy and ideology.

Conclusion. The taxpayer that ultimately benefits from all of the educational provisions provided by the Tax Code is the taxpayer in the

212 Under section 25A, the amount of the educational credit cannot reduce tax liability below zero.

213 It must be noted that section 222 is an above-the-line deduction, whereas section 162 is a below-the-line deduction. Therefore, these two deductions will not normally produce the results obtained in this control test example in a practical setting.

214 The calculation for 135 is: $[\$476 - \{\$476 \times [\$1,359/\$1,400] = \$462\}] = \14 .

215 The calculation for 529 is: $[\$476 \{[\$1,359/\$1,400] \times \$476 = \$462\}] = \14 .

216 The calculation for 530 is: $[[[\$15,000/\$18,000] \times \$1,400 = \$1,167] - \{[\$1,167 \times [\$1,359/\$1,400] = \$1,132\}] = \$35$.

217 The calculation for 72 is: $[[10\% \times (\$1,400 - \$1,359)] + \{[\$28,850 + \$1,400] \times 10\% \text{ tax bracket rate} = \$1,431\}] = \$1,435$.

ten percent tax bracket.²¹⁸ This taxpayer qualifies under all twelve of the educational provisions, and may be able to reduce his overall tax liability by the greatest amount if he chooses the Hope Scholarship Credit for the first two years of his post-secondary education. If the taxpayer then chooses to continue with his education past two years, his tax liability will be lower under the Lifetime Learning Credit than under any other opportunity. This result is consistent with Congress' purpose behind the enactment of all of the educational provisions, which was to provide lower-income taxpayers with an incentive to obtain a post-secondary education. However, Qualified Tuition Programs provide an even greater benefit to all taxpayers that can afford to invest into one because it allows for tax-free accrual of interest that is eventually taxed at a favorable rate when its withdrawn for educational expenditures.

B. Surveys

The statistical data used in this article was obtained by questioning five CPAs in the greater Boston area²¹⁹ on how many of their clients are utilizing the opportunities provided by the Tax Code, and their reasons as to why certain sections were used more frequently than others. From this survey information, a statistical analysis was conducted using a 95 percent confidence interval to roughly determine the total number of taxpayers using each section.²²⁰ The results of which are contained in Appendix Seven.

In summary, this survey shows that the more frequently used provisions of the Tax Code are (in the following order): section 162 (ordinary and necessary business deduction); section 25A (Lifetime Learning Credit); section 72 (traditional IRAs); and section 221 (interest of educational loans deduction). A possible explanation for these provisions being used more frequently than others is that they offer the most flexibility, in terms of future financial planning, and more taxpayers qualify under these provisions according to a majority of the CPAs questioned. Another possibility is that taxpayers are only aware of these educational provisions.

To determine if this is a correct assumption, an informal poll was conducted in downtown Boston. One hundred people were asked the fol-

218 The 15 percent taxpayer substantially benefits from all the educational opportunities as well, but exceptions apply.

219 Although more than five CPAs were asked to participate in the survey, many declined citing feigned confidentiality issues. *See also* Appendix Seven *infra*.

220 The 95% Confidence Interval equals $P\% \pm 1.96 \times \sqrt{[P \times (1 - P)] / N}$, where $P\%$ = percent of sample group, and N = total sample size.

lowing four questions: (1) what income group are you in; (2) what is the highest level of education that you have completed; (3) which of the following tax provisions are you aware of; and (4) which of the following tax provisions have you taken.²²¹ The results of this poll are in Appendix Eight. The questionnaire used for this poll is in Appendix Nine.

The results of the poll demonstrate that as the level of income increases, the taxpayer's awareness of the different educational opportunities also increases.²²² Moreover, as the level of education and subsequent income level rise, the ability of these individuals to qualify for these opportunities declines.²²³ The 25A, 72, 162, and 221 provisions were known by at least 75 percent of the taxpayers questioned. The average awareness of all of the educational provisions was 55 percent. Therefore, it may be concluded that sections 25A, 72, 162, and 221 were more frequently chosen over the other educational provisions because a greater number of taxpayers were aware of them. Alternatively, it may be argued that these sections were taken more often than other provisions because more taxpayers qualified under them. According to the poll results, 60 percent of taxpayers qualified under 25A, 72, 162, and 221 actually took the deduction. For reasons of comparison, of all the taxpayers that qualified under all twelve educational provisions, only 33 percent of them claimed the opportunity available to them.

Conclusion. The results of both polls point out that sections 25A, 72, 162 and 221 are the most frequently claimed by the taxpayers surveyed and known amongst these taxpayers. However, the polls also demonstrate that there is a general lack of awareness amongst the lower-income taxpayers as to what opportunities exist for them.

V. CONCLUSION

Generally, the educational opportunities provided by the Tax Code either reduce the tax liability of the taxpayer or allow accrued interest to help defray educational costs at a minimal taxable gain. Other opportunities simply exclude amounts from the gross income of the taxpayer. The major drawback of these opportunities is that they are generally limited to taxpayers below the 30 percent income tax bracket. Yet, when it is

221 Since there is a large concentration of academic institutions, and most individuals are of salary wages, the results of this poll might be higher than what would ordinarily be seen in the rest of the nation. Additionally, the current attention on sections 25A, 529 and 530 by financial institutions lately, may have increased the awareness levels of these sections on low to middle-income taxpayers.

222 See *infra* Appendix Eight.

223 *Id.*

considered that the purpose of these opportunities is to provide a tax incentive for lower-income taxpayers to acquire a post-secondary education, while limiting the ability of higher-income taxpayers to claim any of them, it may be concluded that Congress was highly successful in achieving this result. This article has demonstrated that taxpayers in the ten percent income tax bracket benefit the greatest from all of the opportunities provided in the Tax Code. However, there are problems with these opportunities.

First, the informal polling survey demonstrates that there is a direct relationship between income and awareness of the opportunities. For example, lower-income taxpayers are less likely to know of which opportunities are available to them. Further, when the CPA survey is compared with the results of the informal poll it is apparent that taxpayers are only claiming the opportunities that are most familiar to them. Of course, it may be stated that they are aware of these opportunities because they are claiming them. Clearly, Congress and the Internal Revenue Service must do a better job of informing lower-income taxpayers of the various opportunities that are available to them.

Second, a number of provisions provide similar benefits but are taxed differently. For example, Qualified Tuition Programs and Coverdell Educational Savings Accounts both provide the taxpayer with a planning incentive for future educational expenditures, but distributions from Coverdell Accounts result in higher taxable gain for the taxpayer. Moreover, Coverdell Accounts have income limitations applicable to its contributors and a yearly contribution limit, which are non-existent for Qualified Tuition Programs. For reasons cited in Part IV, Qualified Tuition Programs are better educational plans than Coverdell, therefore Congress should repeal the less favorable Coverdell.

Third, there is a redundancy of similar benefits provided by several different opportunities. For example, both the ordinary and necessary business deduction and the qualified tuition deduction provide a deduction for qualified educational expenses. However, the Qualified Tuition Deduction is a maximum \$3,000 above-the-line deduction open to all taxpayers whose adjusted gross income is under \$130,000, but no such rules apply to the ordinary and necessary business deduction. Congress could simply eliminate this redundancy by limiting all business educational expenses to the qualified tuition deduction. This would prevent wealthier taxpayers from using the Qualified Tuition Deduction to lower their adjusted gross income, thus allowing them to claim other opportunities previously unavailable to them because of their high income.

Finally, the Tax Code could level the playing field between lower

and higher-income taxpayers by limiting the choice of opportunities to only credits, exclusions and savings plans. As this article has pointed out, a credit is the most beneficial opportunity to lower-income taxpayers, since they generally do not have the financial means to invest in an educational savings plan. This credit would be limited to lower-income taxpayers with existing income limitations. An exclusion opportunity benefits both lower and higher-income taxpayers by excluding scholarship amounts from gross income. Since most scholarships are either financial-need or academic-merit based, this opportunity would neither punish lower-income taxpayers who might not have the means to pay additional tax on scholarship amounts, nor punish wealthier taxpayers who have earned a merit based scholarship with additional tax. Although an educational savings plan tends to favor wealthier taxpayers who have the financial means to invest for future educational costs, it does not equate to being a windfall for only the rich. An educational savings plan could contain yearly contribution limits, to prevent wealthier taxpayers from placing large amounts of cash into an account to allow accrued interest to pay for all future educational costs. This would eliminate the ability of wealthier taxpayers to solely use accrued interest to pay for all of their educational costs, while lower-income taxpayers do not have that option available to them.

In spite of these issues, the Tax Code provides many opportunities for lower-income taxpayers to acquire a post-secondary education in the form of a credit, deduction, exemption or savings plan. For taxpayers with limited funds, tax credits are the most beneficial opportunity available to them. As for wealthier taxpayers, savings plans are the most beneficial opportunity, since they are generally prohibited from claiming other educational opportunities.

APPENDIX ONE: 25A Analysis**Hope Scholarship Credit**

	<u>Educational Cost</u>	<u>TP1</u>	<u>TP2</u>	<u>TP3</u>	<u>TP4</u>
Gross Income		\$28,850	\$59,346	\$82,000	\$102,000
	\$ 1,359.00				
Base Tax		\$ 1,200 \$	5,774 \$	\$ 11,387	\$ 16,787
Tax w/Credit		\$ 21 \$	4,595 \$	\$ 10,207	\$ 16,787
Tax Reduction		98%	20%	10%	0%
	\$ 3,506.00				
Base Tax		\$ 1,200 \$	5,774 \$	\$ 11,387	\$ 16,787
Tax w/Credit		\$ - \$	4,274 \$	\$ 9,887	\$ 16,787
Tax Reduction		100%	26%	13%	0%
	\$ 8,961.00				
Base Tax		\$ 1,200 \$	5,774 \$	\$ 11,387	\$ 16,787
Tax w/Credit		\$ - \$	4,274 \$	\$ 9,887	\$ 16,787
Tax Reduction		100%	26%	13%	0%
	\$ 15,531.00				
Base Tax		\$ 1,200 \$	5,774 \$	\$ 11,387	\$ 16,787
Tax w/Credit		\$ - \$	4,274 \$	\$ 9,887	\$ 16,787
Tax Reduction		100%	26%	13%	0%

Lifetime Learning Credit

	<u>Educational Cost</u>	<u>TP1</u>	<u>TP2</u>	<u>TP3</u>	<u>TP4</u>
Gross Income		\$28,850	\$59,346	\$82,000	\$102,000
	\$ 1,359.00				
Base Tax		\$ 1,200	\$ 5,774	\$ 11,387	\$ 16,787
Tax w/Credit		\$ 928	\$ 5,503	\$ 11,115	\$ 16,787
Tax Reduction		23%	5%	2%	0%
	\$ 3,506.00				
Base Tax		\$ 1,200	\$ 5,774	\$ 11,387	\$ 16,787
Tax w/Credit		\$ 499	\$ 5,073	\$ 10,685	\$ 16,787
Tax Reduction		58%	12%	6%	0%
	\$ 8,961.00				
Base Tax		\$ 1,200	\$ 5,774	\$ 11,387	\$ 16,787
Tax w/Credit		\$ 200	\$ 4,774	\$ 10,387	\$ 16,787
Tax Reduction		83%	17%	9%	0%
	\$ 15,531.00				
Base Tax		\$ 1,200	\$ 5,774	\$ 11,387	\$ 16,787
Tax w/Credit		\$ 200	\$ 4,774	\$ 10,387	\$ 16,787
Tax Reduction		83%	17%	9%	0%

APPENDIX TWO: 135 Analysis

		<u>TP1</u>	<u>TP2</u>	<u>TP3</u>	<u>TP4</u>
Gross Income		\$ 28,850	\$ 59,346	\$ 86,400	\$ 116,400
Base Tax		\$ 1,200	\$ 5,774	\$ 14,897	\$ 20,675
Tax w/oDeduction		\$ 1,650	\$ 6,224	\$ 15,707	\$ 21,485
Tax w/Deduction		\$ 1,275	\$ 5,849	\$ 15,032	\$ 21,485
Tax Reduction		23%	6%	4%	0%
E. Cost =	\$7,500				
Proceeds =	\$9,000				
Principal =	\$6,000				
Interest =	\$3,000				

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EDUCATIONAL OPPORTUNITIES

APPENDIX THREE: 162 Analysis

	Educational Costs	TP1	TP2	TP3	TP4
Gross Income		\$ 28,850	\$ 59,346	\$ 188,800	\$ 323,901
	\$ 1,359				
Base Tax		\$ 1,200	\$ 5,774	\$ 41,996	\$ 89,280
Tax w/Deduction		\$ 1,064	\$ 5,571	\$ 41,588	\$ 88,805
Tax Reduction		11%	4%	1%	1%
	\$ 3,506				
Base Tax		\$ 1,200	\$ 5,774	\$ 41,996	\$ 89,280
Tax w/Deduction		\$ 849	\$ 5,249	\$ 40,944	\$ 88,054
Tax Reduction		29%	9%	3%	1%
	\$ 8,961.00				
Base Tax		\$ 1,200	\$ 5,774	\$ 41,996	\$ 89,280
Tax w/Deduction		\$ 304	\$ 4,430	\$ 39,307	\$ 86,145
Tax Reduction		75%	23%	6%	4%
	\$ 15,531				
Base Tax		\$ 1,200	\$ 5,774	\$ 41,996	\$ 89,280
Tax w/Deduction		\$ -	\$ 3,445	\$ 37,336	\$ 83,845
Tax Reduction		100%	40%	11%	6%

APPENDIX FOUR: 221 Analysis

		TP1	TP2	TP3	TP4
Gross Income		\$ 28,850	\$ 59,346	\$ 100,000	\$ 130,000
Base Tax		\$ 1,200	\$ 5,774	\$ 16,247	\$ 24,356
Tax w/Deduction		\$ 900	\$ 5,324	\$ 15,437	\$ 24,356
Tax Reduction		25%	8%	5%	0%
Interest =	\$ 3,000				

APPENDIX FIVE: 222 Analysis

	Educational Costs	TP1	TP2	TP3	TP4
Gross Income		\$ 28,850	\$ 59,346	\$ 130,000	\$ 140,000
	\$ 1,359				
Base Tax		\$ 1,200	\$ 5,774	\$ 24,431	\$ 27,431
Tax w/Deduction		\$ 1,064	\$ 5,571	\$ 24,047	\$ 27,431
Tax Reduction		11%	4%	2%	0%
	\$ 3,506				
Base Tax		\$ 1,200	\$ 5,774	\$ 24,431	\$ 27,431
Tax w/Deduction		\$ 849	\$ 5,324	\$ 23,400	\$ 27,431
Tax Reduction		29%	8%	4%	0%
	\$ 8,961.00				
Base Tax		\$ 1,200	\$ 5,774	\$ 24,431	\$ 27,431
Tax w/Deduction		\$ 849	\$ 5,324	\$ 23,400	\$ 27,431
Tax Reduction		29%	8%	4%	0%
	\$ 15,531				
Base Tax		\$ 1,200	\$ 5,774	\$ 24,431	\$ 27,431
Tax w/Deduction		\$ 849	\$ 5,324	\$ 23,400	\$ 27,431
Tax Reduction		29%	8%	4%	0%

APPENDIX SIX: Qualifiers

Provision:	25A	72	108	117	127	135	162	170	221	222	529	530	Totals:
Taxpayer:													
10%	X	X	X	X	X	X	X	X	X	X	X	X	12
15%	X	X	X	X	X	X	X	X	X	X	X	X	12
27%		X	X	X	X	X	X	X	X	X	X	X	11
30%		X	X	X	X		X	X			X		7
35%		X	X	X	X		X	X			X		7
38.60%		X	X	X	X		X	X			X		7

APPENDIX SEVEN: CPA Survey

Contact person	Doneghey	Withheld	Hale	Withheld	Withheld	AVERAGES	Confidence Interval
Sec 25A: Hope	5.00%	12.00%	2.00%	1.00%	1.00%	4.20%	4.2% ± 1.24%
Sec 25A: Lifetime	10.00%	20.00%	2.00%	3.00%	1.00%	7.20%	7.2% ± 1.6%
Sec 72	30.00%	0.00%	0.00%	0.00%	0.00%	6.00%	6.0% ± 1.5%
Sec 108	1.00%	0.00%	0.00%	0.00%	0.00%	0.20%	0.20% ± 0.3%
Sec 117	1.00%	15.00%	0.00%	0.00%	0.01%	3.20%	3.2% ± 0.29%
Sec 127	1.00%	0.00%	0.00%	0.00%	0.00%	0.20%	0.20% ± 0.20%
Sec 135	1.00%	0.00%	0.00%	0.00%	0.00%	0.20%	0.20% ± 0.30%
Sec 162	40.00%	20.00%	30.00%	60.00%	90.00%	48.00%	48% ± 3.1%
Sec 170	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.0% ± 0.0%
Sec 221	10.00%	10.00%	2.00%	0.00%	0.00%	4.40%	4.4% ± 1.2%
Sec 222	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.0% ± 0.0%
Sec 529	1.00%	0.00%	0.00%	2.00%	10.00%	2.60%	2.6% ± 0.01%
Sec 530	5.00%	1.00%	0.00%	0.00%	0.00%	1.20%	1.2% ± 0.70%
CPAs' Reasoning	TPs don't qualified because of income limitations	TPs don't qualified because of income limitations	TPs don't qualify because of income limitations	TPs don't qualify because of income limitations	TPs don't qualify because of income limitations		

APPENDIX EIGHT: Informal Survey

CODE SECTION	PERCENTAGE AWARE	PERCENTAGE TAKEN
§ 25A	100%	80%
§ 72	10%	10%
§ 108	3%	1%
§ 117	97%	87%
§ 127	9%	3%
§ 135	84%	16%
§ 162	98%	84%
§ 170	1%	0%
§ 221	91%	67%
§ 222	0%	0%
§ 529	90%	30%
§ 530	78%	20%
TOTALS:		
Selected Provisions	75%	60%
All Provisions	55%	33%

APPENDIX NINE: Informal Poll Questionnaire

- 1) **What income group do you fall within?**
 - under 20K 20-40K 40-60K 60-80K 80-100K 100K plus
- 2) **What is the highest level of education that you have completed?**
 - high school two-year college four-year college graduate school
- 3) **What Tax credits, exemptions, and deductions are you aware of?**
 - Charitable Contribution Deduction for hosting international students (§ 170)
 - Coverdell Account/Educational IRA (§ 530)
 - Discharge of Indebtedness Income Exemption (§ 108)
 - Educational Assistance Programs (§ 127)
 - Hope/Lifetime Credit (§ 25A)
 - IRA (§ 72)
 - Ordinary and Necessary Business Deduction (§ 162)
 - Personal Interest Deduction (§ 222)
 - Qualified Tuition Programs/529 U-plan (§ 529)
 - Scholarship and Fellowship Grant Exclusion (§ 117)
 - Student Loan Interest Deduction (§ 221)
 - US Bond Interest Deduction (§ 135)
- 4) **What tax credits, exemptions, and deductions have you taken?**
 - Charitable Contribution Deduction for hosting international students (§ 170)
 - Coverdell Account/Educational IRA (§ 530)
 - Discharge of Indebtedness Income Exemption (§ 108)
 - Educational Assistance Programs (§ 127)
 - Hope/Lifetime Credit (§ 25A)
 - IRA (§ 72)
 - Ordinary and Necessary Business Deduction (§ 162)
 - Personal Interest Deduction (§ 222)
 - Qualified Tuition Programs/529 U-plan (§ 529)
 - Scholarship and Fellowship Grant Exclusion (§ 117)
 - Student Loan Interest Deduction (§ 221)
 - US Bond Interest Deduction (§ 135)

APPENDIX TEN: Provisions Summary

Code Section	Maximum Exclusion Amount	Limited by Another Code Section
25A-Hope 25A- Life-time	100% for first \$1,000, 50% of next \$2,000 = \$1,500 per student of the taxpayer 20% for first \$5,000 = \$5,000 per taxpayer	Hope is allowed for the first two years, once elected for a post secondary school. Educational expenses. Both the Hope and Life Credit are reduced by any 117 (scholarship) amounts received, by any educational assistance program, and by any payment that is excludable under any law of the United States.
72	Waiver of 10% penalty for early withdrawals	Not applicable
108	Unlimited	Not applicable
117-for degree 117-nondegree	Degree: Unlimited up to the cost of the educational expenses, and employment performance. Non-degree: \$300 per month up to 36 months = \$10,800 (\$3,600 per year)	Reduced by the double benefit limitation.
127	First \$5,250 paid	Not applicable
135	Unlimited up to the cost of the educational expenses or \$15,000 (\$30,000 for a joint return)	Amount of exclusion is reduced when the taxpayer's adjusted gross income exceeds \$40,000 (\$60,000 for joint) in the taxable year. It is further reduced by amounts that have reduced the educational expenses by sections 117, educational assistance allowance, any payment that reduces the educational expense, ²²⁴ any payment, waiver, or reimbursement made 529 and 530. It is further reduced by any amounts considered excludable under 25A.
162	Unlimited up to the cost of the educational expense	Must satisfy the test for ordinary and necessary business expense.

170	\$50 per month for each student residing at the taxpayer's home for a total of \$600 per year per student	Not applicable
221	\$2,500	The amount of exclusion is reduced by a ratio when the taxpayer's adjusted gross income exceeds \$50,000 (\$100,000 in the case of a joint return). Further, the exclusion amount is reduced by any educational expenses paid (and claiming an exclusion) using 25A, 127, 135, 529, and 530.
222	\$3,000	Reduced by the double benefit limitation.
529	Unlimited for amounts used to pay educational expenses	Any educational expenses paid using (and claiming an exclusion for) 25A, 530 reduces the amount excluded. Also, excess distributions amounts not used for educational expenses are included in gross income. Further, any excess amounts of contributions per year are included in gross income.
530	Up to \$2,000 per year deduction for only cash contributions.	Excess amounts above educational expenses are includable in gross income. Further reduced by any educational expenses claimed under any other provision.