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"Understanding Access to Higher Education – The Federal Tax Angle"

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The Internal Revenue Code of 1986, as amended (the "Code"), and corresponding regulations of the Unites States Department of the Treasury ("Treas. Reg.") incorporate many provisions portraying that an important objective of federal income tax policy in the United States is to increase access to higher education. There are tax credits for certain educational expenditures (Hope Scholarship Credits and Lifetime Learning Credits) under Code section 25A and Treas. Reg. sections 1.25A-0 through 1.25A-5; tax deductions for qualified tuition and related expenses under Code section 222; and tax exclusions for income received in the form of qualified scholarships under Code section 117(a) or as qualified tuition reductions under Code section 117(d).

There are tax-favored savings accounts (such as Coverdell Education Savings Accounts under Code section 530) and Qualified Tuition Programs (under Code section 529) to encourage private savings to pay future educational expenses. There are tax benefits provided for employer-provided educational assistance under Code section 127 and business deductions for work-related education expenses.

There are tax exemptions for nonprofit colleges and universities organized and operated exclusively for educational, charitable, scientific, or religious purposes under Code section 501(c)(3) and Treas. Reg. section 1.501(c)(3)-1. There are tax rules encouraging private foundations to make charitable grants to nonprofit institutions of higher learning and to award scholarships and fellowships to undergraduate and graduate students. E.g., Code section 4942(a) and (g) (with respect to required "qualifying distributions") and Code section 4945(d)(3) and (g) (demarking individual study grants that do not constitute restricted "taxable expenditures").

Still – the hope of attainable access to quality higher education studies for young people and adult learners throughout the United States remains, to some significant extent, unrealized. In a recent keynote address, the President of Pennsylvania State University observed that roughly 67% of high school graduates in the United States attend college. Spanier, Graham, "The Future of the Academy: Coping with Changing Demographics and Privatization," College Board Forum 2005, New York City (October 30, 2005). This means that 33% of those graduates never make it to the campus gate, and because of attrition many of those who do pass through the portal are certain to leave without a degree. In addition, President Spanier noted that about 85% of jobs in the United States are classified as "skilled" positions requiring some education beyond high school. Id. Putting other variables aside, the mismatch between the number of high school graduates actually taking advantage of higher education, whether or not receiving a degree, and the types of jobs available to them is clear.

This paper summarizes various forms of federal tax assistance and subsidies available to offset post-secondary educational expenses and searches for the thread of policy that runs through the different incentives. As threads are wont, the connection here may be thin and the efficacy of these benefits toward the goal of increased access to higher education somewhat lacking. Knowing something about the tax rules, nonetheless, may help colleges and universities design programs, especially tutorials for potential students and their families, to make higher education many steps closer than it otherwise appears on the financial horizon. Increased understanding of the tax rules also may better equip educational institutions and educators to advocate for changes that will more effectively provide access where, and for whom, it is most absent in today's system.

More details about the individual tax benefits described below (and about applicable restrictions and limitations) can be found in Internal Revenue Service ("IRS") Publication 970, "Tax Benefits for Education" (Cat. No. 25221V, available at www.irs.gov).

Tax Credits

A tax credit is one of the best tax benefits available to a taxpayer – the credit actually reduces the amount of tax that otherwise must be paid, dollar-for-dollar. Tax deductions, on the other hand, only reduce the amount of income that is subject to tax at the taxpayer's applicable tax rate. Therefore, a tax credit of $1 saves $1 on an income tax bill, regardless of the tax rate payable by the taxpayer; a tax deduction of $1 for a taxpayer in the 25% tax bracket results in tax savings of only 25 cents.

Two federal income tax credits are available for educational expenses paid by a taxpayer – the Hope Scholarship Credit and the Lifetime Learning Credit.

<u>Hope Scholarship Credit</u>. The Hope Scholarship Credit (the "Hope Credit") generally may be available to a taxpayer if all of three fundamental requirements are met:

- The taxpayer pays qualified education expenses of higher education;
- The education expenses are for an eligible student; and
- The eligible student is either the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer can claim an exemption on her or his tax return.

The Hope Credit may be claimed for up to $1,500 in qualified education expenses paid for each eligible student. The credit is nonrefundable – in other words, the credit can reduce a taxpayer's income tax to zero, but if the credit is more than the taxpayer's total tax bill the excess will not be refunded. The Hope Credit is not available if any of the following apply:

- The taxpayer is married filing separately;
- The taxpayer is listed as a dependent in the "Exemptions" section on another person's tax return (such as a parent's return);
- The taxpayer's modified adjusted gross income ("MAGI") is $53,000 or more ($107,000 or more in the case of a joint return) (MAGI is adjusted gross income with minor modifications for different types of educational benefits – for example, in the case of the Hope Credit, MAGI equals adjusted gross income modified by adding

back any foreign earned income or foreign housing exclusion and any exclusion of income for residents of American Samoa or income from Puerto Rico);

- The taxpayer (or her or his spouse) is a nonresident alien for any part of the tax year and the nonresident alien did not elect to be treated as a resident alien for tax purposes; or

- The taxpayer is claiming the Lifetime Learning Credit or a tuition and fees deduction for the same student in the tax year.

The amount of the Hope Credit for 2005 is phased out for MAGI between $43,000 and $53,000 ($87,000 and $107,000 for a joint return).

For purposes of the Hope Credit, "qualified education expenses" include tuition and certain related expenses that are required for enrollment or attendance at an eligible educational institution. An "eligible educational institution" is any college, university, vocational school, or other post-secondary educational institution eligible to participate in a student aid program administered by the United States Department of Education, including proprietary post-secondary institutions. Covered related expenses include student activity fees and expenses for course-related books, supplies, and equipment only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

Qualified education expenses, however, do not include amounts paid for insurance, medical expenses (including student health fees), room and board, transportation, or similar personal, living, or family expenses, even if the amount must be paid to the institution as a condition of enrollment or attendance. In addition, for the 2005 tax year the Hope Credit may not be used for education expenses of a student (i) for whom expenses were used to figure a Hope Credit in any two earlier tax years, (ii) who has completed her or his first two years of post-secondary education (generally, the freshman and sophomore years of college) before 2005, (iii) who has not been enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential for at least one academic period beginning in 2005, or (iv) who was convicted of any federal or state felony for possessing or distributing a controlled substance as of the end of 2005.

Lifetime Learning Credit. Like the Hope Credit, the Lifetime Learning Credit is available to individuals and families based on income level. The credit for 2005 is gradually phased out between the $43,000 and $53,000 MAGI range ($87,000 and $107,000 if the taxpayer is filing a joint return).

The Lifetime Learning Credit is available based on the same three basic criteria that govern eligibility for the Hope Credit:

- The taxpayer must pay qualified education expenses of higher education;
- The education expenses must be for an eligible student; and
- The eligible student must be either the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer can claim an exemption on her or his tax return.

Similar disqualifying factors apply to the Lifetime Learning Credit also – the taxpayer may not be married filing a separate return, the taxpayer cannot be listed as a dependent on someone else's return, and the MAGI and nonresident alien limitations apply. Also, a taxpayer cannot claim a Lifetime Learning Credit with respect to a student for whom the same taxpayer claims a Hope Credit or a tuition and fees deduction in the same tax year. The felony drug conviction rule that limits access to the Hope Credit does not apply to the Lifetime Learning Credit, however.

The Lifetime Learning Credit may total up to $2,000 for qualified education expenses paid for all students enrolled in eligible educational institutions in a year and there is no limit on the number of years that the Lifetime Learning Credit can be claimed (this differs from the Hope Credit, which makes a $1,500 credit available for each student – not each return – and is available only for the first two years of post-secondary education). As with the Hope Credit, qualified education expenses are tuition and certain related expenses required for enrollment in a course at an eligible educational institution; with the Lifetime Learning Credit, however, the course of study must be either part of a post-secondary degree program (as with the Hope Credit) or undertaken by the student to acquire or improve job skills (an option not available under the Hope Credit program). An eligible educational institution for the Lifetime Learning Credit also includes those institutions qualified to participate in a student aid program administered by the Department of Education.

In addition to tuition, the related educational expenses that may be considered in calculating the Lifetime Learning Credit include student activity fees and expenses for course-related books, supplies, and equipment, but only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance. Payments for insurance, medical expenses (including student health fees), room and board, transportation, or similar personal, living, or family expenses do not qualify even if the amount must be paid to the institution as a condition of enrollment or attendance.

Tax Deductions

Federal tax law also provides a number of deductions designed to pay part of the costs of higher education with tax (or more accurately, tax-saved) dollars. These include the deduction for qualified tuition and fees and the student loan interest deduction.

Tuition and Fees Deduction. The Code permits a taxpayer to deduct certain qualified education expenses paid during the year on behalf of the taxpayer or the taxpayer's spouse or dependent. This tuition and fees deduction can reduce the amount of a taxpayer's income subject to tax by up to $4,000 in any year, resulting in different tax savings depending on the taxpayer's marginal tax rate for the year.

Generally, the preliminary requirements for claiming the tuition and fees deduction are the same as those for the Hope and Lifetime Learning Credits:

- The deduction applies to qualified education expenses of higher education;
- The expenses must paid on behalf of an eligible student; and
- The eligible student must be either the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer can claim an exemption on her or his tax return.

The deduction is not available to a taxpayer whose filing status is married filing separately or if any other person can claim an exemption for the taxpayer as a dependent on her or his tax return (even if the other person does not actually claim that exemption). The deduction also cannot be taken by a nonresident alien or if the taxpayer or anyone else claims a Hope or Lifetime Learning Credit in the tax year with respect to expenses of the student for whom the qualified education expenses were paid.

The deduction is limited to taxpayers with MAGI of $80,000 or less ($160,000 if filing a joint return). For taxpayers with MAGI of more than $65,000 ($130,000 if filing jointly) but not more than $80,000 ($160,000 for joint returns), the cap on expenses that may be deducted reduces to $2,000 per return (the $4,000 cap applies to taxpayers with MAGI below these bottom levels).

For purposes of the tuition and fees deduction, qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. As with the tax credits discussed above, deductible expenses generally include student activity fees and expenses for course-related books, supplies, and equipment as long as the fees and expenses must be paid to the institution as a condition of enrollment or attendance. Amounts paid for insurance, medical expenses (including student health fees), room and board, transportation, or similar personal, living, or family expenses do not qualify even if they are required as a condition of enrollment or attendance.

<u>Student Loan Interest Deduction</u>. Generally, personal interest payments, other than certain mortgage interest payments, are not deductible on a federal income tax return. However, if a taxpayer's MAGI is less than $65,000 ($135,000 if filing a joint return), there is a special deduction allowed for interest paid on a student loan that was used for higher education. For 2005, this deduction can reduce the amount of income subject to tax by up to $2,500.

To qualify for the deduction, the interest payment must be on a "qualified student loan," that is, a loan that the taxpayer acquired solely to pay qualified education expenses for the taxpayer or the taxpayer's spouse or dependent, such expenses being paid or incurred within a reasonable period of time before or after the loan is made for education provided during an academic period for an eligible student. Loans from a related person or from a qualified employer plan are not qualified student loans. Also, for purposes of the student loan interest deduction, qualified education expenses include:

- Tuition and fees;
- Room and board;
- Books, supplies, and equipment; and
- Other necessary expenses (such as transportation).

The cost of room and board is a qualified education expense only to the extent that it does not exceed the greater of the following two amounts:

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
- The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

It is important to note that the interest on qualified student loans that were used for room and board and transportation expenses required for past education is deductible, while the actual payment of room and board and transportation expenses at the time of matriculation does not qualify for the tax credits or deductions that are available for other educational expenses.

As with other tax benefits, the amounts and adjustments vary, all based on the general principle that tax credits, deductions, and other tax incentives should not apply to tax-free payments for expenses. A taxpayer is required to reduce the amount of qualified education expenses eligible for the student loan interest deduction by the total amount paid for them with the following tax-free items:

- Employer-provided educational assistance.

- Tax-free distributions from a Coverdell Education Savings Account.
- Tax-free distributions from a Qualified Tuition Program.
- U.S. savings bond interest excluded from income because it is used to pay qualified education expenses.
- The tax-free portion of scholarships and fellowships.
- Veterans educational assistance.
- Any other nontaxable (i.e., tax-free) payments (other than gifts or inheritances) received as educational assistance.

The amount of the student loan interest deduction, which is capped at $2,500 per year, is phased out at MAGI levels between $50,000 and $65,000 ($105,000 and $135,000 for married persons filing joint returns), with the reduction based on a fraction in proportion to the taxpayer's income level within the phase-out range.

Tax Exclusions

Tax exclusions provide benefits similar to those obtained through tax deductions, but different. A tax exclusion allows the taxpayer to disregard an economic benefit that otherwise would be included as gross income subject to tax and treat that benefit as if it had never been provided to the taxpayer. This would have the same effect as if the benefit were included in the taxpayer's income but then allowed as a 100% deduction in calculating taxable income (in cases where deductions are capped or phased-out based on income levels, the result would not be identical).

Qualified Scholarships. In the higher education context, the principal federal income tax exclusion is found in Code section 117(a), which states that "[g]ross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in [Code] section 170(b)(1)(A)(ii)." Reduced to its key elements, this means that a scholarship or fellowship is tax free only if:

- The recipient is a candidate for a degree at eligible educational institution; and
- The scholarship or fellowship is used to pay qualified education expenses.

A student is a candidate for a degree if he or she is (i) attending a primary or secondary school or pursuing a degree at a college or university or (ii) attending an accredited educational institution that is authorized to provide (a) a program that is acceptable for full credit toward a bachelor's or higher degree or (b) a program of training to prepare students for gainful employment in a recognized occupation.

For purposes of Code section 117(a), excludable scholarship and fellowship payments must be used for tuition and fees required to enroll at or attend an eligible educational institution or course-related expenses, such as fees, books, supplies, and equipment that are required for the courses at an eligible educational institution. These course-related items must be required of all students in the course of instruction, however, and the terms of the scholarship or fellowship cannot require that it be used for other non-qualified purposes, such as room and board, or specify that it cannot be used for tuition or course-related expenses.

Qualified Tuition Reduction. "Qualified tuition reduction" means a tax-free reduction in tuition provided by an eligible educational institution. The circumstances under which a tuition reduction program qualifies vary depending on whether the reduction is for education below or at the graduate level. As with excludable scholarships and fellowships, the qualified tuition reduction cannot represent payment for teaching, research, or other services by the student required as a condition for receiving the benefit.

Qualified tuition reductions for education below the graduate level (including primary and secondary school) are tax-free if provided to any of the following individuals (who are treated as employees):

- A current employee of the eligible educational institution.
- A former employee who retired or left on disability.

- A widow or widower of an individual who died while an employee.
- A widow or widower of a former employee who retired or left on disability.
- A dependent child or spouse of any person listed above.

Tuition reductions for graduate education qualify for the exclusion if they are provided by an eligible educational institution to a graduate student who performs teaching or research activities for that institution. All other tuition reductions for graduate education are taxable.

Tax-Favored Savings

The tax laws also provide incentives for individuals to save for future higher education expenses. These include the Coverdell Education Savings Account (the "Coverdell ESA") and Code section 529 Qualified Tuition Programs ("QTPs").

Coverdell ESA. A Coverdell ESA is a trust or custodial account maintained exclusively for the purpose of paying the qualified education expenses of a designated beneficiary of the account. The designated beneficiary must be under age 18 or a special needs beneficiary at the time the account is established, and the account must be designated as a Coverdell ESA when it is created.

The document creating and governing a Coverdell ESA must satisfy all of the following requirements:

- The trustee or custodian must be a bank or an entity approved by the IRS.
- The document must provide that the trustee or custodian can only accept contributions that meet all of the following three conditions –
  - Each contribution must be in cash;
  - The contribution must be made before the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary; and

    - The contribution will not result in total contributions for the year (not including rollover contributions) of more than $2,000.

- Funds in the account cannot be invested in life insurance contracts.

- Account funds cannot be combined with other property (except in a common trust fund or common investment fund).

- The balance in the account generally must be distributed within 30 days after the earlier of the following –

    - The beneficiary reaches age 30 (unless the beneficiary is a special needs beneficiary); or

    - The beneficiary's death.

A Coverdell ESA may be established by a taxpayer whose MAGI is less than $110,000 ($220,000 if filing a joint return), and there is no limit on the number of separate Coverdell ESAs that can be established for a designated beneficiary. However, combined contributions to all Coverdell ESAs for the same beneficiary in any year cannot exceed $2,000.

Contributions to a Coverdell ESA are not tax deductible (nor do they constitute tax credits), but the amounts deposited in these accounts earn interest and appreciation tax free until distribution. In addition, distributions from these accounts for adjusted qualified education expenses generally will not be taxed; the accumulated earnings portion of distributions exceeding the beneficiary's adjusted qualified education expenses for the year will be subject to tax, however.

For purposes of the Coverdell ESA, qualified education expenses include:

- Tuition, fees, books, supplies, and equipment required for enrollment or attendance of a designated beneficiary at an eligible post-secondary school.

- Expenses for special needs services incurred in connection with enrollment or attendance at an eligible postsecondary school.

- Room and board incurred by students who are enrolled at least half-time, but only to the extent that such expense is not more than the greater of the following two amounts –

  - The allowance for room and board, as determined by the school, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student; or

  - The actual amount charged if the student is residing in housing owned or operated by the school.

- Contributions to a Code section 529 QTP on behalf of the designated beneficiary of the Coverdell ESA or, in the case of a change in beneficiary, a family member of the designated beneficiary.

The Coverdell ESA rules include coordination provisions that prevent tax-free distributions based on qualified education expenses that were paid with tax-free educational assistance or used in calculating Hope or Lifetime Learning Credits, and allocate qualified education expenses between Coverdell ESA and QTP distributions. Tax-free Coverdell ESA distributions also are available for some qualified elementary and secondary education expenses.

Qualified Tuition Program (QTP). Code section 529 authorizes states to establish and maintain tax-favored QTPs that allow taxpayers to prepay or to contribute to an account for paying a student's qualified education expenses. The statute also authorizes eligible educational institutions to establish and maintain QTPs for prepayment of such expenses. A taxpayer cannot deduct either payments or contributions to a QTP, but no tax is due on a distribution from a QTP unless the amount distributed is greater than the beneficiary's adjusted qualified education expenses.

If a QTP distribution is more than the beneficiary's adjusted qualified education expenses, the beneficiary must pay tax on the earnings portion of the distribution plus (subject to several specific exceptions) a 10% additional tax on the amount included in income. The QTP rules, like the requirements for Coverdell ESAs, include detailed coordination and allocation provisions with respect to tax benefits provided under other programs.

Other Savings Programs. Federal tax laws also provide some tax relief when assets saved for other purposes are used to pay qualified education expenses. For example, a distribution from an individual retirement account ("IRA") before the beneficiary reaches 59 ½ years of age generally results in a 10% additional tax on the early distribution. However, the additional tax may not apply to distributions from an IRA for the qualified education expenses of the beneficiary, the beneficiary's spouse, or either of their children, or grandchildren.

Similarly, a taxpayer may be able to cash in qualified U.S. savings bonds without having to include in income some or all of the untaxed interest earned on the bonds if the proceeds are used to pay qualified education expenses for the bond owner, her or his spouse, or a dependent for whom the owner claims an exemption. This benefit is only available if the owner's MAGI is less than $76,200 ($121,850 if filing a joint return) and her or his filing status is not married filing separately. A qualified U.S. savings bond is a series EE bond issued after 1989 or a series I bond. The owner must be at least 24 years old before the bond's issue date.

Employment Related Tax Benefits

The Code and regulations also provide tax benefits to assist in the payment of educational expenses relating to a student's employment.

<u>Employer-Provided Educational Assistance</u>. Code section 127 excludes from an employee's gross income educational assistance benefits provided by a taxpayer's employer under an educational assistance program, up to $5,250 each year. An educational assistance plan must be in writing and meet certain other detailed requirements. Tax-free educational assistance benefits under a qualified plan include payments for tuition, fees and similar expenses, books, supplies, and equipment. The study does not need to be work-related, and for courses beginning on or after January 1, 2002, the payments may be for either undergraduate or graduate level education.

<u>Business Deductions</u>. An employee who itemizes deductions also may be able to claim a deduction for work-related education expenses paid by the employee. The deduction generally is the amount paid for qualifying work-related education expenses (plus other job and certain miscellaneous expenses) in excess of 2% of the taxpayer's adjusted gross income. For self-employed individuals, expenses for qualifying work-related education may be deducted

directly from self-employment income. This reduces the amount of income subject to both income tax and self-employment tax.

Tax Exemption for Nonprofit Educational Institutions

Code section 501(c)(3) grants federal income tax exemption to religious, charitable, educational, scientific, and similar nonprofits. Private nonprofit educational institutions generally are freed from paying federal incomes taxes on revenue generated from their educational activities (including tuition, student fees, student housing charges, and similar receipts) by virtue of this statute. (Public schools, colleges, and universities are not taxed by the federal government under the separate constitutional principle of intergovernmental immunity.) Code section 501(c)(3) organizations also are eligible to receive gifts and grants that are deductible as charitable contributions for federal income, gift, and estate tax purposes under Code sections 170(a)(1), 170(c)(2)(B), 2522(a), and 2055(a)(2).

Special Tax Rules for Private Foundation Support of Education

In the Tax Reform Act of 1969, Congress introduced to the Code the concept of the "private foundation," a particular category of charitable organizations described in Code section 501(c)(3). Private foundations are subject to special rules, including Code section 4942 (which imposes penalty taxes on private foundations that fail to distribute for charitable [including educational and scientific] purposes each year an amount that, for the most part, is equal to five percent of their investment assets for that year) and Code section 4945 (which imposes penalty taxes on private foundations that make scholarships or similar individual grants without first having an objective and nondiscriminatory award procedure approved in advance by the IRS, and on unsupervised private foundation grants to non-charitable entities).

Most organizations that are described in Code section 501(c)(3) are presumed to be private foundations until they notify and convince the IRS otherwise (churches and very small charitable organizations are excepted from the notice requirement). See Code section 508(b). If proper notice is given and the appropriate criteria are met, an organization may overcome the presumption and be classified as a "public charity," a term that is used loosely to refer to Code section 501(c)(3) entities that are not private foundations. Public charity status frees a Code section 501(c)(3) organization from the private foundation excise and penalty tax provisions of the Tax Reform Act of 1969, and places the organization in the class of entities that are most attractive to charitable donors, including private foundation donors.

Public charities include eight general classes of Code section 501(c)(3) organizations, six of which are described in Code section 509(a)(1) (which incorporates by reference Code sections 170(b)(1)(A)(i) through 170(b)(1)(A)(vi)), and two of which are described in Code sections 509(a)(2) and 509(a)(3). Private nonprofit colleges and universities most often qualify as public charities under Code sections 509(a)(1) and 170(b)(1)(A)(ii), which describe an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students attending at the place where its educational activities are typically conducted.

Private Foundation Grants to Colleges and Universities. In seeking grants from private foundations, public charity status for a private college or university is important because (i) Code section 4942 requires private foundations to make a stated level of charitable, educational, and similar grants and expenditures each year and (ii) Code section 4945(a) and 4945(d)(4) imposes prohibitive excise taxes on private foundation grants to non-public charities unless the granting foundation exercises "expenditure responsibility" over the grants (unsupervised prohibited grants may be treated as "taxable expenditures" subject to excise tax penalties). Without public charity status, a college or university is not in the best position to receive funds from a private foundation in a manner that is consistent with these rules.

Private Foundation Scholarships and Fellowships. Under Code section 4945(d)(3), grants made to individuals for travel, study, or other similar purposes generally constitute taxable expenditures. However, an individual grant for these purposes will not be deemed to be a taxable expenditure if the following conditions are satisfied:

- The grant is awarded on an objective and nondiscriminatory basis;

- The grant is made pursuant to a procedure approved in advance by the Commissioner of Internal Revenue (the "Commissioner");

- It is demonstrated to the satisfaction of the Commissioner that:

  - The grant constitutes a scholarship or fellowship grant that would be subject to the provisions of Code section 117(a) (prior to the Tax Reform Act of 1986) and is to be utilized for study at an educational institution described in Section 170(b)(1)(A)(ii) [an important difference in Code section 117(a) prior to the Tax Reform Act of 1986 is that scholarship or fellowship payments could be used for all educational expenses, <u>including</u> room and board – so private foundation scholarships and fellowships may pay for room and board today even though such payments are not excludable from the recipients' income under current law];

  - The grant constitutes a prize or award that is excluded from gross income under Code section 74(b) (without regard to paragraph (3) thereof) and the recipient of such prize or award is selected from the general public; or

  - The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

The objective and nondiscriminatory standard is met if the following conditions are satisfied:

- The grant is awarded in accordance with a program which, if it were a substantial part of the private foundation's activities, would be consistent with its exempt status and the allowance of deductions to individuals for contributions to the foundation.

- The group from which the grantees are selected is chosen on the basis of criteria reasonably related to the purpose of the grant and is sufficiently large so as to constitute a charitable class. However, selection from a group is not necessary in all circumstances. For example, in many research fields where there are seldom more than a few people who are qualified to perform scholarly research on a project, a recipient may be selected because he or she is exceptionally qualified to carry out the charitable purpose of the grant.

- The criteria used to select grant recipients from potential grantees are related to the purposes of the grant. Thus, for example, proper criteria for selecting scholarship recipients might include the following: prior academic performance; performance on tests designed to measure ability and aptitude for college work; recommendations from instructors; financial need; and the conclusions that a selection committee might draw from a personal interview as to the individual's motivation, character, ability, and potential.

- Each person who is involved in the selection of grant recipients is not in a position to derive a private benefit, directly or indirectly, if certain potential grantees are selected over others.

In general, a procedure will be approved by the Commissioner if:

- The procedure includes an objective and nondiscriminatory selection process (as described above);
- The procedure is reasonably calculated to result in the performance by grantees of the activities that the grants are intended to finance;
- The awarding private foundation will obtain reports to determine whether the grantees have performed the activities that the grants are intended to finance and a final report describing the grantees' accomplishments with respect to the grants and accounting for the funds received under the grants; and
- The procedure provides for investigating situations where it appears that part or all of a grant is not being used in furtherance of the purposes of the grant and for recovering any part of a grant that has not been used in furtherance of the purposes of such grant.

In the case of a scholarship or fellowship grant excludable from the recipient's income, the second and fourth requirements above (i.e., the performance and investigation requirements) will be considered satisfied if the private foundation pays the scholarship or fellowship grant directly to an educational institution described in Code section 170(b)(1)(A)(ii) and the institution agrees to use the grant funds to defray the recipient's expenses or to pay the funds (or a portion thereof) to the recipient only if the recipient is enrolled at the institution and her or his standing at such institution is consistent with the purposes and conditions of the grant.

Tax Policy on Higher Education and Access – Such That It Is

The tax rules that affect higher education in the United States and the individuals who wish, or for whom we would wish, access to it are many, varied, and complicated. Is there a theme that can be discerned and dissected? Do the rules complement, or conflict with, each other? Does the web of tax credits, deductions, exclusions, exemptions, and incentives promote broader access to higher education opportunities, and, if so, to what end? Can prospective, current, and past students and their families realistically tap the tax resources directed to their benefit, and do those benefits drive consumers of higher education to certain institutions, programs, or areas of the country? Who qualifies for all of this assistance, and why?

Context. The weaving of these tax rules into the legal fabric of our nation did not occur overnight or in one continuous sitting. In discussing the different categories of tax-exempt organizations recognized under the Code, a former executive of the Exempt Organizations Technical Branch of the IRS observed, "The[se] provisions are not the result of any planned legislative scheme and have never been set forth as part of any unified concept of exemption. They were enacted over a period of eighty [now more than one hundred nineteen] years by a variety of legislators for a variety of reasons." McGovern, James, "The Exemption Provisions of Subchapter F," 29 Tax Lawyer 523, 524 (1976).

With respect to charitable, educational, and other exempt objectives, a quick reflection on the history of the federal income tax is instructive. In the early days of the nation, the federal government met most of its needs for revenue through the imposition of special customs and excise taxes referenced in the United States Constitution. See U.S. Const. Art. I, Section 8, Clause 1 ("The congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts and excises shall be uniform throughout the United States; . . . ."). This source of revenue did not prove sufficient to finance the country's needs during the Civil War years, and in 1861 Congress imposed the first national income tax. The 1861 tax was repealed a decade later, and replaced with the traditional customs and excise taxes. See McGovern, supra, at 524.

In 1894, Congress imposed a flat two percent (2%) tax on individual and net corporate income. Tariff of 1894, Chapter 349, Sections 27-37, 28 Stat. 509, 553-557. The tax was declared unconstitutional, however, in Pollock v. Farmers' Loan and Trust Company, 157 U.S. 429, 553-586 (1895), overruled in part on other grounds, South Carolina v. Baker, 485 U.S. 505, 523-525 (1988), because the tax on income from real property was not "apportioned among the several states," as then required in U.S. Const. Art. I, Section 2, Clause 3. Sentiment for a federal income tax increased, and finally in 1913 the Sixteenth Amendment to the Constitution was ratified.

That amendment expressly provides, "The congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." U.S. Const. Amend. XVI. In the same year that the Sixteenth Amendment was ratified, Congress passed legislation to impose a progressive rate of taxation on individuals and a flat tax rate on corporations, and our modern system of federal income taxation has developed since. See, generally, McGovern, supra, at 524-525; Hopkins, The Law of Tax-Exempt Organizations, 6-7 (6th ed. 1992).

Prior to the 1894 legislation, which imposed the income tax that was later determined unconstitutional, tax "exemptions" were not matters of affirmative expression. Previous taxes, such as customs and excise taxes and even the Civil War income tax, specified the entities subject to, and the incidents of, taxation. Therefore, those organizations that were not expressly included in the language of a particular taxing statute were, by omission, "exempted" from the tax. See, McGovern, supra, at 525. The Tariff of 1894 and subsequent income taxes were drafted to apply to individuals and corporations generally, however, creating the need to identify those groups that Congress wanted to exclude from the tax burden. The Tariff of 1894, for example, expressly provided for the exemption of certain corporations, companies, and associations that furthered charitable, religious, or educational purposes, and of various fraternal beneficiary societies, mutual savings banks, and mutual insurance companies. Tariff of 1894, Chapter 349, Section 32, 28 Stat. at 556. See also, McGovern, supra, at 525.

It is from these early beginnings that various policies for exempting certain institutions from growing federal income tax burdens began to develop. Commentators and historians have identified a number of divergent policy reasons underlying Congress' decisions over time to provide tax incentives for "exempt" organizations and activities. Three general policies may explain a number of these provisions. The first has been termed "heritage," which reflects traditional concepts that may even predate the English common law on which much of our legal system rests. Exemptions for religious and charitable organizations arguably fall into this category, being favored organizations that were not subject to toll, tribute, or tax in a number of civilizations, cultures, and systems. See McGovern, supra, at 525-526.

The second general policy has been referred to as "morality," reflecting certain value judgments made by Congress over time that it was simply unfair or wrong to impose an income tax upon certain types of organizations or activities. The third policy often referenced may be called "special interest," under which specific legislative actions result from pressure applied by industry or group representatives seeking tax relief for conduct that would further goals desired by such industries or groups. See id. at 525-527. Simply put, effective lobbying.

These three general policy considerations are by no means the only ones that have been propounded to explain tax favoritism. From a purely economic analysis, arguments have been made that tax exemption for charitable, educational, and similar exempt endeavors is the result of market constraints on capital formation for certain "industries" that provide needed goods and services to consumers but that are not attractive investments. E.g., Hansmann, "The Rationale For Exempting Nonprofit Organizations From Corporate Income Taxation," 91 Yale L.J. 54, 55, 72-75 (1981).

In sum, the policies underlying tax benefits directed at higher education may be more numerous than the benefits themselves. In addition, whatever policies are articulated, they invariably run counter to the ever-increasing need for revenue generation.

Convergence and Conclusions. The eye of the beholder – there lies the answer to any question we ask about tax policy and access to higher education. For each inquiry the questioner can, and must, approach the issue from a perspective that may be challenged, doubted, and even mocked, but because it is a perspective cannot be either proven or discredited. It is a viewpoint and as such is neither right nor wrong.

For any tax credit, deduction, exclusion, exemption, or incentive, there is no one policy that led to its adoption. The legislators who enacted the statute and the executive who signed it into law (or vetoed it only to have it adopted over the veto, or let it pass without signature) each may have a different core motivation for her or his action (or inaction). How are we to explain the "policy" for setting the maximum income level for claiming a credit for education expenses; or for phasing-out the benefits of different credits or at different points on the income scale; or for granting tax credits and deductions with respect to expenses of tuition but not with respect to costs of room and board (students are required to eat and sleep during their years of study, are they not?); or for encouraging a private foundation to award scholarships that cover room and board, but then taxing students on that portion of their award? The explanation in each case will turn on the time, circumstances, and decision-makers extant when that case becomes law.

This is not to say that those with the conviction that tax laws can positively impact "access to higher education" (however that is defined) should despair in that conviction. The thread that connects all of the tax rules described above is the general sense that the education of individuals is a good thing for society and deserves a special push or nod in decisions regarding tax matters. That "sense" is the policy that we can grasp and nurture in using tax rules, and changes to those rules, to more effectively promote and provide access to higher education. Legislators and public officials at all levels should be receptive to "revenue neutral" ways to use tax incentives for higher education more effectively. Can we propose ways to reshuffle the tax deck to better the higher education outcomes for students and for those we want to be students?

Consider two aspects of the current tax system and ask whether access to higher education is improved, restricted, or irrelevant:

- Virtually all of the tax credits and deductions for educational expenses are limited so that higher income students and families are excluded from receiving any general tax support for current costs of higher education. At the same time, the nature of those benefits and the complexity of the rules direct much of that support away from the lowest income classes (who may have little or no tax liability in the first place). One report indicates that families with incomes of over $50,000 per year received 43% of education tax credits and 70% of federal tuition tax deductions in 2003. Farrell, Elizabeth, "Public Colleges Tame Costs of Tuition," Chronicle of Higher Education, Volume LII, Number 10, at A46 (October 28, 2005). That is, access for whom?

- The federal tax credit, deduction, and exclusion framework provides almost no assistance for current costs of room and board or transportation at any income level (Coverdell ESA benefits are one exception, but this program only provides tax savings with respect to earnings on accounts, not for contributions to the accounts themselves or for direct payment of expenses). If tax assistance matters at all to students and their families (query?), does this system restrict access to higher education in terms of geography? That is, access where?

The tax rules together constitute only one piece of a huge puzzle regarding access to higher education, and a relatively small piece at that. But every piece counts, and it is worth the inquiry and effort to understand and improve the tax components of higher education (however insignificant in the grand scheme) while focusing on broader enhancements to the big picture. A jigsaw of the *Mona Lisa* simply would not be the same without the smile.